

An Audit

Wisconsin Lottery

Department of Revenue

2005-2006 Joint Legislative Audit Committee Members

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Janice Mueller
State Auditor

July 13, 2006

Senator Carol A. Roessler and
Representative Suzanne Jeskewitz, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Roessler and Representative Jeskewitz:

As required by s. 13.94(1)(em), Wis. Stats., we have completed our annual financial audit 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) 2003-04 and FY 2004-05 financial statements. We also found that the Wisconsin Lottery was in compliance with statutory spending limitations related to prizes, informational advertising, retailer compensation, and administrative expenses.

Lottery sales steadily increased from FY 2000-01 to FY 2003-04, then decreased by \$31.0 million, or 6.4 percent, in FY 2004-05. However, according to unaudited information, FY 2005-06 sales increased to \$508.9 million. Lottery staff attribute these changes to large Powerball jackpots, which have a significant effect on ticket sales. Total operating expenses decreased by \$20.6 million in FY 2004-05, primarily because lottery prizes and retailer commissions and incentives decreased with sales. In FY 2004-05, lottery proceeds of \$143.4 million were distributed to provide property tax relief.

We appreciate the courtesy and cooperation extended to us by Wisconsin Lottery staff in the Department of Revenue.

Respectfully submitted,

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

Janice Mueller
State Auditor

JM/JG/ss

Introduction ■

***The Wisconsin Lottery
sells instant and on-line
game tickets.***

The Wisconsin Lottery began operations in September 1988, after Wisconsin voters adopted a constitutional amendment in 1987 that allowed the Legislature to create a state lottery and required net proceeds to be distributed for property tax relief. Since August 1995, the Department of Revenue has managed the Wisconsin Lottery, which is permitted to sell tickets for instant and on-line games. Instant games are tickets that reveal a prize when consumers remove scratch-off or pull-tab coverings, while on-line games involve consumers picking numbers from an automated system, with winning numbers selected in drawings held at intervals ranging from daily to twice a week.

We completed a financial audit of the Wisconsin Lottery to fulfill our audit responsibilities under s. 13.94(1)(em), Wis. Stats., and have issued an unqualified opinion on its financial statements for the years ended June 30, 2005 and 2004. As part of our financial audit, we reviewed lottery ticket sales, expenses, and property tax distributions through fiscal year (FY) 2004-05. We also assessed compliance with statutory requirements related to prizes and other costs.

Ticket Sales

***Ticket sales decreased
6.4 percent from
FY 2003-04 to
FY 2004-05.***

The Wisconsin Lottery derives over 99 percent of its operating revenues from instant and on-line ticket sales. Total ticket sales steadily increased from \$401.2 million in FY 2000-01 to \$482.9 million in FY 2003-04, as shown in Table 1. However, total ticket sales declined 6.4 percent in FY 2004-05, to \$451.9 million.

Table 1

Wisconsin Lottery Sales
(In Millions)

Fiscal Year	Instant Games	On-Line Games	Total Sales	Percentage Change
2000-01	\$237.9	\$163.3	\$401.2	–
2001-02	238.2	189.4	427.6	6.6%
2002-03	249.5	185.5	435.0	1.7
2003-04	270.3	212.6	482.9	11.0
2004-05	269.9	182.0	451.9	(6.4)

Unaudited information indicates sales increased in FY 2005-06.

According to preliminary, unaudited sales information, FY 2005-06 sales increased 12.6 percent from FY 2004-05 levels to \$508.9 million. Lottery staff attribute the FY 2004-05 decrease and the FY 2005-06 increase primarily to large Powerball jackpots, which have a significant effect on on-line game ticket sales. There were only two Powerball drawings in which the jackpot exceeded \$200 million in FY 2004-05, but nine such drawings in FY 2005-06, including a Powerball record of \$365 million in February 2006.

Lottery Expenses

Prizes paid to winning ticket holders and the commissions and incentives paid to ticket retailers represent the largest share of operating expenses. These expenses increase or decrease in step with fluctuations in sales. The remaining operating expenses consist of game production costs, including instant ticket printing and delivery costs, payments to the vendor that provides and supports the gaming system, and on-line telecommunications charges; product information costs; and other costs, such as staff salaries and fringe benefits.

Operating expenses decreased 6.0 percent in FY 2004-05 largely due to declines in expenses tied to sales.

Total operating expenses increased from \$294.8 million in FY 2000-01 to \$342.4 million in FY 2003-04, as shown in Table 2. However, total operating expenses decreased to \$321.8 million in FY 2004-05, a 6.0 percent reduction from the prior year. Such a decrease is to be expected with lower ticket sales and, therefore, a decrease in lottery prizes and retailer commissions and incentives.

Table 2

Wisconsin Lottery Operating Expenses
(In Millions)

	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05
Prizes	\$232.9	\$241.6	\$248.5	\$275.2	\$262.1
Retailer Compensation	28.3	30.1	30.8	33.9	31.4
Game Production ¹	18.6	19.6	19.2	19.3	14.4
Product Information	4.6	4.5	4.6	4.6	4.6
Other ²	10.4	9.5	9.6	9.4	9.3
Total	\$294.8	\$305.3	\$312.7	\$342.4	\$321.8

¹ Includes instant and on-line vendor services, instant ticket printing, on-line telecommunications, and instant ticket delivery expenses.

² Includes staff salaries, fringe benefits, supplies, and depreciation expenses.

Along with the FY 2004-05 decrease in prize and retailer commission expenses, costs associated with game production also decreased from \$19.3 million in FY 2003-04 to \$14.4 million in FY 2004-05. This decrease is primarily the result of a new contract for instant ticket, on-line ticket, and telecommunications systems. From August 1989 through June 2004, GTECH Corporation provided the computer systems and services for both the instant ticket and on-line games. Telecommunications services for the private dedicated circuits that connect lottery retailers with the gaming systems were provided under a separate contract for approximately \$3.0 million per year.

In January 2001, the Wisconsin Lottery began the process of soliciting proposals for these services. GTECH was chosen as the vendor and, in November 2003, the Wisconsin Lottery and GTECH entered into a seven-year contract that expires in June 2011. Under this contract, GTECH installed a new instant and on-line gaming system, upgraded computer terminals at retail locations, and assumed responsibility for telecommunications services previously provided by a separate vendor.

While all new systems required under the current GTECH contract were functioning in September 2004, the Wisconsin Lottery, its retailers, and GTECH experienced several problems during the implementation. The contract allows the Wisconsin Lottery to assess liquidated damages against GTECH for various processing complications, such as computer failures or "downtime" for the

Wisconsin Lottery or its retailers, failure to install new games in a timely manner, and computer system reports not being available in a timely manner. Liquidated damage amounts are determined based on specific criteria set forth in the contract. Damages may be assessed on a per minute basis for critical functions, such as computer downtime, or on a per day basis for less significant functions, such as late reports.

Lottery staff calculated liquidated damage from July to September 2004 at \$722,363. Through negotiations, the Wisconsin Lottery received benefits with a value of \$822,363, which is \$100,000 more than the damage assessment. GTECH agreed to:

- reduce its invoice for software upgrades from \$600,000 to \$375,000;
- reduce its October 2004 invoice for routine monthly processing and services by \$347,363; and
- provide a \$250,000 credit to be used for future upgrades.

The \$250,000 credit is reflected on the Statement of Net Assets as a prepaid expense.

Statutory Requirements

The Wisconsin Lottery has complied with statutory limits on lottery expenses.

State statutes and legislative actions impose limitations on four types of lottery expenses. The Wisconsin Lottery is in compliance with each of the limitations.

- According to s. 25.75(3)(a), Wis. Stats., prizes must equal at least 50 percent of each year's revenues from the sale of lottery tickets. In FY 2004-05, when ticket sales totaled \$451.9 million, prize expenses totaled \$262.1 million, or 58.0 percent of sales.
- According to s. 25.75(3)(b), Wis. Stats., lottery administrative expenses are limited to no more than 10 percent of gross revenues. Administrative expenses as defined for this purpose include all expenses except prize and retailer compensation expenses. In FY 2004-05, such administrative expenses totaled \$28.3 million, representing less than 6.3 percent of gross revenues.

- The Wisconsin Constitution prohibits the expenditure of public funds for promotional advertising but permits product informational advertising. Through legislative action, the Wisconsin Lottery's informational advertising expenses have been limited to \$4.6 million annually. This expenditure authority was not exceeded in FY 2004-05.
- State statutes establish maximum compensation rates for basic commissions and incentive-based performance payments to retailers who sell lottery tickets. Basic commission rates are 5.5 percent of the retail price for on-line tickets and 6.25 percent for instant tickets. According to s. 565.02(4)(g), Wis. Stats., the performance payments may provide up to 1.0 percent of total sales as compensation to eligible retailers. In FY 2004-05, incentive-based performance payments totaled nearly \$4.0 million, or 0.9 percent of total sales.

The Wisconsin Lottery provided \$143.4 million in property tax relief in FY 2004-05.

As noted, 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 in Wisconsin and through a farmland tax relief credit. In FY 2004-05, lottery proceeds of \$143.4 million were distributed to provide property tax relief. This distribution represented an increase of 9.0 percent from the FY 2003-04 distribution of \$131.6 million.

■ ■ ■ ■

Audit Opinion ■

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

We have audited the accompanying financial statements of the Wisconsin Lottery as of and for the years ended June 30, 2005 and 2004, as listed in the table of contents. These financial statements are the responsibility of the Wisconsin Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As discussed in Note 1, the financial statements referred to in the first paragraph present only the Wisconsin Lottery and do not purport to, and do not, present fairly the financial position of the State of Wisconsin and the changes in its financial position and its cash flows, where applicable, in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Wisconsin Lottery as of June 30, 2005 and 2004, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the financial statements of the Wisconsin Lottery. The supplementary information, including Schedules 1, 2, and 3 and management's discussion and analysis, is presented for purposes of additional analysis and is not a required part of the financial statements. The schedules on pages 40 and 41 have been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, are fairly stated in all material respects in relation to the financial statements taken as a whole. For management's discussion and analysis on pages 11 through 17, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued a report dated July 5, 2006, on our consideration of the Wisconsin Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

July 5, 2006

LEGISLATIVE AUDIT BUREAU

by
Julie Gordon
Audit Director

Management's Discussion and Analysis ■

Prepared by Wisconsin Lottery Management

This section of the Wisconsin Lottery's annual financial report presents management's discussion and analysis of the financial performance of the lottery during the fiscal years ending June 30, 2005 and June 30, 2004. This discussion should be read in conjunction with the accompanying financial statements and notes. The financial statements, notes, schedules, and this discussion are the responsibility of Wisconsin Lottery management.

Financial Highlights

The financial highlights stated below are comparing the financial statements for the fiscal years ended June 30, 2005, and June 30, 2004.

- Operating revenues for lottery activities decreased by \$31.2 million, or 6.5 percent. On-line ticket sales decreased \$30.6 million, or 14.4 percent, while instant ticket sales essentially remained constant at \$269.9 million.
- Operating expenses for the year decreased \$20.6 million, or 6.0 percent. While administrative expenses did not change significantly, prize expense decreased \$13.1 million, or 4.8 percent; retailer commissions and incentives decreased \$2.5 million, or 7.4 percent; vendor services decreased \$1.8 million, or 14.5 percent; and other game related expenses decreased \$3.1 million, or 27.0 percent.

- Investment income increased \$13.0 million, rising to \$2.9 million against the previous year's loss of \$10.1 million.
- Net income before transfers increased \$2.4 million, or 1.8 percent. The increase is a result of the improved performance of non-operating revenue investment income.
- Statutorily defined administrative expenses declined from 6.9 percent of gross operating revenues in FY 2003-04 to nearly 6.3 percent of gross operating revenues in FY 2004-05. Administrative expenses for both years were below the statutory maximum of 10 percent.

Overview of the Financial Statements

The Wisconsin Lottery is accounted for as an enterprise activity/proprietary fund, reporting on all of the activity's assets and liabilities using the accrual basis of accounting, much like a private business entity. As such, its annual financial report consists of a series of financial statements, along with explanatory notes to the financial statements and supplementary schedules. The Statement of Net Assets is on page 20, the Statement of Revenues, Expenses, and Changes in Fund Net Assets is on page 21, and the Statement of Cash Flows is on pages 22 and 23.

The Wisconsin Constitution requires that net proceeds from the operations of the Wisconsin Lottery be used to provide local property tax relief. In addition, balances from other gaming-related appropriations that are not administered by the Department of Revenue (Lottery), including racing and charitable bingo operations, lapse to the Lottery Fund for distribution in the form of property tax relief. As a result, the net assets of the Wisconsin Lottery consist of capital assets (equipment), restricted income related to unrealized fair-market value adjustments to investments, and restricted net assets for property tax relief. To assess the Wisconsin Lottery's financial position and financial health, the reader of these statements should pay particular attention to changes in the components of assets and liabilities as set forth in the Statement of Net Assets. The Statement of Revenues, Expenses, and Changes in Fund Net Assets and the Statement of Cash Flows also provide information on income and expenses that should be reviewed as an indicator of financial performance.

Net Assets

As shown in Table A, total assets decreased by \$16.0 million, or 8.9 percent, and total liabilities decreased by \$5.8 million, or 4.5 percent. As a result, total net assets decreased by \$10.2 million, or 20.3 percent, from FY 2003-04 to FY 2004-05.

Table A

Net Assets
(In Millions)

	FY 2004-05	FY 2003-04	Change	Percentage Change
Investments	\$121.8	\$128.4	\$(6.6)	(5.1)%
Capital Assets (Net of Accumulated Depreciation)	0.2	0.1	0.1	100.0
Other Assets	42.2	51.7	(9.5)	(18.4)
Total Assets	164.2	180.2	(16.0)	(8.9)
Current Liabilities	32.7	30.4	2.3	7.6
Noncurrent Liabilities	91.5	99.6	(8.1)	(8.1)
Total Liabilities	124.2	130.0	(5.8)	(4.5)
Net Assets:				
Invested in Capital Assets	0.2	0.1	0.1	100.0
Restricted for Investment Fair Market Value Adjustment	15.8	14.4	1.4	9.7
Restricted for Property Tax Relief	24.0	35.7	(11.7)	(32.8)
Total Net Assets	<u>\$40.0</u>	<u>\$50.2</u>	<u>\$(10.2)</u>	(20.3)

Investments decreased by \$6.6 million, or 5.1 percent, from FY 2003-04 to FY 2004-05. The decrease is a net result of a \$1.3 million unrealized investment gain from the changes in market value, \$16.5 million in bond redemptions, \$0.6 million in bond purchases, and \$8.0 million in amortization. The decrease in other assets by \$9.5 million, or 18.4 percent, is mainly the result of a \$10.0 million decrease in cash. The decrease in cash was primarily caused by declining operating revenues.

The decrease in total liabilities by \$5.8 million, or 4.5 percent, is primarily attributable to the \$7.9 million decrease in annuity prizes payable, offset by a \$1.4 million increase in accounts payable and a \$0.9 million increase in prizes payable. The annuity prizes payable decrease is a net result of \$16.5 million in bond redemptions, \$0.6 million in bond purchases, and \$8.0 million in amortization.

Total net assets decreased by \$10.2 million. These resources may be used only for restricted purposes. The total FY 2004-05 net assets consisted of \$0.2 million invested in capital assets, \$15.8 million restricted for investment fair market value adjustments, and \$24.0 million restricted for property tax relief. Accounting principles dictate that the gain or loss related to the change in market value of investments be recorded. The investments have been purchased for the payment of installment prize awards and are generally held to maturity. Therefore, the change in the market value of these investments is not available for property tax relief.

Change in Net Assets

As shown in Table B, the Wisconsin Lottery reported a decrease in net assets of \$10.2 million in FY 2004-05 and \$0.6 million in FY 2003-04. The change between years can be primarily attributed to a decrease in total revenues of \$18.2 million, a decrease in total expenses of \$20.6 million, and an increase in operating transfer out for property tax relief of \$11.8 million.

Table B
Changes in Net Assets
(In Millions)

	FY 2004-05	FY 2003-04	Change	Percentage Change
Revenues				
Operating Revenues:				
Ticket sales	\$451.9	\$482.9	\$(31.0)	(6.4)%
Retailer fees and miscellaneous revenue	0.1	0.3	(0.2)	(66.7)
Nonoperating Revenues:				
Investment income (loss)	2.9	(10.1)	13.0	128.7
Total Revenues	454.9	473.1	(18.2)	(3.8)
Expenses				
Program Expenses:				
Prize expense	262.1	275.2	(13.1)	(4.8)
Retailer commissions and incentives	31.4	33.9	(2.5)	(7.4)
Instant and on-line vendor services	10.6	12.4	(1.8)	(14.5)
Other game-related expenses	8.4	11.5	(3.1)	(27.0)
Office Administration Expenses	9.3	9.4	(0.1)	(1.1)
Total Expenses	321.8	342.4	(20.6)	(6.0)
Net Income Before Transfers	133.1	130.7	2.4	1.8
Operating Transfers				
Transfer for Property Tax Relief	(143.4)	(131.6)	11.8	9.0
Transfer In from General Fund	1.0	1.2	(0.2)	(16.7)
Transfer for Compulsive Gambling Programs	(0.3)	(0.3)	0.0	0.0
Transfer for Law Enforcement	(0.3)	(0.3)	0.0	0.0
Transfer for Lottery Credit Administration	(0.2)	(0.2)	0.0	0.0
Transfer Out to General Fund	(0.1)	(0.1)	0.0	0.0
Change in Net Assets	<u>\$(10.2)</u>	<u>\$(0.6)</u>	<u>\$(9.6)</u>	(1600.0)

The decrease in total revenues of \$18.2 million, or 3.8 percent, is mainly the result of ticket sales decreasing by \$31.0 million and investment income increasing by \$13.0 million. The ticket sales results by game category follow this section. Investment income increased by \$13.0 million because the fair market value adjustment to investments resulted in \$10.9 million of investment loss for FY 2003-04, and \$1.3 million in investment income for FY 2004-05. The interest earnings from the state investment pool and the unreserved account at the Multi-State Lottery Association also increased \$0.8 million.

The decrease in total expenses of \$20.6 million, or 6.0 percent, is mainly the result of prize expense decreasing \$13.1 million, retailer commissions and incentives decreasing \$2.5 million, and vendor services decreasing \$1.8 million. In general, prize expense and retailer commissions and incentives are variable expenses, so they increase or decrease in relation to ticket sales. Prize expense results by game category are discussed later. The Wisconsin Lottery's total statutorily defined administrative expenses (instant and on-line vendor services, other game-related expenses, and office administrative expenses) declined from 6.9 percent of gross operating revenues in FY 2003-04 to nearly 6.3 percent of gross operating revenues in FY 2004-05. See Schedule 2 after the notes to the financial statements for more information.

The operating transfer out for property tax relief increased by \$11.8 million, or 9.0 percent. Each year an estimate of total funds available for distribution under the lottery and gaming credit for property taxes is calculated. This calculation analyzes all revenues and expenses of the Wisconsin Lottery with an emphasis on projected ticket sales and prize expense.

Lottery Ticket Sales and Prize Awards

Table C compares ticket sales and prize awards for each lottery game category for FY 2004-05 and FY 2003-04.

Instant scratch ticket sales were down slightly from FY 2003-04 to FY 2004-05. As a percentage of total sales, the sale of \$1 tickets declined while sales at higher price points increased. The Wisconsin Lottery continues to strategically focus on higher price points through marketing and higher prize payouts on those games. Pull-tab sales increased by \$3.2 million from FY 2003-04 to FY 2004-05 as a result of the introduction of a new style of \$2 pull-tab game.

On-line game sales decreased by \$30.6 million from FY 2003-04 to FY 2004-05, primarily because of decreased sales for the Powerball and Wisconsin's Very Own Megabucks games. Sales of jackpot games such as these are driven by the size of the jackpot. In FY 2004-05, there were three periods in which the Powerball jackpots exceeded \$125 million, contrasted with five periods in FY 2003-04.

See Schedule 3 after the notes to the financial statements for a summary of prize expense.

Table C

Lottery Ticket Sales and Prize Awards
(In Millions)

	Ticket Sales			Prize Awards		
	FY 2004-05	FY 2003-04	Change	FY 2004-05	FY 2003-04	Change
Instant						
Scratch	\$263.0	\$266.6	\$(3.6)	\$166.4	\$167.9	\$(1.5)
Pull-tab	6.9	3.7	3.2	4.3	2.3	2.0
Super 2 nd Chance ¹				0.6	0.1	0.5
On-Line						
SuperCash!	25.5	26.6	(1.1)	14.2	14.1	0.1
Powerball	79.3	108.0	(28.7)	38.0	51.7	(13.7)
WI Very Own Megabucks	18.1	20.2	(2.1)	9.6	10.6	(1.0)
Daily Pick 3	24.5	23.9	0.6	12.5	11.6	0.9
Daily Pick 4	10.4	10.1	0.3	4.4	5.2	(0.8)
Badger 5	24.2	23.8	0.4	11.8	11.6	0.2
Super 2 nd Chance ¹				0.3	0.1	0.2
Total	<u>\$451.9</u>	<u>\$482.9</u>	(31.0)	<u>\$262.1</u>	<u>\$275.2</u>	(13.1)

¹ Super 2nd Chance prizes are awarded through drawings to players who send in non-winning scratch and on-line tickets. The prizes are funded from the original purchase of the scratch and on-line tickets.

Other Known Facts

The Wisconsin Lottery relocated the instant ticket warehouse and distribution site from Milwaukee to Madison in September 2004. This relocation has resulted in annual savings of \$294,000 in space rental costs.

The Wisconsin Lottery contracted with the GTECH Corporation for an integrated gaming computer system and services effective November 24, 2003. The integrated system provides telecommunications services that were previously provided under a separate contract. In future financial statements, these telecommunications services will no longer be identified separately. The FY 2004-05 payments to GTECH for all services, including telecommunications charges, were \$10.6 million, which is 31.2 percent less than the \$15.4 million paid to multiple vendors for similar services in FY 2003-04.

Contacting the Lottery's Management

This financial report is designed to provide the Legislature and the executive branch of government, the public, and other interested parties with an overview of the financial results of the Wisconsin Lottery's activities, and to show the Wisconsin Lottery's accountability for the money it receives.

If you have questions about this report or need additional financial information, contact the Lottery Accounting Section at the Wisconsin Lottery, Post Office Box 8931, Mailstop 6-261, Madison, Wisconsin 53708-8931.

If you have questions concerning general program information relating to the Wisconsin Lottery, contact the Deputy Director at the Wisconsin Lottery, Post Office Box 8941, Madison, Wisconsin 53708-8941.

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Financial Statements ■

Statement of Net Assets

June 30, 2005 and 2004

	June 30, 2005	Restated June 30, 2004
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 26,950,193	\$ 36,944,253
Investments for prize annuities (Note 4)	16,421,937	16,384,203
Accounts receivable (Note 5)	6,467,849	5,577,971
Due from other state programs (Note 5)	1,616,724	1,957,821
Ticket inventory	1,334,355	1,217,878
Grand prize deposit (Note 8)	757,651	593,213
Prepaid expenses	298,522	209,825
Interest receivable	58,486	26,095
Total Current Assets	<u>53,905,717</u>	<u>62,911,259</u>
Noncurrent Assets:		
Investments for prize annuities (Note 4)	105,357,009	112,019,781
Grand prize deposit (Note 8)	4,488,000	5,205,536
Prepaid expense	239,319	0
Capital assets: (Note 9)		
Equipment	766,621	1,095,031
Leasehold improvements	197,102	174,102
Accumulated depreciation	<u>(752,820)</u>	<u>(1,174,042)</u>
Total Noncurrent Assets	<u>110,295,231</u>	<u>117,320,408</u>
TOTAL ASSETS	<u>164,200,948</u>	<u>180,231,667</u>
LIABILITIES		
Current Liabilities:		
Annuity prizes payable (Note 6)	16,276,879	16,122,642
Prizes payable	8,824,006	7,919,069
Accounts payable (Note 5)	3,510,666	2,074,333
Due to other state programs (Note 5)	2,739,626	2,536,096
Lottery association payable	285,466	963,836
Deferred revenue	587,048	428,986
Due to other governments (Note 5)	44,327	47,995
Accrued payroll	179,854	181,466
Compensated absences (Note 14)	189,876	146,791
Total Current Liabilities	<u>32,637,748</u>	<u>30,421,214</u>
Noncurrent Liabilities:		
Annuity prizes payable (Note 6)	91,333,568	99,415,446
Compensated absences (Note 14)	189,032	172,551
Total Noncurrent Liabilities	<u>91,522,600</u>	<u>99,587,997</u>
TOTAL LIABILITIES	<u>124,160,348</u>	<u>130,009,211</u>
NET ASSETS		
Net Assets:		
Invested in capital assets, net of related debt	210,903	95,091
Restricted for investment fair market value adjustment (Note 11)	15,794,568	14,444,391
Restricted for property tax relief (Note 11)	<u>24,035,129</u>	<u>35,682,974</u>
TOTAL NET ASSETS	<u>\$ 40,040,600</u>	<u>\$ 50,222,456</u>

The accompanying notes are an integral part of this statement.

Statement of Revenues, Expenses, and Changes in Fund Net Assets for the Years Ended June 30, 2005 and 2004

	Year Ended June 30, 2005	Restated Year Ended June 30, 2004
OPERATING REVENUES		
Instant Ticket Sales (Net of allowances of \$353,570 and \$323,947, respectively)	\$ 269,904,836	\$ 270,286,747
On-Line Ticket Sales (Net of ticket discounts of \$231,640 and \$220,754, respectively)	181,967,204	212,633,592
Retailer Fees	31,888	90,600
Miscellaneous Revenue	90,033	212,795
Total Operating Revenues	451,993,961	483,223,734
OPERATING EXPENSES		
Program Expenses:		
Instant prize expense	171,269,091	170,353,872
On-line prize expense	90,914,744	104,825,472
Retailer commissions and incentives	31,363,039	33,875,780
Instant and on-line vendor services	10,554,846	12,383,706
Product information costs	4,581,492	4,597,224
Instant ticket printing costs	3,195,303	3,347,743
On-line telecommunication charges	42,430	2,976,463
Instant ticket delivery costs	611,882	593,867
Total Program Expenses	<u>312,532,827</u>	<u>332,954,127</u>
Administrative Expenses:		
Salaries and fringe benefits	5,423,616	5,576,760
Supplies and services	3,826,083	3,812,638
Depreciation expense	55,642	62,534
Total Administrative Expenses	<u>9,305,341</u>	<u>9,451,932</u>
Total Operating Expenses	321,838,168	342,406,059
NET OPERATING INCOME	130,155,793	140,817,675
NONOPERATING REVENUES (EXPENSES) AND OPERATING TRANSFERS		
Investment Income (Loss) (Note 7)	2,861,074	(10,133,745)
Gain (Loss) on Disposal of Fixed Assets	19,980	0
Miscellaneous Revenue	28,140	0
Net Income Before Transfers	133,064,987	130,683,930
Operating Transfers:		
Transfers of lottery proceeds for property tax relief (Note 12)	(143,397,558)	(131,603,371)
Transfer in from General Fund	1,031,000	1,276,999
Transfer to Department of Health and Family Services for compulsive gambling programs	(250,000)	(250,000)
Transfer to Department of Justice for law enforcement	(301,354)	(293,947)
Transfer to Department of Revenue for lottery credit administration	(234,375)	(244,007)
Transfer out to General Fund (Note 15)	(94,556)	(135,035)
CHANGE IN NET ASSETS	(10,181,856)	(565,431)
Total Net Assets—Beginning of the Year	50,222,456	50,819,914
Prior-Period Adjustment (Note 16)	0	(32,027)
Total Net Assets—Beginning of the Year Adjusted	<u>50,222,456</u>	<u>50,787,887</u>
Total Net Assets—End of the Year	<u>\$ 40,040,600</u>	<u>\$ 50,222,456</u>

The accompanying notes are an integral part of this statement.

Statement of Cash Flows for the Years Ended June 30, 2005 and 2004

	Year Ended June 30, 2005	Restated Year Ended June 30, 2004
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash Received from Retailers	\$ 449,889,030	\$ 481,829,313
Cash Paid for Prizes	(276,678,426)	(289,528,321)
Cash Paid/Received for Grand Prize Deposit	717,537	2,256,245
Cash Paid to Employees	(5,386,115)	(5,514,749)
Cash Paid to Suppliers	(21,962,259)	(27,934,323)
Cash Paid for Retailer Commissions and Incentives	(31,148,916)	(33,686,589)
Net Cash Provided by Operating Activities	115,430,851	127,421,576
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Transfer of Proceeds for Property Tax Credit	(142,918,071)	(133,548,016)
Transfer of Proceeds from General Fund	1,276,999	1,185,419
Transfer of Proceeds for Law Enforcement	(315,699)	(316,294)
Transfer of Proceeds for Lottery Credit Administration	(232,617)	(254,965)
Transfer of Proceeds for General Fund	(94,556)	(135,035)
Transfer of Proceeds for Compulsive Gambling Programs	(250,000)	(250,000)
Net Cash Used by Noncapital Financing Activities	(142,533,944)	(133,318,891)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Cash Paid for Purchase of Equipment	(171,673)	0
Cash Received from Sale of Equipment	20,200	0
Net Cash Used by Capital and Related Financing Activities	(151,473)	0
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest Received	1,352,467	613,159
Cash Received for Redemption of Bonds	16,524,234	18,520,193
Cash Paid for Purchase of Bonds	(616,195)	(1,721,588)
Net Cash Provided by Investing Activities	17,260,506	17,411,764
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(9,994,060)	11,514,449
Cash and Cash Equivalents—Beginning of the Year	36,944,253	25,429,804
Cash and Cash Equivalents—End of the Year	<u>\$ 26,950,193</u>	<u>\$ 36,944,253</u>

The accompanying notes are an integral part of this statement.

	Year Ended June 30, 2005	Restated Year Ended June 30, 2004
RECONCILIATION OF NET OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Net Operating Income	\$ 130,155,793	\$ 140,817,675
Adjustments to Reconcile Net Operating Income to Net Cash		
Provided by Operating Activities:		
Depreciation expense	55,642	62,534
Noncash donated prize expense	28,140	0
Changes in Assets and Liabilities:		
Decrease (Increase) in receivables	(889,878)	642,266
Decrease (Increase) in Grand Prize deposit	717,536	2,256,245
Decrease (Increase) in ticket inventory	(116,476)	(177,557)
Decrease (Increase) in prepaid expenses	(328,017)	208,125
Decrease (Increase) in Due from other state programs	(1,388)	1,021
Increase (Decrease) in prizes payable	(14,993,927)	(15,184,279)
Increase (Decrease) in deferred revenue	158,062	(648,745)
Increase (Decrease) in Due to other state programs	(167,618)	190,974
Increase (Decrease) in accounts payable	1,437,503	(234,608)
Increase (Decrease) in Lottery Association payable	(678,370)	(543,635)
Increase (Decrease) in Due to other governments	(4,105)	(56,143)
Increase (Decrease) in accrued payroll	(1,612)	39,619
Increase (Decrease) in compensated absences	59,566	48,084
Total Adjustments	<u>(14,724,942)</u>	<u>(13,396,099)</u>
Net Cash Provided by Operating Activities	<u>\$ 115,430,851</u>	<u>\$ 127,421,576</u>
Noncash Activities:		
Net change in unrealized gains and losses	\$ 1,311,777	\$ (10,894,156)
Vendor liquidated damages settlement	250,000	150,000

The accompanying notes are an integral part of this statement.

Notes to the Financial Statements ■

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. During FY 2004-05, the Wisconsin Lottery administered scratch-off, pull-tab, and on-line games.

The Wisconsin Lottery joined the Multi-State Lottery Association (MUSL) in June 1989. In FY 2004-05, the Wisconsin Lottery, as a member of MUSL, participated in one on-line MUSL game, Powerball (start date April 19, 1992).

During FY 2004-05, the Wisconsin 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 Badger 5 (start date February 17, 2003).

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's 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 Fund Net Assets 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 (GAAP) for proprietary funds. The accompanying financial statements were prepared based upon the flow of economic resources focus and full accrual basis of accounting, with revenues recognized when earned and expenses recognized when incurred.

The Statement of Revenues, Expenses, and Changes in Fund Net Assets classifies the Wisconsin Lottery's fiscal year activity as either operating or nonoperating. Because the Lottery Fund is an enterprise fund, which is a type of proprietary fund, it accounts for operations in a manner similar to private businesses in which operating revenues are derived from exchange transactions, such as sales. Operating expenses include the costs of sales, administrative expenses, and depreciation on capital assets.

Certain revenues and expenses that are not related to the Wisconsin Lottery's primary purpose, such as investment income or the gain or loss on the disposal of capital assets, are reported as nonoperating revenues and expenses.

The Wisconsin Lottery applies all Governmental Accounting Standards Board (GASB) pronouncements, as well as the following pronouncements issued on or before November 30, 1989, unless these pronouncements conflict with or contradict GASB pronouncements: Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedure.

The State of Wisconsin monitors expenses 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 expenses is shown in Schedule 1.

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 2004-05 and FY 2003-04. 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 2004-05 and FY 2003-04 had a winning ticket component, a short-term incentive component, and a sales goals 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.

Up to four short-term incentives a year may be offered for predefined lengths of time. They focus on supporting one product or category of ticket products. Each incentive has a predetermined goal, which lottery retailers must achieve to receive additional compensation. Short-term incentives are limited to a total of \$400,000 per fiscal year, and no more than \$100,000 of funding can be expended on any one short-term incentive.

The sales goals incentive component allows participating retailers to earn additional commissions based on increased sales realized in any of three product categories: instant tickets, on-line non-jackpot games (SuperCash!, Daily Pick 3, Daily Pick 4, and Badger 5), and on-line jackpot games (Wisconsin's Very Own Megabucks and Powerball). For the retailer incentive program, the Wisconsin Lottery considers an on-line jackpot game to have a large top prize that may be paid as an annuity or cash option. An on-line non-jackpot prize is smaller and offers only a cash option for payment. 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 for instant tickets and on-line non-jackpot games, which are paid to them quarterly. Due to the random nature of the on-line jackpot games and the overall program cap, sales goals incentive program payments for on-line jackpot games are calculated and made annually.

F. Administrative Expenses

Administrative expenses, as defined by state statutes, 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 2.

G. Prizes

In accordance with Wisconsin Statutes, at least 50 percent of lottery sales 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 3.

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 or at the end of ticket distribution for a given game, whichever occurs first.

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.

Depending on the on-line game, on-line tickets are sold for up to eight future drawings. 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. Capital Assets

Capital 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	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 Statement of Net Assets 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 Net Lottery Proceeds

The Wisconsin Lottery disburses net 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. DEPOSITS

The Wisconsin Lottery had a balance of \$196 in the State's bank on June 30, 2005, and \$829 on June 30, 2004.

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 and have granted derivatives authority, subject to review and approval by the State of Wisconsin Investment Board's Investment Committee, limited to positions in finance futures, options, and swaps, and only if the purpose is to hedge existing positions, adjust portfolio duration within statutory guidelines, or reduce the interest rate risk. The State Investment Fund is not registered with the Securities and Exchange Commission.

4. INVESTMENTS

Investments have been purchased by the Wisconsin Lottery to finance jackpot prizes that are payable as annuities over the 20-year or 25-year period. The Wisconsin Lottery follows MUSL's policies, which require that these investments for prize annuities be in the form of securities that are backed by the full faith and credit of the United States government or its agencies. 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 Wisconsin Lottery held U. S. Treasury and Agency investments with the following maturities as of June 30, 2005 and 2004:

<u>Maturity</u>	<u>June 30, 2005</u>	<u>June 30, 2004</u>
Less than 1 Year	\$ 16,421,937	\$ 16,384,203
1 to 5 Years	65,558,937	71,412,470
6 to 10 Years	23,339,945	24,417,321
More than 10 Years	<u>16,458,127</u>	<u>16,189,990</u>
Total	<u>\$121,778,946</u>	<u>\$128,403,984</u>

5. ACCOUNTS RECEIVABLE AND ACCOUNTS PAYABLE BALANCES

Accounts receivable and accounts payable balances are disaggregated as follows:

A. Accounts Receivable

	<u>June 30, 2005</u>	<u>June 30, 2004</u>
Accounts Receivable:		
Retailers	\$6,467,426	\$5,576,896
Miscellaneous	<u>423</u>	<u>1,075</u>
Total Accounts Receivable	<u>\$6,467,849</u>	<u>\$5,577,971</u>
Due from Other State Programs:		
Transfers for Gaming	\$1,031,000	\$1,276,757
Transfers for Farmland Tax Credit	584,561	681,047
Miscellaneous	<u>1,163</u>	<u>17</u>
Total Due from Other State Programs	<u>\$1,616,724</u>	<u>\$1,957,821</u>

B. Accounts Payable

	<u>June 30, 2005</u>	<u>June 30, 2004</u>
Accounts Payable:		
Vendors	\$3,462,664	\$2,044,446
Employee Travel Reimbursement	669	1,774
Withholding on Prizes	28,999	5,000
Law Enforcement	178	402
Lottery Credit Administration	2,645	3,591
Miscellaneous	<u>15,511</u>	<u>19,120</u>
Total Accounts Payable	<u>\$3,510,666</u>	<u>\$2,074,333</u>
Due to Other State Programs:		
Farmland Tax Credit	\$2,222,425	\$1,839,423
Due to Other State Programs	131,703	385,839
Employee Fringe Benefits	118,217	133,275
Law Enforcement	11,186	25,320
Lottery Credit Administration	17,303	15,024
Withholding on Prizes (FY 2003-04 restated)	<u>238,792</u>	<u>137,215</u>
Total Due to Other State Programs	<u>\$2,739,626</u>	<u>\$2,536,096</u>

	<u>June 30, 2005</u>	<u>June 30, 2004</u>
Due to Other Governments:		
Employee Fringe Benefits	\$ 40,617	\$ 44,472
Withholding on Prizes (FY 2003-04 restated)	(250)	0
Law Enforcement	2,168	2,155
Lottery Credit Administration	<u>1,792</u>	<u>1,368</u>
Total Due to Other Governments	<u>\$44,327</u>	<u>\$47,995</u>

6. ANNUITY PRIZES PAYABLE

The Wisconsin Lottery has an unconditional obligation to pay all prize winners the future value of the prize. The reported value of future jackpot 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 \$7,971,224 for FY 2004-05 and \$8,597,551 for FY 2003-04. See Note 4 for information related to the investments for prize annuities.

The reported values of future prize payment obligations were as follows:

<u>Fiscal Year</u>	<u>FY 2004-05 Total Payments</u>	<u>FY 2003-04 Total Payments</u>
2004-05	-	\$ 16,515,950
2005-06	\$ 16,674,962	16,642,851
2006-07	16,806,053	16,773,792
2007-08	16,942,383	16,908,929
2008-09	16,935,179	16,900,486
2009-10	14,522,529	14,486,553
Subsequent Years	<u>74,005,827</u>	<u>73,003,242</u>
Future Prize Payments	155,886,933	171,231,803
Less: Present Value Adjustment	<u>48,276,486</u>	<u>55,693,715</u>
Present Value of Future Prize Payments	<u>\$107,610,447</u>	<u>\$115,538,088</u>

Annuity prizes payable activity for the fiscal years ended June 30, 2005, and June 30, 2004, was as follows:

<u>Fiscal Year</u>	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>	<u>Due within One Year</u>
2004-05	\$115,538,088	\$ 8,587,419	\$(16,515,060)	\$107,610,447	\$16,276,879
2003-04	123,731,259	10,319,139	(18,512,310)	115,538,088	16,122,642

7. INVESTMENT INCOME (LOSS)

The investment income shown on the financial statements consists of several elements, as follows:

	<u>FY 2004-05</u>	<u>FY 2003-04</u>
Interest from State Investment Fund	\$ 1,342,683	\$ 621,160
Net Increase (Decrease) in Fair Value of Annuity Investments	9,283,002	(2,296,605)
Decrease for Amortization of Annuity Investments	(7,971,224)	(8,597,552)
Net Change in Fair Value of State Investment Fund	38,399	(8,063)
Interest from MUSL Prize Reserve Accounts	164,438	144,091
Miscellaneous Interest	<u>3,776</u>	<u>3,224</u>
Total Investment Income	<u>\$2,861,074</u>	<u>\$(10,133,745)</u>

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 game should a winning ticket not be properly paid. 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, 2 percent of draw sales is distributed to the Prize Reserve Account (PRA) and the 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 Wisconsin Lottery's portion of the Powerball grand prize deposit is made up of the following:

	<u>June 30, 2005</u>	<u>June 30, 2004</u>
Prize Reserve Account (PRA)	\$3,468,000	\$4,022,460
Balance of Unreserved Account	757,651	593,213
Set Prize Reserve Account (SPRA)	<u>1,020,000</u>	<u>1,183,076</u>
Total Powerball Grand Prize Deposit	<u>\$5,245,651</u>	<u>\$5,798,749</u>

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.

9. CAPITAL ASSETS

Capital asset activity for the fiscal year ended June 30, 2005, was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Leasehold Improvements	\$ 174,102	\$ 23,000	\$ 0	\$ 197,102
Equipment	<u>1,095,031</u>	<u>148,673</u>	<u>(477,083)</u>	<u>766,621</u>
Total Capital Assets	<u>1,269,133</u>	<u>171,673</u>	<u>(477,083)</u>	<u>963,723</u>
Less Accumulated Depreciation for:				
Leasehold Improvements	68,655	11,592	0	80,247
Equipment	<u>1,105,387</u>	<u>44,050</u>	<u>(476,864)</u>	<u>672,573</u>
Total Accumulated Depreciation	<u>1,174,042</u>	<u>55,642</u>	<u>(476,864)</u>	<u>752,820</u>
Total Capital Assets, Net	<u>\$ 95,091</u>	<u>\$116,031</u>	<u>\$ (219)</u>	<u>\$210,903</u>

Capital asset activity for the fiscal year ended June 30, 2004, was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Leasehold Improvements	\$ 174,102	\$ 0	\$ 0	\$ 174,102
Equipment	1,118,131	0	(21,100)	1,097,031
Prior-Period Adjustment	<u>(2,000)</u>	<u>0</u>	<u>0</u>	<u>(2,000)</u>
Total Capital Assets	<u>1,290,233</u>	<u>0</u>	<u>(21,100)</u>	<u>1,269,133</u>
Less Accumulated Depreciation for:				
Leasehold Improvements	55,542	13,113	0	68,655
Equipment	1,058,929	49,421	(21,100)	1,087,250
Prior-Period Adjustment	<u>18,137</u>	<u>0</u>	<u>0</u>	<u>18,137</u>
Total Accumulated Depreciation	<u>1,132,608</u>	<u>62,534</u>	<u>(21,100)</u>	<u>1,174,042</u>
Total Capital Assets, Net	<u>\$ 157,625</u>	<u>\$(62,534)</u>	<u>\$ 0</u>	<u>\$ 95,091</u>

10. 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 2004-05. The lease for the Milwaukee facility expired August 31, 2004. The Madison Beltline facility lease expired August 31, 2004. The Wisconsin Lottery leased a new facility on Dairy Drive in Madison, effective September 1, 2004, which is used for storage and instant ticket operations.

The following schedule summarizes the future minimum lease payments required under operating leases for the Milwaukee and Madison Beltline and Dairy Drive facilities. The Dairy Drive facility has a five-year lease, which runs until August 31, 2009, with two three-year extensions.

	<u>June 30, 2005</u>	<u>June 30, 2004</u>
Fiscal Year Ending June 30, 2005	–	\$163,030
2006	\$142,257	142,257
2007	143,389	143,389
2008	144,555	144,555
2009	<u>145,756</u>	<u>0</u>
Total Minimum Payments Required	<u>\$575,957</u>	<u>\$593,231</u>

Total lease expenses for the Wisconsin Lottery amounted to \$163,030 for the fiscal year ended June 30, 2005, and \$438,880 for the fiscal year ended June 30, 2004.

11. RESTRICTED NET ASSETS

The Wisconsin Lottery has restricted net assets for fair value adjustments of investments of \$15,794,568 as of June 30, 2005, and \$14,444,391 as of June 30, 2004. 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 are not available for distribution as property tax credits.

The portion of restricted net assets related to capital assets is reported in detail in Note 9.

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. This balance makes up the remainder of the restricted net assets.

12. DISTRIBUTION OF NET PROCEEDS

Wisconsin Lottery net proceeds and other gaming-related proceeds were used for the following purposes:

	<u>FY 2004-05</u>	<u>FY 2003-04</u>
Lottery Tax Credit	\$131,702,989	\$118,350,953
Farmland Tax Credit	<u>11,694,569</u>	<u>13,252,418</u>
Total Credits	<u>\$143,397,558</u>	<u>\$131,603,371</u>

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 may be obtained by writing to:

Department of Employee Trust Funds
Post Office Box 7931
Madison, WI 53707-7931

The report is also available on the Department of Employee Trust Funds' Web site, <http://etf.wi.gov>.

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. However, in December 2003 the State issued bonds and subsequently fully liquidated its prior service liability balance as of January 2003. The liquidation of the State's prior service liability resulted in credits being granted to state agencies for amounts already paid in 2003. In addition, state agencies are required to make future contributions to fund the bond payments.

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 \$355,201 for FY 2004-05 and \$386,391 for FY 2003-04. 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. COMPENSATED ABSENCES

Compensated absence activity for the fiscal years ended June 30, 2005, and June 30, 2004, was as follows:

<u>Fiscal Year</u>	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>	<u>Due within One Year</u>
2004-05	\$319,342	\$206,358	\$(146,792)	\$378,908	\$189,876
2003-04	271,258	175,100	(127,016)	319,342	146,791

15. TRANSFERS TO THE GENERAL FUND

- A. Sections 9101(9) and (9q) of 2003 Wisconsin Act 33 gave the State of Wisconsin authority to issue annual appropriation bonds to pay off certain unfunded liabilities in the pension and other employee benefit programs, resulting in cost savings to state agencies. As a result of these savings, the Wisconsin Lottery transferred \$92,456 to the State's General Fund in FY 2004-05 and \$132,935 in FY 2003-04.
- B. Section 9160(3f) of 2003 Wisconsin Act 33 required a fifth week vacation lapse of \$2,100 that was transferred to the General Fund in FY 2004-05 and \$2,100 in FY 2003-04.

16. RESTATEMENT OF FY 2003-04 FINANCIAL STATEMENTS

- A. The Due to Other State Programs account increased by \$164,432 and the Due to Other Governments account decreased by \$152,541 to correct errors in prior years. The effect on ending net assets is a decrease of \$11,891.
- B. An adjustment was made to decrease capital assets by \$2,000 and to increase accumulated depreciation by \$18,137 for previously unrecorded depreciation and miscoding of an inventoried item as a capitalized asset. The effect on ending net assets is a decrease of \$20,137.

■ ■ ■ ■

Supplementary Information ■

Reconciliation of Lottery General Operations Expenses to the Budgetary Basis of Accounting—FY 2004-05

SALARIES AND FRINGE BENEFITS

Per Financial Statement	\$ 5,423,616
Adjustments to Financial Statement Balance:	
Cash paid in FY 2004-05 but expensed in FY 2003-04	381,952
Cash paid in FY 2005-06 but expensed in FY 2004-05	(447,445)
Reclass fringe benefits to transfer out to General Fund	84,155
Budgetary Basis—Salaries and Fringe Benefits	\$ 5,442,278

SUPPLIES AND SERVICES AND PERMANENT PROPERTY

Per Financial Statement:	
Product information costs	\$ 4,581,492
Supplies and services	3,826,083
Instant ticket printing costs	3,195,303
Instant ticket delivery costs	611,882
Depreciation expense	55,642
On-line telecommunications charges	\$ 42,430
Total per Financial Statement	12,312,832
Adjustments to Financial Statement Balance:	
Depreciation expense	(55,642)
Cash paid in FY 2003-04 but expensed in FY 2004-05	(1,217,880)
Cash paid in FY 2004-05 but expensed in FY 2003-04	(4,248)
Cash paid in FY 2004-05 but expensed in FY 2005-06	1,334,355
Cash paid in FY 2005-06 but expensed in FY 2004-05	204,946
Supplies purchased with Lottery's vendor fees appropriation	(540,000)
Compulsive gambling payment not included above	250,000
Banking fees paid with Department of Administration's banking fees appropriation	(38,986)
Noncash revenue transaction expensed in FY 2004-2005	(35,585)
FY 2004-05 capitalized permanent property less disposals	171,673
Budgetary Basis—Supplies and Services	\$ 12,381,465

Statutorily Defined Lottery Administrative Expenses for the Years Ended June 30, 2003 through 2005

	Year Ended June 30, 2005	Year Ended June 30, 2004	Year Ended June 30, 2003
ADMINISTRATIVE EXPENSES			
Instant and On-Line Vendor Services	\$ 10,554,846	\$ 12,383,706	\$ 12,464,364
Salaries and Fringe Benefits	5,423,616	5,576,760	5,399,940
On-Line Telecommunications Charges	42,430	2,976,463	3,093,877
Supplies and Services	3,826,083	3,812,638	4,181,717
Product Information Costs	4,581,492	4,597,224	4,579,937
Instant Ticket Printing Costs	3,195,303	3,347,743	3,117,049
Instant Ticket Delivery Costs	611,882	593,867	554,808
Depreciation Expense	55,642	62,534	63,688
Total Administrative Expenses as Determined in Accordance with s. 25.75(3)(b), Wis. Stats.	<u>\$ 28,291,294</u>	<u>\$ 33,350,935</u>	<u>\$ 33,455,380</u>
Gross Lottery Operating Revenues	<u>\$ 451,993,961</u>	<u>\$ 483,223,734</u>	<u>\$ 435,119,501</u>
Administrative Expenses as a Percentage of Lottery Operating Revenues	6.26%	6.90%	7.69%

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

Summary of Prize Expenses for the Years Ended June 30, 2001 through 2005

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 2004-05		
	Prize Expense	Ticket Sales	Prize Expense as a Percentage of Sales
Instant Games	\$ 171,269,091	\$ 269,904,836	63.5%
On-Line Games	90,914,744	181,967,204	50.0
Total for Fiscal Year	\$ 262,183,835	\$ 451,872,040	58.0

	Fiscal Year 2003-04		
	Prize Expense	Ticket Sales	Prize Expense as a Percentage of Sales
Instant Games	\$ 170,353,872	\$ 270,286,747	63.0%
On-Line Games	104,825,472	212,633,592	49.3
Total for Fiscal Year	\$ 275,179,344	\$ 482,920,339	57.0

	Fiscal Year 2002-03		
	Prize Expense	Ticket Sales	Prize Expense as a Percentage of Sales
Instant Games	\$ 158,065,880	\$ 249,467,428	63.4%
On-Line Games	90,443,737	185,570,386	48.7
Total for Fiscal Year	\$ 248,509,617	\$ 435,037,814	57.1

	Fiscal Year 2001-02		
	Prize Expense	Ticket Sales	Prize Expense as a Percentage of Sales
Instant Games	\$ 150,658,770	\$ 238,214,016	63.2%
On-Line Games	90,940,299	189,336,327	48.0
Total for Fiscal Year	\$ 241,599,069	\$ 427,550,343	56.5

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

NOTE: The above amounts are based on an accrual basis of accounting, with adjustments made to prize expense 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.

Report on Control and Compliance ■

Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters 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, 2005 and 2004, and have issued our report thereon dated July 5, 2006. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

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 an opinion 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 that might be material weaknesses. A material weakness is a reportable 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 caused by error or fraud 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.

COMPLIANCE AND OTHER MATTERS

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 or other matters that are required to be reported under *Government Auditing Standards*.

However, we noted other instances of immaterial noncompliance involving the use of lottery resources for purposes other than property tax relief. The Department of Administration transferred \$94,556 in FY 2004-05 and \$135,035 in FY 2003-04 from the Lottery Fund to the State's General Fund. These lapses were required by the 2003-05 Biennial Budget Act to help address the State's deficit. Article IV, s. 24(6)(a) of the Wisconsin Constitution requires the net proceeds of the state lottery be used only for property tax relief.

This independent auditor's report is intended 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 internal control over financial reporting or on compliance, this report is not intended to be used by anyone other than these specified parties.

July 5, 2006

LEGISLATIVE AUDIT BUREAU

by
Julie Gordon
Audit Director