

An Audit

Wisconsin Lottery

Department of Revenue

2007-2008 Joint Legislative Audit Committee Members

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Janice Mueller
State Auditor

June 26, 2007

Senator Jim Sullivan and
Representative Suzanne Jeskewitz, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Sullivan and Representative Jeskewitz:

As required by s. 13.94(1)(em), Wis. Stats., we have completed our annual financial audit and biennial program evaluation of the Wisconsin Lottery, which is administered by the Department of Revenue. We have issued an unqualified opinion on financial statements prepared by the Wisconsin Lottery for fiscal year (FY) 2005-06 and FY 2004-05.

Over the past five years, total sales increased 19.0 percent, from \$427.6 million in FY 2001-02 to \$509.0 million in FY 2005-06. Net lottery proceeds provided \$133.3 million in property tax relief in FY 2005-06.

To maximize revenue from sales and increase the net proceeds available to fund property tax relief, the Wisconsin Lottery seeks to maintain player interest by offering a variety of games at different prices. It has improved its instant game development and management practices since our 2005 evaluation (report 05-8) and modified the Retailer Performance program, which provides performance-based incentives to retailers.

The annual product information budget for the Wisconsin Lottery has been \$4.6 million since FY 1990-91. Proposals are pending in the Legislature to increase the product information budget to \$7.5 million annually.

We appreciate the courtesy and cooperation extended to us by Wisconsin Lottery staff in the Department of Revenue. The Department's response follows the appendices.

Respectfully submitted,

Handwritten signature of Janice Mueller.

Janice Mueller
State Auditor

JM/KW/ss

Report Highlights ■

We have issued an unqualified opinion on the Wisconsin Lottery's financial statements for FY 2005-06 and FY 2004-05.

In FY 2005-06, ticket sales totaled \$509.0 million.

In FY 2005-06, the Wisconsin Lottery provided \$133.3 million in property tax relief.

Game management practices have been improved.

A 1987 amendment to the Wisconsin Constitution allowed the Legislature to create a state lottery and required that its net proceeds be distributed for property tax relief. The Wisconsin Lottery began operations in the following year and has been managed by the Department of Revenue (DOR) since 1995. Lottery tickets are sold at more than 4,200 retailer locations in Wisconsin, and net lottery proceeds provided \$133.3 million in property tax relief in fiscal year (FY) 2005-06.

We have completed both a financial audit and a program evaluation of the Wisconsin Lottery, as directed by s. 13.94(1)(em), Wis. Stats., and have issued an unqualified opinion on its financial statements for the years ended June 30, 2006 and 2005. As part of our financial audit, we evaluated internal controls, substantiated account balances, and tested for compliance with state laws and regulations. To complete our program evaluation, we also reviewed:

- trends in lottery sales and operating expenses;
- responses to our prior recommendations related to contracting for certain lottery operations;
- the development and management of "instant" pull-tab and scratch-off games, which generate the largest share of lottery revenue; and
- the Retailer Performance program, which provides up to 1.0 percent of gross lottery sales revenues as incentives to increase retailer participation and ticket sales.

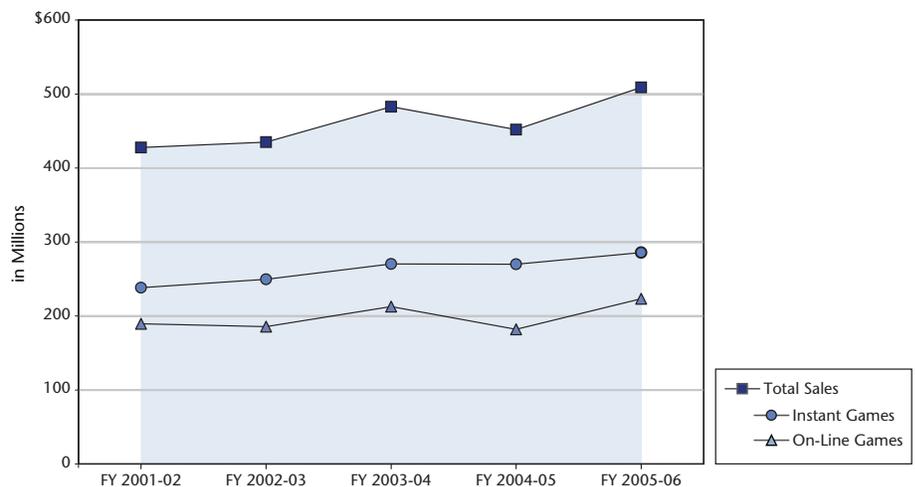
Revenues and Expenses

Ticket sales are the Wisconsin Lottery’s primary revenue source. They totaled \$509.0 million in FY 2005-06, when total operating revenues were \$509.2 million.

Total ticket sales have increased 19.0 percent over the past five fiscal years, although on-line game sales have fluctuated, as shown in Figure 1. Sales of instant scratch-off and pull-tab game tickets increased 19.9 percent, from \$238.2 million in FY 2001-02 to \$285.7 million in FY 2005-06. For on-line games, ticket sales increased 17.9 percent, from \$189.4 million to \$223.3 million.

Figure 1

Lottery Sales



Wisconsin was one of two midwestern states in which per capita lottery sales declined from FY 2003-04 to FY 2004-05. It was fifth among seven midwestern states in per capita lottery sales in both years, which are the most recent for which comparative data were available at the time of our fieldwork.

In FY 2005-06, the Wisconsin Lottery’s operating expenses totaled \$358.2 million. They include prizes paid to winning ticket holders; retailer compensation, including commissions and incentives; game development and production costs; administrative expenses, including the costs of staffing and supplies; and the costs of product information services provided by an advertising firm.

Over the past five fiscal years, operating expenses increased 17.3 percent, primarily because of increases in prizes and retailer compensation, which rose as sales increased. Administrative expenses have not exceeded the statutory limit of 10.0 percent of gross revenues and have declined annually since FY 2001-02.

Operations Contract

One of the Wisconsin Lottery's largest expenses is a seven-year contract with GTECH Corporation for telecommunications and instant and on-line ticket validation and tracking. Through FY 2005-06, GTECH has been paid \$24.1 million under a contract that took effect in June 2004.

The current contract includes provisions for ongoing performance monitoring and a formal annual review. However, the Wisconsin Lottery did not establish annual performance review criteria for GTECH in a timely manner, as we had recommended in 2005, and did not complete its first formal performance evaluation until March 2007.

Performance grades for calendar year 2006 varied from "fair" in resolving software defects to "excellent" in network availability. The evaluation noted that as of October 2006, GTECH had not resolved 125 requests for programming changes. In its response, GTECH indicated that a software update in July 2007 would reduce the number of outstanding programming changes to 25.

Game Development and Management

Effective game development and management help to maximize sales revenue and increase the net proceeds available to fund property tax relief. To maintain player interest, the Wisconsin Lottery has increasingly introduced new instant games: 60 new games were introduced in FY 2005-06, compared to 48 in FY 2001-02.

The number of higher-priced games has also increased over the past five years. In FY 2001-02, four instant games were priced at \$5 or more. In FY 2005-06, 15 higher-priced games were introduced, including two instant games priced at \$20.

Instant games affiliated with certain well-known or popular products typically involve special prize opportunities that are intended to generate player interest. To develop and sell these affiliated games, the Wisconsin Lottery must obtain licensing rights and must compensate the owners of copyrighted or trademarked

property, either through fees or by purchasing merchandise to be used as prizes. It also enters into partnership agreements with entities such as the Wisconsin State Fair, to create related games and engage in joint advertising opportunities.

We found that from FY 2001-02 through FY 2005-06, average per game sales were somewhat higher for affiliated games than for unaffiliated games. As we recommended in 2005, the Wisconsin Lottery has implemented an evaluation tool to analyze instant game costs and revenues, and thereby improve its game development and management.

Retailer Compensation

By statute, retailers that sell Wisconsin Lottery tickets receive commissions of 5.5 percent of on-line ticket sales and 6.25 percent of instant ticket sales. In addition, the Wisconsin Lottery's Retailer Performance program offers retailers up to 1.0 percent of gross lottery sales revenue as performance-based incentives. The program has three components: a winning ticket incentive, short-term incentives, and a sales goals incentive.

In FY 2005-06, retailers were paid \$4.6 million in incentives, an increase of 15.0 percent from the previous fiscal year. Wisconsin Lottery officials estimate that in FY 2005-06, short-term incentives generated \$4.4 million in additional sales.

2007-09 Budget Considerations

The Wisconsin Lottery is constitutionally prohibited from spending public funds or revenues derived from its operations for promotional advertising. However, providing information about the chances of winning lottery games, their prize structures, and other product information is permitted.

The annual product information budget has been \$4.6 million since FY 1990-91. As part of 2007-09 biennial budget deliberations, the Legislature is considering a proposed increase to \$7.5 million annually.

■ ■ ■ ■

Introduction ■

Because ticket sales are the Wisconsin Lottery's primary revenue source, we reviewed sales data for both instant and on-line games during the past five fiscal years and compared them to the most recent lottery sales data available for other midwestern states. We also reviewed the property tax relief funded primarily by net proceeds from the Wisconsin Lottery, and changes in staffing levels.

Lottery Sales

***Lottery sales increased
19.0 percent from
FY 2001-02 to
FY 2005-06.***

The Wisconsin Lottery's total sales increased 19.0 percent during the past five fiscal years, from \$427.6 million in FY 2001-02 to \$509.0 million in FY 2005-06. Sales of scratch-off and pull-tab games increased 19.9 percent, while on-line game sales increased 17.9 percent. Both total sales and instant game sales increased in every year except FY 2004-05. As shown in Table 1, on-line game sales have fluctuated.

Table 1

Wisconsin Lottery Sales
(in Millions)

Fiscal Year	Instant Games	On-line Games	Total Sales	Percentage Change from Prior Year
2001-02	\$238.2	\$189.4	\$427.6	–
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)
2005-06	285.7	223.3	509.0	12.6

The Wisconsin Lottery projects that ticket sales will decline to \$489.7 million in FY 2006-07, largely because of a decline in on-line game sales. The Wisconsin Lottery projects that total lottery ticket sales will be \$504.7 million in FY 2007-08, pending approval of the Governor's budget proposal.

Wisconsin's per capita lottery sales were fifth among seven midwestern states in both FY 2003-04 and FY 2004-05.

As shown in Table 2, Wisconsin was one of two midwestern states that experienced a decline in per capita lottery sales from FY 2003-04 to FY 2004-05, the latest year for which data were available at the time of our fieldwork. Wisconsin's per capita lottery sales declined 7.0 percent, while Indiana's per capita lottery sales declined 0.1 percent. Per capita lottery sales in Illinois increased 7.1 percent over this period, which was the largest increase among the midwestern states reviewed. Wisconsin's per capita lottery sales were fifth among seven midwestern states in both FY 2003-04 and FY 2004-05.

Table 2

Midwestern States' per Capita Lottery Sales

State Lottery	FY 2003-04 per Capita Sales	FY 2004-05 per Capita Sales	Percentage Change
Michigan	\$195.35	\$204.48	4.7%
Ohio	188.18	188.34	0.1
Illinois	132.76	142.15	7.1
Indiana	118.02	117.93	(0.1)
Wisconsin	87.75	81.62	(7.0)
Minnesota	75.92	79.49	4.7
Iowa	70.62	71.02	0.6

Source: La Fleur's 2005 and 2006 World Lottery Almanacs and U.S. Census Bureau

Wisconsin's per capita lottery sales were well below the average of \$177.67 among the 41 United States jurisdictions that operated lotteries in FY 2004-05. Wisconsin ranked 29th, with per capita sales of \$81.62. Massachusetts was ranked first, with per capita lottery sales of \$697.91, and North Dakota was ranked last, with per capita sales of \$30.04. Appendix 1 shows when lottery operations began, total sales, per capita sales, and per capita sales ranks for the 41 jurisdictions that operated lotteries in FY 2004-05.

Property Tax Credit

The Wisconsin Constitution requires that net proceeds from the Wisconsin Lottery be used only for property tax relief. Under current law, property tax relief is provided through a credit to owners of primary residences and through a farmland tax relief credit.

**Approximately
\$2.5 billion in property
tax relief has been
provided since 1988.**

Since 1988, approximately \$2.5 billion in property tax relief has been provided primarily through net proceeds from the Wisconsin Lottery. As shown in Table 3, property tax relief totaled \$656.9 million over the last five fiscal years, including \$133.3 million in FY 2005-06. In FY 2005-06, the average property tax credit was \$82, or \$10 less than in FY 2004-05. Despite an increase in Wisconsin Lottery sales, the average property tax credit was \$10 lower in FY 2005-06 because the

property tax credit was based on lower projected sales than were achieved.

Table 3

Wisconsin Property Tax Relief¹

Fiscal Year	Amount Distributed (millions)	Average Property Tax Credit
2001-02	\$119.0	\$77
2002-03	129.6	76
2003-04	131.6	83
2004-05	143.4	92
2005-06	133.3	82
Total	\$656.9	

¹ Property tax relief is funded by net proceeds from the Wisconsin Lottery and from other gaming-related appropriations, including racing and charitable bingo operations.

Staffing Levels

Authorized staffing decreased 13.6 percent from July 2005 to July 2006.

As shown in Table 4, the number of full-time equivalent (FTE) positions authorized for the Wisconsin Lottery decreased from 109.5 at the start of FY 2005-06 to 94.6 at the start of FY 2006-07, or by 13.6 percent. Wisconsin Lottery officials attribute the decrease to the elimination of 10.85 FTE positions as part of 2005 Wisconsin Act 25, the 2005-07 Biennial Budget Act, and to reductions in response to the Governor's Accountability, Consolidation, and Efficiency (ACE) Initiative. However, during the same period, the number of vacant FTE positions decreased from 24.10 to 12.70. Wisconsin Lottery officials indicated that most of these positions had remained vacant because the Governor's proposed budget for the 2003-05 biennium would have privatized Wisconsin Lottery operations and eliminated the Department of Revenue's Lottery Division, and the Governor's proposed budget for the 2005-07 biennium would have eliminated 55.0 FTE positions. Both proposals were deleted during the Joint Finance Committee's budget deliberations. However, as a result of the uncertainty regarding the future of the Wisconsin Lottery, hiring was delayed until after July 2005, when the 2005-07 Biennial Budget Act took effect.

Table 4

Wisconsin Lottery Staffing Levels
(FTE Positions)

Month and Year	Authorized Positions	Vacant Positions	Percentage Vacant
July 2002	110.5	11.90	10.8%
July 2003	109.5	14.65	13.4
July 2004	109.5	15.35	14.0
July 2005	109.5	24.10	22.0
July 2006	94.6	12.70	13.4

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Financial Operations ■

Operating revenues and expenses increased from FY 2004-05 to FY 2005-06. Statutes require that each year, at least 50 percent of the Wisconsin Lottery's revenues from the sale of lottery tickets be returned to players as prize payments, and other expenses are limited in amount and type by both statutes and the Wisconsin Constitution.

One of the Wisconsin Lottery's largest expenses is a contract with GTECH Corporation for telecommunications and instant and on-line ticket validation and tracking. We followed up on the Wisconsin Lottery's efforts to monitor and review GTECH's performance, as our 2005 program evaluation (report 05-8) had recommended.

Revenues

Total operating revenues reached \$509.2 million in FY 2005-06.

The Wisconsin Lottery's total operating revenues increased 12.7 percent from FY 2004-05 through FY 2005-06, and 19.1 percent over the five-year period shown in Table 5. They were \$509.2 million in FY 2005-06.

Table 5

Wisconsin Lottery Operating Revenues
(in Millions)

Revenue Type	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06
Instant Game Ticket Sales	\$238.2	\$249.5	\$270.3	\$269.9	\$285.7
On-line Game Ticket Sales	189.4	185.5	212.6	182.0	223.3
Subtotal	427.6	435.0	482.9	451.9	509.0
Retailer Fees and Miscellaneous Revenue	0.1	0.1	0.3	0.1	0.2
Total	\$427.7	\$435.1	\$483.2	\$452.0	\$509.2

Expenses

Operating expenses increased 17.3 percent from FY 2001-02 through FY 2005-06.

As shown in Table 6, the Wisconsin Lottery's operating expenses include prizes paid to winning ticket holders; retailer compensation, including commissions and incentives; game development and production costs, such as instant game ticket printing and delivery costs and on-line telecommunications charges; product information costs; and other costs, such as staff salaries and fringe benefits. From FY 2001-02 through FY 2005-06, operating expenses increased from \$305.3 million to \$358.2 million, or 17.3 percent, primarily because of increases in prizes and retailer compensation, which rose with increased sales. It should also be noted that game development and production expenses decreased 16.3 percent over the past five fiscal years, largely because of a reduction in telecommunications costs that occurred when GTECH began providing telecommunication services as part of its contract.

Table 6

Wisconsin Lottery Operating Expenses
(in Millions)

Expense Type	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06
Prizes	\$241.6	\$248.5	\$275.2	\$262.1	293.9
Retailer Compensation	30.1	30.8	33.9	31.4	35.2
Game Development and Production ¹	19.6	19.2	19.3	14.4	16.4
Product Information	4.5	4.6	4.6	4.6	4.6
Other ²	9.5	9.6	9.4	9.3	8.1
Total	\$305.3	\$312.7	\$342.4	\$321.8	\$358.2

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

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

The Wisconsin Lottery returned 57.7 percent of sales to players as prize payments in FY 2005-06.

The amount the Wisconsin Lottery has returned to players as prize payments has increased from \$241.6 million in FY 2001-02 to \$293.9 million in FY 2005-06. Section 25.75(3)(a), Wis. Stats., requires that at least 50 percent of Wisconsin Lottery sales be returned to players as prize payments. The Wisconsin Lottery’s prize payout percentage was 57.0 percent in FY 2003-04, 58.0 percent in FY 2004-05, and 57.7 percent in FY 2005-06. For FY 2006-07, the Wisconsin Lottery projects that its total prize payout percentage will increase to 58.1 percent. Wisconsin Lottery officials attribute the 1.1 percentage point increase between FY 2003-04 and FY 2006-07 to offering higher-priced instant games that include higher prize payout percentages. Prize payout percentages in other midwestern states during FY 2004-05, the last year for which data were available, ranged from 53.9 percent in Iowa to 61.6 percent in Indiana. Wisconsin’s prize payout percentage of 58.0 percent in FY 2004-05 was fourth highest among seven midwestern states.

Administrative expenses have remained within the statutory limit of 10.0 percent of gross revenues.

Section 25.75(3)(b), Wis. Stats., limits certain administrative expenses to no more than 10.0 percent of gross revenues. These administrative expenses include all expenses except prize payments and retailer compensation. The largest categories of administrative expenses include costs related to the Wisconsin Lottery’s contract with GTECH for instant ticket and on-line gaming operations, its contract with the advertising firm Hoffman York for product information services, and staff salaries and fringe benefits. As shown in Table 7,

the Wisconsin Lottery's administrative expenses have remained within the statutory limit. As a percentage of operating revenues, administrative expenses have declined annually since FY 2001-02.

Table 7

Statutorily Defined Administrative Expenses as a Percentage of Operating Revenues
(in Millions)

Fiscal Year	Total Statutorily Defined Administrative Expenses	Operating Revenues	Percentage of Total Gross Revenues
2001-02	\$33.6	\$427.7	7.9%
2002-03	33.4	435.1	7.7
2003-04	33.3	483.2	6.9
2004-05	28.3	452.0	6.3
2005-06	29.1	509.2	5.7

Lottery Operations Contract

Through FY 2005-06, GTECH has received \$24.1 million under its current contract with the Wisconsin Lottery.

In November 2003, the Wisconsin Lottery and GTECH Corporation entered into a seven-year contract that took effect in June 2004 and will expire in June 2011. Under the terms of the contract, GTECH receives 2.54 percent of lottery ticket sales, less any liquidated damages. Through FY 2005-06, GTECH has received \$24.1 million under the current contract. The Wisconsin Lottery has contracted with GTECH for computerized gaming system services since 1989.

According to the terms of its contract with GTECH, the Wisconsin Lottery may assess liquidated damages to recover lost revenue when GTECH's telecommunications systems fail or problems occur related to validating tickets. Between January 2004 and December 2006, the Wisconsin Lottery assessed a total of \$1.3 million in liquidated damages. However, assessments declined from \$703,500 for calendar year 2004, to \$132,900 for 2006. These amounts do not include a \$250,000 credit GTECH issued in September 2004 for software upgrades.

The Wisconsin Lottery did not establish annual performance review criteria for the GTECH contract in a timely manner.

The contract between GTECH and the Wisconsin Lottery includes provisions for ongoing monitoring and review of GTECH's performance, as well as for a formal annual review based on jointly established evaluation criteria. In report 05-8, we recommended that the Wisconsin Lottery develop formal review criteria to annually evaluate GTECH's performance, and DOR noted in its May 2005 response that a review of the first year of operations was scheduled for June 2005. Through 2005 and 2006, Wisconsin Lottery officials conducted monthly assessments of performance and assessed liquidated damages. They also report meeting weekly with GTECH staff to discuss performance. However, formal annual performance criteria were not developed until December 2006.

As of October 2006, GTECH had not resolved 125 requests for programming changes.

In March 2007, the Wisconsin Lottery completed its first formal evaluation of GTECH's performance. The evaluation used quantifiable performance criteria, such as the number of equipment failures and system malfunctions and the resulting amounts of liquidated damages assessed in areas such as service reliability, network availability, and software quality. GTECH received performance grades in each of these areas that varied from "fair" in resolving software defects to "excellent" in network availability. The evaluation noted that as of October 2006, GTECH had not resolved 125 requests for programming changes, 9 of which were submitted in 2004. The evaluation recommended that GTECH allocate more resources to software development and develop strategies to enhance the performance of computer terminals used by retailers that do not sell a significant number of lottery tickets.

In April 2007, GTECH met with Wisconsin Lottery officials and responded in writing to the evaluation. GTECH indicated that it would devote one full-time administrator to addressing requests for programming changes and improving the overall quality and consistency of future software updates. GTECH also indicated that implementation of a software update in July 2007 would reduce the number of outstanding requests for programming changes from 125 to 25.

■ ■ ■ ■

Lottery Game Development ■

The Wisconsin Lottery adapts its instant game sales strategies by frequently adjusting the number and types of instant games available for sale, introducing higher-priced games, and offering games affiliated with a copyrighted or trademarked property to increase sales. We reviewed the development of new instant games, including affiliated instant games, and found that the Wisconsin Lottery has made some improvements in its game development practices since our 2005 program evaluation (report 05-8).

Instant Games

The Wisconsin Lottery frequently introduces new instant games and offers a variety of games to maintain player interest.

To maintain player interest and maximize the net lottery proceeds available for property tax relief, the Wisconsin Lottery frequently introduces new instant games, offers games at different prices and with different play styles, and occasionally introduces games affiliated with copyrighted or trademarked properties. Affiliated instant games also include partnership agreements and joint advertising opportunities. Instant affiliated games may have special prize opportunities. The Wisconsin Lottery continues to adapt its instant game sales strategies by adjusting the number and types of instant games available for sale and by introducing higher-priced games.

Growth of Instant Games

Instant scratch-off games accounted for 55.1 percent of FY 2005-06 sales.

Sales of instant scratch-off games represented 58.2 percent of total sales in FY 2004-05 and 55.1 percent in FY 2005-06. As shown in Table 8, 96 instant scratch-off games were available for sale at some point during FY 2005-06 and accounted for \$280.4 million of total sales. Sales from 12 pull-tab games generated an additional \$5.3 million. Wisconsin Lottery officials indicated that between 30 and 35 instant scratch-off games are available for sale at any given time.

Table 8

Game Availability and Sales¹

Game Type	FY 2004-05			FY 2005-06		
	Number of Games Available	Total Sales (millions)	Percentage of Total	Number of Games Available	Total Sales (millions)	Percentage of Total
Instant						
Scratch-off	119	\$263.0	58.2%	96	\$280.4	55.1%
Pull-tab	12	6.9	1.5	12	5.3	1.0
Subtotal	131	269.9	59.7	108	285.7	56.1
On-line	6	182.0	40.3	6	223.3	43.9
Total	137	\$451.9	100.0%	114	\$509.0	100.0%

¹ The number of games represents games available for sale during at least one point of the year.

The Wisconsin Lottery introduced fewer instant games in FY 2005-06 than in FY 2004-05.

As shown in Table 9, the number of instant games introduced in each fiscal year increased through FY 2004-05 and then declined in FY 2005-06.

Table 9

Number of Instant Lottery Games Introduced

Fiscal Year Introduced	Affiliated Games	Unaffiliated Games	All Games
2001-02	2	46	48
2002-03	2	52	54
2003-04	2	57	59
2004-05	7	58	65
2005-06	5	55	60

Instant Game Development and Management

In FY 2005-06, a written methodology was developed for consistently analyzing instant game costs and revenues.

In 2005, we reviewed the Wisconsin Lottery’s instant game development policies and procedures and recommended that it develop a written methodology to consistently analyze instant game costs and revenues. In FY 2005-06, the Wisconsin Lottery implemented an evaluation tool to develop and manage instant games. This tool:

- identifies the key features of each instant game, such as its theme and play style;
- provides a justification for the game, showing how it complements other games currently available for sale; and
- estimates development costs and sales.

Lottery officials in Wisconsin and nationwide traditionally use 12-week sales as an indicator of overall performance. The sales performance of instant games currently available, and other factors, may hasten or delay the scheduled introduction of new instant games. As a result, the instant game introduction schedule requires frequent adjustments. Most instant games are available for sale for at least 12 weeks, although some may be available for a shorter period if they are seasonal, such as a game with a theme related to Valentine’s Day. After the first 12 weeks of sales, performance data—including sales and prizes—are compared to estimates and compiled so that they can be used to manage the games currently being offered and to develop future instant games.

Game management decisions are based on current sales, prize availability, and ticket inventories.

Wisconsin Lottery officials believe that one of the key elements in maximizing instant game sales is having a variety of different play styles and game prices to provide a wide selection of instant games. They indicated that game management decisions are based on a number of factors, including:

- weekly sales of instant games currently available;
- whether all of the top prizes of an instant game have been won;
- ticket inventories of instant games currently available for sale;
- other instant games that are scheduled to be introduced; and
- the mix of instant games currently available based on price, play style, and theme.

In an effort to increase sales, the Wisconsin Lottery has begun introducing higher-priced instant games.

As shown in Table 10, with the exception of FY 2005-06, more instant games have been introduced in each of the past five fiscal years, and higher-priced games have been introduced with increasing frequency. In FY 2001-02, for example, only four instant games were priced at \$5 or more. In FY 2005-06, 15 such games were introduced, including two instant games priced at \$20.

Table 10

Number of Instant Lottery Games Introduced, by Game Price

Game Price	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06
\$1	29	22	22	19	19
\$2	10	17	19	21	18
\$3	5	7	8	11	8
\$5	3	8	8	11	10
\$10	1	0	2	3	3
\$20	0	0	0	0	2
Total	48	54	59	65	60

Affiliated Instant Lottery Games

Wisconsin Lottery officials noted that affiliated games can have special prize opportunities and are intended to generate interest among individuals who typically do not purchase lottery tickets. The Wisconsin Lottery introduced five affiliated instant games in FY 2005-06. A listing of affiliated instant lottery games introduced from FY 2001-02 through FY 2005-06 is provided in Appendix 2.

Affiliated games can have special prize opportunities and are intended to generate interest in the Wisconsin Lottery.

Although few affiliated games are developed by the Wisconsin Lottery each year, additional costs are associated with their development, typically through negotiated compensation agreements with third-party vendors that have obtained the licensing rights from the copyright or trademark holders. Compensation varies by vendor and by game, but is typically provided through:

- a fixed licensing fee;
- a royalty based on the number of tickets printed or sold; or
- a prize purchased from the vendor to use for the game, such as a motorcycle or a truck.

Prize purchases for all affiliated games introduced from FY 2001-02 through FY 2005-06 totaled \$1.1 million. These purchases are supported by the prize funds for the individual affiliated game and are not included as development costs. The Wisconsin Lottery spent \$334,500 in licensing fees and royalties to develop affiliated instant lottery games that were introduced from FY 2001-02 through FY 2005-06. Other development costs, such as ticket printing, have varied by game. For example, ticket printing costs are based on the number of tickets printed and whether the game ticket had additional features, such as special graphics and imaging, which typically cost more to produce.

The Wisconsin Lottery entered into partnership agreements with some entities to develop affiliated instant games.

Beginning in FY 2004-05, the Wisconsin Lottery entered into partnership agreements with entities such as State Fair Park and Funjet Vacations to develop affiliated instant games. Unlike other affiliated games, the Wisconsin Lottery does not pay a licensing fee or make a prize purchase to the entity owning the licensing rights to the affiliated property. Instead, it enters into a partnership agreement with these entities to engage in joint advertising opportunities.

For example, in the partnership agreement for the “Blue Ribbon Bucks” instant game, the Wisconsin Lottery agreed to include

Wisconsin State Fair Web site information on the back of the game ticket. State Fair Park ran a Wisconsin Lottery ticket message on the Interstate-94 Message Center for approximately nine weeks and included lottery information in the State Fair’s daily schedule books at no cost to the Wisconsin Lottery. State Fair Park also provided 600 admission tickets to the 2006 Wisconsin State Fair to be used at the Wisconsin Lottery’s discretion at statewide events and in conjunction with other Wisconsin State Fair and Wisconsin Lottery ticket marketing opportunities.

To evaluate the effectiveness of affiliated games and unaffiliated games, we compared the average direct costs per game to average sales per game, as shown in Table 11. Complete information regarding all costs was not available. For example, we assumed that all prize payments were made for each game offered. We found that average net sales for affiliated games were slightly higher than net sales for unaffiliated games for the period FY 2001-02 through FY 2005-06.

Table 11

Net Sales Generated by Instant Lottery Games
(for Games Introduced FY 2001-02 through FY 2005-06)

	Affiliated Games	Unaffiliated Games
Number of Games Introduced	18	268
Average Prize Expense per Game ¹	\$2,963,100	\$3,038,400
Average Printing and Staffing Costs per Game ²	72,200	54,500
Average Licensing Costs per Game	18,600	0
Average Costs per Game³	\$3,053,900	\$3,092,900
Average Sales per Game ⁴	\$4,278,200	\$4,218,500
Net Sales per Game	\$1,224,300	\$1,125,600

¹ Assumes that all prizes were won and redeemed.

² Staffing costs are based on an estimate of salaries and fringe benefits for the time spent developing instant lottery games.

³ Does not include indirect costs, such as retailer compensation, telecommunications services, and product information expenses.

⁴ Based on sales generated through April 30, 2007.

On-line Games

Wisconsin participates in Powerball and offers five other on-line games.

Wisconsin participates in Powerball, an on-line lottery game played in 31 jurisdictions and administered by the Multi-State Lottery Association. As shown in Table 12, Wisconsin also offers five other on-line games, which are sold only in Wisconsin. During FY 2005-06, Powerball sales in Wisconsin totaled \$113.3 million, which was more than Wisconsin’s five other on-line games combined.

Table 12

Wisconsin Lottery On-line Games

Game	Date of Introduction	Drawing Frequency	Odds of Winning Maximum Prize	FY 2005-06 Sales (millions)
Powerball	April 19, 1992	Twice weekly	1:146.1 million	\$113.3
SuperCash!	February 4, 1991	Daily	1:1.6 million	27.4
Pick 3	September 21, 1992	Daily	1:1,000	24.8
Megabucks	June 20, 1992	Twice weekly	1:7.0 million	24.4
Badger 5	February 17, 2003	Daily	1:170,000	22.6
Pick 4	September 15, 1997	Daily	1:10,000	10.8

There continues to be a strong relationship between larger jackpots and increases in weekly Powerball sales.

There continues to be a strong relationship between larger jackpots and increases in weekly Powerball sales. For example, during the 44 weeks in calendar year 2005 when the average weekly jackpot was less than \$100.0 million, weekly lottery sales averaged \$1.1 million. During the eight weeks when the average weekly jackpot was greater than \$100.0 million, however, weekly lottery sales averaged \$5.1 million.

Increasing the odds of winning the Powerball jackpot increased the number and amount of large jackpots.

In response to a decrease in Powerball sales and the lack of large jackpots, the Multi-State Lottery Association modified Powerball in August 2005 to make winning the jackpot more difficult and to increase the likelihood of larger jackpots. It increased the main pool of balls from 53 to 55, which changed the odds of winning the jackpot from 1 in 120.5 million to 1 in 146.1 million. As a result, the dollar value of large jackpots increased. Between August 2005 and December 2006, there were 11 drawings for jackpots estimated to exceed \$200.0 million, including a \$365.0 million jackpot in February 2006 and a \$340.0 million jackpot in October 2005. In contrast, between January 2004 and August 2005, only three

Powerball drawings were for jackpots estimated to exceed \$200.0 million. Wisconsin Lottery staff reported that the most significant factor affecting on-line sales in FY 2005-06 was the change in the odds of winning the Powerball jackpot and the resulting higher jackpots.

■ ■ ■ ■

Retailer Compensation ■

Retailers that sell Wisconsin Lottery tickets are compensated at statutorily established commission rates and through the Retailer Performance program, which provides performance-based incentives including a winning ticket incentive, short-term incentives for retailers that purchase a certain number of tickets or upgrade the lottery products they offer, and sales goals incentives. We reviewed commission rates relative to other states, as well as effectiveness of the Retailer Performance program.

Retailer Commission Rates

Retailers receive commission rates of 5.5 percent of on-line ticket sales and 6.25 percent of instant ticket sales.

Under s. 565.10(14)(b), Wis. Stats., retailers receive commission rates of 5.5 percent of on-line ticket sales and 6.25 percent of instant ticket sales. The commission rate has been increased twice since 1995: 1995 Wisconsin Act 27, the 1995-97 Biennial Budget Act, increased the rate from 5.0 percent to 5.5 percent for all ticket sales, and 1997 Wisconsin Act 27, the 1997-99 Biennial Budget Act, increased the rate from 5.5 percent to 6.25 percent for instant ticket sales only.

While Wisconsin's compensation rate for on-line ticket sales is comparable to rates in other midwestern states, its compensation rate for instant ticket sales is the highest among the midwestern states we reviewed. We note, however, that in five of six other midwestern states, retailers can also receive a commission of 1.0 to 2.0 percent on winning tickets cashed with values up to \$600, which the Wisconsin Lottery does not offer.

Wisconsin had the third-highest rate of retailer compensation among seven midwestern states in FY 2004-05.

In addition to sales commission rates, retailers may receive additional payments based upon performance. As shown in Table 13, in FY 2004-05, Wisconsin had the third-highest overall rate of retailer compensation as a percentage of lottery sales among seven midwestern states. In FY 2000-01, Wisconsin had the highest retailer compensation rate among seven midwestern states, with 7.1 percent of sales provided as retailer compensation.

Table 13

**Retailer Compensation in Midwestern States
FY 2004-05**

State Lottery	Sales Commission (percentage of sales)	Lottery Sales (millions)	Total Retailer Compensation ¹ (millions)	Retailer Compensation as a Percentage of Lottery Sales
Iowa ²	Instant—5.5 percent On-line—5.5 percent Pull-tab—5.0 percent	\$ 210.7	\$ 17.3	8.2%
Michigan	6.0 percent	2,069.5	152.6	7.4
Wisconsin	Instant—6.25 percent On-line—5.5 percent	451.9	31.4	6.9
Indiana	Instant—5.5 percent On-line—6.0 percent	739.6	51.4	6.9
Ohio	Instant—5.75 percent On-line—5.5 percent	2,159.1	133.8	6.2
Minnesota	5.5 percent	408.0	25.0	6.1
Illinois	5.0 percent	1,814.3	91.9	5.1

Source: La Fleur's 2006 World Lottery Almanac, with the exception of Iowa

¹ Includes payments made to retailers through sales commissions and retailer performance programs.

² Information for Iowa's sales commission rates was obtained through the Iowa Lottery's Web site.

Retailer Performance Program

The Retailer Performance program provides up to 1.0 percent of gross sales revenues as incentives to retailers.

In January 2000, the Wisconsin Lottery created the Retailer Performance program, as authorized by s. 565.02 (4)(g), Wis. Stats., in response to declining sales and a declining number of retailers selling lottery tickets. It provides up to 1.0 percent of gross sales revenues as incentives to retailers and has three mutually exclusive components. A retailer may qualify for each component.

The Retailer Performance program paid \$4.6 million in incentives to retailers in FY 2005-06.

Table 14 shows the Wisconsin Lottery's payments to retailers through the Retailer Performance program. Although the majority of incentives paid are cash incentives, some of the short-term incentives were provided as merchandise such as promotional hats and shirts. In FY 2005-06, incentives paid to retailers were \$4.6 million, an increase of 15.0 percent from the previous fiscal year, largely because of increases in payments for short-term and sales goals incentives.

Table 14

Retailer Performance Program Incentives Paid to Retailers

Fiscal Year	Incentives Paid to Retailers	Percentage Change
2001-02	\$4,241,700	–
2002-03	4,306,700	1.5%
2003-04	4,756,800	10.5
2004-05	3,983,800	(16.3)
2005-06 ¹	4,581,100	15.0

¹ Changes to the Retailer Performance program were effective in July 2005.

We reviewed the Retailer Performance program during our biennial program evaluation in 2002 (report 02-9) and recommended that the Wisconsin Lottery consider decreasing or eliminating the likelihood that retailers receive quarterly sales goals incentive payments without increasing their annual sales. We also recommended removing limits on short-term incentives and shifting resources to short-term incentives from other Retailer Performance program components if short-term incentives are effective in increasing sales. To address our concerns, the Wisconsin Lottery promulgated changes to ch. Tax 61.085, Wis. Adm. Code, which became effective in July 2005.

The Winning Ticket Incentive

The winning ticket incentive provides promotional opportunities for the Wisconsin Lottery and its retailers. Wisconsin Lottery officials report that many retailers share the winning ticket incentive with their employees or donate a portion of it to charity.

Retailers that sell a winning lottery ticket with a prize of \$600 or more may receive an incentive payment.

Before July 2005, retailers that sold a winning lottery ticket with a prize of \$600 or more received an incentive payment equal to 2.0 percent of the prize. The maximum incentive a retailer could receive for a single winning ticket was \$100,000. In July 2005, the Wisconsin Lottery limited total payments for the winning ticket incentive to \$300,000 per prize level per drawing. This change was made to limit incentive payments if a large number of winning jackpot tickets was sold in Wisconsin, or other large prizes were won in a single drawing for on-line games such as Powerball. With this change, if more than three retailers sell winning jackpot tickets, \$300,000 is divided among the retailers, instead of each retailer receiving the possible maximum incentive of \$100,000.

Payments made through the winning ticket incentive have fluctuated.

Because the incentive payment is dependent on the sale of a winning ticket with a large prize from either instant or on-line games, payments to retailers have fluctuated from year to year, as shown in Table 15. In FY 2005-06, the Wisconsin Lottery paid \$736,800 through the winning ticket incentive, a decrease of 20.5 percent from the previous fiscal year.

Table 15

Winning Ticket Incentives Paid to Retailers

Fiscal Year	Incentives Paid to Retailers	Percentage Change
2001-02	\$780,900	–
2002-03	820,400	5.1%
2003-04	802,100	(2.2)
2004-05	926,700	15.5
2005-06 ¹	736,800	(20.5)

¹ Changes to the Retailer Performance program were effective in July 2005.

Short-Term Incentives

Short-term incentives are focused on specific retailer actions, such as ordering tickets of certain instant games or making upgrades to the placement of lottery products and signage. Unlike the winning ticket and sales goals incentives, some short-term incentives are paid with merchandise.

In FY 2005-06, the Wisconsin Lottery offered seven short-term incentives, which totaled \$486,900 in payments to retailers.

Table 16 shows the number of short-term incentives offered by the Wisconsin Lottery during each of the past five fiscal years, including payments to retailers. These fell sharply in both FY 2003-04 and FY 2004-05. In FY 2005-06, the first year since the Retailer Performance program was modified, the number of short-term incentives increased to seven, and payments to retailers increased to \$486,900, or by 359.8 percent from the previous year. Wisconsin Lottery officials decided to increase the number of short-term incentives in FY 2005-06, the first year after a limit of four incentives per year ended, to increase sales.

Table 16

Short-Term Incentives Paid to Retailers

Fiscal Year	Number of Short-Term Incentives	Incentives Paid to Retailers ¹	Percentage Change
2001-02	4	\$332,100	–
2002-03	4	337,900	1.7%
2003-04	3	185,400	(45.1)
2004-05	4	105,900	(42.9)
2005-06 ²	7	486,900	359.8

¹ Includes incentives provided as merchandise.

² Changes to the Retailer Performance program were effective in July 2005.

We recommended in our 2002 evaluation (report 02-9) that if short-term incentives were found to be effective in increasing sales, the Wisconsin Lottery no longer limit them to four per year and that it shift resources to short-term incentives from other Retailer Performance program components. In July 2005, the Wisconsin Lottery promulgated rules to allow it to offer an unlimited number of short-term incentives, with a limit of \$300,000 per incentive.

The Sales Goals Incentive

The sales goals incentive component of the Retailer Performance program provides payments to retailers that improve ticket sales over time. It is divided into three portions that are paid separately:

- the instant ticket sales incentive, which is paid quarterly and annually;

- the on-line nonjackpot game sales incentive, which includes the Pick 3, Pick 4, Badger 5, and SuperCash! games and is paid quarterly and annually; and
- the on-line jackpot game sales incentive, which includes the Powerball and Megabucks games and is paid annually.

The Wisconsin Lottery makes sales goals incentive payments after paying the winning ticket and short-term incentives, and it may suspend or reduce sales goals incentive payments to ensure that spending authority for the program does not exceed the statutory limit of 1.0 percent of gross sales revenues. Staff monitor incentives paid on a quarterly basis to adequately plan incentive payments. In FY 2002-03, on-line jackpot sales incentive payments were suspended to ensure that spending authority did not exceed the 1.0 percent limit. In FY 2005-06, the Wisconsin Lottery suspended the jackpot sales incentive because it believed increases in on-line jackpot sales were the result of larger jackpots, rather than actions taken by retailers.

In FY 2005-06, sales goals incentives paid to retailers increased to \$3.4 million, or by 13.8 percent.

Table 17 shows sales goals incentives paid to retailers from FY 2001-02 through FY 2005-06. In FY 2005-06, sales goals incentives paid to retailers increased to \$3.4 million, or by 13.8 percent.

Table 17

Sales Goals Incentives Paid to Retailers

Fiscal Year	Incentives Paid to Retailers	Percentage Change
2001-02	\$3,128,700	-
2002-03	3,148,400	0.6%
2003-04	3,769,300	19.7
2004-05	2,951,200	(21.7)
2005-06 ¹	3,357,400	13.8

¹ Changes to the Retailer Performance program were effective in July 2005.

In response to our recommendation in report 02-9, in July 2005 the Wisconsin Lottery added an annual payment of up to 10.0 percent of each annual sales increase and reduced the percentage paid to

retailers for each quarterly increase to up to 2.0 percent. This change has reduced the share of payments made through quarterly sales incentives, while providing retailers with an incentive to increase annual sales. In May 2003, Wisconsin Lottery officials estimated that under the planned modifications, approximately 80.0 percent of the potential expense from quarterly sales incentives would be shifted to annual sales incentive payments. In FY 2005-06, the first year since the modification of the sales goals incentive, \$2.5 million, or 73.5 percent of the total sales goals incentives, was paid through annual incentives, and \$0.9 million, or 26.5 percent, was paid through quarterly incentives.

Number of Retailers

Since 2000, the number of retail locations selling lottery tickets has decreased from 4,255 to 4,236.

The Wisconsin Lottery contracts with retailers in more than 4,200 locations to sell tickets. As shown in Table 18, the number of retail locations increased at the end of 2005 after four consecutive years of decreases, and then remained relatively constant in 2006. Since the Retailer Performance program was implemented in 2000, the number of retail locations selling lottery tickets has decreased slightly, from 4,255 to 4,236, or by 0.4 percent. Wisconsin Lottery officials indicate that most of the increase in retail locations in 2005 can be attributed to signing a contract with Shopko, which includes 44 retail locations that sell lottery tickets.

Table 18

Retail Locations Selling Wisconsin Lottery Tickets (December of Each Year)¹

Year	Number of Retail Locations	Percentage Change
1997	4,335	-
1998	4,272	(1.5%)
1999	4,254	(0.4)
2000 ²	4,255	<0.1
2001	4,239	(0.4)
2002	4,227	(0.3)
2003	4,174	(1.3)
2004	4,163	(0.3)
2005	4,238	1.8
2006	4,236	(<0.1)

¹ December 2004 data were not available from the Wisconsin Lottery. Retailer information for 2004 is based on March 2005 data.

² The Wisconsin Lottery implemented the Retailer Performance program in January 2000.

Wisconsin Lottery officials indicated that much of the change in the number of retail locations from one year to the next results from changes in the ownership of independent stores. In some years, the number of retailers has been significantly affected by the participation of a single chain store. It appears that retailer commissions and incentives have been more effective in retailer retention than in increasing the number of retail locations selling lottery tickets.

Effect on Sales

Although it is difficult to quantify the effect that the winning ticket and sales goals incentives have on Wisconsin Lottery sales, each short-term incentive is developed with specific goals and estimates for return on expense. Wisconsin Lottery officials calculate the return on expense as the increase in sales above projected sales if an incentive were not offered. In doing so, they use historical sales data from similarly priced games to project game sales in absence of the incentive. They indicated that a return on expense ratio of 3:1 is the minimum return a short-term incentive must generate for it to recover its costs and not affect the proceeds available for property tax relief.

It is estimated that short-term incentives generated an additional \$4.4 million in sales in FY 2005-06.

Table 19 shows the expense and return of the seven short-term incentives that were offered in FY 2005-06, the first year since the short-term incentives were modified. Wisconsin Lottery officials estimate that these incentives generated \$4.4 million in sales above what is likely to have been generated without them. On an individual basis, five of the seven short-term incentives had returns in excess of expense.

Table 19

Short-Term Incentives and Returns
FY 2005-06

Incentive Name	Qualifying Action	Expense	Return ¹	Return to Expense Ratio
Big Money Extravaganza	Ticket Purchase	\$132,900	\$ 1,816,500	13.7:1
Bag Incentive	Merchandise Upgrade ²	54,000	662,600	12.3:1
Harley-Davidson® Fat Boy	Ticket Purchase	97,900	965,000	9.9:1
Money Comb	Ticket Purchase	79,800	605,300	7.6:1
Pull-Tab Payday	Ticket Purchase	52,200	392,600	7.5:1
\$75,000 Poker	Ticket Purchase	68,200	(6,000)	(0.1:1)
Bucks and Trucks	Winning Ticket Sold	1,900	(57,500)	(30.3:1)
Total		\$486,900	\$4,378,500	9.0:1

¹ Reflects an estimate of ticket sales above expected sales in the absence of the incentive.

² Includes actions such as improving lottery product signage and adding lottery ticket displays.

As requested by the Wisconsin Lottery, the Governor proposed to change the instant game ticket inventory management to a “push distribution system,” which is a system in which the Wisconsin Lottery would determine the number and types of tickets sent to retailers based on retailer sales and the scheduled introduction of new games. The information needed to determine which tickets to send to retailers would be collected through the ticket inventory management system administered by GTECH.

Under the Wisconsin Lottery’s current ticket inventory management system, retailers may opt to receive automatic shipments of instant game tickets by ticket price or have sales representatives contact them to determine which tickets they would like to order. Wisconsin Lottery officials indicated that the current system may not be maximizing sales because some retailers may not be aware of which games are performing well, may select games based upon their own preferences, and may not order additional tickets promptly when needed. They believe, therefore, that changing to a push distribution system will allow the Wisconsin Lottery to be more responsive to instant game sales by allowing it to distribute more lottery tickets for games that are performing well and end ticket sales more quickly for games that are performing poorly.

However, changing to a push distribution system may limit the effectiveness of short-term incentives included in the Retailer Performance program, such as incentives related to instant ticket purchases. Because push distribution shifts the responsibility of selecting which tickets retailers sell to the Wisconsin Lottery, alternative short-term incentives will need to be designed to maintain retailer participation. Wisconsin Lottery officials indicated that they were aware of this issue and believed they could provide similar incentives to retailers that sell a certain number of instant tickets, instead of ordering a certain number of instant tickets for a game.

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Future Considerations ■

As noted, the net proceeds of the Wisconsin Lottery contributed to \$133.3 million in property tax relief in FY 2005-06, administrative expenses remained below the statutory limit, and revenues from ticket sales increased to \$509.0 million. Continuing to control expenses and increase revenues from ticket sales will maximize the funds available for property tax relief. The Governor's 2007-09 biennial budget proposal included initiatives to increase sales, as well as proposals related to operations of the Wisconsin Lottery. On April 26, 2007, the Joint Committee on Finance acted on the Governor's proposal.

The Governor proposed, consistent with Lottery's request, to increase the Wisconsin Lottery's product information budget by \$2.9 million, to \$7.5 million. The product information budget has been \$4.6 million since FY 1990-91. The Wisconsin Constitution prohibits the expenditure of public funds or of revenues derived from lottery operations for promotional advertising. It directs any advertising to provide information about the chances of winning and prize structure.

In April 2006, the Wisconsin Lottery entered into a two-year contract with Hoffman York, a Milwaukee-based advertising firm that has held the Wisconsin Lottery's product information contract since 1992, to provide product information services. The contract provides for three optional one-year renewal periods by mutual agreement. During FY 2005-06, the Wisconsin Lottery paid \$4.5 million of its \$4.6 million product information budget to Hoffman York for services, including media purchases. The Wisconsin Lottery must

ensure compliance with s. 16.75(3m)(b), Wis. Stats., which encourages state agencies to make 5.0 percent of their purchases of goods and services from certified minority-owned businesses. Wisconsin Lottery's contract with Hoffman York encourages the firm to follow this requirement and report quarterly to DOR on the total amount it has spent on contracts and orders awarded to minority businesses certified by the Wisconsin Department of Commerce.

Hoffman York subcontracted \$253,000 of its contract, or 5.6 percent of its gross payments from the Wisconsin Lottery during FY 2005-06, to certified minority-owned businesses to provide services related to placing ads in newspapers and magazines. These businesses received a commission from Hoffman York for their services.

If the increase in the product information budget is enacted, Wisconsin Lottery officials have indicated they will initiate a request-for-proposals process for the product information contract before the current contract expires in April 2008. They have met with minority businesses, and some options currently under consideration include:

- requiring vendors to propose partnerships with certified minority-owned businesses; or
- encouraging a group of minority vendors to submit a proposal on the entire product information contract.

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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, 2006 and 2005, 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, 2006 and 2005, 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 management's discussion and analysis and Schedules 1, 2, and 3 is presented for purposes of additional analysis and is not a required part of the financial statements. For management's discussion and analysis on pages 41 through 49, 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. The schedules on pages 72 through 74 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.

In accordance with *Government Auditing Standards*, we have also issued a report dated June 13, 2007, 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 audits.

June 13, 2007

LEGISLATIVE AUDIT BUREAU
by 
Bryan Naab
Deputy State Auditor for Financial Audit

Management's Discussion and Analysis ■

Prepared by Wisconsin Lottery Management

This section of the Wisconsin Lottery's financial statements presents management's discussion and analysis of the financial performance of the Wisconsin Lottery during the fiscal years ending June 30, 2006, and June 30, 2005. This discussion should be read in conjunction with the accompanying financial statements and notes. The financial statements, notes, and this discussion are the responsibility of Wisconsin Lottery management.

Financial Highlights

The financial highlights stated below discuss the financial statements for the fiscal years ended June 30, 2006, and June 30, 2005.

- Operating revenues for the Wisconsin Lottery increased by \$57.2 million, or 12.7 percent, in FY 2005-06 after a decrease of \$31.2 million, or 6.5 percent, in FY 2004-05. Almost all of the increase in FY 2005-06 can be attributed to an increase in on-line ticket sales of Powerball and Wisconsin's Very Own Megabucks and an increase in instant ticket sales. On-line ticket sales increased \$41.3 million, or 22.7 percent, while instant ticket sales increased \$15.8 million, or 5.9 percent. The Wisconsin Lottery projects a decrease in operating revenue for FY 2006-07, primarily due to a decrease in Powerball ticket sales, which have had lower jackpots. The decrease in FY 2004-05 was primarily due to decreases in the Wisconsin Lottery's jackpot on-line games: Powerball decreased \$28.7 million, and Wisconsin's Very Own Megabucks decreased \$2.1 million.

- Operating expenses for FY 2005-06 increased \$36.4 million, or 11.3 percent. During the same period, administrative expenses decreased \$1.2 million, or 12.9 percent; prize expenses increased \$31.8 million, or 12.1 percent; retailer commissions and incentives increased \$3.8 million, or 12.1 percent; vendor services increased \$2.1 million, or 19.8 percent; and other game-related expenses decreased \$0.1 million, or 1.2 percent. For FY 2004-05, operating expenses decreased \$20.6 million, or 6.0 percent. While administrative expenses did not change significantly, prize expenses 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.
- Nonoperating revenue, consisting mainly of investment income, decreased to a loss of \$5.3 million in FY 2005-06, compared to a gain of \$2.9 million in FY 2004-05.
- Net income before transfers for FY 2005-06 increased \$12.6 million, or 9.5 percent, primarily as a result of increased ticket sales. For FY 2004-05, net income before transfers increased \$2.4 million, or 1.8 percent, mostly as a result of the increased investment income.
- Statutorily defined administrative expenses declined from 6.3 percent of gross operating revenues in FY 2004-05 to 5.7 percent of gross operating revenues in FY 2005-06. This continues the decline from FY 2003-04, when administrative expenses were 6.9 percent of gross operating revenues. Administrative expenses for all three years were below the statutory maximum of 10.0 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. The Statement of Net Assets is on page 52, the Statement of Revenues, Expenses, and Changes in Fund Net Assets is on page 53, and the Statement of Cash Flows is on pages 54 and 55.

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, are transferred to the Lottery Fund for distribution in the form of property tax relief. 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 the Wisconsin Lottery's financial performance.

Net Assets

As shown in Table A, total assets increased \$6.6 million, or 4.0 percent, and total liabilities decreased by \$5.5 million, or 4.4 percent, during FY 2005-06. As a result, the Wisconsin Lottery's total net assets increased \$12.1 million, or 30.3 percent, during FY 2005-06. During FY 2004-05, total assets decreased \$16.0 million, or 8.9 percent, total liabilities decreased by \$5.8 million, or 4.5 percent, and total net assets decreased \$10.2 million, or 20.3 percent.

Table A

Net Assets (in Millions)

	June 30, 2004	June 30, 2005	Change	June 30, 2006	Change
Investments	\$128.4	\$121.8	\$(6.6)	\$103.7	\$(18.1)
Capital Assets (Net of Accumulated Depreciation)	0.1	0.2	0.1	0.2	0.0
Other Assets	51.7	42.2	(9.5)	66.9	24.7
Total Assets	180.2	164.2	(16.0)	170.8	6.6
Current Liabilities	30.4	32.7	2.3	36.6	3.9
Noncurrent Liabilities	99.6	91.5	(8.1)	82.1	(9.4)
Total Liabilities	130.0	124.2	(5.8)	118.7	(5.5)
Net Assets:					
Invested in Capital Assets	0.1	0.2	0.1	0.2	0.0
Restricted for Investment Fair Market Value Adjustment	14.4	15.8	1.4	7.1	(8.7)
Restricted for Property Tax Relief	35.7	24.0	(11.7)	44.8	20.8
Total Net Assets	<u>\$50.2</u>	<u>\$40.0</u>	<u>\$(10.2)</u>	<u>\$52.1</u>	<u>\$12.1</u>

Investments decreased by \$18.1 million, or 14.9 percent, during FY 2005-06 as a net result of \$1.4 million in unrealized investment losses from changes in fair market value, and \$16.7 million in bond redemptions to make annuity prize payments due in FY 2005-06. During FY 2004-05, investments decreased by \$6.6 million, or 5.1 percent, as a net result of \$9.3 million in unrealized investment gains from changes in fair market value, \$16.5 million in bond redemptions to make annuity prize payments due in FY 2004-05, and \$0.6 million in bond purchases for future prize payments.

The increase in other assets of \$24.7 million, or 58.5 percent, during FY 2005-06 is mainly the result of a \$29.2 million increase in cash offset by a \$5.4 million decrease in accounts receivable. The decrease in other assets of \$9.5 million, or 18.4 percent, during FY 2004-05 is mainly the result of a \$10.0 million decrease in cash. The variability in cash balances is primarily caused by annual sales volume, while the decrease in accounts receivable is the result of the normal weekly collection cycle used by the Wisconsin Lottery.

The decrease in total liabilities of \$5.5 million during FY 2005-06 is primarily attributable to the \$9.4 million decrease in annuity prizes payable, offset by a \$3.4 million increase in other prizes payable and a \$0.3 million increase in accounts payable and payables to the Multi-State Lottery Association. The decrease in annuity prizes payable is the net result of \$16.7 million in bond redemptions to make annuity payments due in FY 2005-06, and \$7.3 million in amortization on the bonds for the period. During FY 2004-05, total liabilities decreased by \$5.8 million, or 4.5 percent, which 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 other prizes payable. The decrease in annuity prizes payable is the net result of \$16.5 million in bond redemptions to make annuity prize payments due in FY 2004-05, \$0.6 million in bond purchases for future prize payments, and \$8.0 million in amortization on the bonds for the period.

The Wisconsin Lottery's net assets consist of amounts invested in capital assets net of related debt, and amounts that may be used only for restricted purposes. There are two restricted purposes. First, accounting principles dictate that the gain or loss related to the change in the fair market value of investments be reported. Investments have been purchased for the payment of installment prize awards and are generally held to maturity. Therefore, the change in the fair market value of these investments is restricted and is not available for property tax relief. Second, all remaining net assets are restricted for property tax relief.

Total net assets increased by \$12.1 million during FY 2005-06. In FY 2005-06, total net assets consisted of \$0.2 million invested in capital assets, \$7.1 million restricted for investment fair market value adjustments, and \$44.8 million restricted for property tax relief. During FY 2004-05, total net assets decreased by \$10.2 million and 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.

Change in Net Assets

As shown in Table B, the Wisconsin Lottery reported an increase in net assets of \$12.1 million in FY 2005-06, and a decrease of \$10.2 million in FY 2004-05. The FY 2005-06 increase can be attributed primarily to an increase in total revenues of \$49.0 million, an increase in total expenses of \$36.4 million, and a decrease in operating transfer out for property tax relief of \$10.1 million. The FY 2004-05 decrease can be attributed primarily 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 2003-04	FY 2004-05	Change	FY 2005-06	Change
Revenues					
Operating Revenues:					
Ticket Sales	\$482.9	\$451.9	\$(31.0)	\$509.0	\$57.1
Retailer fees and miscellaneous revenue	0.3	0.1	(0.2)	0.2	0.1
Nonoperating Revenues:					
Investment income (loss)	(10.1)	2.9	13.0	(5.3)	(8.2)
Total Revenues	473.1	454.9	(18.2)	503.9	49.0
Expenses					
Program Expenses:					
Prize expenses	275.2	262.1	(13.1)	293.9	31.8
Retailer commissions and incentives	33.9	31.4	(2.5)	35.2	3.8
Instant and on-line vendor services	12.4	10.6	(1.8)	12.7	2.1
Other game-related expenses	11.5	8.4	(3.1)	8.3	(0.1)
Office Administration Expenses	9.4	9.3	(0.1)	8.1	(1.2)
Total Expenses	342.4	321.8	(20.6)	358.2	36.4
Net Income Before Transfers	130.7	133.1	2.4	145.7	12.6
Operating Transfers					
Transfer for Property Tax Relief	(131.6)	(143.4)	(11.8)	(133.3)	10.1
Transfer In from General Fund	1.2	1.0	(0.2)	0.7	(0.3)
Transfer for Compulsive Gambling Programs	(0.3)	(0.3)	0.0	(0.3)	0.0
Transfer for Law Enforcement	(0.3)	(0.3)	0.0	(0.3)	0.0
Transfer for Lottery Credit Administration	(0.2)	(0.2)	0.0	(0.3)	(0.1)
Transfer Out to General Fund	(0.1)	(0.1)	0.0	(0.1)	0.0
Change in Net Assets	<u>\$(0.6)</u>	<u>\$(10.2)</u>	<u>\$(9.6)</u>	<u>\$12.1</u>	<u>\$22.3</u>

The increase of \$49.0 million, or 10.8 percent, in total revenues during FY 2005-06 is mainly the result of ticket sales increasing by \$57.1 million and investment income decreasing by \$8.2 million. A discussion of ticket sales results by game category follows this section. Investment income decreased by \$8.2 million mainly because of \$1.4 million in unrealized investment losses from changes in fair market value and \$7.3 million in amortization on the investments for FY 2005-06. The interest earnings from the State Investment Fund and the unreserved account at the Multi-State Lottery Association also increased a total of \$1.9 million. During FY 2004-05, the decrease in total revenues of \$18.2 million, or 3.8 percent, was mainly the result of ticket sales decreasing by \$31.0 million and investment income increasing by \$13.0 million. Investment income increased by \$13.0 million because of fair market value adjustments to investments. The interest earnings from the state investment pool and the unreserved account at the Multi-State Lottery Association also increased a total of \$0.8 million.

The increase in total expenses of \$36.4 million, or 11.3 percent, for FY 2005-06 is mainly the result of prize expenses increasing \$31.8 million, retailer commissions and incentives increasing \$3.8 million, and vendor services increasing \$2.1 million. For FY 2004-05, total expenses decreased \$20.6 million, or 6.0 percent, mainly as the result of prize expenses decreasing \$13.1 million, retailer commissions and incentives decreasing \$2.5 million, and vendor services decreasing \$1.8 million. In general, prize expenses 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 6.3 percent of gross operating revenues in FY 2004-05 to 5.7 percent of gross operating revenues in FY 2005-06. This continues the decline from FY 2003-04, when administrative expenses were 6.9 percent of gross operating revenues. Administrative expenses for all three years were below the statutory maximum of 10.0 percent. See Schedule 2 after the notes to the financial statements for more information.

The operating transfer out for property tax relief decreased by \$10.1 million, or 7.0 percent, during FY 2005-06, while the operating transfer out for property tax relief increased by \$11.8 million, or 9.0 percent, during FY 2004-05. The transfers are based on an estimate of total funds available for distribution under the lottery and gaming credit for property taxes. This estimate analyzes all revenues and expenses of the Wisconsin Lottery, with an emphasis on the projected ticket sales and prize expenses. Therefore, it is possible that increases or decreases in the transfer out for property tax relief will differ from the increases and decreases in net income before transfers in any given year.

Lottery Ticket Sales and Prize Awards

Table C compares ticket sales for each lottery game category for FY 2003-04, FY 2004-05, and FY 2005-06.

Table C

Lottery Ticket Sales (in Millions)

	FY 2003-04	FY 2004-05	Change	FY 2005-06	Change
Instant					
Scratch-off	\$266.6	\$263.0	\$ (3.6)	\$280.4	\$17.4
Pull-tab	3.7	6.9	3.2	5.3	(1.6)
On-line					
SuperCash!	26.6	25.5	(1.1)	27.4	1.9
Powerball	108.0	79.3	(28.7)	113.3	34.0
WI Very Own Megabucks	20.2	18.1	(2.1)	24.4	6.3
Daily Pick 3	23.9	24.5	0.6	24.8	0.3
Daily Pick 4	10.1	10.4	0.3	10.8	0.4
Badger 5	23.8	24.2	0.4	22.6	(1.6)
Total	<u>\$482.9</u>	<u>\$451.9</u>	<u>\$(31.0)</u>	<u>\$509.0</u>	<u>\$57.1</u>

Instant scratch-off ticket sales increased \$17.4 million during FY 2005-06 but were down \$3.6 million during FY 2004-05. Sales of \$1 tickets as a percentage of total sales continued to decline, while sales of higher-priced instant games increased. The Wisconsin Lottery continues to strategically focus on higher-priced instant games through marketing and higher prize payouts on those games. Pull-tab sales decreased \$1.6 million in FY 2005-06, after increasing by \$3.2 million in FY 2004-05.

On-line game sales increased by \$41.3 million during FY 2005-06 and decreased by \$30.6 million during FY 2004-05, primarily due to sales fluctuations of the Powerball and Wisconsin's Very Own Megabucks games. Sales of jackpot games such as these are largely driven by the size of the jackpot.

Table D compares ticket prize awards for each lottery game category for FY 2003-04, FY 2004-05, and FY 2005-06.

Table D

Lottery Ticket Prize Awards
(in Millions)

	FY 2003-04	FY 2004-05	Change	FY 2005-06	Change
Instant					
Scratch-off	\$167.9	\$166.4	\$ (1.5)	\$179.1	\$12.7
Pull-tab	2.3	4.3	2.0	3.3	(1.0)
Super 2 nd Chance ¹	0.1	0.6	0.5	0.8	0.2
On-line					
SuperCash!	14.1	14.2	0.1	14.0	(0.2)
Powerball	51.7	38.0	(13.7)	54.9	16.9
WI Very Own Megabucks	10.6	9.6	(1.0)	12.8	3.2
Daily Pick 3	11.6	12.5	0.9	12.2	(0.3)
Daily Pick 4	5.2	4.4	(0.8)	5.5	1.1
Badger 5	11.6	11.8	0.2	11.0	(0.8)
Super 2 nd Chance ¹	0.1	0.3	0.2	0.3	0.0
Total	<u>\$275.2</u>	<u>\$262.1</u>	<u>\$(13.1)</u>	<u>\$293.9</u>	<u>\$31.8</u>

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

See Schedule 3 after the notes to the financial statements for a multi-year summary of prize expenses.

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 GTECH Corporation for an integrated gaming computer system and services effective November 24, 2003. The integrated system provides telecommunication services that were previously provided under a separate contract. In future financial statements, these telecommunication services will no longer be identified separately. In FY 2005-06, payments to GTECH were \$12.6 million, which is 18.9 percent more than the \$10.6 million paid to GTECH in FY 2004-05. GTECH payments are largely based directly on Wisconsin Lottery sales volume and fluctuate in relation to those sales.

Contacting the Lottery's Financial Management

The financial statements are 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 the financial statements or need additional financial information, contact:

Wisconsin Lottery Accounting Section
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:

Director of the Wisconsin Lottery
Post Office Box 8941
Madison, Wisconsin 53708-8941
Telephone (608) 261-8800

Financial Statements ■

Statement of Net Assets

June 30, 2006 and 2005

	June 30, 2006	Restated June 30, 2005
ASSETS		
Current Assets:		
Cash and cash equivalents (Note 3)	\$ 56,142,816	\$ 26,950,193
Investments for prize annuities (Note 3)	16,426,052	16,421,937
Accounts receivable (Note 4)	1,023,766	6,467,849
Due from other state programs (Note 4)	1,243,316	1,616,724
Ticket inventory	1,532,860	1,334,355
Grand prize deposit (Note 7)	1,188,583	757,651
Prepaid expenses (Note 16)	1,016,537	298,522
Interest receivable	196,225	58,486
Total Current Assets	<u>78,770,155</u>	<u>53,905,717</u>
Noncurrent Assets:		
Investments for prize annuities (Note 3)	87,247,044	105,357,009
Grand prize deposit (Note 7)	4,421,161	4,488,000
Prepaid expense (Note 16)	135,160	239,319
Capital assets: (Note 8)		
Equipment	760,043	766,621
Leasehold improvements	159,724	197,102
Accumulated depreciation	(741,509)	(752,820)
Total Noncurrent Assets	<u>91,981,623</u>	<u>110,295,231</u>
TOTAL ASSETS	<u>170,751,778</u>	<u>164,200,948</u>
LIABILITIES		
Current Liabilities:		
Annuity prizes payable (Note 5)	16,396,867	16,276,879
Prizes payable	12,178,533	8,824,006
Accounts payable (Note 4)	2,975,778	3,528,648
Due to other state programs (Note 4)	2,724,769	2,739,626
Lottery association payable	1,104,692	285,466
Deferred revenue	850,908	587,048
Due to other governments (Note 4)	43,108	44,327
Accrued payroll	196,650	179,854
Compensated absences (Note 13)	158,918	189,876
Total Current Liabilities	<u>36,630,223</u>	<u>32,655,730</u>
Noncurrent Liabilities:		
Annuity prizes payable (Note 5)	81,813,926	91,333,568
Compensated absences (Note 13)	230,233	189,032
Total Noncurrent Liabilities	<u>82,044,159</u>	<u>91,522,600</u>
TOTAL LIABILITIES	<u>118,674,382</u>	<u>124,178,330</u>
NET ASSETS		
Net Assets:		
Invested in capital assets, net of related debt (Note 8)	178,258	210,903
Restricted for investment fair market value adjustment (Note 10)	7,095,846	15,794,568
Restricted for property tax relief (Note 10)	44,803,292	24,017,147
TOTAL NET ASSETS	<u>\$ 52,077,396</u>	<u>\$ 40,022,618</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, 2006 and 2005

	Year Ended June 30, 2006	Restated Year Ended June 30, 2005
OPERATING REVENUES		
Instant Ticket Sales (Net of allowances of \$419,379 and \$353,570, respectively)	\$ 285,757,651	\$ 269,904,836
On-line Ticket Sales (Net of ticket discounts of \$470,547 and \$231,640, respectively)	223,299,704	181,967,204
Retailer Fees	25,720	31,888
Miscellaneous Revenue	155,992	90,033
Total Operating Revenues	509,239,067	451,993,961
OPERATING EXPENSES		
Program Expenses:		
Instant prize expense	183,201,056	171,269,091
On-line prize expense	110,711,493	90,914,744
Retailer commissions and incentives	35,188,988	31,363,039
Instant and on-line vendor services	12,705,302	10,572,828
Product information costs	4,589,159	4,581,492
Instant ticket printing costs	3,167,831	3,195,303
On-line telecommunication charges	0	42,430
Instant ticket delivery costs	611,182	611,882
Total Program Expenses	350,175,011	312,550,809
Administrative Expenses:		
Salaries and fringe benefits	5,206,105	5,423,616
Supplies and services	2,809,610	3,826,083
Depreciation expense	49,825	55,642
Total Administrative Expenses	8,065,540	9,305,341
Total Operating Expenses	358,240,551	321,856,150
NET OPERATING INCOME	150,998,516	130,137,811
NONOPERATING REVENUES (EXPENSES) AND OPERATING TRANSFERS		
Investment Income (Loss) (Note 6)	(5,325,018)	2,861,074
Gain (Loss) on Disposal of Fixed Assets	0	19,980
Miscellaneous Revenue	0	28,140
Net Income Before Transfers	145,673,498	133,047,005
Operating Transfers:		
Transfers of lottery proceeds for property tax relief (Note 11)	(133,296,150)	(143,397,558)
Transfers in from General Fund (Note 14)	660,908	1,031,000
Transfer to Department of Health and Family Services for compulsive gambling programs	(300,000)	(250,000)
Transfer to Department of Justice for law enforcement	(319,547)	(301,354)
Transfer to Department of Revenue for lottery credit administration	(251,523)	(234,375)
Transfers out to General Fund (Note 15)	(112,408)	(94,556)
CHANGE IN NET ASSETS	12,054,778	(10,199,838)
Total Net Assets—Beginning of the Year	40,022,618	50,222,456
Total Net Assets—End of the Year	\$ 52,077,396	\$ 40,022,618

The accompanying notes are an integral part of this statement.

Statement of Cash Flows for the Years Ended June 30, 2006 and 2005

	Year Ended June 30, 2006	Restated Year Ended June 30, 2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash Received from Retailers	\$ 516,529,385	\$ 449,889,030
Cash Paid for Prizes	(309,252,405)	(276,678,426)
Cash Paid for Retailer Commissions and Incentives	(33,823,697)	(31,148,916)
Cash Paid/Received for Grand Prize Deposit	(28,533)	717,537
Cash Paid to Employees	(5,101,798)	(5,386,115)
Cash Paid to Suppliers	(25,414,104)	(21,962,259)
Net Cash Provided by Operating Activities	142,908,848	115,430,851
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Transfers of Proceeds for Property Tax Credit	(133,326,183)	(142,918,071)
Transfer of Proceeds for Law Enforcement	(319,201)	(315,699)
Transfer of Proceeds for Lottery Credit Administration	(255,047)	(232,617)
Transfer of Proceeds for Compulsive Gambling Programs	(300,000)	(250,000)
Transfers to the General Fund	(112,408)	(94,556)
Transfers from the General Fund	1,031,000	1,276,999
Net Cash Used by Noncapital Financing Activities	(133,281,839)	(142,533,944)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Cash Paid for Purchase of Equipment	(17,180)	(171,673)
Cash Received from Sale of Equipment	0	20,200
Net Cash Used by Capital and Related Financing Activities	(17,180)	(151,473)
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest Received	2,900,404	1,352,467
Cash Received for Redemption of Bonds	16,682,390	16,524,234
Cash Paid for Purchase of Bonds	0	(616,195)
Net Cash Provided by Investing Activities	19,582,794	17,260,506
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	29,192,623	(9,994,060)
Cash and Cash Equivalents—Beginning of the Year	26,950,193	36,944,253
Cash and Cash Equivalents—End of the Year	<u>\$ 56,142,816</u>	<u>\$ 26,950,193</u>

The accompanying notes are an integral part of this statement.

	Year Ended June 30, 2006	Restated Year Ended June 30, 2005
RECONCILIATION OF NET OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Net Operating Income	\$ 150,998,516	\$ 130,137,811
Adjustments to Reconcile Net Operating Income to Net Cash Provided by Operating Activities:		
Depreciation expense	49,825	55,642
Vendor liquidated damages settlement	84,480	0
Noncash donated prize expense	0	28,140
Changes in Assets and Liabilities:		
Decrease (Increase) in receivables	5,444,083	(889,878)
Decrease (Increase) in grand prize deposit	(28,533)	717,536
Decrease (Increase) in ticket inventory	(198,505)	(116,476)
Decrease (Increase) in prepaid expenses	(698,336)	(328,017)
Decrease (Increase) in Due from other state programs	(3,125)	(1,388)
Increase (Decrease) in prizes payable	(13,320,388)	(14,993,927)
Increase (Decrease) in deferred revenue	263,860	158,062
Increase (Decrease) in Due to other state programs	23,938	(167,618)
Increase (Decrease) in accounts payable	(551,950)	1,455,485
Increase (Decrease) in Lottery Association payable	819,226	(678,370)
Increase (Decrease) in Due to other governments	(1,282)	(4,105)
Increase (Decrease) in accrued payroll	16,796	(1,612)
Increase (Decrease) in compensated absences	10,243	59,566
Total Adjustments	<u>(8,089,668)</u>	<u>(14,706,960)</u>
Net Cash Provided by Operating Activities	<u><u>\$ 142,908,848</u></u>	<u><u>\$ 115,430,851</u></u>
Noncash Activities:		
Net change in unrealized gains and losses	\$ (8,698,722)	\$ 1,311,777
Vendor liquidated damages settlement	0	250,000

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 2005-06 and 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 2005-06 and 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 2005-06 and 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 Wisconsin Lottery's stand-alone financial statements do not include the Lottery Fund appropriations from which the property tax credit disbursements are made. However, funding for these appropriations is 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 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 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, administration 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 and records financial transactions on the State's central accounting system using the budgetary basis of accounting. A reconciliation between the budgetary basis and the accrual basis of accounting for the Wisconsin Lottery's 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. Consequently, instant scratch-off ticket sales are reduced through a sales allowance estimate, based on historical information of unsold tickets returned by the retailers. 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. The Wisconsin Lottery occasionally features an on-line game promotion that offers bonus tickets, such as six tickets for the price of five. Revenue is recognized for all tickets sold, and a sales discount is used to record the value of the bonus tickets.

C. Cash and Cash Equivalents

Cash and cash equivalents reported on the Statement of Net Assets include cash balances deposited with the State, which are invested in shares of the State Investment Fund, a short-term investment pool of state and local funds. Balances pooled in the State Investment Fund are restricted to legally stipulated investments valued consistent with GASB Statement No. 31, *Accounting and Financial Reporting for Investments and for External Investment Pools*.

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 2005-06 and FY 2004-05. Nonprofit organizations receive higher commissions.

E. Retailer Performance Programs

In addition to the retailer commissions discussed in Note 2(D), the Wisconsin Lottery administers an incentive program for retailers that meet certain performance goals identified by the Lottery. This program began on January 1, 2000. Retailers must be in good standing and sell instant tickets to participate in the program, which in FY 2005-06 and FY 2004-05 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 1.0 percent of gross revenues from the sale of instant and on-line 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 2.0 percent commission of the prize award, up to a maximum of \$100,000 per winning ticket. Winning ticket incentive payments are made weekly.

Short-term incentives may be offered throughout the year for predefined periods. 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 incentive payments are limited to a total of \$300,000 per 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 nonjackpot 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 performance program, the Wisconsin Lottery considers as an on-line jackpot game those games having a large top prize that may be paid as an annuity or cash option. An on-line nonjackpot prize is smaller and offers only a cash option for payment. Subject to certain restrictions and allowances, retailers earn up to 10.0 percent of the increase in quarterly sales over sales for the same quarter of the previous year for instant tickets and on-line nonjackpot games, which are paid to them quarterly. Because of the unpredictable nature of the on-line jackpot games, sales goals incentive program payments for them are calculated and made annually. These payments may be limited to ensure that total performance program payments are within the performance program cap of 1.0 percent of ticket revenues.

F. Administrative Expenses

State statutes limit the Wisconsin Lottery's administrative expenses to 10.0 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 50.0 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

Retailers have the right to return unsold instant scratch-off tickets to the Wisconsin Lottery for a refund. Therefore, receivables and cash collected in advance of these ticket sales represent a contingent liability of the Wisconsin Lottery. An estimate is made for the portion of the tickets that may be returned based on historical information on unsold tickets returned by the retailers, and is reported as deferred revenue.

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 reported as deferred revenue.

J. Capital Assets

Assets purchased for \$5,000 or more and certain other assets are capitalized and recorded at historic cost and 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 or 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

All investments of the Wisconsin Lottery are carried at fair market value based on quoted market prices. State Investment Fund shares are valued at cost, which approximates fair market value.

N. Disbursement of Lottery Proceeds

The State of Wisconsin disburses net lottery proceeds through two means: the Lottery and Gaming Tax Credit and the Farmland Tax Relief 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 and Gaming Tax Credit in a given fiscal year. The Department of Revenue is notified of this amount by November 1. The Lottery and Gaming Tax Credit is paid to municipalities on the 4th Monday in March of the same fiscal year.

The Farmland Tax Relief 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 Relief Credit is determined by the dates that eligible claims for it are processed. Therefore, disbursement of Farmland Tax Relief Credit payments occurs throughout the year.

3. DEPOSITS AND INVESTMENTS

The cash balances of the Wisconsin Lottery are deposited with the State and invested in the State Investment Fund, which 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 and in accordance with Wisconsin Statutes. The carrying amount of shares in the State Investment Fund, which approximates fair market value, was \$56,142,000 as of June 30, 2006, and \$26,950,000 as of June 30, 2005. Holdings include certificates of deposit and investments consisting primarily of direct obligations of the federal government and unsecured notes of qualifying financial and industrial issuers. The State Investment Fund is not registered with the Securities and Exchange Commission.

The Wisconsin Lottery manages its investment activities separate from the cash and investment activities of the State Investment Fund. The investments held by the Wisconsin Lottery have been purchased to finance jackpot prizes that are payable as annuities over a 20-year or 25-year period. The investments are scheduled to mature near the time prize payments become payable to winners. The Wisconsin Lottery follows MUSL's policies for its investments, 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. As of June 30, 2006, all of the assets in investments for prize annuities were held by the State's agent, US Bank, in the State's name.

The Wisconsin Lottery held U. S. Treasury and Agency investments with the following maturities as of June 30, 2006 and 2005:

Maturity	<u>June 30, 2006</u>	Restated <u>June 30, 2005</u>
Less than 1 Year	\$ 16,426,052	\$ 16,421,937
1 to 5 Years	49,637,400	57,688,800
6 to 10 Years	22,466,639	27,352,340
More than 10 Years	<u>15,143,005</u>	<u>20,315,869</u>
Total	<u>\$103,673,096</u>	<u>\$121,778,946</u>

4. ACCOUNTS RECEIVABLE AND ACCOUNTS PAYABLE BALANCES

Accounts Receivable and Accounts Payable balances are disaggregated as follows:

A. Accounts Receivable

	<u>June 30, 2006</u>	<u>June 30, 2005</u>
Accounts Receivable:		
Retailers	\$ 1,020,029	\$ 6,467,426
Miscellaneous	<u>3,737</u>	<u>423</u>
Total Accounts Receivable	<u>\$ 1,023,766</u>	<u>\$ 6,467,849</u>
Due from Other State Programs:		
Transfers for Gaming	\$ 660,908	\$ 1,031,000
Transfers for Farmland Tax Relief Credit	578,120	584,561
Miscellaneous	<u>4,288</u>	<u>1,163</u>
Total Due from Other State Programs	<u>\$ 1,243,316</u>	<u>\$ 1,616,724</u>

B. Accounts Payable

	<u>June 30, 2006</u>	<u>June 30, 2005</u>
Accounts Payable:		
Vendors (June 30, 2005 restated)	\$2,057,767	\$3,480,646
Prizes	790,756	0
Retailer Commissions	97,923	0
Lottery Credit Administration	824	2,645
Law Enforcement	1,078	178
Employee Travel Reimbursement	(2,366)	669
Withholding on Prizes	(2,703)	28,999
Miscellaneous	<u>32,499</u>	<u>15,511</u>
Total Accounts Payable	<u>\$2,975,778</u>	<u>\$3,528,648</u>
Due to Other State Programs:		
Farmland Tax Credit	\$2,185,951	\$2,222,425
Employee Fringe Benefits	198,209	118,217
Withholding on Prizes	119,611	238,792
Lottery Credit Administration	15,584	17,303
Law Enforcement	10,585	11,186
Other State Programs	<u>194,829</u>	<u>131,703</u>
Total Due to Other State Programs	<u>\$2,724,769</u>	<u>\$2,739,626</u>
Due to Other Governments:		
Employee Fringe Benefits	\$ 41,585	\$ 40,617
Lottery Credit Administration	1,807	1,792
Law Enforcement	2,216	2,168
Withholding on Prizes	<u>(2,500)</u>	<u>(250)</u>
Total Due to Other Governments	<u>\$ 43,108</u>	<u>\$ 44,327</u>

5. ANNUITY PRIZES PAYABLE

The Wisconsin Lottery has an unconditional obligation to pay all prize winners the future value of their prizes. The present 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. See Note 3 for information related to the investments for prize annuities. Each year, an adjustment to the annuity prizes payable account is made to amortize the present value using the effective interest method. The present value adjustment was \$7,275,262 for FY 2005-06 and \$7,971,224 for FY 2004-05.

Future prize payments and the present value of those payments is as follows:

<u>Fiscal Year</u>	<u>FY 2005-06 Total Payments</u>	<u>FY 2004-05 Total Payments</u>
2005-06	–	\$ 16,673,962
2006-07	\$ 16,806,053	16,806,053
2007-08	16,942,383	16,942,383
2008-09	16,935,179	16,935,179
2009-10	14,522,529	14,522,529
2010-11	9,705,351	9,705,351
Subsequent Years	<u>64,300,476</u>	<u>64,300,476</u>
Future Prize Payments	139,211,971	155,885,933
Less: Present Value Adjustment	<u>41,001,178</u>	<u>48,276,486</u>
Present Value of Future Prize Payments	<u>\$98,210,793</u>	<u>\$107,609,447</u>

Annuity prizes payable activity for the fiscal years ended June 30, 2006, and June 30, 2005, 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>
2005-06	\$107,609,447	\$7,275,262	\$(16,673,916)	\$ 98,210,793	\$16,396,867
2004-05	115,538,088	8,587,419	(16,516,060)	107,609,447	16,276,879

6. INVESTMENT INCOME (LOSS)

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

	<u>FY 2005-06</u>	<u>FY 2004-05</u>
Interest from State Investment Fund	\$ 3,034,883	\$1,342,683
Net Increase (Decrease) in Fair Market Value of Annuity Investments	(1,423,460)	9,283,002
Decrease for Amortization of Annuity Investments	(7,275,262)	(7,971,224)
Net Change in Fair Market Value of State Investment Fund	0	38,399
Interest from MUSL Prize Reserve Accounts	335,561	164,438
Miscellaneous Interest	<u>3,260</u>	<u>3,776</u>
Total Investment Income (Loss)	<u>\$(5,325,018)</u>	<u>\$2,861,074</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 7. Under GASB Statement 31, which requires investments to be reported at fair market value, the net increases or decreases in fair market 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 amount of the amortization of annuity prizes payable is included as an adjustment to investment income for the bonds reported at fair market value.

7. GRAND PRIZE DEPOSIT

The Wisconsin Lottery participates in the MUSL Powerball game. The total prize pool equals 50.0 percent of sales for each Powerball drawing. Of the total prize pool, 56.577 percent funds the grand prize pool and 39.423 percent funds the low-tier prize pool.

In addition, MUSL has established several reserve funds to be used for various contingencies. 4.0 percent of the total prize pool is used to fund these reserve accounts until the accounts reach their predetermined balances, at which point the 4.0 percent is added to the grand prize pool. The 4.0 percent is first used to fund the set-aside reserve account until it reaches its cap of \$7.5 million. The 4.0 percent is next distributed to the Set Prize Reserve Account (SPRA) and Prize Reserve Account (PRA) until they reach their caps of \$25 million and \$75 million, respectively. For some draws, these accounts are reduced when the actual prizes won are greater than the amounts available in the prize pools. Interest earned on these accounts was deposited to the unreserved account and can be withdrawn by the member lotteries.

The Wisconsin Lottery has the right to a refund of Wisconsin's share of PRA and SPRA balances if it withdraws from MUSL. The Wisconsin Lottery does not have the right to a refund of its share of the set-aside reserve account. 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). 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. The Powerball grand prize deposit is made up of the following:

	<u>June 30, 2006</u>	<u>June 30, 2005</u>
Prize Reserve Account (PRA)	\$3,341,161	\$3,468,000
Set Prize Reserve Account (SPRA)	1,080,000	1,020,000
Balance of Unreserved Account	<u>1,188,583</u>	<u>757,651</u>
Total Powerball Grand Prize Deposit	<u>\$5,609,744</u>	<u>\$5,245,651</u>

8. CAPITAL ASSETS

Capital asset activity for the fiscal year ended June 30, 2006, was as follows:

	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
Leasehold Improvements	\$ 197,102	\$ 0	\$ (37,378)	\$ 159,724
Equipment	<u>766,621</u>	<u>23,179</u>	<u>(29,757)</u>	<u>760,043</u>
Total Capital Assets	<u>963,723</u>	<u>23,179</u>	<u>(67,135)</u>	<u>919,767</u>
Less Accumulated Depreciation for:				
Leasehold Improvements	80,247	12,070	(37,378)	54,939
Equipment	<u>672,573</u>	<u>43,754</u>	<u>(29,757)</u>	<u>686,570</u>
Total Accumulated Depreciation	<u>752,820</u>	<u>55,824</u>	<u>(67,135)</u>	<u>741,509</u>
Total Capital Assets, Net	<u>\$210,903</u>	<u>\$(32,645)</u>	<u>\$ 0</u>	<u>\$178,258</u>

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

	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
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>

9. OPERATING LEASES

The Wisconsin Lottery occupied a facility on Dairy Drive in Madison for storage and instant ticket operations under operating leases during FY 2005-06. During FY 2004-05, the Wisconsin Lottery also had occupied office, warehouse, and storage facilities in Milwaukee and on the Beltline Highway in Madison under operating leases that expired August 31, 2004.

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

	<u>June 30, 2006</u>	<u>June 30, 2005</u>
Fiscal Year Ending June 30, 2006	–	\$142,257
2007	\$143,389	143,389
2008	144,555	144,555
2009	145,756	145,756
2010	<u>24,326</u>	<u>24,326</u>
Total Minimum Payments Required	<u>\$458,026</u>	<u>\$600,283</u>

Total operating lease expenses for the Wisconsin Lottery amounted to \$142,257 for the fiscal year ended June 30, 2006, and \$163,030 for the fiscal year ended June 30, 2005.

10. RESTRICTED NET ASSETS

The Wisconsin Lottery has restricted net assets for fair market value adjustments of investments of \$7,095,846 as of June 30, 2006, and \$15,794,568 as of June 30, 2005. The Wisconsin Lottery does not realize gains or losses from the change in fair market value of its annuity investments because it holds the investments until maturity to pay the annual prize payments. Therefore, fair market value adjustments recognized as investment income as a result of applying GASB Statement 31 are restricted and 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 8. The Wisconsin Lottery has restricted net assets related to capital assets of \$178,258 as of June 30, 2006, and \$210,903 as of June 30, 2005.

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, are transferred to the Lottery Fund for distribution in the form of property tax relief. The net proceeds and gaming-related transfers available for property tax relief make up the remainder of the restricted net assets and were \$44,803,292 as of June 30, 2006, and \$24,017,147 as of June 30, 2005.

11. DISTRIBUTION OF NET PROCEEDS

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

	<u>FY 2005-06</u>	<u>FY 2004-05</u>
Lottery and Gaming Tax Credit	\$119,827,143	\$131,702,989
Farmland Tax Relief Credit	<u>13,469,007</u>	<u>11,694,569</u>
Total Credits	<u>\$133,296,150</u>	<u>\$143,397,558</u>

12. EMPLOYEE RETIREMENT PLAN

Permanent 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 of the Wisconsin Retirement System that includes financial statements and required supplementary information 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://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 were 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. In addition, state agencies are required to make future contributions to fund the bond's debt service.

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 \$417,336 for FY 2005-06 and \$355,201 for FY 2004-05. 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.

13. COMPENSATED ABSENCES

Compensated absence activity for the fiscal years ended June 30, 2006, and June 30, 2005, 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>
2005-06	\$378,908	\$200,118	\$(189,875)	\$389,151	\$158,918
2004-05	319,342	206,357	(146,791)	378,908	189,876

14. TRANSFERS IN FROM GENERAL FUND

Under Wisconsin Statutes, the unencumbered balances and related interest for the following appropriations are to be transferred to the Lottery Fund at the end of the fiscal year: the appropriation under s. 20.435(7)(kg), Wis. Stats., for the Department of Health and Family Services’ compulsive gambling awareness campaign; the appropriation under s. 20.455(2)(g), Wis. Stats., for the Department of Justice’s gaming law enforcement; and the appropriations under ss. 20.505(8)(g) and 20.505(8)(jm), Wis. Stats., for the Department of Administration, Division of Gaming’s general operations related to racing and bingo. The Wisconsin Lottery received \$660,908 from these transfers in FY 2005-06 and \$1,031,000 in FY 2004-05.

15. TRANSFERS OUT TO GENERAL FUND

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 the State. Section 79 of 2005 Wisconsin Act 25 required state agencies to lapse or transfer the amount of these savings to the General Fund for general appropriation. The Wisconsin Lottery transferred \$112,408 to the General Fund in FY 2005-06 and \$92,456 in FY 2004-05 for this purpose.

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 for this purpose.

16. LIQUIDATED DAMAGES

The current contract between the Wisconsin Lottery and GTECH Corporation allows the Wisconsin Lottery to assess liquidated damages 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. GTECH gives the Wisconsin Lottery credit on the next month’s invoice for any liquidated damages of the previous month.

In addition to the typical monthly liquated damages, there were significant liquidated damages during GTECH’s implementation of the Wisconsin Lottery gaming system’s communication system. Wisconsin Lottery staff calculated liquidated damages from July to September 2004 at \$722,363. Through negotiations, the Wisconsin Lottery received benefits with a value of \$822,363 in FY 2004-05, which is \$100,000 more than the damage assessment. GTECH agreed to:

- reduce its charges for additional 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. The Wisconsin Lottery estimates the portion of this credit that will be used within the next year. All activity related to this credit for the fiscal years ended June 30, 2006, and June 30, 2005, was as follows:

<u>Fiscal Year</u>	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>	<u>Used within One Year</u>
2005-06	\$250,000	\$ 0	\$(84,480)	\$165,520	\$30,360
2004-05	0	250,000	0	250,000	10,681

17. RESTATEMENT OF FY 2004-05 FINANCIAL STATEMENTS

An adjustment was made to the FY 2004-05 financial statements to increase accounts payable by \$17,982 and to increase instant and on-line vendor services by \$17,982 for previously unrecorded charges resulting from a vendor’s failure to bill for FY 2004-05 charges until October of 2006. The effect on ending net assets is a decrease of \$17,982.



Supplementary Information ■

Reconciliation of Lottery General Operations Expenses to the Budgetary Basis of Accounting for the Years Ended June 30, 2006 and 2005

	Year Ended June 30, 2006	Restated Year Ended June 30, 2005
SALARIES AND FRINGE BENEFITS		
Per Financial Statement	\$ 5,206,105	\$ 5,423,616
Adjustments to Financial Statement Balance:		
Cash paid in FY 2004-05 but expensed in FY 2003-04	0	381,952
Cash paid in FY 2005-06 but expensed in FY 2004-05	447,445	(447,445)
Cash paid in FY 2006-07 but expensed in FY 2005-06	(473,352)	0
Reclass fringe benefits to transfer out to General Fund	101,264	84,155
Budgetary Basis—Salaries and Fringe Benefits	<u>\$ 5,281,462</u>	<u>\$ 5,442,278</u>
SUPPLIES AND SERVICES AND PERMANENT PROPERTY		
Per Financial Statement:		
Product information costs	\$ 4,589,159	\$ 4,581,492
Supplies and services	2,809,610	3,826,083
Instant ticket printing costs	3,167,831	3,195,303
Instant ticket delivery costs	611,182	611,882
Depreciation expense	49,825	55,642
On-line telecommunications charges	0	42,430
Total per Financial Statement	11,227,607	12,312,832
Adjustments to Financial Statement Balance:		
Depreciation expense	(49,825)	(55,642)
Cash paid in FY 2003-04 but expensed in FY 2004-05	0	(1,237,699)
Cash paid in FY 2004-05 but expensed in FY 2003-04	0	15,571
Cash paid in FY 2004-05 but expensed in FY 2005-06	(1,543,506)	1,543,506
Cash paid in FY 2005-06 but expensed in FY 2004-05	4,205	(4,205)
Cash paid in FY 2005-06 but expensed in FY 2006-07	1,639,656	0
Cash paid in FY 2006-07 but expensed in FY 2005-06	(42,523)	0
Compulsive gambling payment not included above	300,000	250,000
Banking fees paid with Department of Administration's banking fees appropriation	(24,761)	(38,986)
Supplies purchased with Lottery's vendor fees appropriation	0	(540,000)
Noncash revenue transaction expensed in FY 2004-05	0	(35,585)
Post WISMART closing bad debts adjustment	785	0
Capitalized permanent property less disposals	17,180	171,673
Budgetary Basis—Supplies and Services and Permanent Property	<u>\$ 11,528,818</u>	<u>\$ 12,381,465</u>

Statutorily Defined Lottery Administrative Expenses for the Years Ended June 30, 2004 through 2006

	Year Ended June 30, 2006	Restated Year Ended June 30, 2005	Year Ended June 30, 2004
ADMINISTRATIVE EXPENSES			
Instant and On-line Vendor Services	\$ 12,705,302	\$ 10,572,828	\$ 12,383,706
Salaries and Fringe Benefits	5,206,105	5,423,616	5,576,760
On-Line Telecommunications Charges	0	42,430	2,976,463
Supplies and Services	2,809,610	3,826,083	3,812,638
Product Information Costs	4,589,159	4,581,492	4,597,224
Instant Ticket Printing Costs	3,167,831	3,195,303	3,347,743
Instant Ticket Delivery Costs	611,182	611,882	593,867
Depreciation Expense	49,825	55,642	62,534
Total Administrative Expenses as Determined in Accordance with s. 25.75(3)(b), Wis. Stats.	\$ 29,139,014	\$ 28,309,276	\$ 33,350,935
Gross Lottery Operating Revenues	\$ 509,239,067	\$ 451,993,961	\$ 483,223,734
Administrative Expenses as a Percentage of Lottery Operating Revenues	5.72%	6.26%	6.90%

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.

NOTE: The above amounts are based on the accrual basis of accounting.

Summary of Prize Expenses for the Years Ended June 30, 2002 through 2006

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 2005-06		
	Prize Expense	Ticket Sales	Prize Expense as a Percentage of Sales
Instant Games	\$ 183,201,056	\$ 285,757,651	64.1%
On-line Games	110,711,493	223,299,704	49.6
Total for Fiscal Year	\$ 293,912,549	\$ 509,057,355	57.7

	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

NOTE: The above amounts are based on the 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, 2006 and 2005, and have issued our report thereon dated June 13, 2007. 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. Article IV, s. 24(6)(a) of the Wisconsin Constitution requires that the net proceeds of the state lottery be used only for property tax relief. However, as provided for in 2003 Wisconsin Act 33 and 2005 Wisconsin Act 25, \$112,408 was transferred in FY 2005-06 and \$94,556 was transferred in FY 2004-05 from the Lottery Fund to the State's General Fund, to help address budget shortfalls.

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.

June 13, 2007

LEGISLATIVE AUDIT BUREAU
by 
Bryan Naab
Deputy State Auditor for Financial Audit

Appendix 1

National Lottery Sales

FY 2004-05

Jurisdiction	Year Lottery Operations Began	Sales (millions)	Per Capita Sales	Per Capita Sales Rank
Arizona	1981	\$ 397.6	\$ 66.94	37
California	1985	3,333.6	92.26	27
Colorado	1983	417.0	89.38	28
Connecticut	1972	932.9	265.77	5
Delaware	1975	114.1	135.21	22
District of Columbia	1982	234.9	426.74	2
Florida	1988	3,470.7	195.10	12
Georgia	1993	2,734.3	301.39	4
Idaho	1989	113.5	79.42	31
Illinois	1974	1,814.3	142.15	20
Indiana	1989	739.6	117.93	24
Iowa	1985	210.7	71.02	35
Kansas	1987	206.7	75.32	32
Kentucky	1989	707.3	169.47	16
Louisiana	1991	307.0	67.87	36
Maine	1974	209.3	158.38	18
Maryland	1973	1,485.7	265.29	6
Massachusetts	1972	4,465.7	697.91	1
Michigan	1972	2,069.5	204.48	11
Minnesota	1990	408.0	79.49	30
Missouri	1986	785.6	135.44	21
Montana	1987	33.8	36.14	40
Nebraska	1993	100.7	57.23	38
New Hampshire	1964	228.0	174.04	15
New Jersey	1970	2,274.4	260.88	7
New Mexico	1996	139.2	72.20	34
New York	1967	6,038.8	313.63	3
North Dakota	2004	19.1	30.04	41
Ohio	1974	2,159.1	188.34	13
Oregon	1985	360.2	98.92	26
Pennsylvania	1972	2,644.9	212.79	10
Rhode Island	1974	241.9	224.76	9
South Carolina	2002	957.0	224.90	8
South Dakota	1987	32.5	41.89	39
Tennessee	2004	783.7	131.43	23
Texas	1992	3,662.5	160.21	17
Vermont	1978	92.6	148.61	19
Virginia	1988	1,333.9	176.27	14
Washington	1982	458.1	72.86	33
West Virginia	1986	194.2	106.90	25
Wisconsin	1988	451.9	81.62	29
United States	–	47,364.5	177.67	–

Source: La Fleur's 2006 World Lottery Almanac and U.S. Census Bureau

Appendix 2

Affiliated Instant Lottery Games
(by Fiscal Year of Introduction)

FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06
Slingo®	Bonus Slingo®	The Price is Right™	Sweet 16 ¹	Cool Winnings ¹
Elvis®	Harley-Davidson®	Double Up Slingo®	Slingo® Doubler	Lucky Slingo Tripler®
			Plinko (Price is Right™)	Harley-Davidson®
			Cherub Slingo®	Word Search®
			Battleship™	Blue Ribbon Bucks ¹
			Bucks & Trucks	
			Cream Puff Cash ¹	

¹ Games established through partnership agreements with entities to engage in joint advertising opportunities.



State of Wisconsin • DEPARTMENT OF REVENUE

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Jim Doyle
Governor

Roger M. Ervin
Secretary of Revenue

June 15, 2007

Janice Mueller, State Auditor
Legislative Audit Bureau
22 E. Mifflin St. Suite 500
Madison, WI 53703

Dear Ms. Mueller:

The Department of Revenue wishes to thank you and your staff for your detailed, independent analysis of Lottery finances and operations.

As the audit report notes, the Lottery has achieved solid gains in sales while controlling costs. Since fiscal year 2001-02, Lottery sales have increased 19 per cent. During the same time period, costs dropped from 7.9 percent to 5.7 per cent of gross revenues.

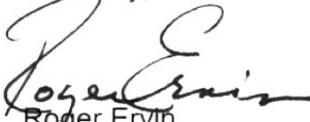
The report notes that the Lottery did not establish annual performance review criteria for the GTECH contract in a timely manner. The Department respectfully submits that this delay had no effect on contract performance. In FY 2005-06, payments to GTECH were \$12.6 million. In FY 2003-04, the last year of the prior contract, the Lottery paid \$15.9 million for similar services. Costs are down, sales are up, resulting in more revenue for property tax relief.

Lottery staff converse with GTECH staff daily, meet face to face with GTECH staff weekly, and evaluate GTECH's performance monthly, assessing liquidated damages for performance failures when appropriate.

With respect to performance criteria, GTECH and the Lottery had difficulty agreeing on the criteria, resulting in a delay in the annual review process. Ultimately, the Lottery unilaterally decided on the criteria using performance measures already contained in the contract. It is the Lottery that is purchasing the service; the Lottery set the criteria for review.

Finally, I note that since the Lottery has been a part of the Department of Revenue, every financial audit has found the Lottery's financial statements in order without any material weaknesses in internal controls.

Sincerely,


Roger Ervin
Secretary