

AN AUDIT

Wisconsin Lottery

Department of Revenue

02-9

May 2002

2001-2002 Joint Legislative Audit Committee Members

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**Independent Auditor's 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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Appendix—Response from the Department of Revenue



State of Wisconsin \ LEGISLATIVE AUDIT BUREAU

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May 31, 2002

Senator Gary R. George and
Representative Joseph K. Leibham, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator George and Representative Leibham:

As required by s. 13.94(1)(em), Wis. Stats., we have completed our annual financial audit and biennial program evaluation of the Wisconsin Lottery, which is administered by the Department of Revenue. We have issued an unqualified opinion on the Wisconsin Lottery's fiscal year (FY) 1999-2000 and FY 2000-01 financial statements.

We also reviewed an incentive-based compensation program for retailers that the Wisconsin Lottery modeled after other states and implemented in January 2000. In addition to the basic commission rates, the Retailer Performance program provides up to an additional 1.0 percent of total sales as compensation to eligible retailers. The program, which provided \$3.9 million in retailer compensation in FY 2000-01, has three components: a sales incentive, winning ticket incentive, and short-term incentives for particular games or sets of games.

There is little evidence that the Retailer Performance program is effective in increasing either lottery sales or the number of retailers selling lottery tickets. Based on other states' experience, the program was projected to increase lottery sales by \$24.9 million in the 1999-2001 biennium; instead, sales decreased by \$27.2 million. The number of retailers selling Wisconsin Lottery tickets has not increased since the program's implementation. However, because several factors influence ticket sales, it is difficult to determine whether the program mitigated larger declines in sales that would have otherwise occurred.

The Retailer Performance program has increased retailer compensation costs. Before the program was implemented, retailers earned approximately 5.9 percent of Wisconsin Lottery sales. In FY 2000-01, retailers earned 7.1 percent of sales, the highest rate among seven midwestern states. As costs for retailer compensation increase, the amount of lottery proceeds available for property tax relief decreases.

The Wisconsin Lottery plans to modify the Retailer Performance program in 2003 and will likely focus more on short-term incentives, which lottery staff believe have the greatest potential to affect sales. To increase the program's effectiveness and reduce its costs, we provide recommendations such as eliminating or reducing incentive payments when retailers' overall lottery sales decline.

We appreciate the courtesy and cooperation extended to us by the Department of Revenue. The Department's response is the appendix.

Respectfully submitted,

A handwritten signature in cursive script that reads 'Janice Mueller'.

Janice Mueller
State Auditor

JM/JG/ss

To fulfill our audit responsibilities under s. 13.94(1)(em), Wis. Stats., we have completed a financial audit of the Wisconsin Lottery and have issued an unqualified opinion on its financial statements for the years ended June 30, 2000 and 2001.

Since its creation in 1988, the Wisconsin Lottery has provided approximately \$1.8 billion in property tax relief. Although exceptionally large jackpots can temporarily boost the sale of lottery tickets, these jackpots cannot be controlled, and overall lottery sales have declined from \$518.9 million in fiscal year (FY) 1994-95 to \$401.1 million in FY 2000-01.

Prior Legislative Audit Bureau reports have noted possible reasons for the overall decline in sales, including a reduction in the number of retailers selling lottery tickets and advertising restrictions included in the Wisconsin Constitution. The Wisconsin Lottery has taken steps to mitigate these factors. For example, it has filled positions that affect ticket sales, such as retailer field support and telemarketing positions. In addition, the basic commission rate, which is the primary means of retailer compensation, was increased to 6.25 percent of the retail price for instant tickets and 5.5 percent for on-line tickets.

Under authority granted in state statutes, the Wisconsin Lottery also implemented an incentive-based program for retailers in January 2000. The Retailer Performance program provides up to an additional 1.0 percent of total sales as compensation to eligible for-profit retailers that achieve certain sales criteria. The program has three components: a sales incentive, a winning ticket incentive, and short-term incentives associated with particular games or sets of games. In FY 2000-01, the first complete year of the program, the Wisconsin Lottery spent \$28.3 million for retailer compensation, including \$3.9 million provided through the Retailer Performance program. Lottery staff indicated the program was modeled on other states' retailer incentive programs and developed with advice from participating retailers.

The Retailer Performance program was expected to increase lottery sales, retailer satisfaction, and the number of retailers selling lottery tickets. Based on other states' experiences with retailer incentive programs, the Wisconsin Lottery originally predicted its Retailer Performance program would increase sales by \$8.3 million in FY 1999-2000, and an additional \$16.6 million in FY 2000-01. However, during these two years, total lottery sales declined by \$27.2 million.

Because lottery staff believe short-term incentives may be most effective in motivating retailers to increase sales in the future, we analyzed lottery sales for three short-term incentives. Two incentives appear to have increased overall sales somewhat. Payments to retailers were greater than the increase in sales generated by a third short-term incentive.

One reason for the Retailer Performance program's implementation was to address the decline in the number of retailers selling lottery tickets. That number had decreased from 5,241 in 1992 to 4,254 in 1999. Since the program was implemented in January 2000, the number of retailers willing to sell lottery tickets has not increased. The Retailer Performance program has, however, increased the percentage of lottery sales paid to retailers. Before the program was implemented, retailers earned approximately 5.9 percent of lottery sales. In FY 2000-01, with basic commissions and incentive payments, retailers earned 7.1 percent of sales, the highest rate among seven midwestern states. Because sales incentive payments are calculated separately for instant, non-jackpot on-line, and jackpot on-line sales, retailers that increase their sales of any one of the three types of games are eligible for a sales incentive, even if their overall sales decline. For example, a retailer would earn \$100 for a \$1,000 increase in instant ticket sales, even if that retailer reported a \$5,000 decline in on-line ticket sales.

Additional costs associated with any lottery initiative, including the Retailer Performance program, reduce the net proceeds available for property tax relief. Therefore, sufficient additional revenues must be generated to make the initiative worthwhile. Although additional revenue has not been generated and the original sales projections for the Retailer Performance program have not been realized, it is difficult to determine whether the program mitigated a larger decline in sales than would otherwise have occurred.

Lottery officials indicated that they plan to modify the Retailer Performance program in 2003. To help increase the program's effectiveness and reduce its costs, we include recommendations that the Wisconsin Lottery continue to analyze the effectiveness of short-term incentives, limit the potential to earn incentives if overall lottery sales decline, and report planned program changes to the Joint Legislative Audit Committee by January 2003.

Introduction

Lottery sales have provided approximately \$1.8 billion in property tax relief.

The Wisconsin Lottery began operations in September 1988, after Wisconsin voters adopted a constitutional amendment in 1987 allowing the Legislature to create a state lottery. From the inception of the Wisconsin Lottery through fiscal year (FY) 2000-01, sales have provided approximately \$1.8 billion in proceeds for property tax relief. Since FY 1995-96, the Department of Revenue has managed the Wisconsin Lottery, which contracts with private retailers for the sale of lottery tickets to the public.

As part of our audit responsibilities under s. 13.94(1)(em), Wis. Stats., the Legislative Audit Bureau completes annual financial audits and biennial program evaluations of the Wisconsin Lottery. We have issued an unqualified opinion on the Wisconsin Lottery's FY 1999-2000 and FY 2000-01 financial statements. In addition, we evaluated the Retailer Performance program, an incentive-based compensation initiative begun in January 2000 that rewards retailers for meeting sales goals and selling winning lottery tickets. The evaluation included a review of:

- the performance goals retailers must achieve to earn compensation through the program;
- the effects of the Retailer Performance program on ticket sales, the number of retailers selling lottery tickets, the Wisconsin Lottery's operating costs, and the amount available for property tax relief; and
- possible future changes to the Retailer Performance program.

In conducting our evaluation, we reviewed program documents and financial information provided by the Wisconsin Lottery and interviewed members of its staff. In addition, we interviewed representatives of retailer associations and reviewed relevant state statutes and administrative code.

Ticket Sales

Lottery sales have decreased in five of the last six fiscal years.

As shown in Figure 1, Wisconsin Lottery ticket sales generally declined from FY 1994-95, when they were \$518.9 million, to FY 2000-01, when they were \$401.1 million. Over the seven years shown, total sales decreased 22.7 percent.

Figure 1

Lottery Sales
(in millions)

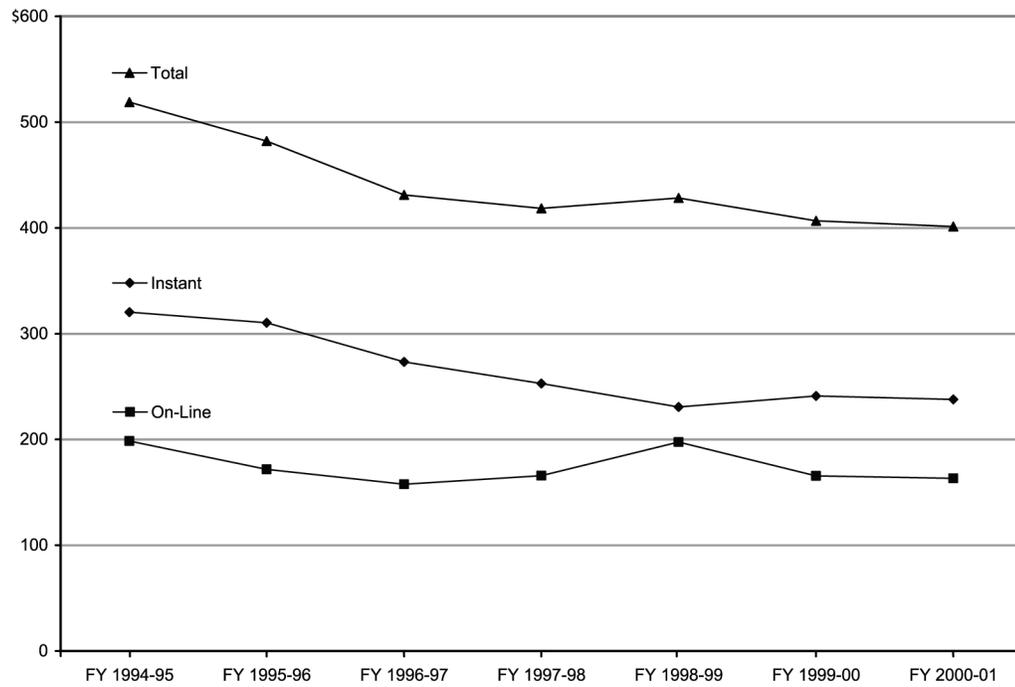


Table 1 shows Wisconsin Lottery sales for both instant and on-line games. Instant games can be further divided into two groups: scratch games, in which lottery players scratch off protective coatings on tickets to reveal prizes, and pull-tabs, in which lottery players pull off perforated ticket coverings to reveal prizes.

Table 1

Wisconsin Lottery Sales
(in millions)

<u>Fiscal Year</u>	<u>Instant Games</u>	<u>On-line Games</u>	<u>Total Sales</u>	<u>Change from Prior Year</u>
1994-95	\$320.3	\$198.6	\$518.9	–
1995-96	310.4	171.7	482.1	(7.1)%
1996-97	273.4	157.7	431.1	(10.6)
1997-98	252.8	165.7	418.5	(2.9)
1998-99	230.8	197.5	428.3	2.3
1999-2000	241.1	165.6	406.7	(5.0)
2000-01	237.9	163.2	401.1	(1.4)

On-line games use automated systems to print lottery tickets that show a series of numbers selected by lottery players or randomly generated by a computer, with winning numbers determined in drawings. On-line games may have a jackpot prize structure, in which prize money is added to the amounts from subsequent drawings if no winner emerges from among the participants, or a non-jackpot prize structure, in which prizes are awarded to winners with no carryover to subsequent drawings.

Wisconsin Lottery sales for instant games have traditionally been higher than sales for on-line games, although the difference in sales between the two product types is narrowing. Large jackpots influence the sales of on-line games: for example, the increase in on-line sales in FY 1998-99 was largely the result of a \$295.7 million Powerball jackpot early in the fiscal year.

Wisconsin's per capita sales are lower than four of six other midwestern states.

Wisconsin's total per capita lottery sales are among the lowest in the Midwest. As shown in Table 2, the Wisconsin Lottery had per capita sales of \$74.30 in FY 2000-01. That amount is lower than the per capita sales of four of six other midwestern states in the comparison group and less than half the per capita sales of the Ohio and Michigan lotteries. However, between FY 1999-2000 and FY 2000-01, per capita sales of other midwestern state lotteries in our comparison group have decreased at a greater rate than those of the Wisconsin Lottery.

Table 2

Midwestern per Capita Lottery Sales

<u>State Lottery</u>	<u>FY 1999-2000 per Capita Sales</u>	<u>FY 2000-01 per Capita Sales</u>	<u>Percentage Change</u>
Ohio	188.63	\$168.41	(10.7)%
Michigan	171.19	161.47	(5.7)
Illinois	118.27	113.90	(3.7)
Indiana	95.50	89.89	(5.9)
Wisconsin	75.31	74.30	(1.3)
Minnesota	81.08	73.24	(9.7)
Iowa	61.45	60.31	(1.9)

Source: LaFleur's 2001 and 2002 World Lottery Almanacs

Prior Legislative Audit Bureau reports have offered possible reasons for the overall decline in ticket sales, including competition with Indian gaming, a decline in the number of retailers selling lottery tickets, and advertising restrictions. The Wisconsin Constitution prohibits the State from engaging in promotional advertising of the Wisconsin Lottery, and instead allows advertising only to inform potential participants of the lottery's existence. In addition, Wisconsin Lottery staff believe that higher sales for jackpot lottery games will be increasingly difficult to achieve as customers become more accustomed to large jackpots. For example, in FY 1998-99, lottery players spent \$15.0 million in one week on Powerball tickets when the jackpot reached \$295.7 million; in FY 2001-02, when the Powerball jackpot reached \$295.0 million, lottery players spent \$13.3 million in one week, or 11.3 percent less.

The Wisconsin Lottery has introduced several initiatives to address declining sales.

In addition to the Retailer Performance program, the Wisconsin Lottery has taken other steps to address declining ticket sales. For example, it:

- reduced its overall staff vacancies from 82.5 of 130.0 full-time equivalent (FTE) staff in January 1997, or 63.5 percent, to 14.5 of 109.5 FTEs in January 2002, or 13.2 percent. The vacancy rate among retailer field support and telemarketing positions declined from 26.7 percent to 3.6 percent over the same period, thereby increasing staff resources available to support ticket sales.

- introduced \$3 and \$10 instant scratch tickets in FY 2000-01, in addition to the \$1, \$2, and \$5 instant scratch tickets already available; and
- plans to introduce special pricing structures for lottery tickets beginning September 2002, such as offering lottery players free tickets after they purchase a certain number of regularly priced tickets.

Wisconsin Lottery Property Tax Credit

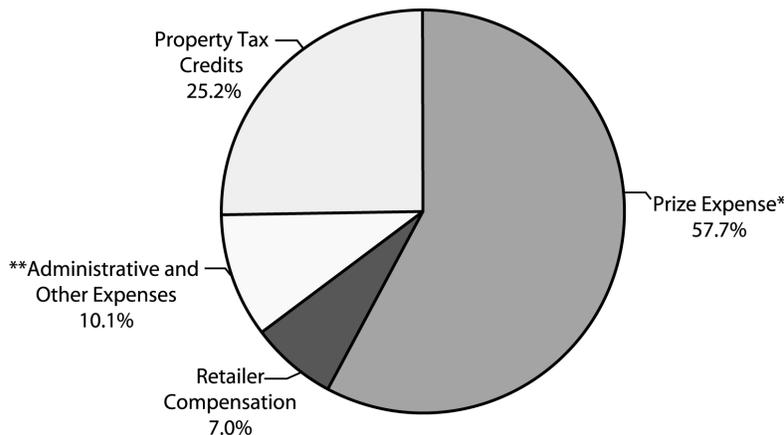
The Wisconsin Constitution requires that net proceeds from the Wisconsin Lottery be used only for property tax relief. Under current law, property tax relief is provided through a credit to owners of primary residences and through a farmland tax relief credit. To calculate the net proceeds available for property tax relief, the following amounts are deducted from Wisconsin Lottery revenues:

- prizes, which according to statute must equal at least 50 percent of each year's revenues from the sale of lottery tickets;
- expenses for the operation and administration of the Lottery, such as staff salaries and ticket printing; and
- retailer compensation.

In FY 2000-01, the Wisconsin Lottery had \$403.8 million in sales and other revenue. As shown in Figure 2, for every dollar collected by the Wisconsin Lottery, 57.7 percent was spent on lottery prizes; 25.2 percent on property tax credits; 10.1 percent on administrative and other expenses; and 7.0 percent on retailer compensation.

Figure 2

Wisconsin Lottery Expenses and Tax Credits
FY 2000-01



* Prize expense is based on total lottery revenues.

** Other expenses include transfers to state agencies for gaming law enforcement and property tax credit administration.

Property tax relief distributions have reflected judicial and legislative actions, as well as the amount generated by the Wisconsin Lottery.

As shown in Table 3, the Wisconsin Lottery has provided \$718.2 million for property tax relief since FY 1996-97. Since its inception in 1988, the Wisconsin Lottery has provided a total \$1.8 billion for property tax relief. Both the amount distributed and the average property tax credit have varied from year to year, because of variations in available lottery proceeds and because of judicial and legislative actions. For example:

- Only \$13.3 million was distributed through property tax credits in FY 1996-97, because an October 1996 circuit court decision found that the method of distributing the credits violated the Wisconsin Constitution.
- As a result of the delay in distributing FY 1996-97 credits, \$216.9 million from two years of lottery proceeds was distributed in FY 1997-98 to owners of all taxable properties.

- In FY 1999-2000, the Legislature provided a one-time general purpose revenue subsidy of \$76.0 million to the Wisconsin Lottery, thereby increasing the amount available for property tax credits by the same amount, to \$232.3 million.

Table 3

Wisconsin Lottery Property Tax Relief
(in millions)

<u>Fiscal Year</u>	<u>Amount Distributed</u>	<u>Average Property Tax Credit</u>
1996-97	\$ 13.3*	—
1997-98	216.9	\$ 77
1998-99	153.9	52
1999-2000	232.3	165
2000-01	<u>101.8</u>	67
Total	\$718.2	

* In FY 1996-97, lottery proceeds were distributed through farmland tax relief credits only.

Retailer Compensation

The Wisconsin Lottery contracts with over 4,200 retailers to sell lottery tickets.

In general, the Wisconsin Lottery does not sell tickets directly to lottery players, but instead contracts with over 4,200 retailers to sell the tickets on its behalf. As shown in Table 4, convenience stores made up over one-half the retailers that sold lottery tickets as of December 2001. Grocery stores, service stations, liquor stores, and taverns also sell lottery tickets. In addition, nonprofit organizations such as church congregations and fraternal organizations may obtain temporary authorization to sell pull-tab tickets at specified locations.

Table 4

Lottery Retailers by Type
December 2001

<u>Type of Retailer</u>	<u>Number of Retailers</u>	<u>Percentage of Total</u>
Convenience Store	2,161	51.0%
Grocery Store	709	16.7
Nonprofit Organization	527	12.4
Service Station	259	6.1
Other*	198	4.7
Liquor Store	195	4.6
Tavern	<u>190</u>	<u>4.5</u>
Total	4,239	100.0%

* Includes restaurants, drug stores, bowling alleys, newsstands, hardware stores, video stores, and department stores.

Contracts with retailers generally cover three years. Lottery retailers are required to sell, on average, at least \$400 in instant scratch tickets each month and may also sell on-line tickets. In addition, retailers are required to display, whenever available, point-of-sale materials, including window stickers, ticket dispensers, and game information posters.

Retailers may earn incentive-based compensation, in addition to basic commissions.

The Wisconsin Lottery has two methods for compensating retailers that sell lottery tickets. A basic commission rate, which is the primary means of retailer compensation, is set by statute and compensates retailers for 6.25 percent of the retail price for instant tickets, and 5.5 percent for on-line tickets. The commission rate has been increased twice since 1995: 1995 Wisconsin Act 27 increased it from 5.0 percent to 5.5 percent for all ticket sales, and 1997 Wisconsin Act 27 increased it from 5.5 percent to 6.25 percent for instant ticket sales only. In addition, retailers may earn additional compensation through the incentive-based Retailer Performance program that began in January 2000. Nonprofit organizations are not eligible to participate in the Retailer Performance program, because they earn a higher commission rate than other retailers. The nonprofit commission rate varies depending on the game, but it may be up to 30 percent of sales in order to maximize fundraising capability.

Retailer Performance Program

The Retailer Performance program comprises sales, winning ticket, and various short-term incentives.

The Wisconsin Lottery created the Retailer Performance program, which provides up to an additional 1.0 percent of total sales, as compensation to eligible for-profit retailers that meet certain sales criteria. The program was created under authority granted in s. 565.02(4)(g), Wis. Stats., modeled on retailer incentive programs in other states, and developed with advice from participating retailers. The program has three components: the sales incentive, the winning ticket incentive, and the various short-term incentives associated with particular games or sets of games.

In response to declining sales and the declining number of retailers selling lottery tickets, the Wisconsin Lottery's 1999-2001 biennial budget proposal requested authorization to provide incentive-based compensation to retailers in addition to the commissions already provided. An incentive-based program, rather than an increase in the commission rate, was requested primarily because lottery staff believed that past increases in the commission rate had not resulted in increased sales. The Legislature and the Governor approved the incentive program in 1999 Wisconsin Act 9, and the Wisconsin Lottery implemented the Retailer Performance program in January 2000. At the time the program was implemented, the Wisconsin Lottery was one of only three lotteries nationwide that did not offer retailers an incentive program. Of those three, only the New York State Lottery still does not offer some form of retailer incentive. The South Carolina Lottery, which began operations in January 2002, also has not implemented a retailer incentive program.

Retailers earned \$3.9 million in incentive payments in FY 2000-01.

As shown in Table 5, the Wisconsin Lottery spent \$28.3 million for total retailer compensation in FY 2000-01. The Retailer Performance program represents a relatively small percentage of that amount: \$3.9 million, or 13.8 percent. The remaining \$24.4 million, or 86.2 percent, spent on retailer compensation in FY 2000-01 was for commissions.

Table 5

Retailer Compensation

<u>Fiscal Year</u>	<u>Commissions</u>	<u>Retailer Performance Compensation</u>	<u>Total Retailer Compensation</u>	<u>Retailer Performance as a Percentage of Total Compensation</u>
1996-97	\$24,500,237	–	\$24,500,237	–
1997-98	24,632,014	–	24,632,014	–
1998-99	25,926,590	–	25,926,590	–
1999-2000*	24,858,323	\$2,116,671	26,974,994	7.8%
2000-01	24,433,089	3,916,488	28,349,577	13.8

* The Retailer Performance program began in January 2000. Therefore, the program was in effect for half of FY 1999-2000.

Other midwestern lotteries offer similar incentive programs.

Statutory language gave the Wisconsin Lottery substantial flexibility in structuring the Retailer Performance program and, as noted, other states' programs served as a model for its design. Common program components in other states include incentives for increasing sales and for selling winning tickets, as well as cashing bonuses, which are additional commissions for paying prize claims at the retailer's location. As shown in Table 6, all midwestern lotteries currently offer at least one of these three forms of retailer incentive.

Table 6

Incentives in Other States
FY 2000-01

<u>State Lottery</u>	<u>Sales Incentive</u>	<u>Winning Ticket Incentive</u>	<u>Cashing Bonus</u>
Illinois	No	Yes	No
Indiana	Yes	No	Yes
Iowa	Yes	No	No
Michigan	No	Yes	Yes
Minnesota	Yes	No	Yes
Ohio	No	No	Yes
Wisconsin	Yes	Yes	No

Source: LaFleur's 2002 World Lottery Almanac

Wisconsin Lottery officials obtained retailers' advice when designing the Retailer Performance program.

Twice in 1999, Wisconsin Lottery officials met with a retailer advisory committee to explain proposed design elements of the Retailer Performance program and to seek retailers' opinions on the structure of the incentive program. Committee members include individual retailers, such as owners of convenience stores, service stations, and grocery stores, as well as representatives of retailer associations such as the Wisconsin Grocers Association. The retailer associations we contacted indicated they were generally satisfied with their opportunities to offer advice on the incentive program's design and that the Wisconsin Lottery was receptive to their ideas. For example, Wisconsin Lottery staff revised the method used for calculating sales increases after retailers expressed concerns that it was too complicated.

The Sales Incentive

Wisconsin Lottery officials stated that the sales incentive is intended to encourage retailers to focus on strategies to increase ticket sales, such as placing ticket dispensers in prominent locations and asking customers if they would like to buy lottery tickets. Retailers that increase their sales of instant, on-line jackpot, or on-line non-jackpot tickets may earn incentive compensation of up to 10.0 percent of the increase to their commissions, subject to the limit of 1.0 percent of gross sales. In FY 2000-01, the Wisconsin Lottery spent \$3.2 million for sales incentives, which accounted for 11.3 percent of total retailer compensation.

Sales increases are measured differently for different product types.

Sales increases are measured differently for different product types. For instant and non-jackpot on-line games, each retailer's quarterly sales are compared to the sales of those product types in the corresponding quarter of the previous year, or to the previous quarter if the retailer did not have sales in the corresponding quarter of the previous year. Retailers that have increased their instant or non-jackpot on-line games over the comparison quarter earn up to 10.0 percent of the sales increase in additional compensation. Retailers that increase their sales of only one of the product types are still eligible to earn a sales incentive for the other type. For instance, a retailer that increased sales of instant tickets but not non-jackpot on-line games over the comparison period is still eligible to earn a sales incentive for instant tickets. For jackpot on-line games, the Wisconsin Lottery measures sales increases on a fiscal year basis, rather than a quarterly basis. Retailers that sold on-line jackpot games for the entire previous fiscal year earn up to 10.0 percent of their sales increases over the previous fiscal year.

Retailers reporting declines in overall ticket sales may be eligible to receive sales incentive payments.

Because the Wisconsin Lottery calculates sales incentives separately for instant, non-jackpot on-line, and jackpot on-line sales, retailers that increase their sales of any one of the three types of games are eligible for a sales incentive, even if their overall sales decline. For example, a retailer with instant ticket sales that increased by \$1,000 over the comparison quarter, but with non-jackpot on-line and jackpot on-line sales that decreased by \$2,000 each, would experience a net decline in sales of \$3,000. Nevertheless, this retailer would earn up to \$100 in sales incentives, or 10.0 percent of the \$1,000 increase in instant ticket sales. In FY 2000-01, retailers with overall sales declines earned \$284,200 of the \$3.2 million paid for sales incentives, or 8.9 percent of total sales incentives. In the last quarter of FY 2000-01, 596 of the 2,433 retailers that received sales incentives, or 24.5 percent, had sales that declined from the same quarter of the prior year.

Wisconsin Lottery staff indicate that sales incentive compensation is calculated separately for the jackpot games because volatility in ticket sales caused by large jackpots makes it difficult to sustain sales increases into the following year. Sales incentives for on-line non-jackpot and instant tickets are calculated separately in order to maintain a separate marketing identity for each of the product lines.

When the program was initially implemented, sales increases were measured and incentives were paid for each individual retail location. Under this method of calculating incentives, the Wisconsin Lottery occasionally paid sales incentives for some locations of a retail chain, although sales at other locations of the chain had decreased. With input from the Retailer Advisory Committee, the Wisconsin Lottery altered its payment methodology in July 2001 so that chain retailers were paid a percentage of their sales incentive based on the percentage of locations that increased their sales. For example, if 80.0 percent of the chain retail locations increased sales and 20.0 percent did not, the Wisconsin Lottery calculates the incentives earned for the increased sales and reduces the total incentive payment by 20.0 percent.

In general, the sales incentive component of the Retailer Performance program is similar to incentives offered by other midwestern state lotteries. For example, the Indiana Lottery pays retailers a year-end incentive of 1.0 percent of sales for meeting sales goals, and a year-end incentive of 2.0 percent of sales in excess of 10.0 percent over goals. The Minnesota Lottery sales incentive offers retailers a cash award for increasing sales over a base established from previous sales history.

Retailers have mixed opinions about the sales incentives.

Retailers expressed varying opinions regarding the sales incentive component of the Retailer Performance program. Some retailers believed that the sales incentive component was a valuable means of rewarding retailers that increased ticket sales. In addition, they believed that the sales incentive component encouraged retailers to develop strategies for increasing ticket sales.

Most retailers earned \$1,000 or less from the sales incentive in FY 2000-01.

Other retailers, however, believed that statutory limitations on state-funded advertising make it difficult for individual retailers to increase sales and earn large sales incentives. In fact, most retailers earned relatively small amounts in sales incentives. As shown in Table 7, over one-half of the retailers that earned sales incentives in FY 2000-01 earned less than \$1,000, although a liquor store in West Allis and a convenience store in Milwaukee each earned more than \$20,000. In the last quarter of FY 2000-01, 68.3 percent of eligible retailers earned sales incentives.

Table 7

Sales Incentive Compensation
FY 2000-01

<u>Incentive Range</u>	<u>Retailers Earning Sales Incentives</u>	<u>Percentage of Total</u>
\$20,000 or greater	2	0.1%
\$15,000 to \$19,999	0	0.0
\$10,000 to \$14,999	4	0.1
\$5,000 to \$9,999	52	1.5
\$1,000 to \$4,999	1,033	30.4
\$100 to \$999	1,798	52.8
Less than \$100	<u>515</u>	<u>15.1</u>
Total	3,404	100.0%

The Winning Ticket Incentive

In addition to compensating retailers for achieving certain sales goals, the Retailer Performance program also rewards retailers for selling winning lottery tickets. Wisconsin Lottery officials believe doing so encourages established retailers and persuades new retailers to sell lottery tickets.

Retailers may receive up to \$100,000 for selling a winning lottery ticket.

Retailers receive an incentive of 2.0 percent of the value of each winning ticket they sell with a prize value of at least \$600, up to a maximum incentive of \$100,000 per ticket. In addition, retailers receive \$30 for each winning lottery ticket they sell that allows the player to appear as a contestant on the lottery television show. In FY 2000-01, the Wisconsin Lottery spent \$727,000 for winning ticket incentives, or 2.6 percent of total retailer compensation.

The winning ticket component of the Wisconsin Lottery's Retailer Performance program is similar in some ways to winning ticket incentives offered in other states. For example, the Illinois Lottery pays a 1.0 percent incentive to retailers that sell winning tickets of \$1,000 or more, with no upper limit on the amount earned by retailers. The Michigan Lottery pays retailers a 2.0 percent incentive for winning tickets with values of between \$600 and \$100,000, and a flat \$2,000 incentive for winning tickets with values of more than \$100,000.

Approximately 95 percent of participating retailers earned less than \$1,000 from the winning ticket incentive in FY 2000-01.

Retailers we contacted expressed mixed opinions regarding the winning ticket component of the Retailer Performance program. Some welcomed the winning ticket incentive as an opportunity to share in large awards to lottery players. Others indicated that business owners cannot rely on the winning ticket incentive as a source of revenue, and that most retailers' earnings through this component are relatively small. As shown in Table 8, in FY 2000-01, two retailers—convenience stores in Germantown and Waukesha—earned over \$100,000 each in winning ticket compensation by selling more than one winning ticket. However, 1,295 of the 2,015 retailers that earned winning ticket incentives in FY 2000-01, or 64.3 percent, earned less than \$100.

Table 8

Winning Ticket Incentive Compensation
FY 2000-01

<u>Award Range</u>	<u>Number of Retailers Earning Incentive</u>	<u>Percentage of Total</u>
\$100,000 or more	2	0.1%
\$20,000 to \$99,999	1	0.1
\$15,000 to \$19,999	0	0.0
\$10,000 to \$14,999	5	0.2
\$5,000 to \$9,999	34	1.7
\$1,000 to \$4,999	52	2.6
\$100 to \$999	626	31.0
Less than \$100	<u>1,295</u>	<u>64.3</u>
Total	2,015	100.0%

Short-Term Incentives

To date, the Wisconsin Lottery has completed three short-term incentives intended to increase sales for specific games.

Administrative code limits the Wisconsin Lottery to four short-term incentives per year, with a maximum total compensation of \$100,000 per incentive. As of April 2002, three short-term incentives had been implemented and completed, each covering different time periods and designed to support different goals. Although data on their effectiveness are limited, Wisconsin Lottery officials believe that the brief time frames and focused performance outcomes associated with short-term incentives encourage retailers to develop strategies to increase sales.

The first short-term incentive was implemented in October 2001, over a year after the sales incentive and winning ticket components of the Retailer Performance program had been implemented. Wisconsin Lottery staff indicated that the introduction was delayed until the sales incentive and winning ticket components were operational.

Short-term incentives implemented through April 2002 include:

- The 20/20 Gold incentive, which was in effect for the month of October 2001, under which retailers that achieved the performance outcome of increasing their non-jackpot on-line sales by at least 20 percent received 20 percent of their sales increase. The Wisconsin Lottery paid \$48,700 to the 566 retailers that achieved the performance goal, an average of \$86 per retailer.
- The TV x Ten incentive, which began in December 2001 and ended in February 2002, under which retailers earned \$300, or ten times the normal compensation of \$30, for selling winning instant tickets that allowed players to appear as contestants on the lottery television show. The Wisconsin Lottery paid \$99,900 under this incentive program, or an average of \$293 per retailer.
- The Tropical Treasures incentive, which began in January 2002 and ended in February 2002, under which retailers that purchased more than one pack of 100 instant tickets for the Tropical Treasures game received twice the normal compensation of \$18.75 per pack for up to three subsequent packs. A retailer that purchased four packs, or 400 tickets, would receive an additional \$56.25 under this incentive. The Wisconsin Lottery paid \$84,400 under this incentive program, or an average of \$41 per retailer.

Priority of Incentive Components

According to statute, compensation provided through the Retailer Performance program may not exceed 1.0 percent of gross sales. The Wisconsin Lottery monitors the program to ensure that incentive payments to retailers do not exceed the statutory limit and adjusts incentive compensation as necessary.

Although administrative code requires any reductions to be applied equally to all retailers, the Wisconsin Lottery may determine the method for incentives to stay within the statutory limit of 1.0 percent of sales. At the end of each fiscal year, it compares the incentives earned by retailers to the statutory limit and, if necessary, reduces the annual sales incentives for jackpot on-line games. If further reductions are necessary after the jackpot on-line sales incentive has been reduced to zero, fourth-quarter sales incentives are reduced for instant and non-jackpot on-line ticket sales, followed by fourth-quarter short-term incentives and fourth-quarter winning ticket incentives, in that order.

The Wisconsin Lottery reduced FY 1999-2000 incentive payments to stay within the 1.0 percent of sales limitation.

Since the Retailer Performance program was implemented, the Wisconsin Lottery reduced payments once in order to limit compensation to 1.0 percent of sales. In the last quarter of FY 1999-2000, it did not pay any annual sales incentives for jackpot sales and in addition, it reduced the fourth-quarter sales incentives for instant and non-jackpot on-line ticket sales from 10.0 percent to 9.94 percent. The Wisconsin Lottery stayed within the 1.0 percent limit in FY 2000-01 and did not need to reduce Retailer Performance program payments to do so.

Program Effects

The Retailer Performance program has not generated additional sales as projected.

The Wisconsin Lottery originally predicted the Retailer Performance program would increase sales. Its projections, however, have not been met. Neither sales nor the number of retailers selling lottery tickets have increased since the incentive program was implemented, although the program has increased retailer compensation costs by \$3.9 million in FY 2000-01.

If any lottery initiative does not generate sufficient revenues to cover its costs, it decreases the net proceeds available for property tax relief. It is difficult to determine what either sales or property tax relief levels would have been if the Retailer Performance program had not been implemented, because several factors influence ticket sales. Nevertheless, future changes should be considered to increase the program's effectiveness and to reduce its costs.

Effect on Sales

Projected sales increases from the Retailer Performance program were based on other states' experiences.

In its 1999-2001 biennial budget request, the Wisconsin Lottery estimated that implementing a retailer incentive program would increase ticket sales by \$8.3 million in FY 1999-2000 and an additional \$16.6 million in FY 2000-01, or by about 2.0 and 4.0 percent, respectively, over FY 1997-98 ticket sales. In fact, sales declined by \$21.6 million in FY 1999-2000 and by an additional \$5.6 million in FY 2000-01. The Wisconsin Lottery indicated that it based estimates for the sales increase on the experiences of other states that had implemented retailer incentive programs. For example, it indicated that Indiana Lottery sales increased by 12.0 percent the year after a retailer incentive program was offered. The Indiana Lottery also made several other program modifications, such as increasing advertising and introducing new games at the same time the retailer incentive program was implemented.

The short-term incentives had varying degrees of effectiveness.

The first short-term incentive was implemented after FY 2000-01. We analyzed sales information for the three short-term incentives that were offered and completed as of April 2002 and found they had varying degrees of effectiveness in increasing sales. For the 20/20 Gold short-term incentive—the first incentive, which was in effect for the month of October 2001—sales of the targeted games increased by \$46,600, or 0.9 percent, over the comparison period, but the \$48,700 paid in retailer incentives exceeded the increase by \$2,100. Wisconsin Lottery officials believe the terrorist attacks on September 11, 2001 may have hindered the incentive's effectiveness.

For the TV x Ten short-term incentive that began in December 2001 and ended in February 2002, total sales of instant games that allowed winners to become contestants on the lottery television show increased by \$1.8 million, or 41.5 percent, over the period immediately before the incentive. However, because four new television instant games were introduced during or just before the incentive period and because sales are typically strongest when a game is first introduced, we considered the effect on games that were well-established before the comparison period. Sales for these three games increased by \$107,600, or 22.1 percent, during the incentive period. Retailers earned \$99,900 for this short-term incentive.

Of the three short-term incentives, the last incentive involving Tropical Treasures, an instant game that is sold for \$3 per ticket, appears to have had the largest impact on sales. During the six-week period prior to this incentive, the Wisconsin Lottery's average weekly sales for \$3 instant games were \$299,500. Average weekly sales for \$3 instant games increased to \$369,000, an 23.2 percent increase, for the six-week period after the incentive. This short-term incentive paid approximately \$84,400 to 2,056 retailers.

Effect on Retailers

The number of retailers selling lottery tickets has been relatively stable since 1999.

Because factors such as advertising and jackpot size influence ticket sales, a more appropriate measure for the effectiveness of the Retailer Performance program may be the number of retailers selling lottery tickets. As shown in Table 9, the number of retailers had decreased from 5,241 in 1992 to 4,272 in 1998, or by 18.5 percent over a seven-year period. Although participation has remained relatively stable from 1999 to the present, the Retailer Performance program's effect on the number of retailers selling lottery tickets may be limited by the fact that the program was not implemented until January 2000. Lottery staff indicated, however, that preliminary discussions held in 1999 regarding a retailer incentive program may have influenced retailers to continue selling lottery tickets

Table 9

Retailers Selling Lottery Tickets
(December of Each Year)

<u>Year</u>	<u>Number of Retailers</u>	<u>Percentage Change</u>
1992	5,241	—
1993	5,152	(1.7)%
1994	5,002	(2.9)
1995	4,854	(3.0)
1996	4,725	(2.7)
1997	4,335	(8.3)
1998	4,272	(1.5)
1999	4,254	(0.4)
2000*	4,255	0.0
2001	4,239	(0.4)

* The Wisconsin Lottery implemented the Retailer Performance program in January 2000.

Effects on Lottery Costs and Property Tax Relief

Among midwestern states, Wisconsin and Michigan have the highest rate of retailer compensation.

With the implementation of the Retailer Performance program, Wisconsin's total retailer compensation as a percentage of sales has increased. In FY 1997-98, before the program was implemented, total retailer compensation was 5.9 percent of sales, placing Wisconsin fifth of seven Midwestern states in retailer compensation. As shown in Table 10, Wisconsin's FY 2000-01 retailer compensation, which included \$24.4 million in commissions and \$3.9 million in incentives, was 7.1 percent of lottery sales. As a result, Wisconsin and Michigan were first in the Midwest in retailer compensation. Among other midwestern states, compensation rates ranged from 5.1 percent to 6.4 percent.

Table 10

Retailer Compensation in Midwestern States

FY 2000-01

(in millions)

<u>State Lottery</u>	<u>Sales</u>	<u>Total Retailer Compensation</u>	<u>Retailer Compensation as a Percentage of Sales</u>
Wisconsin	\$ 401.1	\$ 28.3	7.1%
Michigan	1,614.7	114.9	7.1
Minnesota	366.2	23.5	6.4
Indiana	548.3	35.3	6.4
Iowa	174.9	11.0	6.3
Ohio	1,919.9	120.2	6.3
Illinois	1,423.8	72.4	5.1

Source: LaFleur's 2002 World Lottery Almanac

The Retailer Performance program incurs administrative costs in the form of Wisconsin Lottery staff time for additional accounting, policy, and marketing activities that were absorbed with existing staff, and for creating marketing materials for the retailers, such as brochures. Before the program's implementation, the Wisconsin Lottery estimated its administrative costs would be less than \$50,000 in FY 1999-2000 and less than \$20,000 annually thereafter. Wisconsin Lottery officials have not calculated actual administrative costs for the Retailer Performance program, but they indicate costs are probably higher than originally estimated. If the Wisconsin Lottery had increased the commission rate rather than implementing a performance-based compensation program, the costs of administering the program would likely have been lower.

As retailer compensation and administrative costs increase, the amount of proceeds available for property tax relief is reduced. At the time of the Wisconsin Lottery's 1999-2001 biennial budget request for the incentive program, the Legislative Fiscal Bureau estimated that lottery sales would need to increase by approximately 1.5 percent in FY 1999-2000 and by 3.0 percent in FY 2000-01 for the program to pay for itself. Although sales have decreased, a variety of factors influence ticket sales, and we are unable to determine if the implementation of the Retailer Performance program mitigated a larger decline in sales that would otherwise have occurred.

Future Considerations

The Wisconsin Lottery plans to modify its Retailer Performance program in 2003.

The Wisconsin Lottery plans to revise administrative rules that govern the Retailer Performance program in early 2003, but it had not suggested specific program modifications as of April 2002. Although lottery staff indicated they do not plan to eliminate any component of the current incentive program, they believe that short-term incentives may be most effective in motivating retailers to increase sales, because of their narrow focus on a specific game or type of game for a relatively short period. As previously noted, preliminary data indicate that short-term incentives may have varying degrees of success in increasing sales.

Although total future ticket sales are unlikely to increase without large jackpots, because the Retailer Performance program could mitigate larger declines in ticket sales, we recommend the Wisconsin Lottery continue to analyze the short-term incentives of the Retailer Performance program. If certain short-term incentives prove to be effective in increasing sales, the Wisconsin Lottery should, with the Legislature's concurrence, consider removing the administrative code restriction that limits short-term incentives to four per year and shifting resources to the short-term incentives from other program components.

Furthermore, when determining modifications to the Retailer Performance program, we recommend the Wisconsin Lottery consider decreasing or eliminating the likelihood that retailers receive sales incentives without increasing their overall sales.

Finally, in order to keep the Legislature informed, we recommend the Wisconsin Lottery submit a report to the Joint Legislative Audit Committee by January 2003, describing planned modifications to the Retailer Performance program, the estimated impact on sales, and an updated estimate of the administrative costs required to implement the program.

Independent Auditor's Report on the Financial Statements of the Wisconsin Lottery

We have audited the accompanying balance sheet of the Wisconsin Lottery as of June 30, 2001 and 2000, and the related statement of revenues, expenses, and changes in retained earnings and statement of cash flows for the years then ended. These financial statements are the responsibility of Wisconsin Lottery 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 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements are intended to present the financial position, results of operations, and cash flows of only that portion of the Lottery Fund that is attributable to the transactions of the Wisconsin Lottery. The financial statements are not intended to present fairly the financial position of the State of Wisconsin and the results of its operations and cash flows in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Wisconsin Lottery as of June 30, 2001 and 2000, 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.

Our audits were made for the purpose of forming an opinion on the financial statements taken as a whole. The accompanying financial information listed as Supplementary Information—Schedules I, II, and III in the table of contents—is presented for the purpose of additional analysis and is not a required part of the financial statements of the Wisconsin Lottery. Such information has been subjected to the auditing procedures applied in the audits of the financial statements and, in our opinion, is fairly presented in all material respects in relation to the financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued a report dated May 15, 2002, and provided on pages 53-54, on our consideration of the Wisconsin Lottery's internal control over financial reporting and 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 audit.

LEGISLATIVE AUDIT BUREAU

May 15, 2002

by



Julie Gordon
Audit Director

Wisconsin Lottery
Balance Sheet
June 30, 2001 and 2000

Assets	<u>June 30, 2001</u>	<u>Restated June 30, 2000</u>
Current Assets:		
Cash and cash equivalents	\$ 28,276,130	\$ 6,402,444
Investments for prize annuities (Note 5)	16,499,354	24,123,557
Accounts receivable	3,043,485	2,756,895
Grand prize deposit (Note 8)	10,051,018	10,327,359
Prepaid expenses	609,482	899,860
Ticket inventory	1,413,367	1,179,821
Interest receivable	84,476	169
Due from other state programs	3,816,670	13,316,395
Total Current Assets	<u>63,793,982</u>	<u>59,006,500</u>
Noncurrent Assets:		
Investments for prize annuities (Note 5)	136,400,027	204,650,934
Equipment (net of accumulated depreciation)	194,575	327,942
Leasehold improvements (net of accumulated depreciation)	137,545	40,248
Total Noncurrent Assets	<u>136,732,147</u>	<u>205,019,124</u>
Total Assets	<u>\$ 200,526,129</u>	<u>\$ 264,025,624</u>
Liabilities and Equity		
Current Liabilities:		
Annuity prizes payable (Note 6)	\$ 16,415,682	\$ 24,455,878
Prizes payable	11,010,135	7,496,508
Accounts payable	2,325,165	3,068,784
Lottery association payable	939,349	800,952
Due to other state programs	5,853,677	3,190,686
Deferred revenue	287,329	601,487
Due to other governments	187,295	137,599
Accrued payroll	160,227	140,729
Compensated absences	183,472	158,047
Total Current Liabilities	<u>37,362,331</u>	<u>40,050,670</u>
Long-Term Liabilities:		
Annuity prizes payable (Note 6)	124,891,910	202,864,112
Total Liabilities	<u>162,254,241</u>	<u>242,914,782</u>
Equity:		
Contributed capital	50,751	50,751
Retained earnings:		
Unreserved	25,091,470	12,579,203
Reserved for investment fair market value adjustment	13,129,667	8,480,888
Total Liabilities and Equity	<u>\$ 200,526,129</u>	<u>\$ 264,025,624</u>

The accompanying notes are an integral part of this statement.

Wisconsin Lottery
Statement of Revenues, Expenses, and Changes in Retained Earnings
for the Years Ended June 30, 2001 and 2000

	Year Ended June 30, 2001	Restated Year Ended June 30, 2000
Operating Revenues		
Instant Ticket Sales	\$ 237,944,206	\$ 241,040,896
On-Line Ticket Sales	163,244,349	165,629,273
Retailer Fees	67,671	34,725
Miscellaneous Revenue (Note 16)	2,498,548	79,195
Total Operating Revenues	<u>403,754,774</u>	<u>406,784,089</u>
Operating Expenses		
Program Expenses:		
Instant prize expense	149,827,633	152,238,914
On-line prize expense	83,071,579	80,983,869
Retailer commissions and incentives	28,349,577	26,974,994
Total Program Expenses	<u>261,248,789</u>	<u>260,197,777</u>
Administrative Expenses:		
Instant and on-line vendor services	12,116,681	11,790,160
Salaries and fringe benefits	4,944,999	4,565,186
On-line telecommunication charges	3,094,601	3,603,066
Supplies and services	5,731,096	4,211,556
Product information	4,607,042	4,488,334
Ticket costs	2,893,774	3,526,528
Depreciation expense	191,189	225,410
Total Administrative Expenses	<u>33,579,382</u>	<u>32,410,240</u>
Total Operating Expenses	<u>294,828,171</u>	<u>292,608,017</u>
Net Operating Income	<u>108,926,603</u>	<u>114,176,072</u>
Non-Operating Revenues (Expenses) and Operating Transfers		
Investment Income (Loss)	7,816,145	(2,620,647)
Gain (Loss) on Disposal of Fixed Assets	(20,880)	1,836
Net Income Before Transfers	<u>116,721,868</u>	<u>111,557,261</u>
Operating Transfers:		
Transfers of lottery proceeds for property tax credit	(101,757,270)	(232,274,835)
Transfer in from general purpose revenue subsidies	2,602,581	79,213,534
Transfer to Department of Revenue for lottery precertification	0	(889,927)
Transfer to Department of Justice for law enforcement	(247,000)	(224,483)
Transfer to Department of Revenue for lottery credit administration	(159,133)	(86,608)
Net Income (Loss)	<u>17,161,046</u>	<u>(42,705,058)</u>
Retained Earnings		
Retained Earnings, Beginning of Year	21,060,091	63,765,149
Retained Earnings, End of Year	<u>\$ 38,221,137</u>	<u>\$ 21,060,091</u>

The accompanying notes are an integral part of this statement.

Wisconsin Lottery
Statement of Cash Flows
for the Years Ended June 30, 2001 and 2000

	Year Ended June 30, 2001	Restated Year Ended June 30, 2000
Cash Flows from Operating Activities		
Cash Received from Retailers	\$ 402,958,948	\$ 421,627,638
Cash Paid for Prizes	(327,785,651)	(283,238,858)
Cash Paid/Received for Grand Prize Deposit	1,182,304	(97,331)
Cash Paid to Suppliers and Employees	(36,216,534)	(38,456,247)
Cash Paid for Retailer Commissions and Incentives	(28,037,365)	(27,231,173)
Net Cash Provided by Operating Activities	<u>12,101,702</u>	<u>72,604,029</u>
Cash Flows from Non-Capital Financing Activities		
Transfer of Proceeds for Property Tax Credit	(97,170,740)	(236,054,809)
Transfer In from General Purpose Revenue Subsidies	12,129,099	76,015,043
Transfer of Proceeds for Lottery Precertifications	0	(889,927)
Transfer of Proceeds for Law Enforcement	(247,000)	(224,483)
Transfer of Proceeds for Lottery Credit Administration	(159,133)	(86,608)
Net Cash Used by Non-Capital Financing Activities	<u>(85,447,774)</u>	<u>(161,240,784)</u>
Cash Flows from Capital and Related Financing Activities		
Cash Paid for Purchase of Equipment	(77,418)	(109,134)
Cash Received from Sale of Equipment	10,120	0
Net Cash Used by Capital and Related Financing Activities	<u>(67,298)</u>	<u>(109,134)</u>
Cash Flows from Investing Activities		
Interest Received	2,143,521	3,654,876
Cash Received for Redemption of Bonds	93,143,535	47,687,975
Cash Paid for Purchase of Bonds	0	(5,310,635)
Net Cash Provided by Investing Activities	<u>95,287,056</u>	<u>46,032,216</u>
Net Increase (Decrease) in Cash and Cash Equivalents	21,873,686	(42,713,673)
Cash and Cash Equivalents, Beginning of Year	6,402,444	49,116,117
Cash and Cash Equivalents, End of Year	<u>\$ 28,276,130</u>	<u>\$ 6,402,444</u>

The accompanying notes are an integral part of this statement.

Wisconsin Lottery
Statement of Cash Flows
for the Years Ended June 30, 2001 and 2000

(Reconciliation of Net Operating Income to
Net Cash Provided by Operations)

	<u>Year Ended</u> <u>June 30, 2001</u>	<u>Restated</u> <u>Year Ended</u> <u>June 30, 2000</u>
Net Operating Income	<u>\$ 108,926,603</u>	<u>\$ 114,176,072</u>
Adjustments to Reconcile Net Operating Income to Net Cash Provided by Operating Activities		
Depreciation Expense	191,189	225,410
Changes In Assets and Liabilities		
Decrease (Increase) in Receivables	(286,590)	12,246,185
Decrease (Increase) in Grand Prize Deposit	1,182,304	(97,331)
Decrease (Increase) in Ticket Inventory	(233,547)	885,257
Decrease (Increase) in Prepaid Expenses	290,377	464,350
Decrease (Increase) in Due from Other State Programs	(80,070)	(9,426,102)
Increase (Decrease) in Prizes Payable	(95,084,841)	(44,782,468)
Increase (Decrease) in Deferred Revenue	(314,158)	164,342
Increase (Decrease) in Due to Other State Programs	(1,870,261)	2,653,596
Increase (Decrease) in Accounts Payable	(852,320)	(573,191)
Increase (Decrease) in Lottery Association Payable	138,397	(3,161,738)
Increase (Decrease) in Due to Other Governments	49,696	(55,802)
Increase (Decrease) in Accrued Payroll	19,498	(102,486)
Increase (Decrease) in Compensated Absences	25,425	(12,065)
Total Adjustments	<u>(96,824,901)</u>	<u>(41,572,043)</u>
Net Cash Provided by Operating Activities	<u>\$ 12,101,702</u>	<u>\$ 72,604,029</u>
Non-Cash Activities:		
Net Change in Unrealized Gains and Losses (Note 7)	\$ 2,374,952	\$ 4,875,630
Vendor Liquidated Damages Settlement (Note 16)	250,000	0

The accompanying notes are an integral part of this statement.

1. Description of the Wisconsin Lottery

The Wisconsin Lottery was created in December 1987 and is administered by the Lottery Division within the Department of Revenue. The Wisconsin Lottery manages scratch-off and pull-tab instant ticket games and on-line ticket games. During fiscal year (FY) 2000-01, the Wisconsin Lottery administered 125 active scratch-off, 13 active pull-tab, and 7 active on-line games.

The Wisconsin Lottery joined the Multi-State Lottery Association (MUSL) in June 1989. In FY 2000-01, the Wisconsin Lottery, as a member of MUSL, participated in two on-line MUSL games called Powerball (start date April 19, 1992) and Cash 4 Life (start date March 30, 1998; end date September 7, 2000).

During FY 2000-01, the Lottery also sold tickets for five other on-line games: Supercash! (start date February 4, 1991), Wisconsin's Very Own Megabucks (start date June 20, 1992), Daily Pick 3 (start date September 21, 1992), Daily Pick 4 (start date September 15, 1997), and Money Roll (start date September 8, 2000; end date March 25, 2002).

The Wisconsin Lottery is accounted for within the Lottery Fund, which is part of the State of Wisconsin financial reporting entity. The reporting entity for the Wisconsin Lottery stand-alone financial statements does not include the appropriations from which the property tax credit disbursements are made. However, disbursements to these appropriations are reported on the Statement of Revenues, Expenses, and Changes in Retained Earnings as operating transfers out.

2. Summary of Significant Accounting Policies

A. Fund Accounting and Basis of Presentation - The financial statements of the Wisconsin Lottery have been prepared in conformance with generally accepted accounting principles for proprietary funds as prescribed by the Governmental Accounting Standards Board (GASB). Proprietary funds are accounted for on the accrual basis of accounting, with revenues recognized when earned and expenses recognized when incurred. Enterprise funds, which are a type of proprietary fund, account for operations that are financed and operated in a manner similar to private business enterprises in which the costs, including depreciation, of providing goods or services to the general public are financed through user charges (sales). The accompanying financial statements were prepared based upon the flow of economic resources focus and full accrual basis of accounting.

The State of Wisconsin monitors expenditures and records financial transactions using both the budgetary basis and the accrual basis of accounting. A reconciliation between the budgetary basis and the accrual basis of accounting for general operations expenditures is shown in Schedule I.

- B. Revenue Recognition - Sales of instant scratch-off, instant pull-tab, and on-line tickets are made to the public through licensed retail sales agents.

Instant scratch-off ticket revenues are recognized when tickets are sold to the retailers. Retail sales agents have the right to return unsold instant scratch-off tickets for full refunds. See Note 2(I) for information about accounting for the retailers' right to return scratch-off tickets.

Revenues for pull-tab games are recognized upon sale of the tickets to the retail sales agents. No right of return exists for instant pull-tab tickets.

Ticket revenues for on-line games are recognized at the time the related drawings are held.

- C. Cash and Cash Equivalents - All cash is deposited with the State of Wisconsin Treasurer and is required to be invested in the State Investment Fund. The State Investment Fund is a short-term pool of state and local funds managed by the State of Wisconsin Investment Board with oversight by its Board of Trustees. Since shares in the State Investment Fund are purchased in \$1,000 increments, Wisconsin Lottery cash balances below \$1,000 are deposited in the State's bank. The State Investment Fund is not registered with the Securities and Exchange Commission as an investment company.
- D. Retailer Commissions - Retailer commissions, which are classified as program expenses, were 5.5 percent for on-line ticket sales and 6.25 percent for instant scratch and instant pull-tab tickets during FY 2000-01 and FY 1999-2000. Nonprofit organizations receive additional commissions.
- E. Retailer Incentive Programs - In addition to the retailer commissions discussed in Note 2(D), 1999 Wisconsin Act 9 established an incentive program for retailers who meet certain performance goals identified by the Wisconsin Lottery. This program began on January 1, 2000. Retailers must be in good standing and sell scratch-off tickets to participate in the program, which in FY 2000-01 had a winning ticket component and a sales incentive component. The total compensation provided to all retailers under the components of the program may not exceed 1 percent of the gross revenues from the sale of lottery tickets and lottery shares, which are multi-draw on-line tickets.

Under the winning ticket component, participating retailers that sell a winning scratch-off or on-line game ticket of \$600 or more receive a 2 percent commission of the prize award, up to a maximum of \$100,000 per winning ticket. Winning ticket payments are made weekly.

The sales incentive component allows participating retailers to earn additional commissions based on increased sales realized in any of three product categories: instant scratch-off tickets, on-line daily games (Supercash!, Daily Pick 3, Daily Pick 4, Money Roll, and Cash 4 Life), and on-line jackpot games (Wisconsin's Very Own Megabucks and Powerball). Subject to certain restrictions and allowances, retailers earn up to 10 percent of the increase in quarterly sales over sales for the same quarter of the previous year in each category. Payments for the instant scratch-off ticket and on-line daily portions of the sales incentive program are made quarterly. Due to the random nature of the on-line jackpot games and the overall program cap, sales incentive program payments for jackpot games are made annually.

- F. Administrative Expenses - Administrative expenses are limited to 10 percent of gross lottery revenues. A summary of administrative expenses and related calculations of the administrative expense limit is included in Schedule II.
- G. Prizes - In accordance with Wisconsin Statutes, at least 50 percent of lottery revenues must be returned in the form of prizes. Prizes may be claimed for a period of 180 days after the drawing for on-line games, or 180 days from the declaration of the end of a game for instant games. A summary of prize expenses is shown in Schedule III.
- H. Ticket Inventory - Ticket inventory consists of instant tickets for games in progress that have not yet been sold or shipped, and tickets for new games. The tickets are valued at cost using the first in-first out (FIFO) method. The cost of tickets sold is charged to operations. Unused tickets are charged to operations in the fiscal year the game ends.
- I. Deferred Revenue - Until instant scratch-off tickets are sold to the public, retailers have the right to return unsold tickets to the Wisconsin Lottery for a refund. Therefore, receivables and cash collected in advance of sales of these tickets represent a liability of the Wisconsin Lottery. Deferred revenue is estimated and recorded based on historical information of unsold tickets returned by the retailers.

During FY 2000-01 and FY 1999-2000, Powerball and Wisconsin's Very Own Megabucks tickets were sold for up to the next two drawings. Effective December 2, 2001, these tickets can be sold for up to the next eight drawings. Supercash!, Cash 4 Life, Daily Pick 3, and Daily Pick 4 tickets are sold for the next seven drawings. Money Roll tickets were sold for the next three drawings until that game ended on March 25, 2002. On-line ticket revenues are recognized at the time the related drawings are held. All ticket sales for future drawings are recorded as deferred revenue.

- J. Equipment and Leasehold Improvements - Fixed assets purchased for \$5,000 or more are recorded at historic cost and are depreciated using the straight-line method according to the following schedule:

	<u>Estimated Life</u>
Leasehold Improvements	10 years
Office Furniture and Security Equipment	10 years
Printing and Microfilming Equipment	7 years
Office, Computer, and Data Processing Equipment	5 years
Personal Computers—Acquired After July 1, 1998	4 years

- K. Employee Compensated Absences - The Wisconsin Lottery’s compensated absence liability consists of accumulated unpaid leave, compensatory time, personal holiday hours, and Saturday/legal holiday hours earned and vested as of June 30.
- L. Due to (from) Other State Programs - During the course of operations, numerous transactions for goods provided or services rendered occur among individual state programs. The balance sheet classifies these receivables and payables as “Due from Other State Programs” or “Due to Other State Programs.”
- M. Investment Valuation - Pool shares of the State Investment Fund are bought and redeemed at \$1.00 based on the amortized cost of the investments in the Fund. Income calculations are based on the amortized cost of average pool balances. Where possible, investments in the State Investment Fund are reported at fair value for financial reporting purposes and are based on quoted market prices. Fair value determinations not based on quoted market prices include matrix pricing models or are calculated as the net present value of expected future cash flows. Nonparticipating contracts are valued at cost because these investments do not capture interest rate changes, while other investments are valued at par, which approximates fair value. Fair value of investments for prize annuities is based on quoted market prices.
- N. Disbursement of Lottery Proceeds - The Wisconsin Lottery disburses Lottery proceeds through two means: the Lottery Tax Credit and the Farmland Tax Credit.

The Department of Administration, with the concurrence of the Legislature’s Joint Finance Committee, determines the annual amount available for distribution as the Lottery Tax Credit in a given fiscal year. The Department of Revenue is notified of this amount by November 1. The Lottery Tax Credit is paid to municipalities on the 4th Monday in March of the same fiscal year.

The Farmland Tax Credit is determined by statute and is distributed to eligible individual and corporate taxpayers through the administration of the Wisconsin Department of Revenue's individual and corporate tax processes. The date of distribution of the Farmland Tax Credit is determined by the dates that eligible claims for it are processed. Therefore, disbursement of Farmland Tax Credit payments occurs throughout the year.

3. Recasting of FY 1999-2000 Financial Statements

An adjustment was made to properly accrue FY 1999-2000 transfers of \$3,009,032 received from the Department of Administration-Gaming Division, and the interest related to those transfers of \$189,459.

An adjustment was made to account for the insufficient accrual of prize expense in prior years. This difference, totaling \$818,832, was the result of using an incorrect method to account for certain prizes payable accounting transactions.

4. Deposits

GASB Statement 3 requires deposits with financial institutions to be categorized to indicate the level of risk assumed by the State. The Lottery had a balance of \$248 in the State's bank on June 30, 2001, and \$981 on June 30, 2000. Both balances met the criteria for risk category 1 because they were covered by federal depository insurance.

5. Investments

Investments sufficient to finance the Cash 4 Life prize annuity payments for Wisconsin Lottery Cash 4 Life prize winners are held by MUSL; therefore, they are not shown as an asset, and the related annuity prizes payable are not shown as a liability on the Wisconsin Lottery financial statements. During FY 2000-01, MUSL sold the securities used to fund the Cash 4 Life lifetime prizes and replaced them with insurance annuities. The insurance company transfers weekly prize payments to the Wisconsin Lottery, which then distributes them to the prize winners.

Investments for prize annuities are required by MUSL and the Wisconsin Lottery to be in the form of United States zero-coupon treasury securities, securities guaranteed by the United States government, or investment instruments issued by various brokerage firms secured by United States Treasury bonds held by custodial banks. These investments have been purchased to finance the jackpot prizes that are payable as annuities over the 20-year or 25-year period. See Note 6 for information related to the annuity prizes payable. The investments are scheduled to mature near the time prize payments become payable to winners. The State's custodial bank held investments for prize annuities with a fair value of \$152,899,381 as of June 30, 2001, and a fair value of \$228,774,491 as of June 30, 2000.

The various types of securities in which the State Investment Fund may invest are enumerated in ss. 25.17(3)(b), (ba), and (bd), Wis. Stats., and include direct obligations of the United States and Canada, securities guaranteed by the United States government, securities of federally chartered corporations, unsecured notes of financial and industrial issuers, Yankee/Eurodollar issues, certificates of deposit issued by banks in the United States and solvent financial institutions in this state, and bankers' acceptances. The State of Wisconsin Investment Board's Trustees may approve other prudent investments. The Board of Trustees has given standing authority to the State Investment Board to invest in resale agreements, financial futures contracts, options, and interest rate swaps.

GASB Statement 3 requires investments to be categorized to indicate the level of risk assumed by the Wisconsin Lottery. As of June 30, 2001, all of the assets in investments for prize annuities meet the criteria for risk category 1, because the investments are insured or registered, or are held by the State or its agent in the State's name. The Wisconsin Lottery's State Investment Fund shares are not categorized.

6. Annuity Prizes Payable

The Wisconsin Lottery has an unconditional obligation to pay all jackpot prize winners the future value of prizes. The reported value of future prize payment obligations is included in the financial statements as "Annuity Prizes Payable." To finance the annuity prize payments, the Wisconsin Lottery purchases, or has acquired from MUSL, investments scheduled to mature near the time prize payments become payable to the winners. Each year, an adjustment to the Annuity Prizes Payable account is made to amortize the reported value using the effective interest method. The present value adjustment was \$12,586,071 for FY 2000-01, and \$17,096,987 for FY 1999-2000. See Note 5 for information related to the investments for prize annuities, and Note 15 for information on recent law changes that affect future prize payments. The reported values of future prize payment obligations were as follows:

Fiscal Year	<u>FY 2000-01</u>			<u>FY 1999-2000</u>		
	<u>Current Payments</u>	<u>Long-Term Payments</u>	<u>Total Payments</u>	<u>Current Payments</u>	<u>Long-Term Payments</u>	<u>Total Payments</u>
2000-01	–	–	–	\$24,903,466	–	\$ 24,903,466
2001-02	\$16,787,015	–	\$ 16,787,015	–	\$ 25,054,394	25,054,394
2002-03	–	\$ 16,909,086	16,909,086	–	25,211,517	25,211,517
2003-04	–	17,036,252	17,036,252	–	25,375,034	25,375,034
2004-05	–	17,166,588	17,166,588	–	25,543,064	25,543,064
2005-06	–	17,303,359	17,303,359	–	–	–
Subsequent Years	–	<u>141,562,511</u>	<u>141,562,511</u>	–	<u>243,053,610</u>	<u>243,053,610</u>
Future Prize Payments	16,787,015	209,977,796	226,764,811	24,903,466	344,237,619	369,141,085
Less: Present Value Adjustment	<u>371,333</u>	<u>85,085,886</u>	<u>85,457,219</u>	<u>447,588</u>	<u>141,373,507</u>	<u>141,821,095</u>
Present Value of Future Prize Payments as of Year-End	<u>\$16,415,682</u>	<u>\$124,891,910</u>	<u>\$141,307,592</u>	<u>\$24,455,878</u>	<u>\$202,864,112</u>	<u>\$227,319,990</u>

7. Investment Income (Loss)

The investment income (loss) shown on the financial statements consists of several elements, as shown below:

	<u>FY 2000-01</u>	<u>FY 1999-2000</u>
Interest from State Investment Fund	\$ 2,258,708	\$ 3,214,921
Net Increase in Fair Value of Annuity Investments	17,268,425	10,039,681
Decrease for Amortization of Annuity Investments	(12,586,071)	(17,096,988)
Net Change in Fair Value of State Investment Fund	(33,574)	258,481
Interest from MUSL Prize Reserve Accounts	905,964	956,570
Miscellaneous Interest	<u>2,693</u>	<u>6,688</u>
Total Investment Income (Loss)	\$7,816,145	\$(2,620,647)

The Wisconsin Lottery earns interest on its shares invested in the State Investment Fund and on its share of the grand prize deposit fund established through MUSL, which is discussed in Note 8. Under GASB Statement 31, which requires investments to be reported at fair value, the net increases or decreases in fair value of investments for prize annuities and shares in the State Investment Fund are recognized as investment income (loss). Investments for prize annuities are amortized with a corresponding amortization adjustment to annuity prizes payable. The amortization of annuity prizes payable is included as a reduction to investment income.

8. Grand Prize Deposit

A grand prize deposit fund has been established by MUSL to indemnify states participating in the Powerball and Cash 4 Life games should a winning ticket not be properly paid. The combined Powerball and Cash 4 Life grand prize deposit for the State of Wisconsin was \$10,051,018 at June 30, 2001, and \$10,327,359 at June 30, 2000.

- A. Powerball - The total prize pool equals 50 percent of sales for each Powerball drawing. Of the total prize pool, 58.39 percent funds the grand prize pool, and 41.61 percent funds the low-tier prize pool. After the grand prize pool reaches the annuitized amount of \$5 million, then 2 percent of draw sales is distributed to the Prize Reserve Account (PRA) and Set Prize Reserve Account (SPRA) until they reach their caps of \$52 million and \$30 million, respectively. Interest earned on these accounts is deposited to the Unreserved Account. For some draws, the PRA and SPRA are reduced when the actual prizes won are greater than the amounts available in the prize pools. The Wisconsin Lottery has the right to a refund of the Wisconsin PRA and SPRA balances if it withdraws from MUSL. The Powerball grand prize deposit is made up of the following:

	<u>June 30, 2001</u>	<u>June 30, 2000</u>
Prize Reserve Account (PRA)	\$5,514,054	\$5,514,054
Balance of Unreserved Account	1,382,411	1,676,447
Set Prize Reserve Account (SPRA)	<u>1,947,728</u>	<u>1,947,728</u>
Total Powerball Grand Prize Deposit	\$8,844,193	\$9,138,229

Because the PRA and SPRA are refundable upon withdrawal from MUSL, it is the practice of the Wisconsin Lottery to report the prize reserve balances as a receivable (Grand Prize Deposit) and to reduce the prize expense by the same amount when the reserves are increased. The Wisconsin Lottery increases the Grand Prize Deposit and reports interest revenue in the period when the interest in the unreserved account is increased by MUSL.

- B. Cash 4 Life - The total prize pool equals 50 percent of sales for each Cash 4 Life drawing. Currently, 2 percent of total sales is transferred to MUSL in trust as its proportionate share of the PRA. A cap for the Cash 4 Life prize reserve account has not yet been set. The Wisconsin Lottery has the right to a refund of the Cash 4 Life prize deposit for the State of Wisconsin.

At June 30, 2001, MUSL held as a Cash 4 Life prize deposit for the State of Wisconsin \$1,206,825. At June 30, 2000, the Cash 4 Life prize deposit was \$1,189,130.

Because the Cash 4 Life prize reserve is refundable upon withdrawal from MUSL, it is the practice of the Wisconsin Lottery to report the prize reserve balances as a receivable (Grand Prize Deposit) and to reduce the prize expense by the same amount when the reserves are increased.

The Cash 4 Life game ended on September 7, 2000. Approximately one year after the end of the Cash 4 Life game, MUSL returned the residual Cash 4 Life prize reserve, \$1,206,825, to the Wisconsin Lottery.

9. Operating Leases

The Wisconsin Lottery occupied office, warehouse, and storage facilities in Milwaukee and on the Beltline Highway in Madison under operating leases during FY 2000-01. The lease for the Milwaukee facility expires June 30, 2004. In November 2000, the Wisconsin Lottery office in Madison moved to a new leased facility on Rimrock Road in Madison, in conjunction with the consolidation of all Department of Revenue divisions. However, a small portion of the Madison Beltline facility is still being leased by the Wisconsin Lottery. This lease expires March 31, 2006.

The following schedule summarizes the future minimum lease payments required under operating leases for both the Milwaukee and Madison facilities. Upon renewal at the beginning of FY 1999-2000, the Milwaukee warehouse lease payments are scheduled to increase based on a formula using the Consumer Price Index (CPI) each March. Since the future CPI is not known, the rate of actual increase between FY 2000-01 and FY 2001-02 lease payment amounts was used to estimate subsequent years' increases. The lease rate for the Madison Beltline Highway facility has been fixed for the remainder of the lease period.

	<u>As of</u> <u>June 30, 2001</u>	<u>As of</u> <u>June 30, 2000</u>
Fiscal Year Ending June 30, 2001	–	\$ 699,195
2002	\$ 411,991	387,127
2003	422,948	402,379
2004	434,218	418,231
2005	28,884	–
2006	<u>21,663</u>	<u>–</u>
Total Minimum Payments Required	\$1,319,704	\$1,906,932

Total lease expenses for the Wisconsin Lottery amounted to \$738,996 for the fiscal year ended June 30, 2001, and \$782,009 for the fiscal year ended June 30, 2000.

10. Prize Expense and Prizes Payable

The Wisconsin Lottery is required by law to honor winning tickets up to 180 days after the end of a game for instant games, and 180 days after a drawing for on-line games. After the 180-day period, the prize expense is adjusted for those winners who did not redeem their tickets.

Scratch ticket prizes include low-tier prizes (below \$50), high-tier prizes (\$50 and above), and grand prizes (amounts won through the televised “Money Game Show”). All pull-tab ticket prizes are considered low-tier prizes.

Powerball and Megabucks winners may elect to receive either an annuity or a lump-sum cash payment. Cash 4 Life jackpot winners receive \$1,000 per week for life, and no lump-sum cash option is available. All other on-line games’ jackpot prizes are paid in one lump sum.

On-line ticket prizes vary, depending on the on-line game:

- A. Powerball - The prize structure for Powerball includes a guaranteed minimum jackpot of \$10 million divided equally among all valid game plays that match five of five numbers plus the Powerball. Set prizes are paid for valid tickets matching eight other number combinations.

The Power Play option is an add-on feature to the Powerball game. Players may elect to pay an additional \$1 per panel per draw for the opportunity to multiply set prizes between \$3 and \$100,000 by a number between one and five that is randomly selected at the time of the draw.

The Powerball prize pool for all prize categories consists of 50 percent of each draw period’s sales. The Wisconsin Lottery recognizes as prize expense its share of the prize pool at the time the related drawing is held. The Wisconsin Lottery transfers to MUSL money equal to its share of the

prize pool, less the amount required to pay the non-jackpot prize winners and the first annual payment for any jackpot prize winners purchasing tickets from the Wisconsin Lottery. The amounts withheld from MUSL to pay these prize winners are reported as prizes payable until the winners redeem their tickets.

In the event the Wisconsin Lottery sells a valid annuity payment option winning ticket for the jackpot prize for Powerball, MUSL will purchase investments to finance the prize annuity. The investments are transferred to the State of Wisconsin, and the State assumes the related annuity prizes payable liability. No additional prize expense is reported for the jackpot winners, since the investments are purchased from the prize pool contributed by all states participating in MUSL. No annuity investments were acquired and no prize liabilities were assumed in either FY 2000-01 or FY 1999-2000.

For jackpot prize winning tickets with the cash payment option, MUSL transfers to the Wisconsin Lottery money equal to the cash jackpot. The Wisconsin Lottery then pays this amount to the prize winner. No additional prize expense is reported for the jackpot winners, since the prizes are paid from the prize pool contributed by all states participating in MUSL.

- B. Wisconsin's Very Own Megabucks - The prize structure for Wisconsin's Very Own Megabucks on-line lotto game includes a guaranteed minimum jackpot of \$1 million divided equally among all game plays that match, in any order, six of six numbers drawn, along with set prizes for game plays matching three, four, and five of the six numbers drawn. The number of winners in each of these categories, multiplied by the set prize amount for that category, is equal to the prize expense for the Wisconsin's Very Own Megabucks game, with an adjustment made in the event there is no jackpot winner for the last draw of the year. Prizes expensed are reported as prizes payable until the winners redeem their tickets.

In the event there is a Wisconsin's Very Own Megabucks annuity payment option jackpot winner, the Wisconsin Lottery contracts with MUSL to purchase prize annuities. The investments funded by the Wisconsin Lottery are transferred to the State of Wisconsin, and the State assumes the related annuity prizes payable liability. The Wisconsin Lottery acquired no annuity investments in FY 2000-01. In FY 1999-2000, it acquired \$5,595,731 in annuity investments and assumed an annuity prize liability of the same amount.

The Wisconsin Lottery makes one direct cash payment to Megabucks jackpot prize winners who elect the cash payment option.

- C. Supercash! - The prize structure for the Supercash! daily game includes a set top prize of \$250,000 for each play on a valid game ticket correctly matching, in any order, six of six numbers drawn. However, if there are more than 20 plays on valid game tickets correctly matching, in any order, six of the six winning numbers in the drawing, then \$5,000,000 is to be

divided equally among the winning plays. Set prizes are paid for valid tickets matching four or five of the six numbers drawn. The number of winners in each of these categories, multiplied by the prize amount for that category, is equal to the prize expense for the Supercash! game. Prizes expensed are reported as prizes payable until the winners redeem their tickets.

- D. Daily Pick 3 - The prize structure for the Daily Pick 3 game includes a set top prize of \$500 for each play on a valid game ticket correctly matching three of three numbers in the order drawn. The play options available are straight, box, and straight/box. Prizes vary based on the type of play category. The number of winners in each of these categories, multiplied by the prize amount for that category, is equal to the prize expense for the Daily Pick 3 game. Prizes expensed are reported as prizes payable until the winners redeem their tickets.
- E. Daily Pick 4 - The prize structure for the Daily Pick 4 game includes a set top prize of \$5,000 for each play on a valid game ticket correctly matching four of four numbers in the order drawn. The play options available are straight plays and 24-, 12-, 6-, and 4-way box plays. The selection of numbers determines the box type. Prizes vary based on the type of play category. The number of winners in each of these categories, multiplied by the prize amount for that category, is equal to the prize expense for the Daily Pick 4 game. Prizes expensed are reported as prizes payable until the winners redeem their tickets.
- F. Cash 4 Life - The prize structure for the Cash 4 Life game, which ended on September 7, 2000, included a set top prize of \$1,000 per week for life for each play on a valid game ticket correctly matching four of four numbers drawn in the top prize group. Each play consisted of 15 sets of 4 two-digit numbers. One set of four numbers for the top prize group could be selected by the player or could be randomly selected, at the player's option. The remaining 14 sets of numbers were selected randomly. The number of winners in each of the prize categories, multiplied by the prize amount for that category, was equal to the prize expense for the Cash 4 Life game.
- G. Money Roll - The prize structure for Money Roll, which ended on March 25, 2002, included two prize categories: Win/Share and Money Roll. The Win/Share prize category applied when at least one play on a valid game ticket correctly matched, in any order, five of five numbers drawn. If no play in a drawing correctly matched all five numbers drawn, the Money Roll prize category applied.

The Win/Share prize category included a set top prize of \$500,000 for each play on a valid game ticket correctly matching five of the five numbers drawn. However, if there were more than ten plays correctly matching five of five winning numbers in the drawing, then \$5,000,000 was to be divided equally among the winning plays. Set prizes were also paid for valid tickets matching two, three, or four of the five numbers drawn.

The Money Roll prize category included a set top prize of \$2,000 for each play on a valid game ticket correctly matching four of the five numbers drawn. Set prizes were also paid for valid tickets matching two or three of the five numbers drawn. Prizes for matching two, three, or four of the five numbers drawn in the Money Roll prize category were higher than those in the Win/Share prize category.

The number of winners in each of these categories, multiplied by the prize amount for that category, is equal to the prize expense for the Money Roll game. Prizes expensed are reported as prizes payable until the winners redeem their tickets.

11. Reserved Retained Earnings

The Wisconsin Lottery has reserved retained earnings for fair value adjustments of investments of \$13,129,667 as of June 30, 2001, and \$8,480,888 as of June 30, 2000. The Wisconsin Lottery does not realize gains or losses from the change in fair value of its annuity investments because it holds the investments until maturity to pay the annual prize payments. Therefore, fair value adjustments recognized as investment income as a result of applying GASB Statement 31 will not be available for distribution as property tax credits.

12. Contributed Capital

Between October 1, 1992 and September 30, 1995, costs associated with the purchase of fixed assets were allocated among the Lottery, Racing, Indian Gaming, and Charitable Gaming programs administered by the Gaming Commission. When the Lottery program transferred from the Gaming Commission to the Department of Revenue (DOR), the fixed assets purchased jointly were divided between the Wisconsin Lottery at DOR and the programs that remained with the Gaming Commission. The assets allocated to the Wisconsin Lottery resulted in contributed capital of \$50,751.

13. Employee Retirement Plan

Permanent, full-time employees of the Wisconsin Lottery are participants in the Wisconsin Retirement System, a cost-sharing, multiple-employer, defined benefit plan governed by Chapter 40 of Wisconsin Statutes. State and local government public employees are entitled to an annual formula retirement benefit based on: 1) the employee's final average earnings, 2) years of creditable service, and 3) a formula factor. If an employee's contributions, matching employer's contributions, and interest credited to the employee's account exceed the value of the formula benefit, the retirement benefit may instead be calculated as a money purchase benefit. The Wisconsin Retirement System is considered part of the State of Wisconsin's financial reporting entity. Copies of the separately issued

financial report that includes financial statements and required supplementary information for the year ending December 31, 1999, may be obtained by writing to:

Department of Employee Trust Funds
P.O. Box 7931
Madison, WI 53707-7931

The report is also available on the Department of Employee Trust Funds' Web site, <http://badger.state.wi.us/agencies/etf/>. The separately issued financial reports for the years ended December 31, 2000 and December 31, 2001 are expected to be available in summer of 2002.

Generally, the State's policy is to fund retirement contributions on a level-percentage-of-payroll basis to meet normal and prior service costs of the retirement system. Prior service costs are amortized over 40 years, beginning January 2, 1990. The retirement plan requires employee contributions equal to specified percentages of qualified earnings based on the employee's classification, plus employer contributions at a rate determined annually. The Wisconsin Lottery's contributions to the plan were \$514,427 for FY 2000-01 and \$485,260 for FY 1999-2000. The relative position of the Wisconsin Lottery in the Wisconsin Retirement System is not available because the Wisconsin Retirement System is a statewide, multi-employer plan.

14. Distribution of Net Proceeds

The Wisconsin Constitution requires net proceeds from the operations of the Wisconsin Lottery to be used to provide local property tax relief. In addition, balances from other gaming-related appropriations, including racing and charitable bingo operations, lapse to the Lottery Fund for distribution in the form of property tax relief. For FY 2000-01, a total of \$101,757,270 in net proceeds was used for the following purposes: \$90,009,299 for Lottery Tax Credits, and \$11,747,971 for Farmland Tax Relief Credits.

In 1999 Wisconsin Act 9, the Legislature appropriated general purpose revenue to fund certain lottery expenses that had previously been funded from lottery proceeds. These expenditures, including retailer commissions and all administrative expenses except depreciation, totaled \$74,628,968 in FY 1999-2000. This budgetary provision was effective only for FY 1999-2000.

The use of general purpose revenue to fund these expenditures provided a means of increasing the amount of property tax relief available through the Lottery Fund by increasing the FY 1999-2000 lottery proceeds. For FY 1999-2000, a total of \$232,274,835 in Wisconsin Lottery proceeds and other gaming-related proceeds was used for the following purposes: \$216,255,157 for Lottery Tax Credits, and \$16,019,678 for Farmland Tax Relief Credits.

15. Effect of Recent Wisconsin Law Changes on Lottery Prize Payments

Before the passage of 1999 Wisconsin Act 9, players of Wisconsin's Very Own Megabucks and Powerball selected the lump-sum or annuity payment option at the time a ticket was purchased. Upon enactment of 1999 Wisconsin Act 9, on October 27, 1999, pre-selection of the payment option at the time a ticket is purchased is no longer necessary. Subject to certain restrictions, Wisconsin Lottery prize winners are currently allowed a 60-day period after becoming entitled to a lottery prize to elect either the lump-sum or the annuity payment option.

1999 Wisconsin Act 9 further provided that lottery prize winners who became entitled to receive payment of a lottery prize on or before October 21, 1998, and who currently received payment of the lottery prize in the form of an annuity, had the option to elect to change the form of payment to a lump sum if the lottery prize is payable over at least ten years. Persons making this election needed do so between July 1, 1999 and December 31, 2000.

Twenty-one past annuity prize winners elected to receive the balance of their prize payments as lump-sum payments during FY 1999-2000, and 12 past annuity prize winners elected the option during FY 2000-01. One additional past annuity prize winner's election, which was received by December 31, 2000, will be processed in FY 2001-02. As a result, the balances of both the investment for prize annuities and the annuity prizes payable accounts decreased by \$75,658,021 in FY 2000-01 and by \$21,651,644 in FY 1999-2000. These accounts will decrease by \$3,823,484 in FY 2001-02. The Wisconsin Lottery did not experience gains or losses on these transactions, since each winner will receive current market value at the time of the conversion.

16. Non-recurring Miscellaneous Revenue

Cash 4 Life Prize Pool Reversion - During FY 2000-01, MUSL returned the Wisconsin Lottery's share of the remaining Cash 4 Life prize pool. The amount in this pool had been recorded as prize expense in the fiscal years that the game was active. As a result, the Wisconsin Lottery's reversion share of \$1,673,733 was treated as a refund of prior years' expense and reported as miscellaneous revenue.

Liquidated Damages - Under a previously negotiated settlement, GTECH Corporation, the Wisconsin Lottery's computer system support supplier, paid damages to the Wisconsin Lottery in FY 2000-01. According to the terms of the agreement, GTECH paid \$500,000 in cash and \$250,000 in supplies. The total of these two payments, \$750,000, was recorded as miscellaneous revenue.

Schedule I

**Reconciliation of Lottery General Operations Expenses to the
Budgetary Basis of Accounting
FY 2000-01**

Salaries and Fringe Benefits	
Per Financial Statement	\$ 4,944,999
Adjustments to Financial Statement Balance:	
Cash paid in FY 2000-01 but expensed in FY 1999-2000	324,531
Cash paid in FY 2001-02 but expensed in FY 2000-01	(183,587)
Budgetary Basis	<u>\$ 5,085,943</u>

Supplies and Services	
Per Financial Statement:	
On-line telecommunication charges	\$ 3,094,601
Product information	4,607,042
Ticket costs	2,893,774
Supplies and services	5,731,096
Depreciation expense	191,189
Total per financial statement	<u>16,517,702</u>
Adjustments to Financial Statement Balance:	
Depreciation expense	(191,189)
Cash paid in FY 1999-2000 but expensed in FY 2000-01	(1,179,821)
Cash paid in FY 2000-01 but expensed in FY 1999-2000	43,066
Cash paid in FY 2000-01 but expensed in FY 2001-02	1,413,367
Cash paid in FY 2001-02 but expensed in FY 2000-01	(38,045)
Cash received in FY 2000-01 but recorded in FY 2001-02	40
Non-cash revenue transactions expensed in FY 2000-01	(250,000)
Supplies purchased with the Vendor Fees Appropriation	(94,953)
Reclassifications between Fixed Assets and Supplies and Services	2,898
Budgetary Basis	<u>\$ 16,223,065</u>

Permanent Property	
Per Financial Statement	\$ 0
Adjustments to Financial Statement Balance:	
FY 2000-01 net permanent property capitalized	(1,497,057)
FY 2000-01 disposal of permanent property	1,684,055
Cash paid in FY 2000-01 but expensed in FY 1999-2000	(60,000)
Budgetary Basis	<u>\$ 126,998</u>

Schedule II

Lottery Administrative Expenses

	Fiscal Year Ended June 30,2001	Fiscal Year Ended June 30,2000	Fiscal Year Ended June 30,1999
Administrative Expenses			
Instant and On-line Vendor Services	\$ 12,116,681	\$ 11,790,160	\$ 11,731,420
Salaries and Fringe Benefits	4,944,999	4,565,186	4,074,586
On-line Telecommunication Charges	3,094,601	3,603,066	3,596,842
Supplies and Services	5,731,096	4,211,556	4,180,626
Product Information	4,607,042	4,488,334	4,541,450
Ticket Costs	2,893,774	3,526,528	2,662,437
Depreciation Expense	191,189	225,410	345,578
Total Administrative Expenses as Determined in Accordance with s. 25.75 (3)(b), Wis. Stats.	<u>\$ 33,579,382</u>	<u>\$ 32,410,240</u>	<u>\$ 31,132,939</u>
Gross Lottery Operating Revenues	<u>\$ 403,754,774</u>	<u>\$ 406,784,089</u>	<u>\$ 428,352,188</u>
Administrative Expenses as a Percentage of Lottery Revenues	8.32%	7.97%	7.27%

S. 25.75(3)(b), Wis. Stats., limits the Lottery's administrative expenses to 10 percent of gross lottery revenues. Gross lottery revenues include lottery ticket sales and retailer fees. Retailer commissions are not included as an administrative expense in the calculation.

Schedule III

Summary of Prize Expenses

Section 25.75(3)(a), Wis. Stats., requires that at least 50 percent of each year's revenues from the sale of lottery tickets be returned as prizes to the holders of winning lottery tickets. The amounts expensed for winning lottery tickets for the past five years, for both instant and on-line games, are summarized below.

Fiscal Year 2000-01			
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$149,827,633	\$237,944,206	63.0%
On-Line Games	<u>83,071,579</u>	<u>163,244,349</u>	50.9
Total for Fiscal Year	\$232,899,212	\$401,188,555	58.1

Fiscal Year 1999-2000			
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$152,238,914	\$241,040,896	63.2%
On-Line Games	<u>80,983,869</u>	<u>165,629,273</u>	48.9
Total for Fiscal Year	\$233,222,783	\$406,670,169	57.3

Fiscal Year 1998-99			
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$143,841,064	\$230,817,635	62.3%
On-Line Games	<u>92,860,756</u>	<u>197,378,447</u>	47.0
Total for Fiscal Year	\$236,701,820	\$428,196,082	55.3

Fiscal Year 1997-98			
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$157,853,848	\$252,915,444	62.4%
On-Line Games	<u>80,548,332</u>	<u>165,724,843</u>	48.6
Total for Fiscal Year	\$238,402,180	\$418,640,287	56.9

Fiscal Year 1996-97			
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$171,935,017	\$273,413,635	62.9%
On-Line Games	<u>72,085,236</u>	<u>157,677,534</u>	45.7
Total for Fiscal Year	\$244,020,253	\$431,091,169	56.6

NOTE: The above amounts are based on an accrual basis of accounting, with adjustments made to prize expenses for unclaimed winning tickets and reserve accounts. For each game, the prize structure represents the number, value, and odds of winning for each prize and is used to estimate the expected amounts to be paid to lottery winners. The games' actual prizes (prize expense) may be less than the games' structure because of unclaimed winning tickets and deposits in reserve accounts.

Independent Auditor's Report on Compliance and on Internal Control over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

We have audited the financial statements of the Wisconsin Lottery as of and for the years ended June 30, 2001 and 2000, and have issued our report thereon dated May 15, 2002. We conducted our audits in accordance with auditing standards generally accepted in the United States 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 Wisconsin Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, 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*.

Internal Control over Financial Reporting

In planning and performing our audits, we considered the Wisconsin 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, which we will be reporting to the management of the Wisconsin Lottery in a separate letter.

This report is intended solely for the information and use of Wisconsin Lottery staff, the Department of Revenue's management, and the Wisconsin Legislature. This independent auditor's report, upon submission to the Joint Legislative Audit Committee, is a matter of public record and its distribution is not limited. However, because we do not express an opinion on compliance or provide assurance on internal control over financial reporting, this report is not intended to be used by anyone other than these specified parties.

LEGISLATIVE AUDIT BUREAU



May 15, 2002

by

Julie Gordon
Audit Director



State of Wisconsin • DEPARTMENT OF REVENUE

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Tommy G. Thompson
Governor

Richard G. Chandler
Secretary of Revenue

May 23, 2002

Ms. Janice Mueller, State Auditor
Legislative Audit Bureau
22 East Mifflin Street, Suite 500
Madison, WI 53703

Dear Ms. Mueller:

We appreciate the opportunity to comment on the Legislative Audit Bureau's annual financial audit and biennial program evaluation of the Wisconsin Lottery. The Department of Revenue (DOR) wishes to thank you and your staff for your detailed, independent analysis.

We are certainly in general agreement with the findings contained in this report regarding the Retailer Performance Program. The department was aware of the program's limitations and had met with Legislative Council and Legislative Audit Bureau staff to explore possible alternatives within restrictions of the current administrative code. The result was the change in chain retailer payment methodology implemented in July 2001 (referenced on page 16 of the audit report). Lottery staff are currently working on analyzing the effectiveness of short-term incentives and are developing recommendations on changes to the overall program. We are looking forward to the opportunity to present these proposed modifications, the estimated impact on sales, and an updated estimate of the administrative costs to the Legislative Audit Committee in January 2003.

We value the Legislative Audit Bureau's continued feedback and guidance regarding the operations of the Wisconsin Lottery. Thank you for your thorough review and we look forward to your future assistance.

Sincerely,

A handwritten signature in cursive script that reads "Richard G. Chandler".

Richard G. Chandler
Secretary of Revenue

RGC:PL:ps