

An Audit

Wisconsin Lottery

Department of Revenue

2007-2008 Joint Legislative Audit Committee Members

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Janice Mueller
State Auditor

July 8, 2008

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 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) 2005-06 and FY 2006-07 financial statements. We also found that the Wisconsin Lottery was in compliance with statutory spending limitations related to prizes, product informational advertising, retailer compensation, and administrative expenses.

Total ticket sales increased \$57.8 million, or 13.3 percent, from FY 2002-03 to FY 2006-07. However, FY 2006-07 ticket sales of \$492.8 million were \$16.2 million, or 3.2 percent, less than those of the previous year. Wisconsin Lottery staff attribute this decrease to the timing of large Powerball jackpots, which have a significant effect on ticket sales. Total operating expenses increased \$42.5 million, or 13.6 percent, from FY 2002-03 to FY 2006-07, primarily because lottery prizes and retailer compensation fluctuate with ticket sales. In FY 2006-07, lottery proceeds of \$160.0 million were distributed to provide property tax relief.

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

Respectfully submitted,

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

Janice Mueller
State Auditor

JM/BN/ss

Introduction ■

***The Wisconsin Lottery
sells instant and online
game tickets.***

The Wisconsin Lottery began operations in September 1988, after Wisconsin voters adopted a constitutional amendment in 1987 that allowed the Legislature to create a state lottery and required net proceeds to be distributed for property tax relief. Since August 1995, the Department of Revenue has managed the Wisconsin Lottery, which is permitted to sell tickets for instant and online games. Instant games are tickets that reveal a prize when consumers remove scratch-off or pull-tab coverings, while online games generally involve consumers picking numbers from an automated system, with winning numbers selected in drawings held at intervals ranging from daily to twice a week. In March 2007, the Wisconsin Lottery introduced a raffle style online game in which players purchase a sequential ticket number from an automated system and winning ticket numbers are selected by drawing.

We completed a financial audit of the Wisconsin Lottery to fulfill our audit responsibilities under s. 13.94(1)(em), Wis. Stats., and have issued an unqualified opinion on its financial statements for the years ended June 30, 2007 and 2006. As part of our financial audit, we reviewed lottery ticket sales, operating expenses, and property tax relief distributions through fiscal year (FY) 2006-07. We also assessed compliance with statutory requirements related to prizes and other costs.

Wisconsin Lottery Ticket Sales

Wisconsin Lottery sales increased 13.3 percent from FY 2002-03 to FY 2006-07.

The Wisconsin Lottery derives more than 99 percent of its operating revenues from instant and online ticket sales. Total ticket sales increased 13.3 percent during the past five fiscal years, from \$435.0 million in FY 2002-03 to \$492.8 million in FY 2006-07. Sales of scratch-off and pull-tab games increased 13.9 percent during that period, while online game sales increased 12.5 percent. However, as shown in Table 1, ticket sales fluctuated and total sales decreased during both FY 2004-05 and FY 2006-07. Wisconsin Lottery staff attribute these decreases in total sales to the timing of large Powerball jackpots, which have a significant effect on online game ticket sales.

Table 1

Wisconsin Lottery Ticket Sales (in millions)

Fiscal Year	Instant Games	Online Games	Total Sales	Percentage Change from Prior Year
2002-03	\$249.5	\$185.5	\$435.0	–
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
2006-07	284.1	208.7	492.8	(3.2)

Wisconsin Lottery Operating Expenses

Operating expenses increased 13.6 percent from FY 2002-03 to FY 2006-07.

As shown in Table 2, the Wisconsin Lottery's operating expenses include prizes paid to winning ticket holders; retailer compensation, including commissions and incentives; game development and production costs, including instant game ticket printing and delivery costs, payments to the vendor that provides and supports the gaming system, and online telecommunication charges; product information costs; and other costs, such as staff salaries and fringe benefits. Operating expenses increased from \$312.7 million in FY 2002-03 to \$355.2 million in FY 2006-07, or 13.6 percent, primarily because of increases in prizes and retailer compensation, which fluctuate directly with ticket sales.

Table 2

Wisconsin Lottery Operating Expenses
(in millions)

Expense Type	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07
Prizes	\$248.5	\$275.2	\$262.1	\$293.9	\$292.1
Retailer Compensation	30.8	33.9	31.4	35.2	34.1
Game Development and Production ¹	19.2	19.3	14.4	16.4	16.5
Product Information	4.6	4.6	4.6	4.6	4.5
Other ²	9.6	9.4	9.3	8.1	8.0
Total	\$312.7	\$342.4	\$321.8	\$358.2	\$355.2

¹ Includes instant and online vendor services, instant game ticket printing, online telecommunications, and instant game ticket delivery expenses.

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

Costs associated with game development and production expenses decreased by 14.1 percent over the past five fiscal years. This decrease is primarily the result of the Wisconsin Lottery and GTECH Corporation entering into a seven-year contract that took effect in June 2004 to both maintain the instant and online gaming system and provide telecommunications services. Under the current contract, the Wisconsin Lottery paid \$12.4 million to GTECH during FY 2006-07. In FY 2002-03, the Wisconsin Lottery paid GTECH \$12.5 million to maintain the instant and online gaming system, and \$3.1 million to a different vendor for telecommunications services.

Other Wisconsin Lottery expenses also decreased by 16.7 percent over the past five fiscal years. Wisconsin Lottery staff explain that this decrease is primarily the result of strategies to reduce costs. For example, prior to September 2004 the Wisconsin Lottery leased a facility in Madison and a warehouse in Milwaukee. In September 2004 it began a five-year lease of a warehouse in Madison that expires in August 2009. Warehouse leasing costs prior to September 2004 were approximately \$413,000 per year. The annual cost of the new lease is approximately \$145,000. In addition, in August 2004 the Wisconsin Lottery canceled the Super Money Game Television Show, which eliminated approximately \$300,000 annually in television production costs.

Property Tax Relief Distributions

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 the lottery and gaming tax credit to owners of primary residences in Wisconsin and through the farmland tax relief credit to certain farmland owners in Wisconsin.

Approximately \$2.6 billion in property tax relief has been provided since 1988.

Since its inception in 1988, the Wisconsin Lottery has provided \$2.6 billion in property tax relief. As shown in Table 3, property tax relief totaled \$697.9 million over the past five fiscal years, including \$160.0 million in FY 2006-07.

Table 3

Wisconsin Property Tax Relief¹ (in millions)

Fiscal Year	Lottery and Gaming Tax Credit	Farmland Tax Relief Credit	Total Distributed
2002-03	\$106.1	\$23.5	\$129.6
2003-04	118.3	13.3	131.6
2004-05	131.7	11.7	143.4
2005-06	119.8	13.5	133.3
2006-07	144.6	15.4	160.0
Total	\$620.5	\$77.4	\$697.9

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

Statutory Requirements

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

The Wisconsin Lottery returned 59.3 percent of sales to players as prize payments in FY 2006-07.

Section 25.75(3)(a), Wis. Stats., requires that at least 50 percent of Wisconsin Lottery sales be returned to players as prize payments. As shown in Table 4, the Wisconsin Lottery's prize expenses have increased or decreased with fluctuations in ticket sales. As a percentage of ticket sales, prize expenses have remained generally consistent, although they increased to 59.3 percent during FY 2006-07. Wisconsin Lottery officials attribute the 1.3 percentage point increase between FY 2004-05 and FY 2006-07 to offering higher-priced instant

games that include higher prize payout percentages. They also note that the FY 2006-07 prize payout percentage may be higher because the Wisconsin Lottery paid the \$100,000 prize for Supercash! eight times more in FY 2006-07 than in FY 2005-06. Lower-than-expected sales of the new game Million Dollar Draw, which included a \$1 million prize, also contributed to the higher prize payout percentage in FY 2006-07.

Table 4

Prize Expenses as a Percentage of Ticket Sales
(in millions)

Fiscal Year	Prize Expenses	Ticket Sales	Percentage of Ticket Sales
2002-03	\$248.5	\$435.0	57.1%
2003-04	275.2	482.9	57.0
2004-05	262.1	451.9	58.0
2005-06	293.9	509.0	57.7
2006-07	292.1	492.8	59.3

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

Section 25.75(3)(b), Wis. Stats., limits certain administrative expenses to no more than 10.0 percent of gross operating revenues. These administrative expenses include all expenses except prize payments and retailer compensation. As shown in Table 5, the Wisconsin Lottery's administrative expenses have remained within the statutory limit and were 5.9 percent of gross operating revenues during FY 2006-07.

Table 5

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

Fiscal Year	Total Statutorily Defined Administrative Expenses	Gross Operating Revenues	Percentage of Total Gross Operating Revenues
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
2006-07	29.0	493.1	5.9

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 structures. Through legislative action, the Wisconsin Lottery's product informational advertising expenses have been limited to \$4.6 million annually since FY 1990-91. This expenditure authority was not exceeded in FY 2006-07. The Legislature has increased the Wisconsin Lottery's annual product informational advertising budget to \$7.5 million beginning with FY 2007-08. Wisconsin Lottery staff project that increase will produce an additional \$15.0 million in annual lottery ticket sales.

The Wisconsin Lottery provided 0.9 percent of ticket sales for the retailer performance program in FY 2006-07.

State statutes establish maximum compensation rates for basic commissions and performance program payments to retailers who sell lottery tickets. Basic commission rates are 5.5 percent of the retail price for online tickets and 6.25 percent for instant tickets. According to s. 565.02(4)(g), Wis. Stats., performance program payments to eligible retailers may not exceed 1.0 percent of total ticket sales. As shown in Table 6, the Wisconsin Lottery's retailer performance program payments have remained within the statutory limit for the past five fiscal years and were 0.9 percent of ticket sales during FY 2006-07.

Table 6

Retailer Performance Program Payments as a Percentage of Ticket Sales
(in millions)

Fiscal Year	Retailer Performance Program Payments	Ticket Sales	Percentage of Ticket Sales
2002-03	\$4.2	\$435.0	1.0%
2003-04	4.8	482.9	1.0
2004-05	4.0	451.9	0.9
2005-06	4.6	509.0	0.9
2006-07	4.5	492.8	0.9



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, 2007 and 2006, 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, 2007 and 2006, 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 11 through 18, 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 44 through 46 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 25, 2008, on our consideration of the Wisconsin Lottery's internal control over financial reporting; our tests of its compliance with certain provisions of laws, regulations, and contracts; and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

June 25, 2008

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, 2007, and June 30, 2006. 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, 2007, and June 30, 2006.

- Operating revenues generated from ticket sales for the Wisconsin Lottery were \$492.8 million in FY 2006-07. Sales were the second-highest in a decade, surpassed only by the previous year's sales of \$509.0 million. Sales decreased by \$16.2 million, or 3.2 percent, from FY 2005-06, due primarily to a \$25.2 million decrease in Powerball sales. In FY 2005-06, annual ticket sales increased \$57.1 million, or 12.6 percent, with the increase attributed to increased sales of Powerball, Wisconsin's Very Own Megabucks, and instant scratch-off game tickets.

- Operating expenses for FY 2006-07 decreased \$3.0 million, or 0.8 percent. For FY 2005-06, operating expenses increased \$36.4 million, or 11.3 percent, primarily as a result of higher prize expense and retailer compensation necessary to support the \$57.1 million in increased ticket sales.
- Nonoperating revenues, consisting mainly of investment income, increased \$9.0 million, to post a gain of \$3.7 million in FY 2006-07, compared to a loss of \$5.3 million in FY 2005-06. In FY 2005-06, nonoperating revenues declined \$8.2 million.
- Net income before transfers was \$141.6 million for FY 2006-07, a decrease of \$4.1 million, or 2.8 percent, primarily as the result of lower ticket sales. In FY 2005-06, net income before transfers rose \$12.6 million, or 9.5 percent, as a result of record sales for that year.
- Statutorily defined administrative expenses declined \$0.1 million, from \$29.1 million in FY 2005-06 to \$29.0 million in FY 2006-07. The FY 2005-06 increase over FY 2004-05 was \$0.8 million. Administrative expenses remained well below the statutory maximum of 10.0 percent of gross operating revenues. As a percentage of gross operating revenues, defined administrative expenses increased slightly, from 5.7 percent in FY 2005-06 to 5.9 percent in FY 2006-07, while they were 6.3 percent in FY 2004-05.

Overview of the Financial Statements

The Wisconsin Lottery is accounted for as an enterprise activity, a type of 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 Wisconsin Constitution requires that net proceeds from the operations of the Wisconsin Lottery be used to provide 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 deposits for Powerball reserves, restricted income related to unrealized fair market value adjustments to investments, and restricted net assets for property tax relief.

This annual report consists of a series of financial statements, along with explanatory notes to the financial statements and supplemental schedules. 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, and to changes in income and expenses as set forth in the Statement of Revenues, Expenses, and Changes in Fund Net Assets and the Statement of Cash Flows.

Net Assets

The Statement of Net Assets provides detailed information on the nature and amount of the Wisconsin Lottery's assets, liabilities, and net assets at the close of FY 2006-07 and FY 2005-06. Table A presents these data in a condensed form for the past three fiscal years. The relationship of assets to liabilities and resulting net assets is one indicator of the financial condition of the Wisconsin Lottery.

Table A

Net Assets
(in millions)

	June 30, 2007	June 30, 2006	Change	June 30, 2005	Change
Investments	\$ 93.4	\$103.7	\$(10.3)	\$121.8	\$(18.1)
Capital Assets (Net of Accumulated Depreciation)	0.1	0.2	(0.1)	0.2	0.0
Other Assets	50.9	66.9	(16.0)	42.2	24.7
Total Assets	144.4	170.8	(26.4)	164.2	6.6
Current Liabilities	38.8	36.6	2.2	32.7	3.9
Noncurrent Liabilities	72.6	82.1	(9.5)	91.5	(9.4)
Total Liabilities	111.4	118.7	(7.3)	124.2	(5.5)
Net Assets:					
Invested in Capital Assets	0.1	0.2	(0.1)	0.2	0.0
Restricted for MUSL Powerball Reserves	3.9	4.4	(0.5)	4.5	(0.1)
Restricted for Investment Fair Market Value Adjustment	6.2	7.1	(0.9)	15.8	(8.7)
Restricted for Property Tax Relief	22.8	40.4	(17.6)	19.5	20.9
Total Net Assets	<u>\$ 33.0</u>	<u>\$52.1</u>	<u>\$(19.1)</u>	<u>\$40.0</u>	<u>\$12.1</u>

As shown in Table A, total assets decreased \$26.4 million, or 15.5 percent, while total liabilities decreased \$7.3 million, or 6.1 percent, during FY 2006-07. As a result, the Wisconsin Lottery's total net assets decreased \$19.1 million, or 36.7 percent, during FY 2006-07. During FY 2005-06, total assets increased \$6.6 million, or 4.0 percent, and total liabilities decreased \$5.5 million, or 4.4 percent, resulting in total net assets increasing \$12.1 million, or 30.3 percent.

The Wisconsin Lottery's net assets are generally available for property tax relief unless restricted for other uses. There are currently three restricted uses of the Wisconsin Lottery's net assets. Amounts invested in capital assets cannot be used to provide property tax relief, just as Powerball reserve deposits held by the Multi-State Lottery Association (MUSL) are not currently available for property tax relief. Accounting principles dictate that the unrealized gains or losses related to the change in the fair market value of investments be reported as a restricted net asset. 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. All remaining net assets are available for property tax relief.

Changes in Net Assets

The Statement of Revenues, Expenses, and Changes in Fund Net Assets provides detailed information on the nature and financial impact of the Wisconsin Lottery's operations for FY 2006-07 and FY 2005-06. Table B presents these data in a condensed form for the past three fiscal years. Also illustrated in this statement is the change in net assets for the year.

As shown in Table B, total net assets decreased \$19.1 million in FY 2006-07 and increased \$12.1 million in FY 2005-06. Ticket sales decreased \$16.2 million for FY 2006-07. The decrease in ticket sales was due primarily to a \$25.2 million decrease in sales of the Powerball game. FY 2005-06 ticket sales increased \$57.1 million, with \$34.0 million of the increase driven by Powerball sales. Powerball sales are driven by jackpot amounts, and several large jackpots contributed to record Powerball sales in FY 2005-06. A discussion of ticket sales results by game category follows this section.

Investment income increased by \$8.9 million in FY 2006-07, following a decrease in FY 2005-06 of \$8.2 million. The FY 2006-07 increase primarily resulted from \$5.6 million in unrealized investment gains from changes in fair market value for investments, following unrealized investment losses of \$1.4 million from changes in fair market value for investments for FY 2005-06.

Total expenses decreased \$3.0 million, or 0.8 percent, for FY 2006-07, due mainly to decreases in prize expenses, retailer commissions and incentives, and vendor services. For FY 2005-06, total expenses increased \$36.4 million, or 11.3 percent, due mainly to increases in these same expense lines. 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.

Table B

Changes in Net Assets
(in millions)

	FY 2006-07	FY 2005-06	Change	FY 2004-05	Change
Revenues					
Operating Revenues:					
Ticket sales	\$492.8	\$509.0	\$(16.2)	\$451.9	\$57.1
Retailer fees and miscellaneous revenue	0.3	0.2	0.1	0.1	0.1
Nonoperating Revenues:					
Investment income (loss)	3.6	(5.3)	8.9	2.9	(8.2)
Miscellaneous revenue	0.1	0.0	0.1	0.0	0.0
Total Revenues	496.8	503.9	(7.1)	454.9	49.0
Expenses					
Program Expenses:					
Prize expenses	292.1	293.9	(1.8)	262.1	31.8
Retailer commissions and incentives	34.1	35.2	(1.1)	31.4	3.8
Instant and online vendor services	12.4	12.7	(0.3)	10.6	2.1
Other game-related expenses	8.6	8.3	0.3	8.4	(0.1)
Office Administration Expenses	8.0	8.1	(0.1)	9.3	(1.2)
Total Expenses	355.2	358.2	(3.0)	321.8	36.4
Net Income Before Transfers	141.6	145.7	(4.1)	133.1	12.6
Operating Transfers					
Transfer for Property Tax Relief	(160.0)	(133.3)	(26.7)	(143.4)	10.1
Transfer In from General Fund	0.3	0.7	(0.4)	1.0	(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	(0.3)	(0.3)	0.0	(0.2)	(0.1)
Transfer Out to General Fund	(0.1)	(0.1)	0.0	(0.1)	0.0
Change in Net Assets	<u>\$(19.1)</u>	<u>\$12.1</u>	<u>\$(31.2)</u>	<u>\$(10.2)</u>	<u>\$22.3</u>

The operating transfer out for property tax relief increased by \$26.7 million, or 20.0 percent, during FY 2006-07, while it decreased by \$10.1 million, or 7.0 percent, during FY 2005-06. This may seem counterintuitive given the sales decline in FY 2006-07. However, the transfers occur before the end of the fiscal year and are based on an estimate of the total funds available for distribution under the lottery

and gaming credit for property taxes. 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.

Wisconsin Lottery Ticket Sales and Prize Awards

Table C compares ticket sales for each lottery game category for FY 2006-07, FY 2005-06, and FY 2004-05.

Instant scratch-off ticket sales decreased \$0.4 million during FY 2006-07 after increasing \$17.4 million during FY 2005-06. 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 \$1.2 million in FY 2006-07, following a \$1.6 million decrease in FY 2005-06.

Online game sales decreased by \$14.6 million during FY 2006-07 after an increase of \$41.3 million during FY 2005-06, primarily due to the timing of Powerball and Wisconsin's Very Own Megabucks jackpot amounts.

Table C

Wisconsin Lottery Ticket Sales (in millions)

	FY 2006-07	FY 2005-06	Change	FY 2004-05	Change
Instant					
Scratch-off	\$280.0	\$280.4	\$ (0.4)	\$263.0	\$17.4
Pull-tab	4.1	5.3	(1.2)	6.9	(1.6)
Online					
SuperCash!	28.1	27.4	0.7	25.5	1.9
Powerball	88.1	113.3	(25.2)	79.3	34.0
WI Very Own Megabucks	28.4	24.4	4.0	18.1	6.3
Daily Pick 3	25.9	24.8	1.1	24.5	0.3
Daily Pick 4	11.7	10.8	0.9	10.4	0.4
Badger 5	23.1	22.6	0.5	24.2	(1.6)
Million Dollar Draw	3.4	0.0	3.4	0.0	0.0
Total	<u>\$492.8</u>	<u>\$509.0</u>	<u>\$(16.2)</u>	<u>\$451.9</u>	<u>\$57.1</u>

Table D compares ticket prize awards for each lottery game category for FY 2006-07, FY 2005-06, and FY 2004-05.

Generally, prizes awarded are a function of ticket sales; higher ticket sales will result in greater prize expense, while lower sales will result in lower prize expense. For example, when Powerball had a decrease in ticket sales of \$25.2 million during FY 2006-07, prize awards also decreased \$12.8 million. For FY 2005-06, Powerball sales increased \$34.0 million and the related prize awards increased \$16.9 million.

See Schedule 3 after the notes to the financial statements for a multi-year summary of ticket sales and their related prize expenses.

Table D
Wisconsin Lottery Ticket Prize Awards
(in millions)

	FY 2006-07	FY 2005-06	Change	FY 2004-05	Change
Instant					
Scratch-off	\$180.4	\$179.6	\$ 0.8	\$166.7	\$12.9
Pull-tab	2.6	3.3	(0.7)	4.3	(1.0)
Super 2 nd Chance ¹	0.3	0.3	(0.0)	0.3	0.0
Online					
SuperCash!	19.0	14.0	5.0	14.2	(0.2)
Powerball	42.1	54.9	(12.8)	38.0	16.9
WI Very Own Megabucks	14.9	12.8	2.1	9.6	3.2
Daily Pick 3	13.6	12.2	1.4	12.5	(0.3)
Daily Pick 4	5.2	5.5	(0.3)	4.4	1.1
Badger 5	11.2	11.0	0.2	11.8	(0.8)
Million Dollar Draw	2.5	0.0	2.5	0.0	0.0
Super 2 nd Chance ¹	0.3	0.3	0.0	0.3	0.0
Total	<u>\$292.1</u>	<u>\$293.9</u>	<u>\$(1.8)</u>	<u>\$262.1</u>	<u>\$31.8</u>

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

Other Known Facts

The Wisconsin Lottery contracted with GTECH Corporation for an integrated gaming computer system and services effective November 24, 2003. In FY 2006-07, payments to GTECH were \$12.4 million. In FY 2005-06, these payments were \$12.7 million. GTECH payments are based directly on Wisconsin Lottery sales volume and fluctuate in relation to those sales.

Contacting the Wisconsin 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 Department of Revenue
Attention: Director, Bureau of Financial Management Services
Post Office Box 8931
Mailstop 6-261
Madison, Wisconsin 53708-8931
Telephone (608) 266-8469

If you have questions concerning general program information relating to the Wisconsin Lottery, contact:

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

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Financial Statements ■

Statement of Net Assets

June 30, 2007 and 2006

	June 30, 2007	Restated June 30, 2006
ASSETS		
Current Assets:		
Cash and cash equivalents (Note 3)	\$ 41,282,068	\$ 56,142,816
Investments for prize annuities (Note 3)	16,616,461	16,426,052
Accounts receivable (Note 4)	1,788,708	1,023,766
Due from other state programs (Note 4)	508,334	1,243,316
Ticket inventory	1,333,925	1,532,860
Grand prize deposit (Note 9)	1,261,273	1,188,583
Prepaid expenses (Note 20)	594,744	1,016,537
Interest receivable	157,840	196,225
Total Current Assets	<u>63,543,353</u>	<u>78,770,155</u>
Noncurrent Assets:		
Investments for prize annuities (Note 3)	76,805,394	87,247,044
Grand prize deposit (Note 9)	3,832,620	4,421,161
Prepaid expense (Note 20)	96,160	135,160
Capital assets: (Note 10)		
Equipment	766,678	760,043
Leasehold improvements	159,724	159,724
Accumulated depreciation	(785,682)	(741,509)
Total Noncurrent Assets	<u>80,874,894</u>	<u>91,981,623</u>
TOTAL ASSETS	<u>144,418,247</u>	<u>170,751,778</u>
LIABILITIES		
Current Liabilities:		
Annuity prizes payable (Note 5)	16,560,788	16,396,867
Prizes payable	15,700,358	12,178,533
Accounts payable (Note 4)	2,289,081	2,975,778
Due to other state programs (Note 4)	3,068,843	2,724,769
Lottery association payable	370,696	1,104,692
Deferred revenue	454,249	850,908
Due to other governments (Note 4)	51,010	43,108
Accrued payroll	204,251	196,650
Compensated absences (Note 17)	149,451	158,918
Total Current Liabilities	<u>38,848,727</u>	<u>36,630,223</u>
Noncurrent Liabilities:		
Annuity prizes payable (Note 5)	72,294,666	81,813,926
Compensated absences (Note 17)	285,960	230,233
Total Noncurrent Liabilities	<u>72,580,626</u>	<u>82,044,159</u>
TOTAL LIABILITIES	<u>111,429,353</u>	<u>118,674,382</u>
NET ASSETS		
Net Assets:		
Invested in capital assets (Note 10)	140,720	178,258
Restricted for MUSL Powerball reserves (Note 14)	3,832,620	4,421,161
Restricted for investment fair market value adjustment (Note 14)	6,208,734	7,095,846
Restricted for property tax relief (Note 14)	22,806,820	40,382,131
TOTAL NET ASSETS	<u>\$ 32,988,894</u>	<u>\$ 52,077,396</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, 2007 and 2006

	Year Ended June 30, 2007	Year Ended June 30, 2006
OPERATING REVENUES		
Instant Ticket Sales (Net of allowances of \$399,758 and \$419,379, respectively) (Note 7)	\$ 284,131,772	\$ 285,757,651
Online Ticket Sales (Net of ticket discounts of \$232,697 and \$470,547, respectively) (Note 7)	208,646,840	223,299,704
Retailer Fees	71,720	25,720
Miscellaneous Revenue	262,200	155,992
Total Operating Revenues	493,112,532	509,239,067
OPERATING EXPENSES		
Program Expenses:		
Instant prize expense (Note 8)	183,279,333	183,201,056
Online prize expense (Note 8)	108,835,614	110,711,493
Retailer commissions and incentives	34,127,726	35,188,988
Instant and online vendor services	12,428,020	12,705,302
Product information costs	4,512,191	4,589,159
Instant ticket printing costs	3,422,112	3,167,831
Instant ticket delivery costs	640,032	611,182
Total Program Expenses	<u>347,245,028</u>	<u>350,175,011</u>
Administrative Expenses:		
Salaries and fringe benefits	5,487,777	5,206,105
Supplies and services	2,412,304	2,809,610
Depreciation expense	44,173	49,825
Total Administrative Expenses	<u>7,944,254</u>	<u>8,065,540</u>
Total Operating Expenses	355,189,282	358,240,551
NET OPERATING INCOME	137,923,250	150,998,516
NONOPERATING REVENUES (EXPENSES) AND OPERATING TRANSFERS		
Investment Income (Loss) (Note 6)	3,569,737	(5,325,018)
Miscellaneous Revenue (Note 12)	70,714	0
Net Income Before Transfers	141,563,701	145,673,498
Operating Transfers:		
Transfers of lottery proceeds for property tax relief (Note 15)	(159,982,765)	(133,296,150)
Transfers in from General Fund (Note 18)	320,906	660,908
Transfer to Department of Health and Family Services for compulsive gambling programs	(300,000)	(300,000)
Transfer to Department of Justice for law enforcement	(340,331)	(319,547)
Transfer to Department of Revenue for lottery credit administration	(254,137)	(251,523)
Transfers out to General Fund (Note 19)	(95,876)	(112,408)
CHANGE IN NET ASSETS	(19,088,502)	12,054,778
Total Net Assets—Beginning of the Year	<u>52,077,396</u>	<u>40,022,618</u>
Total Net Assets—End of the Year	<u><u>\$ 32,988,894</u></u>	<u><u>\$ 52,077,396</u></u>

The accompanying notes are an integral part of this statement.

Statement of Cash Flows for the Years Ended June 30, 2007 and 2006

	Year Ended June 30, 2007	Year Ended June 30, 2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash Received from Retailers	\$ 492,173,252	\$ 516,529,385
Cash Paid for Prizes	(303,619,964)	(309,252,405)
Cash Paid for Retailer Commissions and Incentives	(34,396,592)	(33,823,697)
Cash Paid/Received for Grand Prize Deposit	588,541	(28,533)
Cash Paid to Employees	(5,634,792)	(5,101,798)
Cash Paid to Suppliers	(23,400,431)	(25,414,104)
Net Cash Provided by Operating Activities	125,710,014	142,908,848
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Transfers of Proceeds for Property Tax Credit	(160,565,763)	(133,326,183)
Transfer of Proceeds for Law Enforcement	(321,780)	(319,201)
Transfer of Proceeds for Lottery Credit Administration	(259,955)	(255,047)
Transfer of Proceeds for Compulsive Gambling Programs	(300,000)	(300,000)
Transfers to the General Fund	(95,876)	(112,408)
Transfers from the General Fund	660,908	1,031,000
Net Cash Used by Noncapital Financing Activities	(160,882,466)	(133,281,839)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Cash Paid for Purchase of Equipment	(6,635)	(17,180)
Net Cash Used by Capital and Related Financing Activities	(6,635)	(17,180)
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest Received	4,422,544	2,900,404
Cash Received for Redemption of Bonds	16,814,120	16,682,390
Cash Paid for Purchase of Bonds	(918,325)	0
Net Cash Provided by Investing Activities	20,318,339	19,582,794
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(14,860,748)	29,192,623
Cash and Cash Equivalents—Beginning of the Year	56,142,816	26,950,193
Cash and Cash Equivalents—End of the Year	<u>\$ 41,282,068</u>	<u>\$ 56,142,816</u>

The accompanying notes are an integral part of this statement.

	Year Ended June 30, 2007	Year Ended June 30, 2006
RECONCILIATION OF NET OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Net Operating Income	\$ 137,923,250	\$ 150,998,516
Adjustments to Reconcile Net Operating Income to Net Cash Provided by Operating Activities:		
Depreciation expense	44,173	49,825
Noncash donated prize expense	49,814	0
Noncash donated product information costs	20,900	0
Vendor liquidated damages settlement	30,360	84,480
Changes in Assets and Liabilities:		
Decrease (Increase) in receivables	(764,942)	5,444,083
Decrease (Increase) in grand prize deposit	588,541	(28,533)
Decrease (Increase) in ticket inventory	198,935	(198,505)
Decrease (Increase) in prepaid expenses	430,431	(698,336)
Decrease (Increase) in Due from other state programs	3,884	(3,125)
Increase (Decrease) in prizes payable	(12,365,180)	(13,320,388)
Increase (Decrease) in deferred revenue	(396,659)	263,860
Increase (Decrease) in Due to other state programs	1,308,009	23,938
Increase (Decrease) in accounts payable	(688,430)	(551,950)
Increase (Decrease) in Lottery Association payable	(733,996)	819,226
Increase (Decrease) in Due to other governments	7,063	(1,282)
Increase (Decrease) in accrued payroll	7,601	16,796
Increase (Decrease) in compensated absences	46,260	10,243
Total Adjustments	<u>(12,213,236)</u>	<u>(8,089,668)</u>
Net Cash Provided by Operating Activities	<u>\$ 125,710,014</u>	<u>\$ 142,908,848</u>
Noncash Activities:		
Net change in unrealized gains and losses	\$ 887,111	\$ (8,698,722)
Noncash donated prize expense	49,814	0
Noncash donated product information costs	20,900	0

The accompanying notes are an integral part of this statement.

Notes to the Financial Statements ■

1. DESCRIPTION OF THE WISCONSIN LOTTERY

On April 7, 1987, by a 65 percent to 35 percent margin, Wisconsin voters ratified a constitutional amendment authorizing the creation of a lottery. The Wisconsin Lottery was created in December 1987 and is administered by the Lottery Division within the Department of Revenue. During FY 2006-07 and FY 2005-06, the Wisconsin Lottery administered scratch-off, pull-tab, and online games. The Wisconsin Constitution requires that the net proceeds from Wisconsin lottery operations be used to provide local property tax relief.

Online games (also known as lotto games) are games in which tickets are produced from a terminal located at a retailer's place of business (e.g. Powerball, Badger 5). The term should not be confused with Internet-based games which, although widely available, are prohibited by the Wisconsin Constitution.

The Wisconsin Lottery joined the Multi-State Lottery Association in June 1989. In FY 2006-07 and FY 2005-06, as a member of MUSL, the Wisconsin Lottery participated in one MUSL online game, Powerball (start date April 19, 1992). See Note 9 for information about MUSL.

During FY 2006-07 and FY 2005-06, the Wisconsin Lottery also sold tickets for five other online 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). During FY 2006-07, the Wisconsin Lottery began selling tickets for an online, limited-term raffle-style game that, for the initial game, was known as Million Dollar Draw (start date

March 4, 2007). The Wisconsin Lottery expects to continue offering limited-term raffle-style games in the future.

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 activities 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, 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 online 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 a full refund. 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 online games are recognized at the time the related drawings are held. The Wisconsin Lottery occasionally features online game promotions that offer 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 online ticket sales and 6.25 percent for instant scratch-off and instant pull-tab tickets during FY 2006-07 and FY 2005-06. Nonprofit organizations receive higher commissions.

E. Retailer Performance Program

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 Wisconsin 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 2006-07 and FY 2005-06 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 online lottery tickets and lottery shares, which are multiple-draw online tickets.

Under the winning ticket component, participating retailers that sell a winning scratch-off or online 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. Subject to certain restrictions and allowances, retailers earn up to 2.0 percent of the increase in quarterly sales over sales for the same quarter of the previous year for instant tickets and certain online nonjackpot games (SuperCash!, Daily Pick 3, Daily Pick 4, and Badger 5) and up to 10.0 percent of the increase in annual sales over the previous year. The 2.0 percent incentive payments are made quarterly, and the 10.0 percent payments are made annually. Because of the unpredictable nature of the online jackpot games (Wisconsin's Very Own Megabucks and Powerball) and the raffle-style game (Million Dollar Draw), sales goals incentive program payments for them are calculated and made annually. The annual 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 online 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 ticket printing costs and related royalty fees for instant tickets of 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 game, online tickets are sold for up to eight future drawings. Online ticket revenue is 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 Committee on Finance, 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 fourth Monday in March of the same fiscal year. Therefore, the credit is based on a combination of the prior year's balance carryover and the current year's estimated performance and is distributed in advance of the end of the current 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 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 the credit 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 \$41,282,000 as of June 30, 2007, and \$56,142,000 as of June 30, 2006. 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.

Credit Risk, Concentration of Credit Risk, and Custodial Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Concentration of credit risk is the risk of loss attributed to the magnitude of an investor's holdings in a single issuer. Custodial credit risk is the risk that, in the event a financial institution or counterparty fails, the investor will not be able to recover the value of its

deposits, investments, or collateral. The Wisconsin Lottery does not have a formal investment policy but follows MUSL’s policies for its investments, which require that 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, 2007, and 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. Therefore, the investments are not considered to have credit risk, a concentration of credit risk, or custodial risk as defined by GASB.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment or a deposit. Typically, this risk is higher in debt securities with longer maturities. The Wisconsin Lottery manages this risk by holding investments to maturity, at which time the fair value of the investment is equal to its stated maturity value. Investments are held to maturity unless an annuitant requests premature termination of an annuity. Then any loss or gain due to market fluctuations is passed through to the redeeming annuitant. Therefore, the Wisconsin Lottery has minimal interest rate risk exposure.

The Wisconsin Lottery held U. S. Treasury and Agency investments with the following maturities as of June 30, 2007 and 2006:

<u>Maturity</u>	<u>June 30, 2007</u>	<u>June 30, 2006</u>
Less than 1 Year	\$ 16,616,461	\$ 16,426,052
1 to 5 Years	41,773,649	49,637,400
6 to 10 Years	22,031,345	22,466,639
More than 10 Years	<u>13,000,400</u>	<u>15,143,005</u>
Total	<u>\$93,421,855</u>	<u>\$103,673,096</u>

4. ACCOUNTS RECEIVABLE AND ACCOUNTS PAYABLE BALANCES

Accounts receivable and accounts payable balances are disaggregated as follows:

A. Accounts Receivable

	<u>June 30, 2007</u>	<u>June 30, 2006</u>
Accounts Receivable:		
Retailers	\$1,783,234	\$1,020,029
Miscellaneous	<u>5,474</u>	<u>3,737</u>
Total Accounts Receivable	<u>\$1,788,708</u>	<u>\$1,023,766</u>
Due from Other State Programs:		
Transfers for Gaming	\$ 320,906	\$ 660,908
Transfers for Farmland Tax Relief Credit	187,025	578,120
Miscellaneous	<u>403</u>	<u>4,288</u>
Total Due from Other State Programs	<u>\$ 508,334</u>	<u>\$1,243,316</u>

B. Accounts Payable

	<u>June 30, 2007</u>	<u>June 30, 2006</u>
Accounts Payable:		
Vendors	\$1,838,654	\$2,057,767
Prizes	416,732	790,756
Retailer Commissions	0	97,923
Lottery Credit Administration	270	824
Law Enforcement	3,365	1,078
Miscellaneous	<u>30,060</u>	<u>27,430</u>
Total Accounts Payable	<u>\$2,289,081</u>	<u>\$2,975,778</u>
Due to Other State Programs:		
Farmland Tax Credit	\$1,211,856	\$2,185,951
Employee Fringe Benefits	85,030	198,209
Withholding on Prizes	1,535,606	119,611
Lottery Credit Administration	10,129	15,584
Law Enforcement	26,200	10,585
Other State Programs	<u>200,022</u>	<u>194,829</u>
Total Due to Other State Programs	<u>\$3,068,843</u>	<u>\$2,724,769</u>
Due to Other Governments:		
Employee Fringe Benefits	\$ 43,652	\$ 41,585
Lottery Credit Administration	1,999	1,807
Law Enforcement	2,864	2,216
Withholding on Prizes	<u>2,495</u>	<u>(2,500)</u>
Total Due to Other Governments	<u>\$ 51,010</u>	<u>\$ 43,108</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 using the effective interest method. The amortization of annuity adjustment was \$6,531,666 for FY 2006-07 and \$7,275,262 for FY 2005-06.

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

<u>Fiscal Year</u>	<u>FY 2006-07</u> <u>Total Payments</u>	<u>FY 2005-06</u> <u>Total Payments</u>
2006-07	–	\$ 16,806,053
2007-08	\$ 16,979,383	16,942,383
2008-09	16,974,179	16,935,179
2009-10	14,563,529	14,522,529
2010-11	9,747,351	9,705,351
2011-12	7,284,396	7,240,396
Subsequent Years	<u>58,853,080</u>	<u>57,060,080</u>
Future Prize Payments	124,401,918	139,211,971
Less: Present Value Adjustment	<u>35,546,464</u>	<u>41,001,178</u>
Present Value of Future Prize Payments	<u>\$88,855,454</u>	<u>\$98,210,793</u>

Annuity prizes payable activity for the fiscal years ended June 30, 2007, and June 30, 2006, 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>
2006-07	\$ 98,210,793	\$7,449,991	\$(16,805,330)	\$88,855,454	\$16,560,788
2005-06	107,609,447	7,275,262	(16,673,916)	98,210,793	16,396,867

6. INVESTMENT INCOME (LOSS)

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

	<u>FY 2006-07</u>	<u>FY 2005-06</u>
Interest from State Investment Fund	\$ 4,380,529	\$3,034,883
Net Increase (Decrease) in Fair Market Value of Annuity Investments	5,644,555	(1,423,460)
Decrease for Amortization of Annuity Investments	(6,531,666)	(7,275,262)
Interest from MUSL Prize Reserve Accounts	72,690	335,561
Miscellaneous Interest	<u>3,629</u>	<u>3,260</u>
Total Investment Income (Loss)	<u>\$3,569,737</u>	<u>\$(5,325,018)</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 9. 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. INSTANT AND ONLINE TICKET SALES

Lottery instant and online ticket sales shown on the financial statements consist of the following:

	<u>FY 2006-07</u>	<u>FY 2005-06</u>
Instant Ticket Sales:		
Scratch-off	\$280,040,983	\$280,481,932
Pull-tab	<u>4,090,789</u>	<u>5,275,719</u>
Total Instant Ticket Sales	<u>\$284,131,772</u>	<u>\$285,757,651</u>
Online Ticket Sales:		
Supercash!	\$ 28,081,206	\$ 27,349,328
Powerball	88,093,973	113,292,917
WI Very Own Megabucks	28,389,313	24,410,887
Daily Pick 3	25,873,242	24,781,424
Daily Pick 4	11,665,814	10,853,203
Badger 5	23,086,942	22,611,945
Million Dollar Draw	<u>3,456,350</u>	<u>0</u>
Total Online Ticket Sales	<u>\$208,646,840</u>	<u>\$223,299,704</u>

8. INSTANT AND ONLINE PRIZE EXPENSE

Lottery instant and online prize expenses shown on the financial statements consist of the following:

	<u>FY 2006-07</u>	<u>FY 2005-06</u>
Instant Prize Expense:		
Scratch-off	\$180,423,647	\$179,627,125
Pull-tab	2,596,186	3,313,931
Super 2 nd Chance	<u>259,500</u>	<u>260,000</u>
Total Instant Prize Expense	<u>\$183,279,333</u>	<u>\$183,201,056</u>
Online Prize Expense:		
Supercash!	\$ 18,963,736	\$ 14,055,371
Powerball	42,104,590	54,957,280
WI Very Own Megabucks	14,940,387	12,792,187
Daily Pick 3	13,654,731	12,165,660
Daily Pick 4	5,237,600	5,514,600
Badger 5	11,175,070	10,966,395
Million Dollar Draw	2,500,000	0
Super 2 nd Chance	<u>259,500</u>	<u>260,000</u>
Total Online Prize Expense	<u>\$108,835,614</u>	<u>\$110,711,493</u>

9. MULTI-STATE LOTTERY ASSOCIATION

A. Joint Venture Association

The Wisconsin Lottery is a member of the Multi-State Lottery Association, a nonprofit, government-benefit voluntary association. MUSL was established September 16, 1987, and has 31 member lotteries from 29 states, the District of Columbia, and the U.S. Virgin Islands. It is owned and operated by the member lotteries, which sell one or more games administered by the association. The association is controlled by its Board of Directors, consisting of the director or chief executive officer of each member lottery. Each MUSL member sells tickets through its licensed retailers and makes weekly wire transfers to MUSL in an amount equivalent to the member lottery's share of the weekly prize liability less the actual low-tier prize liability for tickets sold by the respective lottery.

B. Multi-State Lottery Association Financial Position and Activity

The following schedule presents the summarized audited financial position and activity of MUSL as of June 30, 2007 and 2006, as audited by other auditors.

	<u>June 30, 2007</u>	<u>June 30, 2006</u>
Total Assets	<u>\$972,391,954</u>	<u>\$1,054,179,556</u>
Total Liabilities	\$972,194,562	\$1,053,967,990
Total Unrestricted Net Assets	<u>197,392</u>	<u>211,566</u>
Total Liabilities and Net Assets	<u>\$972,391,954</u>	<u>\$1,054,179,556</u>
Total Revenues	\$ 14,334,698	\$ 10,780,028
Total Expenses	(3,049,852)	(2,708,215)
Distribution to Member Lotteries	<u>(11,299,020)</u>	<u>(8,085,909)</u>
Increase (Decrease) in Unrestricted Net Assets	<u>\$ (14,174)</u>	<u>\$ (14,096)</u>

Complete separate financial statements for MUSL may be obtained from:

Multi-State Lottery Association
 Attention: Charles Strutt
 4400 NW Urbandale Drive
 Urbandale, Iowa 50322

C. Powerball Grand Prize Deposit

The Wisconsin Lottery participates in the MUSL Powerball game. The Powerball 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. The remaining 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 Prize Reserve Account (PRA) and Set Prize Reserve Account (SPRA) until they reach their caps of \$75 million and \$25 million, respectively. For some drawings, these accounts are reduced when the actual prizes won are greater than the amounts available in the prize pools. Interest earned on these accounts is 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 only upon withdrawal from MUSL, it is the practice of the Wisconsin Lottery to report the prize reserve balances as a restricted noncurrent asset (grand prize deposit). The Powerball grand prize deposit is made up of the following:

	<u>June 30, 2007</u>	<u>June 30, 2006</u>
Prize Reserve Account (PRA)	\$2,961,570	\$3,341,161
Set Prize Reserve Account (SPRA)	<u>871,050</u>	<u>1,080,000</u>
Grand Prize Deposit—Noncurrent	3,832,620	4,421,161
Balance of Unreserved Account	<u>1,261,273</u>	<u>1,188,583</u>
Total Powerball Grand Prize Reserve Deposit	<u>\$5,093,893</u>	<u>\$5,609,744</u>

10. CAPITAL ASSETS

Capital asset activity for the fiscal year ended June 30, 2007, was as follows:

	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
Leasehold Improvements	\$ 159,724	\$ 0	\$ 0	\$ 159,724
Equipment	<u>760,043</u>	<u>6,635</u>	<u>0</u>	<u>766,678</u>
Total Capital Assets	<u>919,767</u>	<u>6,635</u>	<u>0</u>	<u>926,402</u>
Less Accumulated Depreciation for:				
Leasehold Improvements	54,939	12,070	0	67,009
Equipment	<u>686,570</u>	<u>32,103</u>	<u>0</u>	<u>718,673</u>
Total Accumulated Depreciation	<u>741,509</u>	<u>44,173</u>	<u>0</u>	<u>785,682</u>
Total Capital Assets, Net	<u>\$178,258</u>	<u>\$(37,538)</u>	<u>\$ 0</u>	<u>\$140,720</u>

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>

11. OPERATING LEASES

The Wisconsin Lottery occupied a facility in Madison for storage and instant ticket operations under an operating lease during FY 2006-07 and FY 2005-06.

The following schedule summarizes the future minimum lease payments required under the operating lease for this facility, which is a five-year lease that runs until August 31, 2009, with two optional three-year extensions that have not yet been exercised.

	<u>June 30, 2007</u>	<u>June 30, 2006</u>
Fiscal Year Ending June 30, 2007	-	\$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>\$314,637</u>	<u>\$458,026</u>

Total operating lease expenses for the Wisconsin Lottery amounted to \$143,297 for the fiscal year ended June 30, 2007, and \$142,257 for the fiscal year ended June 30, 2006.

12. DONATIONS

On January 18, 2007, the Wisconsin Lottery executed an agreement with Scientific Games International as part of the current master ticket printing contract. Under this agreement, Scientific Games would print 960,000 tickets for the Milwaukee Brewers scratch-off ticket lottery game for \$47,215, and the Wisconsin Lottery would pay Scientific Games up to \$311,650 for the cost of distribution of 542 merchandise prize packs that were part of the prize structure of the game. In addition, Scientific Games would provide four experiential prize awards with a total value of \$49,814, donate marketing

support of \$15,000 to be used as determined by the Wisconsin Lottery, and donate game brochures and point-of-sale promotional items worth \$5,900. These donations are reflected on the Statement of Revenues, Expenses, and Changes in Fund Net Assets as nonoperating miscellaneous revenue.

13. CONTRACTUAL OBLIGATIONS

A. Scratch-off Tickets

The Wisconsin Lottery has a contract with Scientific Games International to print scratch-off game tickets. This original contract was for the period July 1, 2004, through June 30, 2006. The Wisconsin Lottery has exercised the first two of three possible renewal options, with the current option period expiring June 30, 2008. The Wisconsin Lottery purchased ticket printing services worth \$1,837,277 in FY 2006-07 and \$1,812,541 in FY 2005-06 under this contract. Previously, the Wisconsin Lottery had two printing contracts: a primary contract with Scientific Games, and a secondary contract with Oberthur Gaming Technologies. On May 2, 2007, Scientific Games announced that it had acquired Oberthur Gaming Technologies. Before its acquisition, Oberthur provided ticket printing services worth \$943,399 to the Wisconsin Lottery in FY 2006-07 and printing services worth \$1,360,512 in FY 2005-06.

B. Pull-tab Tickets

The Wisconsin Lottery has a contract with Pollard Banknote Ltd. to print pull-tab game tickets. The original contract was for the period July 1, 2004, through June 30, 2006. The Wisconsin Lottery has exercised the third of three possible yearly renewal options, with the current option period expiring June 30, 2009. The Wisconsin Lottery purchased ticket printing services worth \$423,243 in FY 2006-07 and \$71,256 in FY 2005-06 under this contract.

C. Online Vendor

The Wisconsin Lottery has a contract with GTECH Holdings Corporation that supports a network of approximately 3,700 online locations where traditional online lottery games are sold. The contract expires on June 25, 2011, and can be extended for two additional one-year periods. GTECH receives 2.54 percent of the price of each ticket sold, offset by claims for liquidated damages due to the Wisconsin Lottery. Liquidated damages are discussed further in Note 20. FY 2006-07 expenses under this contract were \$12,428,020, while FY 2005-06 expenses were \$12,705,302. GTECH announced in January 2006 that GTECH and Lottomatica S.p.A. had entered into an agreement under which Lottomatica would acquire GTECH. This transaction has been completed and is not anticipated to have any adverse effect on Wisconsin Lottery operations based on the terms of the agreement and the original contract.

D. Advertising

The Wisconsin Lottery has a contract with Hoffman York to provide informational advertising services through April 9, 2008. The Wisconsin Lottery executed the first of two annual renewal options, with a current end date of April 9, 2009. The cost of the contract was \$4.6 million for both FY 2006-07 and FY 2005-06. Beginning in FY 2007-08, the Wisconsin Lottery is authorized to spend \$7.5 million per year for informational advertising services.

E. Audit of Financial Statements

The Wisconsin Lottery has a contract with the Legislative Audit Bureau for auditing of the Wisconsin Lottery's annual financial statements and providing odds verification services. The current contract was signed on November 30, 2007, and ends on December 31, 2008. It includes the financial audit of the Wisconsin Lottery's financial statements for the period July 1, 2006, through June 30, 2007. Total fees for these services are not expected to exceed \$80,000. During FY 2005-06, the Legislative Audit Bureau provided the aforementioned services as well as a biennial performance evaluation at a total contract cost of \$120,000.

14. RESTRICTED NET ASSETS

The Wisconsin Lottery has restricted net assets for fair market value adjustments of investments of \$6,208,734 as of June 30, 2007, and \$7,095,846 as of June 30, 2006. 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 Wisconsin Lottery has restricted net assets related to the MUSL Powerball reserves as reported in detail in Note 9. Restricted net assets related to the MUSL deposit were \$3,832,620 as of June 30, 2007, and \$4,421,161 as of June 30, 2006.

The portion of restricted net assets related to capital assets is reported in detail in Note 10. The Wisconsin Lottery has restricted net assets related to capital assets of \$140,720 as of June 30, 2007, and \$178,258 as of June 30, 2006.

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 \$22,806,820 as of June 30, 2007, and \$40,382,131 as of June 30, 2006.

15. DISTRIBUTION OF NET PROCEEDS

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

	<u>FY 2006-07</u>	<u>FY 2005-06</u>
Lottery and Gaming Tax Credit	\$144,591,718	\$119,827,143
Farmland Tax Relief Credit	<u>15,391,047</u>	<u>13,469,007</u>
Total Property Tax Relief Credits	<u>\$159,982,765</u>	<u>\$133,296,150</u>

16. 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 ch. 40, Wis. Stats. 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 \$446,491 for FY 2006-07 and \$417,336 for FY 2005-06. 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.

17. COMPENSATED ABSENCES

Compensated absence activity for the fiscal years ended June 30, 2007, and June 30, 2006, 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>
2006-07	\$389,151	\$205,178	\$(158,918)	\$435,411	\$149,451
2005-06	378,908	200,118	(189,875)	389,151	158,918

18. 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 general operations of the Department of Administration’s Division of Gaming related to racing and bingo. The Wisconsin Lottery received \$320,906 from these transfers in FY 2006-07 and \$660,908 in FY 2005-06.

19. 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 make certain transfers to the General Fund. The Wisconsin Lottery transferred \$70,721 to the General Fund in FY 2006-07 for debt service payments for the bonds, and \$25,155 in FY 2006-07 and \$112,408 in FY 2005-06 for general appropriation.

20. 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 liquidated damages, there were significant liquidated damages during GTECH's implementation of the Wisconsin Lottery gaming system's communications 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 during FY 2004-05 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 remaining balance of 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, 2007, and June 30, 2006, 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>
2006-07	\$165,520	\$ 0	\$(30,360)	\$135,160	\$39,000
2005-06	250,000	0	(84,480)	165,520	30,360

21. RESTATEMENT OF FY 2005-06 FINANCIAL STATEMENTS

An adjustment was made to the FY 2005-06 financial statements to present, as a separate line item, restricted assets for MUSL Powerball reserves in the amount of \$4,421,161. The FY 2005-06 financial statements reported restricted net assets related to property tax relief of \$44,803,292. This amount included the \$4,421,161 related to the MUSL reserve deposit. Accordingly, the restricted net assets related to property tax relief for FY 2005-06 has been restated to \$40,382,131. There is no effect on ending net assets.



Supplementary Information ■

Reconciliation of Lottery General Operations Expenses to the Budgetary Basis of Accounting for the Years Ended June 30, 2007 and 2006

	Year Ended June 30, 2007	Year Ended June 30, 2006
SALARIES AND FRINGE BENEFITS		
Per Financial Statement	\$ 5,487,777	\$ 5,206,105
Adjustments to Financial Statement Balance:		
Cash paid in FY 2005-06 but expensed in FY 2004-05	0	447,445
Cash paid in FY 2006-07 but expensed in FY 2005-06	473,352	(473,352)
Cash paid in FY 2007-08 but expensed in FY 2006-07	(523,479)	0
Reclass fringe benefits to transfer out to General Fund	85,736	101,264
Budgetary Basis—Salaries and Fringe Benefits	<u>\$ 5,523,386</u>	<u>\$ 5,281,462</u>
SUPPLIES AND SERVICES AND PERMANENT PROPERTY		
Per Financial Statement:		
Product information costs	\$ 4,512,191	\$ 4,589,159
Supplies and services	2,412,304	2,809,610
Instant ticket printing costs	3,422,112	3,167,831
Instant ticket delivery costs	640,032	611,182
Depreciation expense	44,173	49,825
Total per Financial Statement	11,030,812	11,227,607
Adjustments to Financial Statement Balance:		
Depreciation expense	(44,173)	(49,825)
Donated product information costs	(20,900)	0
Cash paid in FY 2004-05 but expensed in FY 2005-06	0	(1,543,506)
Cash paid in FY 2005-06 but expensed in FY 2004-05	0	4,205
Cash paid in FY 2005-06 but expensed in FY 2006-07	(1,639,656)	1,639,656
Cash paid in FY 2006-07 but expensed in FY 2005-06	42,523	(42,523)
Cash paid in FY 2006-07 but expensed in FY 2007-08	1,597,526	0
Cash paid in FY 2007-08 but expensed in FY 2006-07	(42,389)	0
Compulsive gambling payment not included above	300,000	300,000
Banking fees paid with Department of Administration's banking fees appropriation	(30,040)	(24,761)
Post WISMART closing bad debts adjustment	(785)	785
Post WISMART prior year adjustments	(302,665)	0
Capitalized permanent property less disposals	6,635	17,180
Budgetary Basis—Supplies and Services and Permanent Property	<u>\$ 10,896,888</u>	<u>\$ 11,528,818</u>

Statutorily Defined Lottery Administrative Expenses for the Years Ended June 30, 2005 through 2007

	Year Ended June 30, 2007	Year Ended June 30, 2006	Year Ended June 30, 2005
ADMINISTRATIVE EXPENSES			
Instant and Online Vendor Services	\$ 12,428,020	\$ 12,705,302	\$ 10,572,828
Salaries and Fringe Benefits	5,487,777	5,206,105	5,423,616
Online Telecommunications Charges	0	0	42,430
Supplies and Services	2,412,304	2,809,610	3,826,083
Product Information Costs	4,512,191	4,589,159	4,581,492
Instant Ticket Printing Costs	3,422,112	3,167,831	3,195,303
Instant Ticket Delivery Costs	640,032	611,182	611,882
Depreciation Expense	44,173	49,825	55,642
Total Administrative Expenses as Determined in Accordance with s. 25.75(3)(b), Wis. Stats.	<u>\$ 28,946,609</u>	<u>\$ 29,139,014</u>	<u>\$ 28,309,276</u>
Gross Lottery Operating Revenues	<u>\$ 493,112,532</u>	<u>\$ 509,239,067</u>	<u>\$ 451,993,961</u>
Administrative Expenses as a Percentage of Lottery Operating Revenues	5.87%	5.72%	6.26%

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, 2003 through 2007

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 online games, are summarized below.

	Fiscal Year 2006-07		
	Prize Expense	Ticket Sales	Prize Expense as a Percentage of Sales
Instant Games	\$ 183,279,333	\$ 284,131,772	64.5%
Online Games	108,835,614	208,646,840	52.2
Total for Fiscal Year	\$ 292,114,947	\$ 492,778,612	59.3

	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%
Online 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%
Online 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%
Online 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%
Online Games	90,443,737	185,570,386	48.7
Total for Fiscal Year	\$ 248,509,617	\$ 435,037,814	57.1

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, 2007 and 2006, and have issued our report thereon dated June 25, 2008. 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 as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Wisconsin Lottery's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Wisconsin Lottery's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report

financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.


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 2005 Wisconsin Act 25, \$25,155 was transferred from the Lottery Fund to the State's General Fund to help address budget shortfalls in FY 2006-07, and \$112,408 was transferred for the same purpose in FY 2005-06.

This independent auditor's report is intended for the information and use of the Wisconsin Lottery's staff, the Department of Revenue's management, and the Wisconsin Legislature. This 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 the effectiveness of the Wisconsin Lottery's internal control or on compliance, this report is not intended to be used by anyone other than these specified parties.

June 25, 2008

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