

AN AUDIT

Wisconsin Lottery

Department of Revenue

00-6

June 2000

1999-2000 Joint Legislative Audit Committee Members

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State of Wisconsin \ LEGISLATIVE AUDIT BUREAU

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June 12, 2000

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

Dear Senator George and Representative Kelso:

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) 1998-99 and FY 1997-98 financial statements.

Total lottery sales increased from \$418.6 million in FY 1997-98 to nearly \$428.2 million in FY 1998-99. This increase, which is the first since FY 1994-95, is due largely to several large on-line jackpots. For example, in July 1998, the Powerball jackpot reached a record amount of \$295.7 million. Sales of instant ticket lottery games, however, continued a four-year decline from \$252.9 million in FY 1997-98 to \$230.8 million in FY 1998-99.

During our audit, we identified a concern related to payment of liquidated damages. In June 1997, GTECH Corporation implemented a new computer system to support the Lottery's instant ticket and on-line games. Between June 1997 and April 1999, GTECH Corporation experienced significant complications with the system and the Lottery assessed liquidated damages totaling \$2.53 million. GTECH has already paid the Lottery \$235,200 in the form of sales credits on its monthly invoices. Recently, the Lottery and GTECH have agreed to a tentative settlement of \$750,000, including \$500,000 in cash, to resolve the outstanding balance due. The remaining \$250,000 will be received in the form of goods and services, which GTECH may contract with any vendor to provide. To ensure sufficient legislative and budgetary oversight of the tentative \$750,000 settlement, we recommend that the Lottery report to the Legislature on its plans for these funds.

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

Respectfully submitted,

Janice Mueller
State Auditor

JM/JG/ao

SUMMARY

The Wisconsin Lottery, which sells tickets for instant and on-line lottery games, began operations in September 1988 and has been under the management of the Department of Revenue since August 1995. 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, 1999 and 1998.

During our audit, we noted that, for the first time since fiscal year (FY) 1994-95, overall lottery sales increased. This increase from \$418.6 million in FY 1997-98 to nearly \$428.2 million in FY 1998-99 is primarily due to several large on-line jackpots, including a record Powerball jackpot of \$295.7 million in July 1998. Because Lottery staff cannot control jackpot size, future on-line lottery sales may not continue at this level. Sales of instant ticket lottery games have continued to decline, from \$252.9 million in FY 1997-98 to \$230.8 million in FY 1998-99.

As part of our audit, we also reviewed the computer system that supports the Lottery's instant ticket and on-line games. In October 1996, the Lottery awarded GTECH Corporation a contract, worth approximately \$11.7 million in FY 1998-99, to provide and maintain this computer system. Significant processing complications were encountered upon implementation of the GTECH system and, between June 1997 and April 1999, the Lottery assessed liquidated damages of \$2.53 million against GTECH as provided for in the contract.

Through negotiations, Lottery and GTECH have tentatively agreed that, in addition to \$235,200 previously received by the Lottery in the form of sales credits, a one-time payment of \$750,000 would settle the outstanding liquidated damages balance. Under the terms of the agreement, GTECH will pay the Lottery \$500,000 in cash and \$250,000 in goods and services. In addition, the Lottery may require GTECH to contract with another vendor, if the desired goods and services can not be provided directly by GTECH. Lottery staff indicated there is currently no detailed plan for specific goods and services to be purchased with the \$250,000. We believe receiving payment in the form of goods and services will circumvent the legislative and budgetary process. Therefore, we include a recommendation that the Wisconsin Lottery report to the Legislature on its planned use of the GTECH settlement.

CONTRACT LIQUIDATED DAMAGES

Throughout its history, the Wisconsin Lottery has relied on private contractors to provide significant operating assistance. Computer services have been, and continue to be, a major area of contracting. Since 1989, the Wisconsin Lottery has contracted with GTECH Corporation to operate a computer system supporting its on-line games, such as Powerball and Wisconsin's Very Own Megabucks.

GTECH Corporation was awarded the instant-ticket and on-line system contracts in 1996.

In 1994, the Wisconsin Lottery concluded that a state-run system that supported its instant ticket lottery games was inadequate to meet current and future lottery needs. A study commissioned by the Lottery concluded that contracting with a private company for instant ticket computer services would be more cost-effective than updating the old system or purchasing a new one. As a result of this study and as part of an extensive privatization initiative, the Lottery in 1996 requested bids to operate a computer system to support on-line lottery games and another system to support instant ticket games. In October 1996, the Lottery awarded both contracts to GTECH Corporation.

On June 15, 1997, GTECH Corporation implemented a computer system, known as Pro:Sys, to fulfill the terms of both contracts. The primary function of Pro:Sys include:

- maintaining inventory records for instant lottery tickets by recording the purchase of tickets from the printer and the sale of tickets to retailers;
- validating tickets by ensuring winning tickets are legitimate and have not previously been paid;
- recording instant ticket and on-line lottery sales;
- billing retailers on a weekly basis; and
- generating sales reports for lottery management.

Computer system vendor payments represent 38 percent of the Lottery's administrative expenses.

Under the terms of a five-year contract, the Wisconsin Lottery pays GTECH Corporation an annually determined fixed fee, plus 0.2 percent of sales. The fixed fee for instant ticket lottery games is \$723,000 annually, while the fee for on-line games increases from \$10.0 million in year one of the contract to \$10.8 million in year five. During fiscal year (FY) 1997-98 and FY 1998-99, total payments to

GTECH Corporation totaled \$11,659,039 and \$11,731,420, respectively. These amounts represent approximately 38 percent of the Lottery's administrative expenses.

Collection of liquidated damages reduces expenditures and increases the amount available for property tax relief.

The contract also allows the Wisconsin Lottery to assess liquidated damages against GTECH Corporation for various processing complications. Payment of liquidated damages reduces the Lottery's expenditures, resulting in higher net income and increased amounts available for providing property tax relief. Liquidated damage amounts are determined based on specific criteria set forth in the contract. Examples of situations that may warrant the assessment of liquidated damages are computer failure 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. Damages are typically 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. The damage amounts are credited against the next monthly invoice, thereby reducing the Lottery's monthly payment to GTECH Corporation.

Significant computer system problems were identified after system implementation.

After the implementation of Pro:Sys in June 1997, the Wisconsin Lottery, its retailers, and GTECH Corporation experienced significant complications with the system. For example, for various periods of time:

- instant ticket validations could not be performed;
- the hotline telephone number for retailer questions and concerns was unavailable; and
- invoices were not available for retailers.

The Lottery experienced its most significant computer system difficulties between June 15, 1997, and January 15, 1998. For that time period, it assessed over \$2.97 million in liquidated damages against GTECH Corporation. In March 1999, the Lottery reevaluated these damage assessments and reduced the assessment to \$1.23 million, as shown in Table 1. Lottery staff indicated the reassessment was necessary because, in some instances, the computer system difficulties were misreported or the incorrect contract sections were applied when determining the per minute or per day charge, resulting in overstated liquidated damage assessments. Since January 15, 1998, additional liquidated damages of \$1.30 million have been assessed. Of the total liquidated damages of \$2.53 million, only \$235,213 has been collected. For computer system problems after April 30, 1999, liquidated damages have been assessed and collected on a timely basis.

Table 1

Liquidated Damages Assessments
June 15, 1997 through April 30, 1999

<u>Assessment Period</u>	<u>Assessment</u>	<u>Collected</u>	<u>Balance Due</u>
June 15, 1997 to January 15, 1998	\$1,232,067	\$151,052	\$1,081,015
January 16-31, 1998	37,697	-	37,697
February 1998	268,472	-	268,472
March 1998	217,429	-	217,429
April 1998	80,289	-	80,289
May 1998	115,386	84,161	31,225
June 1998	184,747	-	184,747
July 1998	41,768	-	41,768
August 1998	26,187	-	26,187
September 1998	34,038	-	34,038
October 1998	25,796	-	25,796
November 1998	5,752	-	5,752
December 1998	15,569	-	15,569
January 1, 1999 to April 30, 1999	<u>247,386</u>	<u>-</u>	<u>247,386</u>
Totals	\$2,532,583	\$235,213	\$2,297,370

Given the volume of problems, Lottery staff indicated that it has been difficult to determine the total amount of liquidated damages. Therefore, they attempted to negotiate a settlement amount with GTECH Corporation to fairly compensate the Lottery and its retailers for computer system problems. Through negotiations, the Lottery and GTECH have tentatively agreed that, in addition to \$235,200 previously received by the Lottery in the form of sales credits on its monthly invoices, a one-time payment of \$750,000 would be paid by GTECH Corporation to settle the outstanding balance due.

Lottery staff indicated this agreement will require GTECH Corporation to pay the Wisconsin Lottery \$500,000 in cash and provide \$250,000 in goods and services, which do not necessarily have to be provided directly from GTECH. Therefore, based on the terms of this agreement, the Wisconsin Lottery could require GTECH Corporation to contract with another vendor to provide goods or services, such as computer hardware or marketing research. These goods or services, if purchased through GTECH, will not appear as an expenditure on the Lottery's financial statements. Lottery staff added that, currently, there is no plan for how the \$250,000 will be spent.

To ensure there is sufficient legislative and budgetary oversight of the use of the settlement funds, we recommend the Wisconsin Lottery report to the Legislature's Joint Finance Committee and Joint Audit Committee by September 1, 2000, on its planned use of the GTECH settlement.

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, 1999 and 1998, 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 generally accepted auditing standards 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 proprietary fund types 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 changes in financial position of its proprietary fund types 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, 1999 and 1998, and the results of its operations and cash flows for the years then ended in conformity with generally accepted accounting principles.

The Wisconsin Lottery implemented Governmental Accounting Standards Board Statement 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, during fiscal year 1997-98, as discussed in Note 3 to the financial statements.

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 purposes 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 March 22, 2000, and provided on page 35, 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.

LEGISLATIVE AUDIT BUREAU

March 22, 2000

by

Julie Gordon
Audit Director

Wisconsin Lottery
Balance Sheet
June 30, 1999 and 1998

	<u>June 30, 1999</u>	<u>June 30, 1998</u>
Assets		
Current Assets:		
Cash and cash equivalents	\$ 49,116,117	\$ 69,834,291
Investments for prize annuities	25,336,820	24,026,458
Accounts receivable	15,003,081	5,993,644
Grand prize deposit	9,273,458	9,681,343
Prepaid expenses	1,364,210	1,401,064
Ticket inventory	2,065,078	1,911,154
Interest receivable	174,955	308,104
Due from other state programs	691,802	932,391
Total Current Assets	103,025,521	114,088,449
Noncurrent Assets:		
Investments for prize annuities	235,775,330	240,567,253
Equipment (net of accumulated depreciation)	514,919	747,497
Leasehold improvements (net of accumulated depreciation)	59,823	90,926
Total Noncurrent Assets	236,350,072	241,405,676
Total Assets	<u>\$ 339,375,593</u>	<u>\$ 355,494,125</u>
Liabilities and Equity		
Current Liabilities:		
Annuity prizes payable	\$ 25,559,827	\$ 24,288,163
Prizes payable	9,808,451	6,957,122
Accounts payable	3,702,795	2,422,643
Lottery association payable	3,962,690	1,202,073
Due to other state programs	4,317,064	10,111,963
Deferred revenue	437,146	801,454
Due to other governments	193,401	239,912
Accrued payroll	243,215	190,821
Compensated absences	170,112	126,495
Total Current Liabilities	48,394,701	46,340,646
Long-Term Liabilities:		
Annuity prizes payable	227,133,700	219,947,414
Total Liabilities	275,528,401	266,288,060
Equity:		
Contributed capital	50,751	50,751
Retained earnings:		
Unreserved	48,516,728	62,983,991
Reserved for investment fair market value adjustment	15,279,713	26,171,323
Total Liabilities and Equity	<u>\$ 339,375,593</u>	<u>\$ 355,494,125</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, 1999 and 1998

Operating Revenues	<u>June 30, 1999</u>	<u>June 30, 1998</u>
Instant Ticket Sales	\$ 230,817,635	\$ 252,915,444
On-Line Ticket Sales	197,378,447	165,724,843
Retailer Fees	39,310	112,760
Miscellaneous Revenue	116,796	99,774
Total Operating Revenues	<u>428,352,188</u>	<u>418,852,821</u>
Operating Expenses		
Program Expenses:		
Instant prize expense	143,841,064	157,853,848
On-line prize expense	92,860,756	80,548,332
Retailer commissions	25,926,590	24,632,014
Total Program Expenses	<u>262,628,410</u>	<u>263,034,194</u>
Administrative Expenses:		
Instant and on-line vendor services	11,731,420	11,659,039
Salaries and fringe benefits	4,074,586	3,538,468
On-line telecommunication charges	3,596,842	3,532,029
Supplies and services	4,180,626	4,363,801
Product information	4,541,450	4,347,039
Ticket costs	2,662,437	2,560,351
Depreciation expense	345,578	625,710
Total Administrative Expenses	<u>31,132,939</u>	<u>30,626,437</u>
Total Operating Expenses	<u>293,761,349</u>	<u>293,660,631</u>
Net Operating Income	<u>134,590,839</u>	<u>125,192,190</u>
Non-Operating Revenues (Expenses)		
Investment Income (Loss)	(5,692,148)	24,676,120
Loss on Disposal of Fixed Assets	(10,928)	(18,254)
Net Income Before Transfers	<u>128,887,763</u>	<u>149,850,056</u>
Operating Transfers:		
Transfers of lottery proceeds for property tax credit	(153,918,219)	(216,895,949)
Transfer to Department of Health and Family Services for compulsive gambling awareness campaign	(36,000)	0
Transfer to Department of Justice for law enforcement	(234,091)	(229,587)
Transfer to Department of Revenue for lottery credit administration	(58,326)	(54,628)
Net Income (Loss)	<u>(25,358,873)</u>	<u>(67,330,108)</u>
Retained Earnings		
Retained Earnings, Beginning of Year as Previously Stated	89,155,314	156,859,784
Change in accounting for State Investment Fund investments	0	(828,727)
Prior-period adjustment for accounts receivable	0	454,365
Retained Earnings, Beginning of Year Adjusted	<u>89,155,314</u>	<u>156,485,422</u>
Retained Earnings, End of Year	<u>\$ 63,796,441</u>	<u>\$ 89,155,314</u>

The accompanying notes are an integral part of this statement.

Wisconsin Lottery
Statement of Cash Flows
for the Years Ended June 30, 1999 and 1998

	<u>June 30, 1999</u>	<u>June 30, 1998</u>
Cash Flows from Operating Activities		
Cash Received from Retailers	\$ 418,163,645	\$ 426,757,689
Cash Paid for Prizes	(246,448,627)	(257,978,432)
Cash Paid/Received for Grand Prize Deposit	1,059,637	(367,339)
Cash Paid to Suppliers and Employees	(29,365,076)	(34,965,968)
Cash Paid for Retailer Commissions	<u>(25,844,288)</u>	<u>(25,061,025)</u>
Net Cash Provided by Operating Activities	<u>117,565,291</u>	<u>108,384,925</u>
Cash Flows from Non-Capital Financing Activities		
Transfer of Proceeds for Property Tax Credit	(152,543,757)	(216,240,198)
Transfer of Proceeds for Compulsive Gambling Awareness Campaign	(36,000)	0
Transfer of Proceeds for Law Enforcement	(234,091)	(229,587)
Transfer of Proceeds for Lottery Credit Administration	<u>(58,326)</u>	<u>(54,628)</u>
Net Cash Provided (Used) by Non-Capital Financing Activities	<u>(152,872,174)</u>	<u>(216,524,413)</u>
Cash Flows from Capital and Related Financing Activities		
Cash Paid for Purchase of Equipment	(84,495)	(357,489)
Cash Received from Sale of Equipment	<u>0</u>	<u>1,935</u>
Net Cash Provided (Used) by Capital and Related Financing Activities	<u>(84,495)</u>	<u>(355,554)</u>
Cash Flows from Investing Activities		
Interest Received	5,722,188	6,996,048
Cash Received for Redemption of Bonds	24,748,683	28,754,355
Cash Paid for Purchase of Bonds	<u>(15,797,667)</u>	<u>(7,593,627)</u>
Net Cash Provided by Investing Activities	<u>14,673,204</u>	<u>28,156,776</u>
Net Increase (Decrease) in Cash and Cash Equivalents	(20,718,174)	(80,338,266)
Cash and Cash Equivalents, Beginning of Year	<u>69,834,291</u>	<u>150,172,557</u>
Cash and Cash Equivalents, End of Year	<u>\$ 49,116,117</u>	<u>\$ 69,834,291</u>

The accompanying notes are an integral part of this statement.

Statement of Cash Flows
for the Years Ended June 30, 1999 and 1998

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

	<u>June 30, 1999</u>	<u>June 30, 1998</u>
Net Operating Income	<u>\$ 134,590,839</u>	<u>\$ 125,192,190</u>
Adjustments to Reconcile Net Operating Income to Net Cash Provided by Operating Activities		
Depreciation Expense	345,578	625,710
Changes in Assets and Liabilities		
Decrease (Increase) in Receivables	(9,009,437)	2,605,712
Decrease (Increase) in Grand Prize Deposit	1,059,637	(367,339)
Decrease (Increase) in Ticket Inventory	(153,924)	(709,626)
Decrease (Increase) in Prepaid Expenses	36,854	(1,332,608)
Decrease (Increase) in Due from Other State Programs	240,589	(402,224)
Increase (Decrease) in Prizes Payable	(6,093,114)	(22,784,612)
Increase (Decrease) in Deferred Revenue	(364,308)	193,635
Increase (Decrease) in Due to Other State Programs	(7,169,361)	6,908,958
Increase (Decrease) in Accounts Payable	1,271,821	(2,724,224)
Increase (Decrease) in Lottery Association Payable	2,760,617	906,826
Increase (Decrease) in Due to Other Governments	(46,511)	204,047
Increase (Decrease) in Accrued Payroll	52,394	39,058
Increase (Decrease) in Compensated Absences	43,617	29,422
Total Adjustments	<u>(17,025,548)</u>	<u>(16,807,265)</u>
Net Cash Provided by Operating Activities	<u>\$ 117,565,291</u>	<u>\$ 108,384,925</u>

The accompanying notes are an integral part of this statement.

NOTES TO FINANCIAL STATEMENTS

1. Description of the Wisconsin Lottery

The Wisconsin Lottery, which was created in December 1987, manages scratch-off and pull-tab instant ticket games and on-line ticket games. During fiscal year (FY) 1998-99, the Wisconsin Lottery administered 108 active scratch-off, 11 active pull-tab, and 6 active on-line games.

The Wisconsin Lottery voted to join the Multi-State Lottery Association (MUSL) in June 1989. The Wisconsin Lottery, as a member of MUSL, participated in three on-line MUSL games called Powerball (start date April 19, 1992), Daily Millions (start date September 16, 1996, end date March 29, 1998), and Cash 4 Life (start date March 30, 1998).

During FY 1998-99, the Lottery also sold tickets for four 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), and Daily Pick 4 (start date September 15, 1997).

The Wisconsin Lottery is accounted for within the Lottery Fund, which is part of the State of Wisconsin financial reporting entity. Effective July 1, 1996, the Wisconsin Lottery was transferred from the Wisconsin Gaming Commission to the Wisconsin Department of Revenue.

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(H) 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 during FY 1998-99 and FY 1997-98. Retailer commissions were 5.5 percent for instant scratch and instant pull-tab tickets ordered during the period from July 1, 1997 through December 31, 1997, and were increased to 6.25 percent for instant scratch and instant pull-tab tickets ordered during the period January 1, 1998 through June 30, 1999. Nonprofit organizations receive additional commissions.

- E. Administrative Expenses - Prior to FY 1997-98, Wisconsin Statutes limited lottery administrative expenses to 15 percent of gross lottery revenues and required that retailer commissions and instant and on-line vendor fees be included as administrative expenses in the calculation. Beginning in FY 1997-98, the administrative expense limit was reduced to 10 percent of gross lottery revenues, but retailer commissions are no longer included as an administrative expense in the calculation.

Instant and on-line vendor service fees represent payments to a vendor who receives a contractual fixed amount and a percentage of the revenues generated through the instant and on-line network maintained by the vendor.

A summary of administrative expenses and related calculations of the administrative expense limit are included in Schedule II.

- F. 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 payments is shown in Schedule III.
- G. 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 specific identification method. The cost of tickets sold is charged to operations. Unused tickets are charged to operations in the fiscal year the game ends.
- H. 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 to the Wisconsin Lottery. Deferred revenue is estimated and recorded based on historical information of unsold tickets returned by the retailers.

On-line Powerball and Wisconsin's Very Own Megabucks tickets are sold for up to two drawings. On-line Supercash!, Cash 4 Life, Daily Pick 3, and Daily Pick 4 tickets are sold for the next seven 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.

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

Estimated Lives

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 During FY 1997-98 and Thereafter	4 years

- J. 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.
- K. 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."
- L. 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 are based on quoted market prices.

3. Accounting Changes

In FY 1997-98, the Wisconsin Lottery implemented GASB Statement 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, which requires the Wisconsin Lottery to report its investments at fair value on its balance sheet and to include changes in fair value in investment income. See Note 8 for current year fair value changes included in the comparative statements.

The Wisconsin Lottery did not restate the FY 1996-97 financial statement balances for its pool shares in the State Investment Fund, as this information was not readily available, but first applied this statement to FY 1997-98. The cumulative effect of applying this statement for periods prior to FY 1997-98 for cash and cash equivalents is shown as a restatement of the beginning balance of retained earnings as of July 1, 1997, in the amount of negative (-) \$828,727.

4. Prior-Period Adjustment

An adjustment was made, effective FY 1997-98, to account for the difference in accounts receivable in the State's accounting system, WiSMART, and the Lottery's retailer accounting system, Pro:Sys. This difference, totaling \$454,365, accumulated over time as a result of accounting transactions through the accounts receivable account that were not reconciled.

5. Deposits

GASB Statement 3 requires deposits with financial institutions to be categorized to indicate the level of risk assumed by the State. At June 30, 1999, the Lottery had a balance of \$464 in the State's bank, which meets the criteria for risk category 1 because it is covered by federal depository insurance.

6. Investments

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 7 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 \$261,112,150 as of June 30, 1999, and a fair value of \$264,593,711 as of June 30, 1998.

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.

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 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, 1999, 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.

7. Annuity Prizes Payable

The Wisconsin Lottery has an unconditional obligation to pay all jackpot prize winners the future value of the prize. 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 \$17,402,393 for FY 1998-99, and \$17,193,268 for FY 1997-98. See Note 6 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 1998-99</u>			<u>FY 1997-98</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>
1998-99	-	-	-	\$24,737,194	-	\$ 24,737,194
1999-00	\$26,025,203	-	\$ 26,025,203	-	\$ 24,912,988	24,912,988
2000-01	-	\$ 26,214,983	26,214,983	-	25,095,286	25,095,286
2001-02	-	26,411,786	26,411,786	-	25,284,330	25,284,330
2002-03	-	26,615,868	26,615,868	-	25,480,366	25,480,366
2003-04	-	26,827,505	26,827,505	-	25,683,659	25,683,659
Subsequent Years	-	<u>292,877,349</u>	<u>292,877,349</u>	-	<u>269,070,517</u>	<u>269,070,517</u>
Future Prize Payments	26,025,203	398,947,491	424,972,694	24,737,194	395,527,146	420,264,340
Less: Present Value Adjustment	<u>465,376</u>	<u>171,813,791</u>	<u>172,279,167</u>	<u>449,031</u>	<u>175,579,732</u>	<u>176,028,763</u>
Present Value of Future Prize Payments as of Year End	<u>\$25,559,827</u>	<u>\$227,133,700</u>	<u>\$252,693,527</u>	<u>\$24,288,163</u>	<u>\$219,947,414</u>	<u>\$244,235,577</u>

8. Investment Income (Loss)

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

	<u>FY 1998-99</u>	<u>FY 1997-98</u>
Interest from State Investment Fund	\$ 4,539,247	\$ 7,967,175
Net Increase in Fair Value of Annuity Investments	5,469,456	33,811,499
Decrease for Amortization of Annuity Investments	(17,402,393)	(17,193,268)
Net Change in Fair Value of State Investment Fund	1,041,327	(493,712)
Interest from MUSL Prize Reserve Accounts	651,752	580,660
Miscellaneous Interest	<u>8,463</u>	<u>3,766</u>
Total Investment Income (Loss)	\$(5,692,148)	\$24,676,120

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 9. As the result of implementing 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). See Note 3 for further discussion of the implementation of GASB Statement 31. Before implementation of GASB Statement 31, investments for prize annuities had been amortized with a corresponding amortization adjustment to annuity prizes payable. Because investments are now required to be reported at fair value, the amortization of annuity prizes payable is included as a reduction to investment income.

9. 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 \$9,273,458 at June 30, 1999, and \$9,681,343 at June 30, 1998.

- A. For 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, 1999</u>	<u>June 30, 1998</u>
Prize Reserve Account (PRA)	\$5,514,054	\$5,514,054
Balance of Unreserved Account	724,877	1,273,125
Set Prize Reserve Account (SPRA)	<u>1,947,728</u>	<u>1,947,728</u>
Total Powerball Grand Prize Deposit	\$8,186,659	\$8,734,907

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 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. For Cash 4 Life, the total prize pool equals 50 percent of sales for each Cash 4 Life drawing. Currently, 2 percent of total sales are transferred to MUSL on 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.

When Daily Millions ceased on March 29, 1998, the balance of the Daily Millions Prize Reserve Account, totaling \$872,578, was transferred to the Cash 4 Life Prize Reserve Account. At June 30, 1999, MUSL held \$1,086,799 as a Cash 4 Life prize deposit for the State of Wisconsin.

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 Prize Expense by the same amount when the reserves are increased.

10. Commitments

Operating Leases - The Wisconsin Lottery occupied office, warehouse, and storage facilities in Milwaukee and Madison under operating leases during FY 1998-99. The lease for the Milwaukee facility expires June 30, 2004. The lease for the currently occupied Madison facility expires on March 31, 2001. However, in approximately November 2000, the Wisconsin Lottery office in Madison will move to a new leased facility, in conjunction with the consolidation of all Department of Revenue divisions. It is uncertain whether opportunities to sublease the current Madison facility will arise to recover the rent commitment between December 2000 and March 2001. At this time, no sublessor has been identified.

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, an estimate was made using the rate of actual increase between FY 1998-99 and FY 1999-2000 lease payment amounts to estimate subsequent years' increases. The Madison facility lease rate has been set for the remainder of the lease period:

		As of <u>June 30, 1999</u>	As of <u>June 30, 1998</u>
Fiscal Year Ending June 30,	1999	-	\$ 747,489
	2000	\$ 811,942	691,307
	2001	723,843	368,198
	2002	370,813	379,244
	2003	377,214	390,622
	2004	<u>383,726</u>	<u>402,340</u>
Total Minimum Payments Required		\$2,667,538	\$2,979,200

Total lease expenses for the Wisconsin Lottery amounted to \$749,144 for the fiscal year ended June 30, 1999, and \$677,685 for the fiscal year ended June 30, 1998.

11. 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 tickets may be purchased with either the annuity payment or cash payment option. Cash 4 Life jackpot winners receive \$1,000 per week for life and no 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 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. During FY 1998-99, the Wisconsin Lottery acquired annuity investments of \$12,430,690 and assumed annuity prize liability of the same amount. No annuity investments were acquired and no prize liabilities were assumed in FY 1997-98.

For jackpot prize winning tickets purchased 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 annuity investments of \$3,874,714 in FY 1998-99 and \$7,778,914 in FY 1997-98, and assumed annuity prize liabilities of the same amounts.

The Wisconsin Lottery makes one direct cash payment to Megabucks jackpot prize winners who elect the cash payment option at the time of ticket purchase.

- 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 drawn in correct order. 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 drawn in correct order. 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 includes 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 consists of 15 sets of 4 two-digit numbers. One set of four numbers for the top prize group may be selected by the player or may be randomly selected, at the player's option. The remaining 14 sets of numbers are selected randomly. The number of winners in each of the prize categories, multiplied by the prize amount for that category, is equal to the prize expense for the Cash 4 Life game. Prizes expensed are reported as prizes payable until the winners redeem their tickets.

Unlike other grand prize games, the prizes payable liability and the related investments to pay Cash 4 Life prize winners are held by MUSL and are therefore not included in the financial statements of the Wisconsin Lottery. MUSL transfers weekly prize payments to the Wisconsin Lottery, which then makes payments to the eligible top prize winners.

- G. Daily Millions - The on-line Daily Millions game ended March 29, 1998. While the game was active, the prize pool for all prize categories consisted of 50 percent of each draw period's sales. Players won by matching 2, 3, 4, 5, or 6 numbers, by color, to win \$2, \$5, \$100, \$5,000, or the top prize of \$1,000,000. The top prize was paid in one installment. If there were more than 10 winning plays for the top prize, \$10,000,000 was shared equally among winning plays.

The Wisconsin Lottery recognized as prize expense its share of the prize pool at the time the related Daily Millions drawing was held. The number of winners in each prize category, multiplied by the prize amount for that category, was the amount of prize expense for the Daily Millions game. The Wisconsin Lottery transferred to MUSL money equal to its share of the prize pool, less the amount required to pay the non-top prize winners. The amounts withheld from MUSL to pay these prize winners were reported as prizes payable until the winners redeemed their tickets.

12. Reserved Retained Earnings

The Wisconsin Lottery has reserved retained earnings for fair value adjustments of investments of \$15,279,713 as of June 30, 1999, and \$26,171,323 as of June 30, 1998. 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.

13. Contributed Capital

Between October 1, 1992 and September 30, 1995, costs associated with the purchase of commonly used 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 commonly used fixed assets purchased jointly were divided between the Lottery program at DOR and the programs that remained with the Gaming Commission. The assets allocated to the Lottery program resulted in contributed capital of \$50,751.

14. 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, 1998, 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/>.

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 \$456,169 for FY 1998-99 and \$392,714 for FY 1997-98. 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.

15. Distribution of Net Proceeds

The Wisconsin Constitution requires proceeds from the operations of the Wisconsin Lottery to be used to provide local property tax relief. For FY 1998-99, a total of \$153,918,219 in Wisconsin Lottery proceeds was used for the following purposes: \$142,699,977 for Lottery Tax Credits, and \$11,218,242 for Farmland Tax Relief Credits. For FY 1997-98, a total of \$216,895,949 in Wisconsin Lottery proceeds was used for the following purposes: \$205,777,240 for Lottery Tax Credits, and \$11,118,709 for Farmland Tax Relief Credits.

On October 29, 1996, the Dane County Circuit Court ruled that the method of distributing lottery property tax credit at the time violated the Wisconsin Constitution. As a result, \$126 million available for 1996 lottery property tax credits was not distributed in FY 1996-97. Provisions were enacted in the 1997-99 biennial budget, 1997 Wisconsin Act 27, to distribute available lottery proceeds for property tax credits in FY 1997-98, which effectively resulted in the distribution of two years of property tax credits in that fiscal year.

16. Subsequent Events

- A. Effect of 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 now allowed a 60-day period within becoming entitled to a lottery prize to elect either the lump-sum or annuity payment option.

1999 Wisconsin Act 9 further provides that lottery prize winners who became entitled to receive payment of a lottery prize on or before October 21, 1998, and who currently receive payment of the lottery prize in the form of an annuity, may 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 must do so between July 1, 1999 and December 31, 2000.

It is anticipated that a significant number of past annuity prize winners will elect to receive the balance of their prize payments as a lump-sum payment during FY 1999-2000 or FY 2000-01. As a result, the balances of both the Investment for Prize Annuities and the Annuity Prizes Payable accounts are expected to decrease significantly in the future. The Wisconsin Lottery will not experience gains or losses on these transactions, since each winner will receive current market value at the time of the conversion.

- B. Retailer Incentive Programs - In addition to the retailer commissions discussed in Note 2D, 1999 Wisconsin Act 9 established another compensation program to be paid to retailers who meet certain performance goals identified by the Department of Revenue. Under this program, the total compensation provided to retailers may not exceed 1 percent of the gross revenues from the sale of lottery tickets and lottery shares.

The effective date of this program is January 1, 2000. Retailers must be in good standing and sell scratch-off tickets to participate in the program, which has a winning ticket component and a sales incentive component.

Under the winning ticket component, participating retailers who sell a winning scratch-off or on-line game ticket of \$600 or more will receive a 2 percent commission up to a maximum of \$100,000 per winning ticket. Winning ticket payments will be 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, daily terminal generated games (Supercash!, Daily Pick 3, Daily Pick 4, and Cash 4 Life), and jackpot games (Wisconsin's Very Own Megabucks and Powerball). Subject to certain restrictions and allowances, retailers can earn up to 10 percent of the increase in quarterly sales over sales for the same quarter of the previous year. Payments for the instant scratch-off ticket and daily terminal-generated portions of the sales incentive program will be made quarterly. Due to the random nature of the jackpot games and the overall program cap, sales incentive program payments for jackpot games will be made annually.

- C. Budget Adjustments - When the Wisconsin Legislature enacted 1999 Wisconsin Act 9, it provided that in FY 1999-2000, general purpose revenue (GPR) would fund certain lottery expenses that had previously been funded with Lottery program revenues. In FY 1999-2000, administrative expenses, retailer commissions, and on-line vendor fees will be paid with GPR funding. This budgetary provision is effective only for FY 1999-2000.

Using GPR to fund these expenditures provides a means of increasing the amount of property tax relief available through the Lottery Fund. Accordingly, the transfer for property tax relief shown is expected to increase.

Schedule I

**Reconciliation of Lottery General Operations Expenses to the
Budgetary Basis of Accounting
FY 1998-99**

Salaries and Fringe Benefits	
Per Financial Statement	\$ 4,074,586
Adjustments to Financial Statement Balance:	
Cash paid in FY 1998-99 but expensed in FY 1997-98	217,522
Cash paid in FY 1999-00 but expensed in FY 1998-99	<u>(292,365)</u>
Budgetary Basis	<u><u>\$ 3,999,743</u></u>
Supplies and Services	
Per Financial Statement:	
On-line telecommunication charges	\$ 3,596,842
Supplies and services	4,180,626
Product information	4,541,450
Ticket costs	2,662,437
Depreciation expense	<u>345,578</u>
Total per financial statement	15,326,933
Adjustments to Financial Statement Balance:	
Depreciation expense	(345,578)
Cash paid in FY 1997-98 but expensed in FY 1998-99	(1,926,150)
Cash paid in FY 1998-99 but expensed in FY 1997-98	171,406
Cash paid in FY 1998-99 but expensed in FY 1999-00	1,861,702
Cash paid in FY 1999-00 but expensed in FY 1998-99	<u>(639,836)</u>
Budgetary Basis	<u><u>\$ 14,448,477</u></u>
Permanent Property	
Per Financial Statement	\$ 0
Adjustments to Financial Statement Balance:	
FY 1998-99 net permanent property capitalized	(262,732)
FY 1998-99 disposal of permanent property	355,557
Cash paid in FY 1998-99 but expensed in FY 1997-98	60,609
Cash paid in FY 1999-00 but expensed in FY 1998-99	<u>(92,111)</u>
Budgetary Basis	<u><u>\$ 61,323</u></u>

Schedule II

Lottery Administrative Expenses

	Fiscal Year Ended June 30,1999	Fiscal Year Ended June 30,1998	Fiscal Year Ended June 30,1997
Administrative Expenses			
Instant and On-line Vendor Services	\$ 11,731,420	\$ 11,659,039	\$ 6,943,013
Salaries and Fringe Benefits	4,074,586	3,538,468	2,780,335
On-line Telecommunication Charges	3,596,842	3,532,029	4,997,895
Supplies and Services	4,180,626	4,363,801	7,020,129
Product Information	4,541,450	4,347,039	4,477,771
Ticket Costs	2,662,437	2,560,351	3,129,469
Depreciation Expense	<u>345,578</u>	<u>625,710</u>	<u>615,702</u>
Total Administrative Expenses as Determined in Accordance With s. 25.75 (3)(b), Wis. Stats.	<u>\$ 31,132,939</u>	<u>\$ 30,626,437</u>	<u>\$ 29,964,314</u>
Gross Lottery Operating Revenues	<u>\$ 428,352,188</u>	<u>\$ 418,852,821</u>	<u>\$ 431,146,786</u>
Administrative Expenses as a Percentage of Lottery Revenues	7.27%	7.31%	6.95%
Under Prior Law:			
Retailer Commissions			<u>\$ 24,500,237</u>
Total Administrative Expenses			<u>\$ 54,464,551</u>
Administrative Expenses as a Percentage of Lottery Revenues			12.63%

In FY 1996-97, s. 25.75(3)(b), Wis. Stats., limited the Lottery's administrative expenses to 15 percent of gross lottery revenues. Gross lottery revenues include lottery ticket sales and retailer fees. The statutes required retailer commissions to be included as an administrative expense along with general lottery expenses in determining compliance with the 15 percent limit. Beginning in FY 1997-98, the administrative expense limit was reduced to 10 percent of gross lottery revenues, but retailer commissions are no longer included as an administrative expense in the calculation. This schedule has been restated to show prior years' data and using the new law for comparative purposes with the current year. Below this comparative data is the prior year information as previously presented under the rules of the law in effect during that fiscal year.

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 expended for winning lottery tickets for the past five years, for both instant and on-line games, are summarized below.

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	\$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	\$244,020,253	\$431,091,169	56.6

Fiscal Year 1995-96			
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$194,635,387	\$310,401,692	62.7%
On-Line Games	<u>82,330,739</u>	<u>171,722,268</u>	47.9
Total for Fiscal	\$276,966,126	\$482,123,960	57.4

Fiscal Year 1994-95			
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$200,351,918	\$320,356,094	62.5%
On-Line Games	<u>98,465,771</u>	<u>198,558,877</u>	49.6
Total for Fiscal	\$298,817,689	\$518,914,971	57.6

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 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, 1999 and 1998, and have issued our report thereon dated March 22, 2000. We conducted our audits in accordance with generally accepted auditing standards 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.

This report is intended solely for the information and use of the Wisconsin Lottery staff, the Department of Revenue's management, and the Wisconsin Legislature. This restriction is not intended to limit the distribution of this report, which, upon submission to the Joint Legislative Audit Committee, is a public document. 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

March 22, 2000 by

Julie Gordon
Audit Director



APPENDIX

State of Wisconsin • DEPARTMENT OF REVENUE

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Tommy G. Thompson
Governor

Cate Zeuske
Secretary of Revenue

May 30, 2000

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 review of the Wisconsin Lottery. The Department of Revenue (DOR) wishes to thank you and your staff for your detailed, independent analysis.

Regarding the tentative settlement agreement with the GTECH Corporation for payment of liquidated damages, we feel the settlement of \$985,213 is fair and not punitive to GTECH. This figure represents \$235,213 collected from GTECH through April 30, 1999, an additional \$500,000 cash payment upon finalization of the settlement, and \$250,000 in goods and services. The \$250,000 in goods and services will be used to benefit retailers since they were inconvenienced during the implementation of the new computer system. We will provide a plan on the specific use of these goods and services to the Joint Finance Committee and the Joint Audit Committee by September 1, 2000.

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,

Cate S. Zeuske
Secretary of Revenue