

AN AUDIT

Wisconsin Lottery

Department of Revenue

01-5

March 2001

2001-2002 Joint Legislative Audit Committee Members

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State Auditor - Janice Mueller

Editor of Publications - Jeanne Thieme

Audit Prepared by

Julie Gordon, Director and Contact Person
Heather Apfelbeck
Dan Besteman
Xia Cha

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State of Wisconsin \ LEGISLATIVE AUDIT BUREAU

JANICE MUELLER
STATE AUDITOR

22 E. MIFFLIN ST., STE. 500
MADISON, WISCONSIN 53703
(608) 266-2818
FAX (608) 267-0410
Leg.Audit.Info@legis.state.wi.us

March 8, 2001

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

Dear Senator George and Representative Leibham:

As required by s. 13.94(1)(em), Wis. Stats., we have completed our annual financial audit of the Wisconsin Lottery, which is administered by the Department of Revenue. We have issued an unqualified opinion on the Wisconsin Lottery's fiscal year (FY) 1998-99 and FY 1999-2000 financial statements.

Overall, total lottery sales decreased from \$428.2 million in FY 1998-99 to \$406.7 million in FY 1999-2000. Sales of instant ticket lottery games, however, increased for the first time in four years, from \$230.8 million in FY 1998-99 to \$241.0 million in FY 1999-2000.

In 1999 Wisconsin Act 9, the Legislature provided general purpose revenue to fund certain lottery expenses, including retailer commissions and all administrative expenses except depreciation. These expenses totaled \$76.0 million in FY 1999-2000. The budgetary funding provision was effective only in FY 1999-2000, and it contributed to an increase in the amount available for property tax relief from \$153.9 million in FY 1998-99 to \$232.3 million in FY 1999-2000.

We appreciate the courtesy and cooperation extended to us by the Department of Revenue.

Respectfully submitted,

Janice Mueller
State Auditor

JM/JG/cm

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

We have audited the accompanying balance sheet of the Wisconsin Lottery as of June 30, 2000 and 1999, and the related statement of revenues, expenses, and changes in retained earnings and statement of cash flows for the years then ended. These financial statements are the responsibility of Wisconsin Lottery management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Wisconsin Lottery as of June 30, 2000 and 1999, and the results of its operations and cash flows for the years then ended in conformity with generally accepted accounting principles.

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

In accordance with *Government Auditing Standards*, we have also issued a report dated February 26, 2001, and provided on pages 27-28, on our consideration of the Wisconsin Lottery's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts.

LEGISLATIVE AUDIT BUREAU

February 26, 2001

by

Julie Gordon
Audit Director

Wisconsin Lottery
Balance Sheet
June 30, 2000 and 1999

Assets	<u>June 30, 2000</u>	<u>June 30, 1999</u>
Current Assets:		
Cash and cash equivalents	\$ 6,402,444	\$ 49,116,117
Investments for prize annuities	24,123,557	25,336,820
Accounts receivable	2,756,895	15,003,081
Grand prize deposit	10,327,359	9,273,458
Prepaid expenses	899,860	1,364,210
Ticket inventory	1,179,821	2,065,078
Interest receivable	169	174,955
Due from other state programs	10,117,904	691,802
Total Current Assets	<u>55,808,009</u>	<u>103,025,521</u>
Noncurrent Assets:		
Investments for prize annuities	204,650,934	235,775,330
Equipment (net of accumulated depreciation)	327,942	514,919
Leasehold improvements (net of accumulated depreciation)	40,248	59,823
Total Noncurrent Assets	<u>205,019,124</u>	<u>236,350,072</u>
Total Assets	<u>\$ 260,827,133</u>	<u>\$ 339,375,593</u>
Liabilities and Equity		
Current Liabilities:		
Annuity prizes payable	\$ 24,455,878	\$ 25,559,827
Prizes payable	6,677,676	9,808,451
Accounts payable	3,068,784	3,734,087
Lottery association payable	800,952	3,962,690
Due to other state programs	3,190,686	4,317,064
Deferred revenue	601,487	437,146
Due to other governments	137,599	193,401
Accrued payroll	140,729	243,215
Compensated absences	158,047	170,112
Total Current Liabilities	<u>39,231,838</u>	<u>48,425,993</u>
Long-Term Liabilities:		
Annuity prizes payable	202,864,111	227,133,700
Total Liabilities	<u>242,095,949</u>	<u>275,559,693</u>
Equity:		
Contributed capital	50,751	50,751
Retained earnings:		
Unreserved	10,199,545	48,485,436
Reserved for investment fair market value adjustment	8,480,888	15,279,713
Total Liabilities and Equity	<u>\$ 260,827,133</u>	<u>\$ 339,375,593</u>

The accompanying notes are an integral part of this statement.

Wisconsin Lottery
Statement of Revenues, Expenses, and Changes in Retained Earnings
for the Years Ended June 30, 2000 and 1999

Operating Revenues	<u>June 30, 2000</u>	<u>June 30, 1999</u>
Instant Ticket Sales	\$ 241,040,896	\$ 230,817,635
On-Line Ticket Sales	165,629,273	197,378,447
Retailer Fees	34,725	39,310
Miscellaneous Revenue	<u>79,195</u>	<u>116,796</u>
Total Operating Revenues	<u>406,784,089</u>	<u>428,352,188</u>
Operating Expenses		
Program Expenses:		
Instant prize expense	151,420,082	143,841,064
On-line prize expense	80,983,869	92,860,756
Retailer commissions and incentives	<u>26,974,994</u>	<u>25,926,590</u>
Total Program Expenses	<u>259,378,945</u>	<u>262,628,410</u>
Administrative Expenses:		
Instant and on-line vendor services	11,790,160	11,731,420
Salaries and fringe benefits	4,565,186	4,074,586
On-line telecommunication charges	3,603,066	3,596,842
Supplies and services	4,211,556	4,180,626
Product information	4,488,334	4,541,450
Ticket costs	3,526,528	2,662,437
Depreciation expense	<u>225,410</u>	<u>345,578</u>
Total Administrative Expenses	<u>32,410,240</u>	<u>31,132,939</u>
Total Operating Expenses	<u>291,789,185</u>	<u>293,761,349</u>
Net Operating Income	<u>114,994,904</u>	<u>134,590,839</u>
Non-Operating Revenues (Expenses) and Operating Transfers		
Investment Income (Loss)	(2,620,647)	(5,692,148)
Gain (Loss) on Disposal of Fixed Assets	<u>1,836</u>	<u>(10,928)</u>
Net Income Before Transfers	<u>112,376,093</u>	<u>128,887,763</u>
Operating Transfers:		
Transfers of lottery proceeds for property tax credit	(232,274,835)	(153,918,219)
Transfer in from general purpose revenue subsidies	76,015,043	0
Transfer to Department of Health and Family Services for compulsive gambling awareness campaign	0	(36,000)
Transfer to Department of Revenue for lottery precertification	(889,927)	0
Transfer to Department of Justice for law enforcement	(224,483)	(234,091)
Transfer to Department of Revenue for lottery credit administration	<u>(86,608)</u>	<u>(58,326)</u>
Net Income (Loss)	<u>(45,084,717)</u>	<u>(25,358,873)</u>
Retained Earnings		
Retained Earnings, Beginning of Year as Previously Stated	63,765,149	89,155,314
Prior-period Adjustment for Accounts Payable	<u>0</u>	<u>(31,292)</u>
Retained Earnings, Beginning of Year Adjusted	<u>63,765,149</u>	<u>89,124,022</u>
Retained Earnings, End of Year	<u>\$ 18,680,432</u>	<u>\$ 63,765,149</u>

The accompanying notes are an integral part of this statement.

Wisconsin Lottery
Statement of Cash Flows
for the Years Ended June 30, 2000 and 1999

	<u>June 30, 2000</u>	<u>June 30, 1999</u>
Cash Flows from Operating Activities		
Cash Received from Retailers	\$ 421,627,638	\$ 418,163,645
Cash Paid for Prizes	(283,238,858)	(246,448,627)
Cash Paid/Received for Grand Prize Deposit	(97,331)	1,059,637
Cash Paid to Suppliers and Employees	(38,456,247)	(29,365,076)
Cash Paid for Retailer Commissions and Incentives	(27,231,173)	(25,844,288)
Net Cash Provided by Operating Activities	<u>72,604,029</u>	<u>117,565,291</u>
Cash Flows from Non-Capital Financing Activities		
Transfer of Proceeds for Property Tax Credit	(236,054,809)	(152,543,757)
Transfer in from General Purpose Revenue Subsidies	76,015,043	0
Transfer of Proceeds for Lottery Precertifications	(889,927)	0
Transfer of Proceeds for Compulsive Gambling Awareness Campaign	0	(36,000)
Transfer of Proceeds for Law Enforcement	(224,483)	(234,091)
Transfer of Proceeds for Lottery Credit Administration	(86,608)	(58,326)
Net Cash Provided (Used) by Non-Capital Financing Activities	<u>(161,240,784)</u>	<u>(152,872,174)</u>
Cash Flows from Capital and Related Financing Activities		
Cash Paid for Purchase of Equipment	<u>(109,134)</u>	<u>(84,495)</u>
Cash Flows from Investing Activities		
Interest Received	3,654,876	5,722,188
Cash Received for Redemption of Bonds	47,687,975	24,748,683
Cash Paid for Purchase of Bonds	(5,310,635)	(15,797,667)
Net Cash Provided by Investing Activities	<u>46,032,216</u>	<u>14,673,204</u>
Net Increase (Decrease) in Cash and Cash Equivalents	(42,713,673)	(20,718,174)
Cash and Cash Equivalents, Beginning of Year	<u>49,116,117</u>	<u>69,834,291</u>
Cash and Cash Equivalents, End of Year	<u>\$ 6,402,444</u>	<u>\$ 49,116,117</u>

The accompanying notes are an integral part of this statement.

Statement of Cash Flows
for the Years Ended June 30, 2000 and 1999

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

	<u>June 30, 2000</u>	<u>June 30, 1999</u>
Net Operating Income	<u>\$ 114,994,904</u>	<u>\$ 134,590,839</u>
Adjustments to Reconcile Net Operating Income to Net Cash Provided by Operating Activities		
Depreciation Expense	225,410	345,578
Changes In Assets and Liabilities		
Decrease (Increase) in Receivables	12,246,185	(9,009,437)
Decrease (Increase) in Grand Prize Deposit	(97,331)	1,059,637
Decrease (Increase) in Ticket Inventory	885,257	(153,924)
Decrease (Increase) in Prepaid Expenses	464,350	36,854
Decrease (Increase) in Due from Other State Programs	(9,426,101)	240,589
Increase (Decrease) in Prizes Payable	(45,601,301)	(6,093,114)
Increase (Decrease) in Deferred Revenue	164,342	(364,308)
Increase (Decrease) in Due to Other State Programs	2,653,596	(7,169,361)
Increase (Decrease) in Accounts Payable	(573,191)	1,271,821
Increase (Decrease) in Lottery Association Payable	(3,161,738)	2,760,617
Increase (Decrease) in Due to Other Governments	(55,802)	(46,511)
Increase (Decrease) in Accrued Payroll	(102,486)	52,394
Increase (Decrease) in Compensated Absences	(12,065)	43,617
Total Adjustments	<u>(42,390,875)</u>	<u>(17,025,548)</u>
Net Cash Provided by Operating Activities	<u>\$ 72,604,029</u>	<u>\$ 117,565,291</u>

The accompanying notes are an integral part of this statement.

1. Description of the Wisconsin Lottery

The Wisconsin Lottery was created in December 1987 and is administered by the Lottery Division within the Department of Revenue. The Wisconsin Lottery manages scratch-off and pull-tab instant ticket games and on-line ticket games. During fiscal year (FY) 1999-2000, the Wisconsin Lottery administered 112 active scratch-off, 11 active pull-tab, and 6 active on-line games.

The Wisconsin Lottery joined the Multi-State Lottery Association (MUSL) in June 1989. In FY 1999-2000, the Wisconsin Lottery, as a member of MUSL, participated in two on-line MUSL games called Powerball (start date April 19, 1992) and Cash 4 Life (start date March 30, 1998; end date September 7, 2000).

During FY 1999-2000, the Lottery also sold tickets for four other on-line games: Supercash! (start date February 4, 1991), Wisconsin's Very Own Megabucks (start date June 20, 1992), Daily Pick 3 (start date September 21, 1992), and Daily Pick 4 (start date September 15, 1997).

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

2. Summary of Significant Accounting Policies

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

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

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

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

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

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

- C. Cash and Cash Equivalents - All cash is deposited with the State of Wisconsin Treasurer and is required to be invested in the State Investment Fund. The State Investment Fund is a short-term pool of state and local funds managed by the State of Wisconsin Investment Board with oversight by its Board of Trustees. Since shares in the State Investment Fund are purchased in \$1,000 increments, Wisconsin Lottery cash balances below \$1,000 are deposited in the State's bank. The State Investment Fund is not registered with the Securities and Exchange Commission as an investment company.
- D. Retailer Commissions - Retailer commissions, which are classified as program expenses, were 5.5 percent for on-line ticket sales and 6.25 percent for instant scratch and instant pull-tab tickets during FY 1999-2000 and FY 1998-99. Nonprofit organizations receive additional commissions.
- E. Retailer Incentive Programs - In addition to the retailer commissions discussed in Note 2(D), 1999 Wisconsin Act 9 established an incentive program for retailers who meet certain performance goals identified by the Wisconsin Lottery. The effective date of this program was January 1, 2000. Retailers must be in good standing and sell scratch-off tickets to participate in the program, which has a winning ticket component and a sales incentive component. The total compensation provided to all retailers under the two components of the program may not exceed 1 percent of the gross revenues from the sale of lottery tickets and lottery shares, which are multi-draw on-line tickets.

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

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

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

On-line Powerball and Wisconsin's Very Own Megabucks tickets are sold for up to two drawings. On-line Supercash!, Cash 4 Life, Daily Pick 3, and Daily Pick 4 tickets are sold for the next seven drawings. On-line ticket revenues are recognized at the time the related drawings are held. All ticket sales for future drawings are recorded as deferred revenue.

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

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

- K. Employee Compensated Absences - The Wisconsin Lottery's compensated absence liability consists of accumulated unpaid leave, compensatory time, personal holiday hours, and Saturday/legal holiday hours earned and vested as of June 30.
- L. Due to (from) Other State Programs - During the course of operations, numerous transactions for goods provided or services rendered occur among individual state programs. The balance sheet classifies these receivables and payables as "Due from Other State Programs" or "Due to Other State Programs." As discussed in Note 14, general purpose revenue subsidized certain expenditures during FY 1999-2000. The entire subsidy was not received by June 30, 2000, causing the increase in the Due from Other State Programs account on the Balance Sheet between FY 1998-99 and FY 1999-2000.
- M. Investment Valuation - Pool shares of the State Investment Fund are bought and redeemed at \$1.00 based on the amortized cost of the investments in the Fund. Income calculations are based on the amortized cost of average pool balances. Where possible, investments in the State Investment Fund are reported at fair value for financial reporting purposes and are based on quoted market prices. Fair value determinations not based on quoted market prices include matrix pricing models or are calculated as the net present value of expected future cash flows. Nonparticipating contracts are valued at cost because these investments do not capture interest rate changes, while other investments are valued at par, which approximates fair value. Fair value of investments for prize annuities is based on quoted market prices.

3. **Prior-period Adjustment**

Lottery staff identified an adjustment, which was made for FY 1998-1999, to account for the difference in accounts payable in the State's accounting system, WiSMART, and the Lottery's retailer accounting system. This difference, totaling \$31,292, was the result of two incorrectly coded accounting transactions.

4. Deposits

GASB Statement 3 requires deposits with financial institutions to be categorized to indicate the level of risk assumed by the State. The Lottery had a balance of \$981 in the State's bank on June 30, 2000, and \$464 on June 30, 1999. Both balances met the criteria for risk category 1 because they were covered by federal depository insurance.

5. Investments

Investments sufficient to finance the Cash 4 Life prize annuity payments for Wisconsin Lottery Cash 4 Life prize winners are held by MUSL; therefore, they are not shown as an asset and the related annuity prizes payable are not shown as a liability on the Wisconsin Lottery financial statements.

Investments for prize annuities are required by MUSL and the Wisconsin Lottery to be in the form of United States zero-coupon treasury securities, securities guaranteed by the United States government, or investment instruments issued by various brokerage firms secured by United States Treasury bonds held by custodial banks. These investments have been purchased to finance the jackpot prizes that are payable as annuities over the 20-year or 25-year period. See Note 6 for information related to the annuity prizes payable. The investments are scheduled to mature near the time prize payments become payable to winners. The State's custodial bank held investments for prize annuities with a fair value of \$228,774,491 as of June 30, 2000, and a fair value of \$261,112,150 as of June 30, 1999.

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

GASB Statement 3 requires investments to be categorized to indicate the level of risk assumed by the Wisconsin Lottery. As of June 30, 2000, all of the assets in investments for prize annuities meet the criteria for risk category 1, because the investments are insured or registered, or are held by the State or its agent in the State's name. The Wisconsin Lottery's State Investment Fund shares are not categorized.

6. Annuity Prizes Payable

The Wisconsin Lottery has an unconditional obligation to pay all jackpot prize winners the future value of the prize. The reported value of future prize payment obligations is included in the financial statements as Annuity Prizes Payable. To finance the annuity prize payments, the Wisconsin Lottery purchases, or has acquired from MUSL, investments scheduled to mature near the time prize payments become payable to the winners. Each year, an adjustment to the Annuity Prizes Payable account is made to amortize the reported value using the effective interest method. The present value adjustment was \$17,096,987 for FY 1999-2000, and \$17,402,393 for FY 1998-99. See Note 5 for information related to the investments for prize annuities. The reported values of future prize payment obligations were as follows:

Fiscal Year	FY 1999-2000			FY 1998-99		
	Current Payments	Long-Term Payments	Total Payments	Current Payments	Long-Term Payments	Total Payments
1999-2000	-	-	-	\$26,025,203	-	\$ 26,025,203
2000-01	\$24,903,466	-	\$ 24,903,466	-	\$ 26,214,983	26,214,983
2001-02	-	\$ 25,054,394	25,054,394	-	26,411,786	26,411,786
2002-03	-	25,211,517	25,211,517	-	26,615,868	26,615,868
2003-04	-	25,375,034	25,375,034	-	26,827,505	26,827,505
2004-05	-	25,543,064	25,543,064	-	-	-
Subsequent Years	-	<u>243,053,610</u>	<u>243,053,610</u>	-	<u>292,877,349</u>	<u>292,877,349</u>
Future Prize Payments	24,903,466	344,237,619	369,141,085	26,025,203	398,947,491	424,972,694
Less: Present Value Adjustment	<u>447,588</u>	<u>141,373,507</u>	<u>141,821,095</u>	<u>465,376</u>	<u>171,813,791</u>	<u>172,279,167</u>
Present Value of Future Prize Payments as of Year-End	<u>\$24,455,878</u>	<u>\$202,864,112</u>	<u>\$227,319,990</u>	<u>\$25,559,827</u>	<u>\$227,133,700</u>	<u>\$252,693,527</u>

7. Investment Income (Loss)

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

	<u>FY 1999-2000</u>	<u>FY 1998-99</u>
Interest from State Investment Fund	\$ 3,214,921	\$ 4,539,247
Net Increase in Fair Value of Annuity Investments	10,039,681	5,469,456
Decrease for Amortization of Annuity Investments	(17,096,988)	(17,402,393)
Net Change in Fair Value of State Investment Fund	258,481	1,041,327
Interest from MUSL Prize Reserve Accounts	956,570	651,752
Miscellaneous Interest	<u>6,688</u>	<u>8,463</u>
Total Investment Income (Loss)	\$(2,620,647)	\$(5,692,148)

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

8. Grand Prize Deposit

A grand prize deposit fund has been established by MUSL to indemnify states participating in the Powerball and Cash 4 Life games should a winning ticket not be properly paid. The combined Powerball and Cash 4 Life grand prize deposit for the State of Wisconsin was \$10,327,359 at June 30, 2000, and \$9,273,458 at June 30, 1999.

- A. Powerball - The total prize pool equals 50 percent of sales for each Powerball drawing. Of the total prize pool, 58.39 percent funds the grand prize pool, and 41.61 percent funds the low-tier prize pool. After the grand prize pool reaches the annuitized amount of \$5 million, then 2 percent of draw sales is distributed to the Prize Reserve Account (PRA) and Set Prize Reserve Account (SPRA) until they reach their caps of \$52 million and \$30 million, respectively. Interest earned on these accounts is deposited to the Unreserved Account. For some draws, the PRA and SPRA are reduced

when the actual prizes won are greater than the amounts available in the prize pools. The Wisconsin Lottery has the right to a refund of the Wisconsin PRA and SPRA balances if it withdraws from MUSL. The Powerball Grand Prize Deposit is made up of the following:

	<u>June 30, 2000</u>	<u>June 30, 1999</u>
Prize Reserve Account (PRA)	\$5,514,054	\$5,514,054
Balance of Unreserved Account	1,676,447	724,877
Set Prize Reserve Account (SPRA)	<u>1,947,728</u>	<u>1,947,728</u>
Total Powerball Grand Prize Deposit	\$9,138,229	\$8,186,659

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

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

At June 30, 2000, MUSL held as a Cash 4 Life prize deposit for the State of Wisconsin \$1,189,130. At June 30, 1999, the Cash 4 Life prize deposit was \$1,086,799.

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

9. Operating Leases

The Wisconsin Lottery occupied office, warehouse, and storage facilities in Milwaukee and on the Beltline Highway in Madison under operating leases during FY 1999-2000. The lease for the Milwaukee facility expires June 30, 2004. The lease for the Madison Beltline facility expires March 31, 2001. However, in November 2000, the Wisconsin Lottery office in Madison moved to a new leased facility on Rimrock Road in Madison, in conjunction with the consolidation of all Department of Revenue divisions.

The following schedule summarizes the future minimum lease payments required under operating leases for both the Milwaukee and Madison facilities. Upon

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

	<u>As of June 30, 2000</u>	<u>As of June 30, 1999</u>
Fiscal Year Ending June 30, 2000	-	\$ 811,942
2001	\$ 699,195	723,843
2002	387,127	370,813
2003	402,379	377,214
2004	<u>418,231</u>	<u>383,726</u>
Total Minimum Payments Required	\$1,906,932	\$2,667,538

As of February 2001, the future minimum lease payments for the space that the Wisconsin Lottery uses in the new Rimrock Road Department of Revenue building are still being developed and are not yet available.

Total lease expenses for the Wisconsin Lottery amounted to \$782,009 for the fiscal year ended June 30, 2000, and \$749,144 for the fiscal year ended June 30, 1999.

10. Prize Expense and Prizes Payable

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

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

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

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

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

The Powerball prize pool for all prize categories consists of 50 percent of each draw period's sales. The Wisconsin Lottery recognizes as prize expense its share of the prize pool at the time the related drawing is held. The Wisconsin Lottery transfers to MUSL money equal to its share of the prize pool, less the amount required to pay the non-jackpot prize winners and the first annual payment for any jackpot prize winners purchasing tickets from the Wisconsin Lottery. The amounts withheld from MUSL to pay these prize winners are reported as prizes payable until the winners redeem their tickets.

In the event the Wisconsin Lottery sells a valid annuity payment option winning ticket for the jackpot prize for Powerball, MUSL will purchase investments to finance the prize annuity. The investments are transferred to the State of Wisconsin, and the State assumes the related annuity prizes payable liability. No additional prize expense is reported for the jackpot winners, since the investments are purchased from the prize pool contributed by all states participating in MUSL. No annuity investments were acquired and no prize liabilities were assumed in FY 1999-2000. During FY 1998-99, the Wisconsin Lottery acquired annuity investments of \$12,430,690 and assumed annuity prize liability of the same amount.

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

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

In the event there is a Wisconsin's Very Own Megabucks annuity payment option jackpot winner, the Wisconsin Lottery contracts with MUSL to purchase prize annuities. The investments funded by the Wisconsin Lottery are transferred to the State of Wisconsin, and the State assumes the related annuity prizes payable liability. The Wisconsin Lottery acquired annuity investments of \$5,595,731 in FY 1999-2000 and \$3,874,714 in FY 1998-99, and assumed annuity prize liabilities of the same amounts.

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

- C. Supercash! - The prize structure for the Supercash! daily game includes a set top prize of \$250,000 for each play on a valid game ticket correctly matching, in any order, six of six numbers drawn. However, if there are more than 20 plays on valid game tickets correctly matching, in any order, six of the six winning numbers in the drawing, then \$5,000,000 is to be divided equally among the winning plays. Set prizes are paid for valid tickets matching four or five of the six numbers drawn. The number of winners in each of these categories, multiplied by the prize amount for that category, is equal to the prize expense for the Supercash! game. Prizes expensed are reported as prizes payable until the winners redeem their tickets.
- D. Daily Pick 3 - The prize structure for the Daily Pick 3 game includes a set top prize of \$500 for each play on a valid game ticket correctly matching three of three numbers drawn in correct order. The play options available are straight, box, and straight/box. Prizes vary based on the type of play category. The number of winners in each of these categories, multiplied by the prize amount for that category, is equal to the prize expense for the Daily Pick 3 game. Prizes expensed are reported as prizes payable until the winners redeem their tickets.
- E. Daily Pick 4 - The prize structure for the Daily Pick 4 game includes a set top prize of \$5,000 for each play on a valid game ticket correctly matching four of four numbers drawn in correct order. The play options available are straight plays and 24-, 12-, 6-, and 4-way box plays. The selection of numbers determines the box type. Prizes vary based on the type of play category. The number of winners in each of these categories, multiplied by the prize amount for that category, is equal to the prize expense for the Daily Pick 4 game. Prizes expensed are reported as prizes payable until the winners redeem their tickets.
- F. Cash 4 Life - The prize structure for the Cash 4 Life game included a set top prize of \$1,000 per week for life for each play on a valid game ticket correctly matching four of four numbers drawn in the top prize group. Each play consisted of 15 sets of 4 two-digit numbers. One set of four numbers

for the top prize group could be selected by the player or could be randomly selected, at the player's option. The remaining 14 sets of numbers were selected randomly. The number of winners in each of the prize categories, multiplied by the prize amount for that category, was equal to the prize expense for the Cash 4 Life game. Prizes expensed are reported as prizes payable until the winners redeem their tickets. The Cash 4 Life game ended on September 7, 2000.

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

11. Reserved Retained Earnings

The Wisconsin Lottery has reserved retained earnings for fair value adjustments of investments of \$8,480,888 as of June 30, 2000, and \$15,279,713 as of June 30, 1999. The Wisconsin Lottery does not realize gains or losses from the change in fair value of its annuity investments because it holds the investments until maturity to pay the annual prize payments. Therefore, fair value adjustments recognized as investment income as a result of applying GASB Statement 31 will not be available for distribution as property tax credits.

12. Contributed Capital

Between October 1, 1992 and September 30, 1995, costs associated with the purchase of commonly used fixed assets were allocated among the Lottery, Racing, Indian Gaming, and Charitable Gaming programs administered by the Gaming Commission. When the Lottery program transferred from the Gaming Commission to the Department of Revenue (DOR), the commonly used fixed

assets purchased jointly were divided between the Lottery program at DOR and the programs that remained with the Gaming Commission. The assets allocated to the Lottery program resulted in contributed capital of \$50,751.

13. Employee Retirement Plan

Permanent, full-time employees of the Wisconsin Lottery are participants in the Wisconsin Retirement System, a cost-sharing, multiple-employer, defined benefit plan governed by Chapter 40 of Wisconsin Statutes. State and local government public employees are entitled to an annual formula retirement benefit based on: 1) the employee's final average earnings, 2) years of creditable service, and

3) a formula factor. If an employee's contributions, matching employer's contributions, and interest credited to the employee's account exceed the value of the formula benefit, the retirement benefit may instead be calculated as a money purchase benefit. The Wisconsin Retirement System is considered part of the State of Wisconsin's financial reporting entity. Copies of the separately issued financial report that includes financial statements and required supplementary information for the year ending December 31, 1999, may be obtained by writing to:

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

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

Generally, the State's policy is to fund retirement contributions on a level-percentage-of-payroll basis to meet normal and prior service costs of the retirement system. Prior service costs are amortized over 40 years, beginning January 2, 1990. The retirement plan requires employee contributions equal to specified percentages of qualified earnings based on the employee's classification, plus employer contributions at a rate determined annually. The Wisconsin Lottery's contributions to the plan were \$485,260 for FY 1999-2000 and \$456,169 for FY 1998-99. The relative position of the Wisconsin Lottery in the Wisconsin Retirement System is not available because the Wisconsin Retirement System is a statewide, multi-employer plan.

14. Distribution of Net Proceeds

The Wisconsin Constitution requires proceeds from the operations of the Wisconsin Lottery to be used to provide local property tax relief.

In 1999 Wisconsin Act 9, the Legislature appropriated general purpose revenue to fund certain lottery expenses that had previously been funded with Lottery program revenues. These expenditures, including retailer commissions and all administrative expenses except depreciation, totaled \$76,015,043 in FY 1999-2000. This budgetary provision was effective only for FY 1999-2000.

Using general purpose revenue to fund these expenditures provided a means of increasing the amount of property tax relief available through the Lottery Fund by increasing the amount of property tax relief available through the Lottery Fund by increasing the FY 1999-2000 Wisconsin Lottery proceeds. For FY 1999-2000, a total of \$232,274,835 in Wisconsin Lottery proceeds was used for the following purposes: \$216,255,158 for Lottery Tax Credits, and \$16,019,678 for Farmland Tax Relief Credits. For FY 1998-99, a total of \$153,918,219 in Wisconsin Lottery proceeds was used for the following purposes: \$142,699,977 for Lottery Tax Credits, and \$11,218,242 for Farmland Tax Relief Credits.

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

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

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

Twenty-one past annuity prize winners elected to receive the balance of their prize payments as a lump-sum payment during FY 1999-2000, and 12 past annuity prize winners elected the option during FY 2000-01. As a result, the balances of both the Investment for Prize Annuities and the Annuity Prizes Payable accounts decreased by \$21,651,644 in FY 1999-2000 and will decrease by an undetermined amount in FY 2000-01. The Wisconsin Lottery did not experience gains or losses on these transactions, since each winner will receive current market value at the time of the conversion.

Schedule I

**Reconciliation of Lottery General Operations Expenses to the
Budgetary Basis of Accounting
FY 1999-2000**

Salaries and Fringe Benefits	
Per Financial Statement	\$ 4,565,186
Adjustments to Financial Statement Balance:	
Cash paid in FY 1999-00 but expensed in FY 1998-99	292,365
Cash paid in FY 2000-01 but expensed in FY 1999-2000	(324,531)
	4,533,020
Budgetary Basis	\$ 4,533,020
Supplies and Services	
Per Financial Statement:	
On-line telecommunication charges	\$ 3,603,065
Supplies and services	4,211,556
Product information	4,488,334
Ticket costs	3,526,528
Depreciation expense	225,410
	16,054,893
Total per financial statement	16,054,893
Adjustments to Financial Statement Balance:	
Depreciation expense	(225,410)
Cash paid in FY 1998-99 but expensed in FY 1999-2000	(1,861,702)
Cash paid in FY 1999-2000 but expensed in FY 1998-99	636,791
Cash paid in FY 1999-2000 but expensed in FY 2000-01	1,179,820
Cash paid in FY 2000-01 but expensed in FY 1999-2000	(40,168)
Reclassifications between Fixed Assets and Supplies and Services	(2,898)
	15,741,326
Budgetary Basis	\$ 15,741,326
Permanent Property	
Per Financial Statement	\$ 0
Adjustments to Financial Statement Balance:	
FY 1999-2000 net permanent property capitalized	(2,826,145)
FY 1999-2000 disposal of permanent property	2,843,168
Cash paid in FY 1999-2000 but expensed in FY 1998-99	92,111
Cash paid in FY 1999-2000 but expensed in FY 2000-2001	60,000
Reclassifications between Fixed Assets and Supplies and Services	(2,898)
	166,236
Budgetary Basis	\$ 166,236

Schedule II

Lottery Administrative Expenses

	Fiscal Year Ended <u>June 30, 2000</u>	Fiscal Year Ended <u>June 30, 1999</u>	Fiscal Year Ended <u>June 30, 1998</u>
Administrative Expenses			
Instant and On-line Vendor Services	\$ 11,790,160	\$ 11,731,420	\$ 11,659,039
Salaries and Fringe Benefits	4,565,186	4,074,586	3,538,468
On-line Telecommunication Charges	3,603,066	3,596,842	3,532,029
Supplies and Services	4,211,556	4,180,626	4,363,801
Product Information	4,488,334	4,541,450	4,347,039
Ticket Costs	3,526,528	2,662,437	2,560,351
Depreciation Expense	225,410	345,578	625,710
Total Administrative Expenses as Determined in Accordance with s. 25.75 (3)(b), Wis. Stats.	<u>\$ 32,410,240</u>	<u>\$ 31,132,939</u>	<u>\$ 30,626,437</u>
Gross Lottery Operating Revenues	<u>\$ 406,784,089</u>	<u>\$ 428,352,188</u>	<u>\$ 418,852,821</u>
Administrative Expenses as a Percentage of Lottery Revenues	7.97%	7.27%	7.31%

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

Schedule III

Summary of Prize Expenses

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

Fiscal Year 1999-2000			
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$151,420,082	\$241,040,896	62.8%
On-Line Games	<u>80,983,869</u>	<u>165,629,273</u>	48.9%
Total for Fiscal	\$232,403,951	\$406,670,169	57.2%

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

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

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

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

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

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

We have audited the financial statements of the Wisconsin Lottery as of and for the years ended June 30, 2000 and 1999, and have issued our report thereon dated February 26, 2001. We conducted our audits in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Wisconsin Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audits, we considered the Wisconsin Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements, and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving the internal control over financial reporting, which we will be reporting to the management of the Wisconsin Lottery in a separate letter.

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

LEGISLATIVE AUDIT BUREAU

February 26, 2001

by

Julie Gordon
Audit Director