

An Audit:

Wisconsin Lottery

Department of Revenue

June 2007

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.

Key Facts and Findings

From FY 2001-02 through FY 2005-06, ticket sales have increased 19.0 percent.

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

The Wisconsin Lottery has introduced new games more frequently and at higher ticket prices.

Short-term incentives provided through the Retailer Performance program have generated an estimated \$4.4 million in additional sales.

The Governor has proposed increasing the Wisconsin Lottery's product information budget from \$4.6 million to \$7.5 million annually.

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.

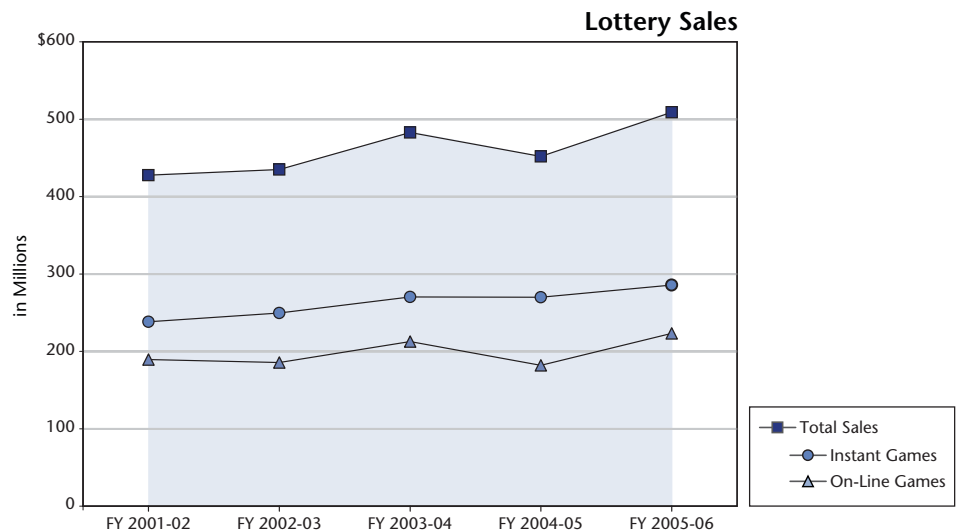
Total ticket sales have increased 19.0 percent over the past five fiscal years, although on-line game sales have fluctuated. Sales of instant scratch-off and pull-tab game tickets increased 19.9 percent, from \$238.2 million in FY 2001-02 to \$285.7 million in FY 2005-06. For on-line games, ticket sales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

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.

Additional Information

For a copy of report 07-8, which includes a response from the Department of Revenue, call **(608) 266-2818** or visit our Web site:



www.legis.wisconsin.gov/lab

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