

An Audit

Wisconsin Lottery

Department of Revenue

2005-2006 Joint Legislative Audit Committee Members

Senate Members:

Carol A. Roessler, Co-chairperson
Robert Cowles
Scott Fitzgerald
Mark Miller
Julie Lassa

Assembly Members:

Suzanne Jeskewitz, Co-chairperson
Samantha Kerkman
Dean Kaufert
David Travis
David Cullen

LEGISLATIVE AUDIT BUREAU

The Bureau is a nonpartisan legislative service agency responsible for conducting financial and program evaluation audits of state agencies. The Bureau's purpose is to provide assurance to the Legislature that financial transactions and management decisions are made effectively, efficiently, and in compliance with state law and that state agencies carry out the policies of the Legislature and the Governor. Audit Bureau reports typically contain reviews of financial transactions, analyses of agency performance or public policy issues, conclusions regarding the causes of problems found, and recommendations for improvement.

Reports are submitted to the Joint Legislative Audit Committee and made available to other committees of the Legislature and to the public. The Audit Committee may arrange public hearings on the issues identified in a report and may introduce legislation in response to the audit recommendations. However, the findings, conclusions, and recommendations in the report are those of the Legislative Audit Bureau. For more information, write the Bureau at 22 E. Mifflin Street, Suite 500, Madison, WI 53703, call (608) 266-2818, or send e-mail to leg.audit.info@legis.state.wi.us. Electronic copies of current reports are available on line at www.legis.state.wi.us/lab.

State Auditor - Janice Mueller

Audit Prepared by

Julie Gordon, Financial Audit Director and Contact Person
Stephanie Beardsley
John Brewah
Patrick Bushman
Brian Geib

Kate Wade, Program Evaluation Director and Contact Person
Robin Lecoanet
David Bajkiewicz

CONTENTS

Letter of Transmittal	1
Report Highlights	3
Introduction	7
Property Tax Credit	8
Staffing Levels and Retailers	9
Financial Operations	11
Revenues	11
Ticket Sales	12
Expenses	13
Lottery Sales in Other States	14
Contract Award Process	15
Initial Request for Proposals Process	16
Second Request for Proposals Process	18
Final Contract	19
Lottery Game Management	21
Growth of Instant Games	21
Instant Game Development and Management	23
Affiliated Instant Lottery Games	24
Special Powerball Prize Drawing	26
Launching the Super Bowl Prize Drawing	27
Terminating Lottery Participation	27
Future Considerations	29
Audit Opinion	33
Independent Auditor's Report on the Financial Statements of the Wisconsin Lottery	
Management's Discussion and Analysis	35

Financial Statements

Statement of Net Assets as of June 30, 2004 and 2003	46
Statement of Revenues, Expenses, and Changes in Fund Net Assets for the Years Ended June 30, 2004 and 2003	47
Statement of Cash Flows for the Years Ended June 30, 2004 and 2003	48

Notes to the Financial Statements

Supplementary Information

Schedule 1—Reconciliation of Lottery General Operations Expenses to the Budgetary Basis of Accounting—FY 2003-04	66
Schedule 2—Statutorily Defined Lottery Administrative Expenses for the Years Ended June 30, 2002 through 2004	67
Schedule 3—Summary of Prize Expenses for the Years Ended June 30, 2000 through 2004	68

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	69
--	----

Appendices

Appendix 1—National Lottery Sales	
Appendix 2—Affiliated Instant Lottery Games	

Response

From the Department of Revenue



STATE OF WISCONSIN
Legislative Audit Bureau

22 E. Mifflin St., Ste. 500
Madison, Wisconsin 53703
(608) 266-2818
Fax (608) 267-0410
Leg.Audit.Info@legis.state.wi.us

Janice Mueller
State Auditor

May 11, 2005

Senator Carol A. Roessler and
Representative Suzanne Jeskewitz, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Roessler and Representative Jeskewitz:

As required by s. 13.94(1)(em), Wis. Stats., we have completed our annual financial audit and biennial program evaluation of the Wisconsin Lottery, which is administered by the Department of Revenue. We have issued an unqualified opinion on the Wisconsin Lottery's fiscal year (FY) 2002-03 and FY 2003-04 financial statements.

Total sales increased from \$406.7 million in FY 1999-2000 to \$482.9 million in FY 2003-04, or 18.7 percent. Both instant game and on-line ticket sales increased during this period. Approximately \$2.2 billion in property tax relief has been provided through gaming-related proceeds since the Wisconsin Lottery's inception in 1988.

Because instant game ticket sales account for the majority of the Wisconsin Lottery's revenues, we reviewed the process used to develop instant games, including those affiliated with copyrighted or trademarked properties. We include a recommendation to formalize game development and management practices and analyses. We also found that a loss of approximately \$212,000 was incurred in 2003 when participation in a Super Bowl prize drawing tied to the Powerball game was cancelled. We include a recommendation that the Wisconsin Lottery protect itself by ensuring that its contracts require a performance bond or similar guarantees.

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

Respectfully submitted,

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

Janice Mueller
State Auditor

JM/KW/ss

Report Highlights ■

From FY 1999-2000 through FY 2003-04, total sales increased 18.7 percent.

We issued an unqualified opinion on the Wisconsin Lottery's financial statements for FY 2002-03 and FY 2003-04.

We make several recommendations for game and contract management.

The Wisconsin Lottery generates most of its revenues from the sale of instant and on-line game tickets. More than 4,100 retailer locations currently sell lottery tickets in Wisconsin. Approximately \$2.2 billion in property tax relief has been provided through the Wisconsin Lottery and other gaming-related proceeds since 1988.

As directed by s. 13.94(1)(em), Wis. Stats., we completed a financial audit and program evaluation of the Wisconsin Lottery. For the financial audit, we evaluated internal controls, substantiated account balances, and verified compliance with state laws and regulations. We issued an unqualified opinion on the Wisconsin Lottery's financial statements for the years ended June 30, 2003 and 2004.

For the program evaluation we:

- examined trends in revenues and expenses;
- reviewed the Wisconsin Lottery's process to award the most recent instant ticket, on-line gaming, telecommunications, and internal control systems contracts;
- reviewed the development and management of instant games offered by the Wisconsin Lottery, focusing on the development of instant games affiliated with copyrighted or trademarked products; and

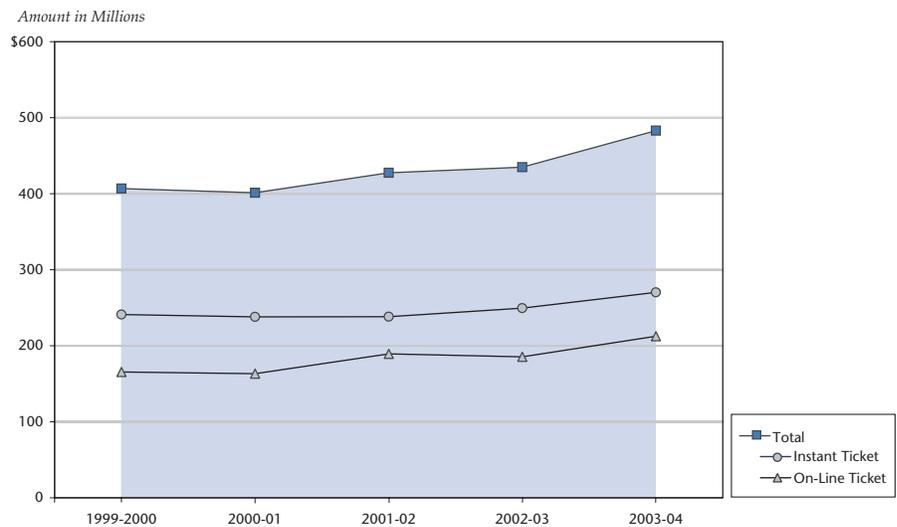
- assessed participation in a 2003 special prize drawing tied to the Powerball on-line game.

Lottery Revenues and Expenses

Wisconsin’s 2002-03 per capita lottery sales were fifth among seven midwestern states. From fiscal year (FY) 1999-2000 to FY 2003-04, total ticket sales increased from \$406.7 million to \$482.9 million, as shown in Figure 1, or 18.7 percent. Instant game ticket sales, which have consistently represented over 50 percent of the Wisconsin Lottery’s total sales, increased 12.1 percent, while on-line game ticket sales increased 28.4 percent. Revenues from all sources reached \$483.2 million in FY 2003-04.

Figure 1

Lottery Sales
FY 1999-2000 through FY 2003-04



Operating expenses increased 17.0 percent, to \$342.4 million, from FY 1999-2000 to FY 2003-04. Administrative expenses have not exceeded 10 percent of gross revenues, as required by statutes, and the Legislature has limited expenses for informational advertising to \$4.6 million annually since FY 1990-91.

Contract Award

In November 2003, the Wisconsin Lottery entered into a seven-year systems and services contract with GTECH Corporation. Two requests for proposals were issued for the contract; the first ended after appeals were filed contesting the Wisconsin Lottery's initial decision.

GTECH provides computer systems and services for instant ticket, on-line gaming, telecommunications, and internal control systems. We estimate that in FY 2004-05, payments to GTECH will total \$11.7 million. Under the terms of the previous contract, payments for similar services totaled \$15.9 million in FY 2003-04.

All new systems required under the terms of the current contract with GTECH were functioning in September 2004. However, the Wisconsin Lottery has not yet developed performance criteria for an annual review that is specified in the contract. Our report includes a recommendation for the development of formal review criteria.

Instant Game Development

The number of instant lottery games introduced each year increased from 37 in FY 1999-2000 to 59 in FY 2003-04.

In determining which instant games to develop and sell, the Wisconsin Lottery considers information from different sources, including studies that identify game player preferences, analyses of the effectiveness of informational advertising, in-house testing of potential games, and past sales from comparable games. However, we found that more could be done to formalize policies and procedures that would improve the game development process, ensure consistent application of policy, and maximize sales of individual games.

Affiliated Instant Lottery Games

As part of its sales strategy, the Wisconsin Lottery sells affiliated instant games that are associated with copyrighted or trademarked names or products. It must obtain permission from the party that holds the licensing rights to these properties and provide compensation through fees or by purchasing merchandise to be used as prizes. We found that affiliated instant games are more costly to develop than other instant lottery games. From FY 1998-99 through FY 2002-03, development costs were 56.2 percent higher for affiliated than for unaffiliated games. They averaged \$107,900 for affiliated and \$69,100 for unaffiliated games.

Lottery officials indicate that affiliated games are intended to generate interest and sales by appealing to individuals who may not typically purchase lottery tickets. However, the Wisconsin Lottery does not have formal procedures to analyze costs and revenues associated with affiliated games.

Special Prize Drawing

To generate awareness of the Powerball on-line game, the Wisconsin Lottery decided in 2003 to participate in a special prize drawing to provide ticket and travel packages to the Super Bowl game held in February 2004. It joined 17 other members of the Multi-State Lottery Association (MUSL), a nonprofit organization that operates multi-state on-line lottery games, in the special prize drawing. However, in response to a cease and desist letter issued by the National Football League to another MUSL member, the Wisconsin Lottery subsequently decided to withdraw from this special prize drawing. It was able to recover some costs it had already incurred, but others could not be recovered and an estimated \$212,000 was lost.

Before deciding to participate in this special prize drawing, the Wisconsin Lottery could have minimized its loss either by ensuring that the third party offering the prize package was contractually required to deliver the tickets, or by purchasing a performance bond to protect itself and its customers. Our report includes a recommendation for all vendor contracts to include guarantees that will protect the Wisconsin Lottery if products are not delivered.

Recommendations

Our recommendations address the need for the Wisconsin Lottery to:

- ☑ develop formal review criteria to evaluate, on an annual basis, GTECH's performance in complying with the current systems and services contract (*p. 20*);
- ☑ develop a written methodology to analyze costs and revenues for all instant games, including affiliated games (*p. 26*); and
- ☑ require all vendor contracts to provide guarantees that will protect it in the case of nondelivery of products (*p. 28*).



Introduction ■

***The Wisconsin Lottery
began operations in
September 1988.***

The Wisconsin Lottery began operations in September 1988, after Wisconsin voters adopted a constitutional amendment in 1987 allowing the Legislature to create a state lottery. Net lottery proceeds are required 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 on-line games. Instant game tickets reveal a prize when consumers remove scratch-off or pull-tab coverings; on-line games involve consumers choosing numbers from an automated system, with winning numbers selected in drawings held at intervals ranging from daily to twice a week.

As part of our audit responsibilities under s. 13.94(1)(em), Wis. Stats., we complete annual financial audits and biennial program evaluations of the Wisconsin Lottery. In our 2004 financial audit (report 04-4), we issued an unqualified opinion on the Wisconsin Lottery's FY 2001-02 and FY 2002-03 financial statements. This report includes our financial audits of the Wisconsin Lottery for the years ended June 30, 2003 and 2004. The financial section begins with our unqualified opinion and includes four items prepared by lottery staff—management's discussion and analysis of financial activity for the audit period, the financial statements, notes, and various schedules provided to demonstrate the Wisconsin Lottery's compliance with statutory requirements.

As part of our program evaluation, we reviewed:

- trends in program revenues and expenses;

- the process to award the most recent computerized gaming systems and services contract;
- the development and management of instant games offered by the Wisconsin Lottery; and
- circumstances surrounding a 2003 special prize drawing that was tied to the Powerball on-line game.

In conducting our evaluation, we reviewed financial information and other documents provided by the Wisconsin Lottery and materials from national organizations that research lottery issues, and we interviewed members of the Wisconsin Lottery’s staff. We also surveyed other states’ lottery officials.

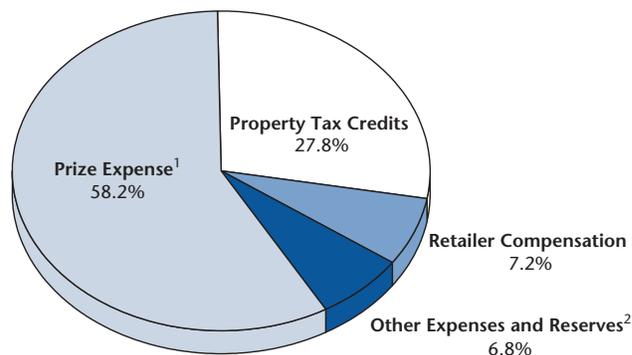
Property Tax Credit

Property tax credits represented 27.8 percent of lottery revenues in FY 2003-04.

The Wisconsin Constitution requires that net proceeds from the Wisconsin Lottery be used only for property tax relief. Under current law, property tax relief is provided through a credit to homeowners whose primary residence is in Wisconsin and through a farmland tax relief credit. As shown in Figure 2, 27.8 percent of lottery revenues were distributed as property tax credits in FY 2003-04.

Figure 2

**Distribution of Wisconsin Lottery Revenue
FY 2003-04**



¹ Prize expense is based on total lottery sales.

² Other expenses include transfers to state agencies for gaming law enforcement and property tax credit administration. Because estimates are used in distributing property tax credits, not all funds may be distributed each year. Remaining funds are carried over to the next year for distribution.

Approximately \$2.2 billion in property tax relief has been provided since 1988.

Approximately \$2.2 billion in property tax relief has been provided through the Wisconsin Lottery and other gaming-related proceeds since 1988. As shown in Table 1, \$714.3 million has been provided for property tax relief in the past five years. The amounts distributed and the average property tax credits have fluctuated from year to year because of variations in lottery and other gaming-related proceeds and because of legislative action. For example, in FY 1999-2000 the Legislature provided a one-time general purpose revenue subsidy of \$76.0 million to the Wisconsin Lottery. This action increased the amount available for property tax credits to \$232.3 million and resulted in the highest average property tax credit provided since 1993. The average credit declined in FY 2000-01 but then began to increase. For FY 2003-04, \$131.6 million was made available for property tax relief; the average credit for 2004 was \$83.

Table 1

Wisconsin Property Tax Relief¹
(In Millions)

Fiscal Year	Amount Distributed	Average Property Tax Credit
1999-2000	232.3	\$165
2000-01	101.8	67
2001-02	119.0	77
2002-03	129.6	79
2003-04	131.6	83
Total	\$714.3	

¹ Available proceeds include fund balances from the Wisconsin Lottery, as well as other gaming-related appropriations, including racing and charitable bingo operations.

Staffing Levels and Retailers

The percentage of vacant staff positions has declined since 1999.

In 1999 (report 99-14), we noted concerns about the large number of field support and telemarketing staff positions that had remained vacant for an extended period of time. The percentage of vacancies has declined from 18.6 percent of authorized positions in January 1999 to 14.0 percent in July 2004. The vacant positions did not include any customer service staff, and several positions remained vacant because of automation or reassignment of duties.

More than 4,100 retail locations sell lottery tickets in Wisconsin.

The Wisconsin Lottery contracts with retailers in more than 4,100 locations to sell tickets, and the Retailer Performance program was implemented in January 2000 with the expectation that the addition of incentive-based compensation to retailers’ commissions would increase both lottery sales and the number of retailers. In the past, we noted that the original sales projections for the Retailer Performance program were not realized. We now note that total sales have increased each year since FY 2000-01, the first full year after implementation of the Retailer Performance program, but as shown in Table 2, the number of retail locations has continued to decline steadily. Lottery officials note that during the last several years, a number of large retailers with many sales locations stopped selling tickets.

Table 2

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

Year	Number of Retail Locations	Percentage Change
1995	4,854	–
1996	4,725	(2.7)%
1997	4,335	(8.3)
1998	4,272	(1.5)
1999	4,254	(0.4)
2000	4,255	0.0
2001	4,239	(0.4)
2002	4,227	(0.3)
2003	4,174	(1.3)
2005 ¹	4,163	(0.3)

¹ December 2004 data were not available from the Wisconsin Lottery. The number of retailers noted is based on March 2005 data.



Financial Operations ■

As noted, the Wisconsin Constitution requires net lottery proceeds to be used for property tax relief. Statutes require that prizes equal at least 50 percent of each year's revenues from the sale of lottery tickets. Expenses are limited in amount and type by the Wisconsin Constitution and state statutes. The on-line gaming and instant ticket system is one of the Wisconsin Lottery's largest expenses. The computerized system records sales, validates winning tickets, and tracks the inventory of instant tickets. In November 2003, the State entered into a seven-year contract for this system, at an estimated cost of \$11.7 million for the first year.

Revenues

Lottery revenues reached \$483.2 million in FY 2003-04.

From FY 1999-2000 through FY 2003-04, the Wisconsin Lottery's total operating revenues increased 18.8 percent. As shown in Table 3, revenues declined at the start of this five-year period, then increased to \$483.2 million in FY 2003-04. The increase resulted in large part from a 14.6 percent increase in on-line game ticket sales from FY 2002-03 through FY 2003-04.

Table 3

Wisconsin Lottery Operating Revenues
(In Millions)

Revenue Type	FY 1999-2000	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04
Instant Game Ticket Sales	\$241.1	\$237.9	\$238.2	\$249.5	\$270.3
On-Line Game Ticket Sales	165.6	163.3	189.4	185.5	212.6
Subtotal	406.7	401.2	427.6	435.0	482.9
Retailer Fees and Miscellaneous Revenue	0.1	2.5	0.1	0.1	0.3
Total	\$406.8	\$403.7	\$427.7	\$435.1	\$483.2

Ticket Sales

Instant and on-line game ticket sales represent over 99 percent of the Wisconsin Lottery's operating revenues. Total ticket sales increased to \$482.9 million in FY 2003-04, their highest level since FY 1994-95 and an increase of 11.0 percent from FY 2002-03 levels. Nevertheless, the most recent projections for FY 2004-05 sales show a decline to \$460.8 million primarily because large Powerball jackpots, which have a significant effect on on-line game ticket sales, have not materialized. Lottery staff also believe that there has been a nationwide "desensitization" of players to high jackpot levels. Even with these caveats, Wisconsin Lottery officials project that total sales will increase again, to \$480.3 million for FY 2005-06.

The sales performance of instant and on-line game tickets has varied in each of the past five years. Overall, ticket sales increased by 18.7 percent during this period. Instant game ticket sales in FY 2003-04 exceeded FY 1999-2000 levels by 12.1 percent, and on-line game ticket sales increased by 28.4 percent. Instant game tickets have consistently represented more than one-half of total sales.

Sales of on-line game tickets increase when a jackpot increases.

Sales of on-line games are, to a great extent, directly related to the size of available jackpots. Typically, the amount of money in a jackpot increases with each ticket sold until a winning number is drawn. As the jackpot increases, on-line game ticket sales increase. In 2003, for example, weekly Powerball ticket sales averaged \$2.0 million. However, in late July 2003 Powerball sales were at their highest levels for the year, reaching \$8.1 million for the week ending

July 12, 2003, when the value of the Powerball jackpot was \$261.3 million.

Expenses

Operating expenses increased 17.0 percent from FY 1999-2000 through FY 2003-04.

As shown in Table 4, the Wisconsin Lottery’s operating expenses include prizes paid to winning ticket holders; retailer compensation, including commissions and incentives; game development and production costs, such as instant game ticket printing and delivery costs and on-line telecommunication charges; product information costs; and administrative and other costs, such as staff salaries and fringe benefits. From FY 1999-2000 through FY 2003-04, operating expenses increased by 17.0 percent, from \$292.6 million to \$342.4 million, primarily because of the increases in prizes and retailer compensation, which rose with increased sales.

Table 4

Wisconsin Lottery Operating Expenses (In Millions)

Expense Type	FY 1999-2000	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04
Prizes	\$233.2	\$232.9	\$241.6	\$248.5	\$275.2
Retailer Compensation	27.0	28.3	30.1	30.8	33.9
Game Production ¹	18.9	18.6	19.6	19.2	19.3
Product Information	4.5	4.6	4.5	4.6	4.6
Other ²	9.0	10.4	9.5	9.6	9.4
Total	\$292.6	\$294.8	\$305.3	\$312.7	\$342.4

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

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

The Legislature has limited the Wisconsin Lottery’s informational advertising expenses to \$4.6 million annually since FY 1990-91.

Some types of expenses incurred by the Wisconsin Lottery are limited by the Wisconsin Constitution and state statutes. The Constitution prohibits the expenditure of public funds, including revenues derived from lottery operations, for promotional advertising. Informational advertising is permitted. Through legislative action, the Wisconsin Lottery’s informational advertising expenses have been limited to \$4.6 million annually since FY 1990-91.

Administrative expenses have remained within the statutory limit of 10 percent of gross revenues.

Section 25.75(3)(b), Wis. Stats., provides that certain administrative expenses be limited to no more than 10 percent of gross revenues. These administrative expenses are defined as all expenses except prize expense and retailer compensation. The largest categories of administrative expenses include the costs of a contract with a private vendor to operate the computer system that supports the Wisconsin Lottery’s games, informational advertising, and staff salaries and fringe benefits. As shown in Table 5, lottery administrative expenses have remained within the statutory limit, and as a percentage of gross revenues they have declined annually since FY 2000-01.

Table 5
Statutorily Defined Administrative Expenses as a Percentage of Gross Revenues
(In Millions)

Fiscal Year	Total Statutorily Defined Administrative Expenses	Total Gross Revenues	Percentage of Total Gross Revenues
1999-2000	\$32.4	\$406.8	8.0%
2000-01	33.6	403.7	8.3
2001-02	33.6	427.7	7.9
2002-03	33.5	435.1	7.7
2003-04	33.4	483.2	6.9

Lottery Sales in Other States

Wisconsin’s per capita lottery sales were fifth of seven midwestern states in both FY 2001-02 and FY 2002-03.

An analysis of midwestern per capita lottery sales data for FY 2001-02 and FY 2002-03, the latest year for which data were available at the time of our fieldwork, indicates that per capita sales in three other midwestern states decreased more than Wisconsin’s, while sales in Indiana, Ohio, and Iowa increased. As shown in Table 6, Wisconsin’s per capita lottery sales were fifth among seven midwestern states in both FY 2001-02 and FY 2002-03.

Table 6

Midwestern States' per Capita Lottery Sales

State Lottery	FY 2001-02 per Capita Sales	FY 2002-03 per Capita Sales	Percentage Change
Ohio	\$174.00	\$182.30	4.8%
Michigan	167.10	166.50	(0.4)
Illinois	124.30	123.20	(0.9)
Indiana	101.00	107.20	6.1
Wisconsin	79.20	79.10	(0.1)
Minnesota	75.40	69.00	(8.5)
Iowa	62.50	64.80	3.7

Source: La Fleur's 2003 and 2004 World Lottery Almanacs

For the 39 jurisdictions that operated lotteries in FY 2002-03, per capita sales averaged \$172.00. Wisconsin ranked 28th, with per capita sales of \$79.10. South Dakota was ranked first, with per capita sales of \$808.60, and Montana was 39th, with per capita sales of \$38.60. Appendix 1 shows when lottery operations began, total sales, per capita sales, and per capita sales ranks for the 39 jurisdictions that operated lotteries in FY 2002-03.

Contract Award Process

The Wisconsin Lottery has contracted with GTECH for computerized gaming system services since 1989.

Since it began operating in 1988, the Wisconsin Lottery has developed or contracted with a private vendor for its instant ticket and on-line gaming operations and for related telecommunications services. In its first year of operation, it sold only instant tickets and operated its own mainframe computer system. In August 1989, it contracted with GTECH Corporation, a private vendor, for an on-line gaming system and related services but continued to maintain its own computer system for instant ticket games. From June 1997 through June 2004, GTECH provided the computer system and services for both the instant ticket and the on-line gaming systems and, through a subcontractor, provided the Wisconsin Lottery's internal control system.

The ticket systems consist of computer hardware and software that support the inventory, sales, validation, reporting, and payment of instant ticket products; the generation of on-line gaming tickets; and

the support of testing, sales, validation, reporting, and payment of on-line gaming products. The internal control system allows the Wisconsin Lottery to have administrative and security control over the transactions generated by the on-line gaming and instant ticket systems. In FY 2003-04, the last year of the previous contract, GTECH was paid \$12.4 million for these services. In addition, the Department of Administration was paid \$500,000 for access to its statewide telecommunications network, and SBC/Ameritech was paid \$3.0 million for private dedicated digital circuits connecting the statewide telecommunications network with lottery retailers and the on-line gaming computer system vendor.

For more than two-and-one-half years, the Wisconsin Lottery pursued new contracts for computer and telecommunications services.

In January 2001, the Wisconsin Lottery began a more than two-and-one-half year process to solicit proposals and contract for instant ticket, on-line, telecommunications, and internal control systems and services. The initial request for proposals was issued in June 2002, for a contract period beginning upon signing the contract, estimated to be in January 2003. It was expected that the new instant ticket, on-line gaming, internal control, and telecommunications systems would be operational in June 2004 and that the contract would remain in effect for five years from the acceptance date, with a renewal option by mutual agreement for up to four additional one-year periods. A second request for proposals process was started in February 2003, after questions were raised about the initial process. Given legislative interest in contracting, we reviewed the scoring methodology for both processes, the awards and subsequent protests, the decision to begin a second process, and the terms of the final contract.

Initial Request for Proposals Process

Potential vendors could submit proposals for all four systems or solely for the internal control system.

In June 2002, the Wisconsin Lottery issued two requests for proposals: one for the instant ticket system and the other for the on-line gaming, internal control, and telecommunications systems. Any vendor submitting a proposal for either the instant ticket or the on-line gaming system was required to submit proposals for the three other systems. On the other hand, a proposal for the internal control system could be made independently of the other systems. Three proposals were received. Each included all four systems.

Vendors' proposals were scored based on:

- general requirements and qualifications, which included previous experience in providing systems and services to lotteries comparable to the Wisconsin Lottery, and the vendor's financial capacity for timely and complete performance of its obligations;

- technical requirements, which included providing a data center facility; meeting stated hardware and software specifications; and providing services such as ticket validation, prize check printing, and training; and
- cost.

The most important criterion in the proposal evaluation process was the vendor’s ability to meet technical requirements.

As is common with state contracting, the cost of the proposal was important, but it was not the sole criterion in the evaluation process. Section 3.1 of the request for proposals stated, “the award will be made to the vendor(s) who best meets the needs of the Lottery, and will not necessarily be the lowest cost proposal.” For each system sought, technical requirements were assigned the highest value. We reviewed other technology-related requests for proposals issued by the State and found that it is typical for technical requirements to be assigned the highest value in the evaluation process.

Based on the evaluation criteria, GTECH’s proposal received the highest score, as shown in Table 7. On November 8, 2002, the Wisconsin Lottery issued a letter of intent to negotiate a contract with GTECH.

Table 7

**Scores and Proposed Costs
Initial Request for Proposals Process
November 2002**

Proposed Vendor	Scores	Proposed Cost (In Millions)
Intralot, Inc.	3,926.1	\$34.3
Scientific Games International, Inc.	4,570.3	45.2
GTECH Corporation	4,607.1	50.7

Two vendors protested the decision to contract with GTECH.

The other two proposers, Intralot and Scientific Games, protested the decision to award GTECH the contract because it was not the lowest-cost proposal, and because they objected to the method of scoring and the importance of the internal control system in the scoring process.

In December 2002, the Wisconsin Lottery denied both protests, noting the scoring process and results were fully consistent with the requests for proposals, but vendors appealed to the Department of Administration. On December 30, 2002, the outgoing Secretary of the Department of Administration directed the Wisconsin Lottery to withdraw the letter of intent to negotiate a contract with GTECH and to pursue a best and final offer process. This process required each vendor to resubmit its proposed cost for each of the four components, and the Department determined the successful vendor using the existing scoring methodology but with the newly submitted cost information.

The initial request for proposals process was discontinued in January 2003.

A best and final offer process is typically not undertaken once a letter of intent to negotiate is issued. In January 2003, the best and final offer process was cancelled and the new Secretary of Revenue discontinued the first request for proposals process. This decision was the result, in part, of the protests and appeals filed to contest the decision to award the contract to GTECH. Correspondence from Wisconsin Lottery staff to the three bidders noted concern about the time likely required for litigation of these issues.

Second Request for Proposals Process

A second request for proposals process was begun in February 2003.

In February 2003, a second request for proposals process was begun. Again, separate proposals were requested for the instant game system and for the other three systems. As with the initial process, potential vendors could submit proposals for all four systems or solely for the internal control system. However, a major change in the second process was to require that proposals combine the on-line gaming and the telecommunications systems. Lottery staff believed an integrated system provided under one contract would be less expensive and more efficient to operate. The evaluation criteria were similar to those developed for the initial process.

GTECH, Intralot, and Scientific Games again submitted proposals for all four systems, and a fourth vendor submitted an independent proposal for the internal control system only. GTECH included this vendor as a subcontractor in its full proposal.

The GTECH proposal again received the highest score.

In June 2003, the Wisconsin Lottery issued a letter of intent to negotiate a contract with GTECH. Table 8 shows vendor scores based on the evaluation criteria and proposed costs for the full systems. The GTECH proposal again received the highest score, although by only ten points.

Table 8
Scores and Proposed Costs
Second Request for Proposals Process
 June 2003

Proposed Vendor	Scores	Proposed Cost (in Millions)
Scientific Games International, Inc.	4,323.92	\$44.9
Intralot, Inc.	4,732.26	31.4
GTECH Corporation	4,742.87	43.8

Intralot protested and then appealed the contract decision. Among the ten claims raised in Intralot’s protest were an allegation that GTECH had been allowed to “lowball” its bid by not considering Intralot’s offer to provide “optional” features at a low or no cost, and concerns about the reduction in value given to cost and the “excessive” value given to the internal control system when compared to the instant ticket and on-line systems. In early August 2003, Intralot withdrew its appeal, noting that it had been selected to provide services to the Nebraska Lottery and wanted to focus on delivery of those services, rather than on litigation in Wisconsin.

Final Contract

Although the two request for proposals processes took more than two-and-one-half years from planning to contract award, Wisconsin Lottery staff believe that the second process resulted in more favorable contract terms than had been attained in the first. First, a longer initial contract period was established. While both processes proposed a five-year contract with a renewal option of up to four additional one-year periods, in November 2003 the Wisconsin Lottery and GTECH entered into a seven-year contract which expires in June 2011. The contract provides for two optional one-year renewal periods by mutual agreement.

Purchasing staff believe a longer initial contract period is in the Wisconsin Lottery’s best interest because the request for proposals process is lengthy, and conversions from old hardware and software can be time-consuming. The new telecommunications system began operating in June 2004, and the new system for gaming and ticket sales became operational in September 2004.

Lottery staff also believe costs have been reduced. Under the terms of the final negotiated contract, GTECH receives:

- 2.05 percent of on-line, instant scratch, and pull-tab game sales;
- 0.49 percent of sales to pay for additional options, including player ticket scanner devices, instant ticket vending machines, wireless technology to support training terminals, and keyless instant ticket validation technology; and
- a one-time payment of \$540,000 to upgrade computer terminals at retail locations.

FY 2004-05 payments to GTECH are estimated to be 26.4 percent below payments for similar services in FY 2003-04.

Based on actual costs incurred during the first seven months of the current fiscal year, we estimate FY 2004-05 payments to GTECH will total \$11.7 million. In contrast, estimated total costs under the first request for proposals were \$11.3 million, but additional negotiated options might have increased the final total. We note that estimated FY 2004-05 payments to GTECH are 26.4 percent less than the \$15.9 million the Wisconsin Lottery paid for all instant ticket, on-line, telecommunications, and internal control systems services in FY 2003-04.

Formal criteria have not yet been established to evaluate GTECH's performance.

The contract includes provisions for ongoing monitoring and review of the vendor's performance, as well as for a formal annual review. These monitoring and review processes will allow the Wisconsin Lottery to ensure that the vendor's performance is effective and efficient, and they may also be used to reduce future costs by identifying technological improvements. To date, the Wisconsin Lottery and GTECH have not yet established formal review criteria to evaluate GTECH's performance, although Wisconsin Lottery staff note they meet at least weekly with GTECH to review system performance.

Recommendation

We recommend the Wisconsin Lottery develop formal review criteria to evaluate, on an annual basis, the vendor's performance in complying with the current contract.

■ ■ ■ ■

Lottery Game Management ■

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

Instant games generate the majority of the Wisconsin Lottery's revenue. Player interest is maintained by frequently introducing new instant games, operating a variety of games, and occasionally introducing instant games affiliated with copyrighted or trademarked properties. We reviewed the development of new instant games and methods for deciding to offer affiliated games, and we found improvements could be made.

Growth of Instant Games

Instant scratch games accounted for 55.2 percent of FY 2003-04 sales.

Sales of instant scratch games represented over 50 percent of total sales in both FY 2002-03 and FY 2003-04. As shown in Table 9, 108 instant scratch games were available for sale during at least one point during FY 2003-04. They accounted for \$266.6 million, or 55.2 percent, of total sales; 11 pull-tab games generated an additional \$3.7 million. The number of games available for sale during at least one point of the year increased from 109 in FY 2002-03 to 125 in FY 2003-04. Lottery officials note that at any given time, approximately 30 different instant games are available for distribution to retailers.

Table 9

Number and Sales of Games¹

Game Type	FY 2002-03			FY 2003-04		
	Number of Games Available	Total Sales (millions)	Percentage of Total	Number of Games Available	Total Sales (millions)	Percentage of Total
On-Line	7	\$185.5	42.6%	6	\$212.6	44.0%
Instant						
Scratch	89	245.2	56.4	108	266.6	55.2
Pull-Tab	13	4.3	1.0	11	3.7	0.8
Subtotal	102	249.4	57.4	119	270.3	56.0
Total	109	\$435.0	100.0%	125	\$482.9	100.0%

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

The Wisconsin Lottery has steadily increased the number of instant lottery games introduced each year.

Just as the number of games available for sale has increased, the number of instant games introduced, or made available for sale for the first time, has also increased each year. As shown in Table 10, it increased from 37 in FY 1999-2000 to 59 in FY 2003-04. The number of unaffiliated games introduced each year increased from 34 in FY 1999-2000 to 57 in FY 2003-04. In contrast, the number of games affiliated with copyrighted or trademarked properties has been relatively constant except in FY 2000-01, when nine were introduced. Six of these nine games were introduced under the terms of a contract that required the Wisconsin Lottery to introduce eight games in a two-year period.

Table 10

Number of Instant Lottery Games Introduced by Fiscal Year

Year Introduced	Affiliated Games	Unaffiliated Games	All Games
1999-2000	3	34	37
2000-01	9	31	40
2001-02	2	46	48
2002-03	2	52	54
2003-04	2	57	59

Instant Game Development and Management

Effective game selection, development, and management are important in maximizing sales revenues and property tax relief. In 1999, we analyzed management of the Wisconsin Lottery’s instant games and found that new instant scratch games were introduced frequently in an effort to increase sales. In each month reviewed, revenues from new game sales were, on average, between four and eight times greater than revenues from the sale of older games. However, because the costs associated with each game had not been determined by the Wisconsin Lottery, we concluded that it should analyze these costs to ensure that strong sales trends would continue.

The Wisconsin Lottery reviews information from a number of sources to select and develop instant games.

To follow up on our earlier findings, we reviewed the process by which instant lottery games are selected and developed. Lottery staff indicate that they consider information from a number of sources, including:

- external studies that identify the preferences of both regular and occasional game players;
- tracking studies that determine the Wisconsin Lottery’s visibility and the effectiveness of its informational advertising;
- in-house testing of potential instant lottery games; and
- past sales from comparable instant lottery games.

This information is used in determining the number of instant lottery games to develop; the number of games offered for sale at any one time; game themes such as casino-style or word-related themes; ticket prices, which typically range from \$1 to \$10; and the number of tickets to print for the initial sale of each game.

Lottery staff must also manage instant lottery games after their introduction and review weekly sales and prize payout trends to determine, for example, whether to re-order tickets for a game that is selling well or to end the distribution of a game that is no longer meeting minimum weekly sales goals or when the last top prize has been won. For example, the game “Vegas Nights” was first introduced in April 1997. Because of its initial success and strong weekly sales, the Wisconsin Lottery has continued to offer this game and has re-ordered tickets several times.

Affiliated Instant Lottery Games

The analysis of costs incurred in the development and introduction of new instant games is of particular importance in any consideration of affiliated games, which are tied to well-known products or properties. Although relatively few affiliated games have been sold in Wisconsin, additional costs are associated with obtaining permission from the holders of licensing rights to copyrighted or trademarked property. The Wisconsin Lottery negotiates agreements with third-party vendors that have purchased the licensing rights from copyright or trademark holders such as Harley-Davidson, Inc. Appendix 2 lists its affiliated instant lottery games by fiscal year of introduction.

Vendors must also be compensated to develop affiliated instant lottery games. This compensation varies by vendor and by game, but it is usually provided through either:

- a fixed licensing fee;
- a royalty based on the number of tickets printed or ticket sales; or
- a prize purchase from the vendor to use for the game, such as a Harley-Davidson motorcycle or a trip to Graceland to visit the Elvis Presley estate.

Both licensing fees and prize purchases are associated with affiliated games.

Prize purchase expenses, which totaled \$3.2 million from FY 1998-99 through FY 2002-03, are supported by the prize funds for the individual games and are accounted for as prizes, not development costs.

Development costs have been 56.2 percent higher for games affiliated with copyrighted or trademarked properties than for unaffiliated games.

The Wisconsin Lottery spent \$496,000 in licensing fees and royalties to develop affiliated instant lottery games that were introduced from FY 1998-99 through FY 2002-03. Development costs varied based on game ticket features, such as special graphics and imaging, and the number of tickets printed. As shown in Table 11, the average cost for the Wisconsin Lottery to offer an affiliated instant lottery game was \$107,900, or 56.2 percent more than the average cost to offer an unaffiliated game. Licensing fees represented 24.2 percent of the average development cost of affiliated instant lottery games.

Table 11

Average Development Costs and Revenues per Instant Lottery Game
(For Games Introduced FY 1998-99 through FY 2002-03)

	Affiliated Games	Unaffiliated Games
Number of Games Introduced	19	191
Printing and Staffing Costs ¹	\$ 81,800	\$ 69,100
Licensing Costs	26,100	0
Average Cost per Game	107,900	69,100
Average Revenue per Game ²	4,811,200	5,434,500

¹ Staffing costs are based on an estimate of salaries and fringe benefits for the time spent developing instant lottery games.

² Based on revenue generated through April 30, 2004.

Some of the difference in affiliated game costs shown in Table 11 can be attributed to additional printing costs. Average printing and staffing costs for affiliated games are 18.4 percent higher than those for unaffiliated games. While printing costs are recorded separately for all games, staffing costs are not.

Although affiliated games are costlier to produce, they generate less revenue. However, they are also intended to generate interest in the Wisconsin Lottery and to generate sales by game players who may not typically purchase lottery tickets. For example, a player who typically does not purchase instant lottery games may choose to buy a "Holiday Harley" ticket.

Formal policies and procedures are not in place to analyze costs and revenues associated with instant and affiliated games.

While it is important to note that instant game sales have increased in the last three fiscal years, decisions regarding which instant games to offer—including which affiliated games—and the duration of each of those games merit a thorough analysis. We found that the Wisconsin Lottery has not established standard procedures to review its existing analyses, nor does it review the costs and revenue projections associated with individual games. Both the variability in performance between affiliated and unaffiliated games and the value of institutionalizing management decisions regarding game offerings require sound game development policies and procedures.

☑ Recommendation

We recommend the Wisconsin Lottery develop a written methodology to ensure the consistent analysis of the costs and revenues associated with all instant games, including affiliated games.

Special Powerball Prize Drawing

In July 2003, the Multi-State Lottery Association proposed a special Powerball prize drawing that would offer ticket and travel packages to the Super Bowl held in Houston, Texas, in February 2004. Prize packages could be purchased through MUSL from a third party that had organized previous Super Bowl travel packages. Each package, with an estimated value of \$26,000, included travel and hotel accommodations, two tickets to a suite for the Super Bowl game, Super Bowl jackets, \$500 cash, and payment of the applicable federal withholding taxes for the prize package. Each participating MUSL member was to administer the special prize drawing.

Lottery officials believed offering a unique prize and interest in professional football were reasons to participate in a special prize drawing.

Although the Wisconsin Lottery had not previously participated in special Powerball prize drawings, a decision was made in August 2003 to purchase nine prize packages from MUSL. Lottery officials believed that the prize package would be attractive because Super Bowl tickets cannot be easily purchased by the general public, and the high interest in professional football in Wisconsin could stimulate Powerball sales. Eighteen MUSL members agreed to participate in the prize drawing. During our discussions with MUSL members, some raised concerns that the National Football League would not approve of using Super Bowl tickets as lottery prizes without its prior written consent.

Launching the Super Bowl Prize Drawing

In October 2003, the National Football League requested that Colorado end its special prize drawing.

Participating MUSL members were responsible for their own advertising campaigns, and several launched their campaigns in September. The Wisconsin Lottery planned to launch its campaign for the Super Bowl prize drawing, including informational advertising in newspapers, radio, and on television, the week of October 26, 2003. However, right before that date, MUSL learned that the National Football League was considering taking action against participating MUSL members when the Colorado Lottery received a cease and desist letter dated October 22, 2003. The League noted that the terms of each Super Bowl ticket specified that it may not be used for promotional purposes without prior express written consent of the National Football League.

The Wisconsin Lottery suspended its participation in the special prize drawing in October 2003.

Wisconsin Lottery officials were uncertain whether the issues between the National Football League and Colorado would be resolved and if similar action would be taken by the National Football League against the Wisconsin Lottery. There was time to cancel print advertising that had been scheduled to run in regional and statewide newspapers, and thereby recover \$100,000 in costs. Therefore, on October 23, 2003, the campaign was suspended until the issues with the National Football League could be resolved.

Unclear guidelines and time constraints precluded modifications to Wisconsin's advertising campaign.

In November 2003, the National Football League and the third party agreed to allow MUSL members to continue the Super Bowl prize drawing if advertising was modified. Although neither the League nor the third party provided written guidelines defining acceptable advertising language, Wisconsin Lottery officials determined the advertising that had already been produced under contract did not meet the new restrictions. The advertising agency estimated that changes were impractical because of time constraints. Furthermore, the third party continued to refuse to provide participating lotteries with written guarantees that it would have Super Bowl tickets from the National Football League.

Terminating Lottery Participation

In mid-November 2003, the Wisconsin Lottery decided to cancel the drawing and to sell the ticket packages and other items it had reserved or purchased. Wisconsin was the only MUSL member to cancel its drawing after the National Football League raised objections. In addition to much of the scheduled advertising cost, the Wisconsin Lottery was able to recoup some costs already incurred for hotel accommodations and tour packages, and to mitigate other charges such as airline fees. In addition, the third party agreed to sell the Super Bowl tickets, and Wisconsin Lottery staff have used the

Super Bowl jackets as prizes for retailers. The estimated loss for all expenses not recouped is approximately \$212,000. As we completed this report, the Wisconsin Lottery was considering legal action to recover its losses, but MUSL has decided not to file a lawsuit.

Although a conservative approach was adopted in canceling the Wisconsin prize drawing, less caution was displayed in the initial decision to participate in the Super Bowl prize drawing. First, the Wisconsin Lottery agreed to participate in the promotion, and to bear the financial risk of participating, before reviewing the contract between MUSL and the third party, as would have been a reasonable and expected business practice.

The Lottery should have exercised more caution in deciding to participate in the Super Bowl special prize drawing.

Second, the Wisconsin Lottery regularly requires vendors to provide performance bonds so that it is not responsible for payment in the event a vendor cannot deliver a product purchased under contract. This is consistent with the provisions in administrative code that authorize the Department of Administration to require contractors to purchase performance bonds or take similar measures to ensure product delivery. These measures were absent from the MUSL contract with the third party. Absent a review of that contract, the Lottery could not have been aware of the need for such assurances.

Recommendation

We recommend the Wisconsin Lottery ensure that its contracts, including those entered on its behalf by MUSL or other agents, require all vendors delivering products to be used as prizes for instant or on-line games to purchase a performance bond or to provide similar contractual guarantees to protect the Lottery if the specified products are not delivered.

■ ■ ■ ■

Future Considerations ■

The net proceeds of the Wisconsin Lottery contributed to \$131.6 million in property tax relief in FY 2003-04. As noted, expenses in FY 2003-04 remained below the statutory limit, and revenues from ticket sales increased to their highest levels since FY 1994-95. To the extent revenues from ticket sales increase and administrative expenses are controlled, additional property tax relief will be generated. The Governor's 2005-07 biennial budget proposal included initiatives to increase sales, as well as proposals related to the administrative operations of the Wisconsin Lottery. On April 20, 2005, the Joint Committee on Finance acted on the Governor's proposals and recommended additional strategies to generate property tax relief.

First, the Joint Committee on Finance addressed administrative operations related to retailer contracts and compensation. The Committee's action included:

- adjusting the base-level funding for retailer compensation and vendor fees to reflect projected ticket sales in the 2005-07 biennium, which are now estimated to increase by 4.2 percent over FY 2004-05 levels in FY 2005-06, and 6.4 percent in FY 2006-07;
- prohibiting a retail contract with a person who owes a payment to the uninsured employers fund or the work injury supplemental benefit fund;
- allowing the Department of Revenue to assess, collect, and review delinquent income and franchise taxes owed by a retailer;

- allowing the Department of Revenue to promulgate a rule to permit lottery ticket retailers to submit their ticket proceeds to the Department not less than once every 60 days, rather than the current weekly requirement; and
- statutorily requiring the Department of Revenue to notify retailers when the top prizes in instant games have been claimed, and directing the Department to promulgate rules related to the public posting by retailers of such notification.

Second, the Committee approved proposals to increase ticket sales. For example, the Committee approved an increase in the payout ratio for instant scratch games in order to sell higher-priced scratch tickets with the expectation of increasing sales. The Committee also directed the Wisconsin Lottery to place lottery ticket vending machines, which are provided for in the current contract with GTECH, in the passenger terminals of five state airports, as well as in the Amtrak rail station in Milwaukee. The Committee rejected, however, the Governor's proposal to further privatize the Wisconsin Lottery by expanding contracting for lottery operations, including services such as game design, Web site design and maintenance, and player relations, and by eliminating 55.0 lottery positions.

If the issue of expanded contracting for Wisconsin Lottery operations is raised again in the future, the Legislature may wish to consider:

- whether savings or increased effectiveness of operations have been identified to justify additional contracting;
- whether adequate administrative and oversight mechanisms are in place to ensure contractor compliance with legal constraints on promotional advertising, the types of games, and the manner in which tickets are sold;
- whether vendor compensation should be based on a percentage of sales or include other performance incentives that cannot be provided to state employees; and
- how effective legislative oversight of contractors can be best ensured.

Financial Section ■

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, 2004 and 2003. 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, 2004, and 2003, 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 Schedules 1, 2, and 3 and management's discussion and analysis, is presented for purposes of additional analysis and is not a required part of the financial statements referred to in the first paragraph. The schedules on pages 66 through 68 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. For management's discussion and analysis on pages 35 through 43, 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.

In accordance with *Government Auditing Standards*, we have also issued a report dated April 22, 2005, on our consideration of the Wisconsin Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

April 22, 2005

LEGISLATIVE AUDIT BUREAU
by 
Julie Gordon
Audit Director

Management's Discussion and Analysis ■

Prepared by Wisconsin Lottery Management

This section of the Wisconsin Lottery's annual financial report presents management's discussion and analysis of the financial performance of the Wisconsin Lottery during the fiscal years ended June 30, 2004, and June 30, 2003. 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 are comparing the financial statements for the fiscal years ended June 30, 2004 and June 30, 2003.

- Operating revenues for lottery activities have increased by \$48.1 million, or 11.1 percent. This increase is mainly the result of instant ticket sales increasing \$20.8 million, or 8.3 percent, while on-line ticket sales increased \$27.1 million, or 14.6 percent.
- Operating expenses for the year increased \$29.7 million, or 9.5 percent. While some expenses did not change significantly, prize expense increased \$26.7 million, or 10.7 percent, and retailer commissions and incentives increased \$3.1 million, or 10.1 percent.

- Nonoperating revenue consisting mainly of investment income decreased \$20.8 million, or 194.4 percent.
- Net income before transfers decreased \$2.4 million, or 1.8 percent. The decrease is a net result of the operating revenue increase, operating expense increase, and the nonoperating revenue decrease.

Overview of the Financial Statements

The Wisconsin Lottery is accounted for as an enterprise activity/proprietary fund, reporting on all of the activity's assets and liabilities using the accrual basis of accounting much like a private business entity.

As such, the annual financial report consists of a series of financial statements, along with explanatory notes to the financial statements and supplementary schedules. The Statement of Net Assets is on page 46, the Statement of Revenues, Expenses, and Changes in Fund Net Assets is on page 47, and the Statement of Cash Flows is on pages 48 and 49.

The Wisconsin Constitution requires that net proceeds from the operations of the Lottery be used to provide local property tax relief. In addition, balances from other gaming-related appropriations that are not administered by the Department of Revenue (Lottery), including racing and charitable bingo operations, lapse to the Lottery Fund for distribution in the form of property tax relief. As a result, the net assets of the Wisconsin Lottery consist of capital assets (equipment), restricted income related to unrealized fair market value adjustments to investments, and restricted net assets for property tax relief. To assess the Wisconsin Lottery's financial position and financial health, the reader of these statements should pay particular attention to changes in the components of assets and liabilities as set forth in the Statement of Net Assets. The Statement of Revenues, Expenses, and Change in Fund Net Assets and the Statement of Cash Flows also provide information on income and expenses that should be reviewed as an indicator of the Wisconsin Lottery's financial performance.

Net Assets

As shown in Table A, the total assets decreased \$10.4 million, or 5.5 percent, and the total liabilities decreased by \$9.8 million, or 7.0 percent. As a result, the Wisconsin Lottery's total net assets decreased \$0.6 million, or 1.2 percent, from FY 2002-03 to FY 2003-04.

Table A

Net Assets (In Millions)

	FY 2003-04	FY 2002-03	Change	Percentage Change
Investments	\$128.4	\$147.5	(\$19.1)	(12.9%)
Capital Assets (Net of Accumulated Depreciation)	0.1	0.2	(0.1)	(50.0)
Other Assets	51.7	42.9	8.8	20.5
Total Assets	180.2	190.6	(10.4)	(5.5)
Current Liabilities	30.4	32.3	(1.9)	(5.9)
Noncurrent Liabilities	99.6	107.5	(7.9)	(7.3)
Total Liabilities	130.0	139.8	(9.8)	(7.0)
Net Assets:				
Invested in Capital Assets	0.1	0.2	(0.1)	(50.0)
Restricted for Investment Fair Market Value Adjustment	14.4	25.3	(10.9)	(43.1)
Restricted for Property Tax Relief	35.7	25.3	10.4	41.1
Total Net Assets	<u>\$50.2</u>	<u>\$50.8</u>	<u>(\$0.6)</u>	(1.2)

The investments decreased by \$19.1 million, or 12.9 percent, from FY 2002-03 to FY 2003-04. The decrease is a net result of a \$10.9 million unrealized investment loss from the changes in market value, \$18.5 million in bond redemptions, \$1.7 million in bond purchases, and \$8.6 million in amortization. The increase in other assets by \$8.8 million, or 20.5 percent, is mainly the result of a \$11.5 million increase in cash and a \$2.1 million decrease in grand prize deposit. The increase in cash was caused by operating revenues increasing more than operating expenses. The grand prize deposit decreased when the Multi-State Lottery Association returned \$2.1 million to the Wisconsin Lottery because Wisconsin's share of the Powerball reserve was greater than the required balance.

The decrease in total liabilities by \$9.8 million, or 7.0 percent, is primarily attributable to the \$8.2 million decrease in annuity prizes payable. This annuity prizes payable decrease is a net result of \$18.5 million in bond redemptions, \$1.7 million in bond purchases, and \$8.6 million in amortization.

Total net assets decreased by \$0.6 million. These resources cannot be used for purposes other than restricted purposes. The total net assets consist of \$0.1 million invested in capital assets, \$14.4 million restricted for investment fair market value adjustment, and \$35.7 million restricted for property tax relief. Accounting principles dictate that the gain or loss related to the change in market value of investments be recorded. The investments have been purchased for the payment of installment prize awards and are generally held to maturity. Therefore, the change in the market value of these investments is not available for property tax relief.

Change in Net Assets

As shown in Table B, the change in net assets decreased by \$4.4 million, or 115.8 percent. The decrease can be attributed primarily to an increase in total revenues of \$27.3 million, an increase in total expenses of \$29.7 million, and an increase in operating transfer out for property tax relief of \$2.0 million.

Table B
Changes in Net Assets
(In Millions)

	FY 2003-04	FY 2002-03	Change	Percentage Change
Revenues				
Operating Revenues:				
Ticket sales	\$482.9	\$435.0	\$47.9	11.0%
Retailer fees and miscellaneous revenue	0.3	0.1	0.2	200.0
Nonoperating Revenues:				
Investment income (loss)	(10.1)	10.7	(20.8)	(194.4)
Total Revenues	473.1	445.8	27.3	6.1
Expenses				
Program Expenses:				
Prize expense	275.2	248.5	26.7	10.7
Retailer commissions and incentives	33.9	30.8	3.1	10.1
Instant and on-line vendor services	12.4	12.5	(0.1)	(0.8)
Other game-related expenses	11.5	11.3	0.2	1.8
Office Administration Expenses	9.4	9.6	(0.2)	(2.1)
Total Expenses	342.4	312.7	29.7	9.5
Net Income Before Transfers	130.7	133.1	(2.4)	(1.8)
Operating Transfers				
Transfer for Property Tax Relief	(131.6)	(129.6)	(2.0)	1.5
Transfer In from General Fund	1.2	1.2	0.0	0.0
Transfer for Compulsive Gambling Programs	(0.3)	(0.3)	0.0	0.0
Transfer for Law Enforcement	(0.3)	(0.3)	0.0	0.0
Transfer for Lottery Credit Administration	(0.2)	(0.2)	0.0	0.0
Transfer Out to General Fund	(0.1)	(0.1)	0.0	0.0
Change in Net Assets	<u>(\$0.6)</u>	<u>\$3.8</u>	<u>\$(4.4)</u>	(115.8)

The increase in total revenues of \$27.3 million, or 6.1 percent, is mainly the result of ticket sales increasing by \$47.9 million and investment income decreasing by \$20.8 million. The ticket sales results by game category are discussed later. The investment income decreased by \$20.8 million because the fair market value adjustment to investments resulted in \$9.5 million of investment income for FY 2002-03 and \$10.9 million in investment loss for FY 2003-04. The interest

earnings from the state investment pool and the unreserved account at the Multi-State Lottery Association also decreased \$0.4 million.

The increase in total expenses of \$29.7 million, or 9.5 percent, is mainly the result of prize expense increasing \$26.7 million and retailer commissions and incentives increasing \$3.1 million. In general, prize expense and retailer commissions and incentives are variable expenses, so they increase or decrease in relation to ticket sales. Prize expense results by game category are discussed later. The Wisconsin Lottery's total statutorily defined administrative expenses (instant and on-line vendor services, other game-related expenses, and office administrative expenses) declined from 7.7 percent of gross operating revenues in FY 2002-03 to 6.9 percent of gross operating revenues in FY 2003-04. See Schedule 2 after the notes to the financial statements for more information.

The operating transfer out for property tax relief increased by \$2.0 million, or 1.5 percent. Each year an estimate of total funds available for distribution under the lottery and gaming credit for property taxes is calculated. This calculation analyzes all revenues and expenses of the Wisconsin Lottery, with an emphasis on the projected ticket sales and prize expense.

Lottery Ticket Sales and Prize Awards

Table C compares ticket sales and prize awards for each lottery game category for FY 2003-04 versus FY 2002-03.

Table C

Lottery Ticket Sales and Prize Awards
(In Millions)

	Ticket Sales			Prize Awards		
	FY 2003-04	FY 2002-03	Change	FY 2003-04	FY 2002-03	Change
Instant						
Scratch	\$266.6	\$245.2	\$21.4	\$167.9	\$155.4	\$12.5
Pull-tab	3.7	4.3	(0.6)	2.3	2.7	(0.4)
Super 2 nd Chance ¹				0.1	0.0	0.1
On-Line						
SuperCash!	26.6	28.7	(2.1)	14.1	16.7	(2.6)
Powerball	108.0	89.1	18.9	51.7	40.8	10.9
WI Very Own Megabucks	20.2	22.1	(1.9)	10.6	11.5	(0.9)
Daily Pick 3	23.9	24.6	(0.7)	11.6	11.3	0.3
Daily Pick 4	10.1	9.6	0.5	5.2	4.4	0.8
Badger 5	23.8	8.5	15.3	11.6	4.3	7.3
Super 2 nd Chance ¹				0.1	0.0	0.1
On-Line (Discontinued Games)						
City Picks	0.0	2.9	n/a	0.0	1.4	n/a
Total	<u>\$482.9</u>	<u>\$435.0</u>	<u>\$47.9</u>	<u>\$275.2</u>	<u>\$248.5</u>	<u>\$26.7</u>

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

Instant scratch ticket sales increased by \$21.4 million from FY 2002-03 to FY 2003-04. Although sales of \$1 tickets declined by 11.6 percent and sales of \$3 tickets declined by 3.2 percent, sales of \$2 tickets increased by 2.9 percent and sales of \$5 tickets increased by 6.8 percent. There were no sales for \$10 tickets in FY 2002-03, but \$10 tickets accounted for \$24.3 million in sales in FY 2003-04. The Wisconsin Lottery has continued to focus strategically on higher price points through marketing and higher prize payouts on those games. Pull-tab sales decreased by \$0.6 million from FY 2002-03 to FY 2003-04.

On-line game sales increased by \$27.1 million from FY 2002-03 to FY 2003-04, primarily due to increased sales of the Powerball and Badger 5 games. Powerball had large jackpots in July, October, December, and May, which tend to attract players and increase sales. Badger 5, which was launched in February 2003, had a full year of sales for FY 2003-04 against the previous partial year, which accounts

for its increase in sales. The SuperCash! game may have been negatively affected by increased Badger 5 sales.

The increase in prize expense for instant scratch games is directly correlated to the increase in sales for that product category. Increased prize expense for the on-line games is primarily correlated to the increase in sales for the Powerball and Badger 5 games. The four large Powerball jackpots in FY 2003-04 had a significant impact on sales and, in turn, the prize payout for that game. Badger 5 was not available for all of FY 2002-03, so there was a significant increase in sales and subsequently in prize payouts for that game in FY 2003-04. The Badger 5 game has performed much better than the City Picks game it replaced.

See Schedule 3 after the notes to the financial statements for a summary of prize expense.

Other Known Facts

The Wisconsin Lottery relocated the instant ticket warehouse and distribution site from Milwaukee to Madison in September 2004. This relocation has resulted in annual savings of \$294,000 in space rental costs. These savings are included as a reduction in operating expenses in the Governor's 2005-07 biennial budget proposal.

The Wisconsin Lottery contracted with GTECH Corporation for an integrated gaming computer system and services effective November 24, 2003. The integrated system provides telecommunications services that were previously provided under a separate contract. In future financial statements, these telecommunications services will no longer be identified separately. It is estimated that FY 2004-05 payments to GTECH are 26.4 percent less than the \$15.9 million the Wisconsin Lottery paid for all instant ticket, on-line, telecommunications, and internal control systems in FY 2003-04. The Governor has proposed that \$2.7 million of these contract savings be reductions in the Wisconsin Lottery's annual operating expenses.

On December 31, 2003, the Wisconsin Lottery terminated its contract for the production and broadcast of the lottery game show and drawings. This resulted in savings of \$350,000 annually, which are included as reductions in operating expenses in the Governor's 2005-07 biennial budget proposal.

Contacting the Lottery's Management

This financial report is 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 this report or need additional financial information, contact the Lottery Accounting Section at the Wisconsin Lottery, Post Office Box 8931, Mailstop 6-261, Madison, Wisconsin 53708-8931.

If you have questions concerning general program information relating to the Wisconsin Lottery, contact the Deputy Director at the Wisconsin Lottery, Post Office Box 8941, Madison, Wisconsin 53708-8941.

■ ■ ■ ■

Financial Statements ■

Statement of Net Assets

June 30, 2004 and 2003

	June 30, 2004	Restated June 30, 2003
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 36,944,253	\$ 25,429,804
Investments for prize annuities (Note 4)	16,384,203	16,663,190
Accounts receivable (Note 5)	5,577,971	6,220,237
Due from other state programs (Note 5)	1,957,821	1,936,058
Ticket inventory	1,217,878	1,040,322
Grand prize deposit (Note 8)	593,213	449,122
Prepaid expenses	209,825	417,950
Interest receivable	26,095	22,934
Total Current Assets	<u>62,911,259</u>	<u>52,179,617</u>
Noncurrent Assets:		
Investments for prize annuities (Note 4)	112,019,781	130,836,003
Grand prize deposit (Note 8)	5,205,536	7,461,782
Capital assets: (Note 9)		
Equipment	1,097,031	1,118,131
Leasehold improvements	174,102	174,102
Accumulated depreciation	<u>(1,155,905)</u>	<u>(1,114,471)</u>
Total Noncurrent Assets	<u>117,340,545</u>	<u>138,475,547</u>
TOTAL ASSETS	<u>180,251,804</u>	<u>190,655,164</u>
LIABILITIES		
Current Liabilities:		
Annuity prizes payable (Note 6)	16,122,642	16,356,070
Prizes payable	7,919,069	6,300,734
Accounts payable (Note 5)	2,074,333	2,307,176
Due to other state programs (Note 5)	2,371,665	4,393,839
Lottery association payable	963,836	1,507,471
Deferred revenue	428,986	1,077,732
Due to other governments (Note 5)	200,536	103,935
Accrued payroll	181,466	141,847
Compensated absences (Note 14)	<u>146,791</u>	<u>127,016</u>
Total Current Liabilities	<u>30,409,324</u>	<u>32,315,820</u>
Noncurrent Liabilities:		
Annuity prizes payable (Note 6)	99,415,446	107,375,188
Compensated absences (Note 14)	<u>172,551</u>	<u>144,242</u>
Total Noncurrent Liabilities	<u>99,587,997</u>	<u>107,519,430</u>
TOTAL LIABILITIES	<u>129,997,321</u>	<u>139,835,250</u>
NET ASSETS		
Net Assets:		
Invested in capital assets, net of related debt	115,228	177,762
Restricted for investment fair market value adjustment (Note 11)	14,444,391	25,346,610
Restricted for property tax relief (Note 11)	<u>35,694,864</u>	<u>25,295,542</u>
TOTAL NET ASSETS	<u>\$ 50,254,483</u>	<u>\$ 50,819,914</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, 2004 and 2003

	Year Ended June 30, 2004	Year Ended June 30, 2003
OPERATING REVENUES		
Instant Ticket Sales (Net of allowances of \$323,947 and \$220,778, respectively)	\$ 270,286,747	\$ 249,467,428
On-Line Ticket Sales (Net of ticket discounts of \$220,754 and \$605,091, respectively)	212,633,592	185,570,386
Retailer Fees	90,600	47,725
Miscellaneous Revenue	212,795	33,962
Total Operating Revenues	483,223,734	435,119,501
OPERATING EXPENSES		
Program Expenses:		
Instant prize expense	170,353,872	158,065,880
On-line prize expense	104,825,472	90,443,737
Retailer commissions and incentives	33,875,780	30,767,379
Instant and on-line vendor services	12,383,706	12,464,364
Product information costs	4,597,224	4,579,937
Instant ticket printing costs	3,347,743	3,117,049
On-line telecommunication charges	2,976,463	3,093,877
Instant ticket delivery costs	593,867	554,808
Total Program Expenses	<u>332,954,127</u>	<u>303,087,031</u>
Administrative Expenses:		
Salaries and fringe benefits	5,576,760	5,399,940
Supplies and services	3,812,638	4,181,717
Depreciation expense	62,534	63,688
Total Administrative Expenses	<u>9,451,932</u>	<u>9,645,345</u>
Total Operating Expenses	342,406,059	312,732,376
NET OPERATING INCOME	140,817,675	122,387,125
NONOPERATING REVENUES (EXPENSES) AND OPERATING TRANSFERS		
Investment Income (Loss) (Note 7)	(10,133,745)	10,671,307
Gain (Loss) on Disposal of Fixed Assets	0	(37)
Miscellaneous Revenue	0	13,235
Net Income Before Transfers	130,683,930	133,071,630
Operating Transfers:		
Transfers of lottery proceeds for property tax relief (Note 12)	(131,603,371)	(129,564,994)
Transfer in from General Fund	1,276,999	1,185,419
Transfer to Department of Health and Family Services for compulsive gambling programs	(250,000)	(250,000)
Transfer to Department of Justice for law enforcement	(293,947)	(292,177)
Transfer to Department of Revenue for lottery credit administration	(244,007)	(250,448)
Transfer out to General Fund (Note 15)	(135,035)	(99,155)
CHANGE IN NET ASSETS	(565,431)	3,800,275
Total Net Assets—Beginning of the Year	<u>50,819,914</u>	<u>47,019,639</u>
Total Net Assets—End of the Year	<u><u>\$ 50,254,483</u></u>	<u><u>\$ 50,819,914</u></u>

The accompanying notes are an integral part of this statement.

Statement of Cash Flows for the Years Ended June 30, 2004 and 2003

	Year Ended June 30, 2004	Restated Year Ended June 30, 2003
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash Received from Retailers	\$ 481,829,313	\$ 431,629,141
Cash Paid for Prizes	(289,528,321)	(263,785,041)
Cash Paid/Received for Grand Prize Deposit	2,256,245	1,700,000
Cash Paid to Employees	(5,514,749)	(5,258,230)
Cash Paid to Suppliers	(27,934,323)	(28,731,489)
Cash Paid for Retailer Commissions and Incentives	(33,686,589)	(31,347,752)
Net Cash Provided by Operating Activities	127,421,576	104,206,629
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Transfer of Proceeds for Property Tax Credit	(133,548,016)	(128,337,485)
Transfer of Proceeds from General Fund	1,185,419	1,589,298
Transfer of Proceeds for Law Enforcement	(316,294)	(255,826)
Transfer of Proceeds for Lottery Credit Administration	(254,965)	(238,861)
Transfer of Proceeds for General Fund	(135,035)	(99,155)
Transfer of Proceeds for Compulsive Gambling Programs	(250,000)	(250,000)
Net Cash Used by Noncapital Financing Activities	(133,318,891)	(127,592,029)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Cash Paid for Purchase of Equipment	0	(5,865)
Cash Received from Sale of Equipment	0	640
Net Cash Used by Capital and Related Financing Activities	0	(5,225)
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest Received	613,159	856,422
Cash Received for Redemption of Bonds	18,520,193	16,645,756
Cash Paid for Purchase of Bonds	(1,721,588)	0
Net Cash Provided by Investing Activities	17,411,764	17,502,178
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	11,514,449	(5,888,447)
Cash and Cash Equivalents—Beginning of the Year	25,429,804	31,318,251
Cash and Cash Equivalents—End of the Year	\$ 36,944,253	\$ 25,429,804

The accompanying notes are an integral part of this statement.

	Year Ended June 30, 2004	Restated Year Ended June 30, 2003
RECONCILIATION OF NET OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Net Operating Income	\$ 140,817,675	\$ 122,387,125
Adjustments to Reconcile Net Operating Income to Net Cash Provided by Operating Activities:		
Depreciation expense	62,534	63,688
Noncash donated prize expense	0	13,235
Changes in Assets and Liabilities:		
Decrease (Increase) in receivables	642,266	(3,684,920)
Decrease (Increase) in Grand Prize deposit	2,256,245	1,700,000
Decrease (Increase) in ticket inventory	(177,557)	(190,700)
Decrease (Increase) in prepaid expenses	208,125	(10,986)
Decrease (Increase) in Due from other state programs	1,021	9,681
Increase (Decrease) in prizes payable	(15,172,389)	(17,496,830)
Increase (Decrease) in deferred revenue	(648,745)	709,677
Increase (Decrease) in Due to other state programs	26,542	58,725
Increase (Decrease) in accounts payable	(234,608)	(360,898)
Increase (Decrease) in Lottery Association payable	(543,635)	1,066,548
Increase (Decrease) in Due to other governments	96,399	(95,007)
Increase (Decrease) in accrued payroll	39,619	(19,066)
Increase (Decrease) in compensated absences	48,084	56,357
Total Adjustments	<u>(13,396,099)</u>	<u>(18,180,496)</u>
Net Cash Provided by Operating Activities	<u>\$ 127,421,576</u>	<u>\$ 104,206,629</u>
Noncash Activities:		
Net change in unrealized gains and losses	\$ (10,894,156)	\$ 9,525,698
Noncash donated prize expense	0	13,235
Vendor liquidated damages settlement	150,000	0

The accompanying notes are an integral part of this statement.

Notes to the Financial Statements ■

1. DESCRIPTION OF THE WISCONSIN LOTTERY

The Wisconsin Lottery was created in December 1987 and is administered by the Lottery Division within the Department of Revenue. During FY 2003-04, the Wisconsin Lottery administered scratch-off, pull-tab, and on-line games.

The Wisconsin Lottery joined the Multi-State Lottery Association (MUSL) in June 1989. In FY 2003-04, the Wisconsin Lottery, as a member of MUSL, participated in one on-line MUSL game, Powerball (start date April 19, 1992).

During FY 2002-03 and FY 2003-04, the Wisconsin Lottery also sold tickets for six other on-line games: SuperCash! (start date February 4, 1991), Wisconsin's Very Own Megabucks (start date June 20, 1992), Daily Pick 3 (start date September 21, 1992), Daily Pick 4 (start date September 15, 1997), City Picks (start date March 26, 2002, end date February 15, 2003), and Badger 5 (start date February 17, 2003).

The Wisconsin Lottery is accounted for within the Lottery Fund, which is part of the State of Wisconsin financial reporting entity. The reporting entity for the Wisconsin Lottery's stand-alone financial statements does not include the appropriations from which the property tax credit disbursements are made. However, disbursements to these appropriations are 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 focus 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 fiscal year activity as either operating or nonoperating. Because the Lottery Fund is an enterprise fund, which is a type of proprietary fund, it accounts for operations in a manner similar to private businesses in which operating revenues are derived from exchange transactions, such as sales. Operating expenses include the costs of sales, administration expenses, and depreciation on capital assets.

Certain revenues and expenses that are not related to the Wisconsin Lottery's primary purpose, such as investment income or gain or loss on the disposal of capital assets, are reported as nonoperating revenues and expenses.

The Wisconsin Lottery applies all Governmental Accounting Standards Board (GASB) pronouncements, as well as the following pronouncements issued on or before November 30, 1989, unless these pronouncements conflict with or contradict GASB pronouncements: Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedure.

The State of Wisconsin monitors expenses and records financial transactions using both the budgetary basis and the accrual basis of accounting. A reconciliation between the budgetary basis and the accrual basis of accounting for general operations expenses is shown in Schedule 1.

B. Revenue Recognition

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

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

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

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

C. Cash and Cash Equivalents

All cash is deposited with the State of Wisconsin Treasurer and is required to be invested in the State Investment Fund. The State Investment Fund is a short-term pool of state and local funds managed by the State of Wisconsin Investment Board with oversight by its Board of Trustees. Since shares in the State Investment Fund are purchased in \$1,000 increments, Wisconsin Lottery cash balances below \$1,000 are deposited in the State's bank. The State Investment Fund is not registered with the Securities and Exchange Commission as an investment company.

D. Retailer Commissions

Retailer commissions, which are classified as program expenses, were 5.5 percent for on-line ticket sales and 6.25 percent for instant scratch and instant pull-tab tickets during FY 2003-04 and FY 2002-03. Nonprofit organizations receive additional commissions.

E. Retailer Incentive Programs

In addition to the retailer commissions discussed in Note 2(D), 1999 Wisconsin Act 9 established an incentive program for retailers who meet certain performance goals identified by the Wisconsin Lottery. This program began on January 1, 2000. Retailers must be in good standing and sell scratch-off tickets to participate in the program, which in FY 2003-04 and FY 2002-03 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 percent of gross revenues from the sale of lottery tickets and lottery shares, which are multi-draw on-line tickets.

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

Up to four short-term incentives a year may be offered for predefined lengths of time. 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 incentives are limited to a total of \$400,000 per fiscal year, and no more than \$100,000 of funding can be expended on any one short-term incentive.

The sales goals incentive component allows participating retailers to earn additional commissions based on increased sales realized in any of three product categories: instant tickets, on-line non-jackpot games (SuperCash!, Daily Pick 3, Daily Pick 4, City Picks, and Badger 5), and on-line jackpot games (Wisconsin's Very Own Megabucks and Powerball). For the retailer incentive program, the Wisconsin Lottery considers an on-line jackpot game to have a large top prize that may be paid as an annuity or cash option. An on-line non-jackpot prize is smaller and offers only a cash option for payment. Subject to certain restrictions and allowances, retailers earn up to 10 percent of the increase in quarterly sales over sales for the same quarter of the previous year for instant tickets and on-line non-jackpot games, which are paid to them quarterly. Due to the random nature of the on-line jackpot games and the overall program cap, sales goals incentive program payments for on-line jackpot games are calculated and made annually.

F. Administrative Expenses

Administrative expenses, as defined by state statutes, are limited to 10 percent of gross lottery revenues. A summary of administrative expenses and related calculations of the administrative expense limit are included in Schedule 2.

G. Prizes

In accordance with Wisconsin Statutes, at least 50 percent of lottery sales must be returned in the form of prizes. Prizes may be claimed for a period of 180 days after the drawing for on-line games, or 180 days from the declaration of the end of a game for instant games. A summary of prize expenses is shown in Schedule 3.

H. Ticket Inventory

Ticket inventory consists of instant tickets for games in progress that have not yet been sold or shipped, and tickets for new games. The tickets are valued at cost using the first in–first out (FIFO) method. The cost of tickets sold is charged to operations. Unused tickets are charged to operations in the fiscal year the game ends or at the end of ticket distribution for a given game, whichever occurs first.

I. Deferred Revenue

Until instant scratch-off tickets are sold to the public, retailers have the right to return unsold tickets to the Wisconsin Lottery for a refund. Therefore, receivables and cash collected in advance of sales of these tickets represent a liability of the Wisconsin Lottery. Deferred revenue is estimated and recorded based on historical information of unsold tickets returned by the retailers.

Depending on the on-line game, on-line tickets are sold for up to eight future drawings. On-line ticket revenues are recognized at the time the related drawings are held. All ticket sales for future drawings are recorded as deferred revenue.

J. Capital Assets

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

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

K. Employee Compensated Absences

The Wisconsin Lottery’s compensated absence liability consists of accumulated unpaid leave, compensatory time, personal holiday hours, and Saturday/legal holiday hours earned and vested as of June 30.

L. Due to (from) Other State Programs

During the course of operations, numerous transactions for goods provided or services rendered occur among individual state programs. The Statement of Net Assets classifies these receivables and payables as “Due from other state programs” or “Due to other state programs.”

M. Investment Valuation

Pool shares of the State Investment Fund are bought and redeemed at \$1.00 based on the amortized cost of the investments in the fund. Income calculations are based on the amortized cost of average pool balances. Where possible, investments in the State Investment Fund are reported at fair value for financial reporting purposes and are based on quoted market prices. Fair value determinations not based on quoted market prices include matrix pricing models or are calculated as the net present value of expected future cash flows. Nonparticipating contracts are valued at cost because these investments do not capture interest rate changes, while other investments are valued at par, which approximates fair value. Fair value of investments for prize annuities is based on quoted market prices.

N. Disbursement of Net Lottery Proceeds

The Wisconsin Lottery disburses net lottery proceeds through two means: the Lottery Tax Credit and the Farmland Tax Credit. The Department of Administration, with the concurrence of the Legislature’s Joint Finance Committee, determines the annual amount

available for distribution as the Lottery Tax Credit in a given fiscal year. The Department of Revenue is notified of this amount by November 1. The Lottery Tax Credit is paid to municipalities on the 4th Monday in March of the same fiscal year.

The Farmland Tax Credit is determined by statute and is distributed to eligible individual and corporate taxpayers through the administration of the Wisconsin Department of Revenue's individual and corporate tax processes. The date of distribution of the Farmland Tax Credit is determined by the dates that eligible claims for it are processed. Therefore, disbursement of Farmland Tax Credit payments occurs throughout the year.

3. DEPOSITS

The Lottery had a balance of \$829 in the State's bank on June 30, 2004, and \$638 on June 30, 2003.

The various types of securities in which the State Investment Fund may invest are enumerated in ss. 25.17(3)(b), (ba), and (bd), Wis. Stats., and include direct obligations of the United States and Canada, securities guaranteed by the United States government, securities of federally chartered corporations, unsecured notes of financial and industrial issuers, Yankee/Eurodollar issues, certificates of deposit issued by banks in the United States and solvent financial institutions in this state, and bankers' acceptances. The State of Wisconsin Investment Board's trustees may approve other prudent investments. The Board of Trustees has given standing authority to the State of Wisconsin Investment Board to invest in resale agreements, financial futures contracts, options, and interest rate swaps. The State Investment Fund is not registered with the Securities and Exchange Commission.

4. INVESTMENTS

Investments have been purchased by the Wisconsin Lottery to finance jackpot prizes that are payable as annuities over the 20-year or 25-year period. The Wisconsin Lottery follows MUSL's policies, which require that these investments for prize annuities be in the form of securities that are backed by the full faith and credit of the United States government or its agencies. See Note 6 for information related to the annuity prizes payable. The investments are scheduled to mature near the time prize payments become payable to winners.

The Wisconsin Lottery held U. S. Treasury and Agency investments with the following maturities as of June 30, 2004 and 2003:

<u>Maturity</u>	<u>June 30, 2004</u>	<u>June 30, 2003</u>
Less than 1 Year	\$ 16,384,203	\$ 16,663,190
1 to 5 Years	71,412,470	79,062,368
6 to 10 Years	24,417,321	31,886,680
More than 10 Years	<u>16,189,989</u>	<u>19,886,955</u>
Total	<u>\$128,403,983</u>	<u>\$147,499,193</u>

5. ACCOUNTS RECEIVABLE AND ACCOUNTS PAYABLE BALANCES

Accounts Receivable and Accounts Payable balances are disaggregated as follows:

A. Accounts Receivable

	<u>June 30, 2004</u>	<u>June 30, 2003</u>
Accounts Receivable:		
Retailers	\$5,576,896	\$6,216,041
Miscellaneous	<u>1,075</u>	<u>4,196</u>
Total Accounts Receivable	<u>\$5,577,971</u>	<u>\$6,220,237</u>
Due from Other State Programs:		
Transfers for Gaming	\$1,276,757	\$1,185,419
Transfers for Farmland Tax Credit	681,047	749,844
Miscellaneous	<u>17</u>	<u>795</u>
Total Due from Other State Programs	<u>\$1,957,821</u>	<u>\$1,936,058</u>

B. Accounts Payable

	<u>June 30, 2004</u>	<u>June 30, 2003</u>
Accounts Payable:		
Vendors	\$2,044,446	\$2,154,442
Employee Travel Reimbursement	1,774	1,162
Withholding on Prizes	5,000	121,230
Law Enforcement	402	63
Lottery Credit Administration	3,591	2,164
Miscellaneous	<u>19,120</u>	<u>28,115</u>
Total Accounts Payable	<u>\$2,074,333</u>	<u>\$2,307,176</u>
Due to Other State Programs:		
Farmland Tax Credit	\$1,839,423	\$3,846,515
Due to Other State Programs	358,623	148,057
Employee Fringe Benefits	133,275	153,560
Law Enforcement	25,320	48,491
Lottery Credit Administration	15,024	27,126
Withholding on Prizes	0	163,740
Property Tax	<u>0</u>	<u>6,350</u>
Total Due to Other State Programs	<u>\$2,371,665</u>	<u>\$4,393,839</u>

Due to Other Governments:		
Employee Fringe Benefits	\$ 44,472	\$ 42,844
Withholding on Prizes	152,541	57,771
Law Enforcement	2,155	1,669
Lottery Credit Administration	<u>1,368</u>	<u>1,651</u>
Total Due to Other Governments	<u>\$200,536</u>	<u>\$103,935</u>

6. ANNUITY PRIZES PAYABLE

The Wisconsin Lottery has an unconditional obligation to pay all prize winners the future value of the prize. The reported 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. Each year, an adjustment to the annuity prizes payable account is made to amortize the reported value using the effective interest method. The present value adjustment was \$8,597,551 for FY 2003-04 and \$9,244,618 for FY 2002-03. See Note 4 for information related to the investments for prize annuities.

The reported values of future prize payment obligations were as follows:

<u>Fiscal Year</u>	<u>FY 2003-04 Total Payments</u>	<u>FY 2002-03 Total Payments</u>
2003-04	–	\$ 16,749,915
2004-05	\$ 16,515,950	16,867,731
2005-06	16,642,851	16,991,521
2006-07	16,773,792	17,118,314
2007-08	16,908,929	17,250,339
2008-09	16,900,486	17,237,749
Subsequent Years	<u>87,489,795</u>	<u>84,579,973</u>
Future Prize Payments	171,231,803	186,795,542
Less: Present Value Adjustment	<u>55,693,715</u>	<u>63,064,283</u>
Present Value of Future Prize Payments	<u>\$115,538,088</u>	<u>\$123,731,259</u>

Annuity prizes payable activity for the fiscal years ended June 30, 2004, and June 30, 2003, 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>
2003-04	\$123,731,259	\$10,319,139	\$(18,512,310)	\$115,538,088	\$16,122,642
2002-03	131,124,797	9,244,618	(16,638,156)	123,731,259	16,356,070

7. INVESTMENT INCOME (LOSS)

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

	<u>FY 2003-04</u>	<u>FY 2002-03</u>
Interest from State Investment Fund	\$ 621,160	\$ 814,523
Net Increase (Decrease) in Fair Value of Annuity Investments	(2,296,605)	18,770,316
Decrease for Amortization of Annuity Investments	(8,597,552)	(9,244,618)
Net Change in Fair Value of State Investment Fund	(8,063)	20,579
Interest from MUSL Prize Reserve Accounts	144,091	305,627
Miscellaneous Interest	<u>3,224</u>	<u>4,880</u>
Total Investment Income	<u>(\$10,133,745)</u>	<u>\$10,671,307</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 8. Under GASB Statement 31, which requires investments to be reported at fair value, the net increases or decreases in fair value of investments for prize annuities and shares in the State Investment Fund are recognized as investment income (loss). Investments for prize annuities are amortized with a corresponding amortization adjustment to annuity prizes payable. The amortization of annuity prizes payable is included as a reduction to investment income.

8. GRAND PRIZE DEPOSIT

A grand prize deposit fund has been established by MUSL to indemnify states participating in the Powerball game should a winning ticket not be properly paid.

The total prize pool equals 50 percent of sales for each Powerball drawing. Of the total prize pool, 58.39 percent funds the grand prize pool and 41.61 percent funds the low-tier prize pool. After the grand prize pool reaches the annuitized amount of \$5 million, 2 percent of draw sales is distributed to the Prize Reserve Account (PRA) and Set Prize Reserve Account (SPRA) until they reach their caps of \$52 million and \$30 million, respectively. Interest earned on these accounts is deposited to the Unreserved Account. For some draws, the PRA and SPRA are reduced when the actual prizes won are greater than the amounts available in the prize pools. The Wisconsin Lottery has the right to a refund of the Wisconsin PRA and SPRA balances if it withdraws from MUSL. The Powerball grand prize deposit is made up of the following:

	<u>June 30, 2004</u>	<u>June 30, 2003</u>
Prize Reserve Account (PRA)	\$4,022,460	\$6,204,154
Balance of Unreserved Account	593,213	449,122
Set Prize Reserve Account (SPRA)	<u>1,183,076</u>	<u>1,257,628</u>
Total Powerball Grand Prize Deposit	<u>\$5,798,749</u>	<u>\$7,910,904</u>

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

9. CAPITAL ASSETS

Capital asset activity for the fiscal year ended June 30, 2004, was as follows:

	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
Leasehold Improvements	\$ 174,102	\$ 0	\$ 0	\$ 174,102
Equipment	<u>1,118,131</u>	<u>0</u>	<u>(21,100)</u>	<u>1,097,031</u>
Total Capital Assets	<u>1,292,233</u>	<u>0</u>	<u>(21,100)</u>	<u>1,271,133</u>
Less Accumulated Depreciation for:				
Leasehold Improvements	55,542	13,113	0	68,655
Equipment	<u>1,058,929</u>	<u>49,421</u>	<u>(21,100)</u>	<u>1,087,250</u>
Total Accumulated Depreciation	<u>1,114,471</u>	<u>62,534</u>	<u>(21,100)</u>	<u>1,155,905</u>
Total Capital Assets, Net	<u>\$ 177,762</u>	<u>\$(62,534)</u>	<u>\$ 0</u>	<u>\$ 115,228</u>

Capital asset activity for the fiscal year ended June 30, 2003, was as follows:

	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
Leasehold Improvements	\$ 168,077	\$ 6,025	\$ 0	\$ 174,102
Equipment	<u>1,287,812</u>	<u>0</u>	<u>(169,681)</u>	<u>1,118,131</u>
Total Capital Assets	<u>1,455,889</u>	<u>6,025</u>	<u>(169,681)</u>	<u>1,292,233</u>
Less Accumulated Depreciation for:				
Leasehold Improvements	42,877	12,665	0	55,542
Equipment	<u>1,176,749</u>	<u>51,023</u>	<u>(168,843)</u>	<u>1,058,929</u>
Total Accumulated Depreciation	<u>1,219,626</u>	<u>63,688</u>	<u>(168,843)</u>	<u>1,114,471</u>
Total Capital Assets, Net	<u>\$ 236,263</u>	<u>\$(57,663)</u>	<u>\$ (838)</u>	<u>\$ 177,762</u>

10. OPERATING LEASES

The Wisconsin Lottery occupied office, warehouse, and storage facilities in Milwaukee and on the Beltline Highway in Madison under operating leases during FY 2003-04. The lease for the Milwaukee facility expired August 31, 2004. The Madison Beltline facility lease expired August 31, 2004. The Wisconsin Lottery leased a new facility on Dairy Drive in Madison, effective September 1, 2004, which is used for storage and instant ticket operations.

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

	<u>June 30, 2004</u>	<u>June 30, 2003</u>
Fiscal Year Ending June 30, 2004	–	\$439,723
2005	\$163,030	39,526
2006	142,257	29,644
2007	143,389	0
2008	<u>144,555</u>	<u>0</u>
Total Minimum Payments Required	<u>\$593,231</u>	<u>\$508,893</u>

Total lease expenses for the Wisconsin Lottery amounted to \$438,880 for the fiscal year ended June 30, 2004, and \$418,763 for the fiscal year ended June 30, 2003.

11. RESTRICTED NET ASSETS

The Wisconsin Lottery has restricted net assets for fair value adjustments of investments of \$14,444,391 as of June 30, 2004, and \$25,346,610 as of June 30, 2003. The Wisconsin Lottery does not realize gains or losses from the change in fair value of its annuity investments because it holds the investments until maturity to pay the annual prize payments. Therefore, fair value adjustments recognized as investment income as a result of applying GASB Statement 31 are not available for distribution as property tax credits.

The portion of restricted net assets related to capital assets is reported in detail in Note 9.

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, lapse to the Lottery Fund for distribution in the form of property tax relief. This balance makes up the remainder of the restricted net assets.

12. DISTRIBUTION OF NET PROCEEDS

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

	<u>FY 2003-04</u>	<u>FY 2002-03</u>
Lottery Tax Credit	\$118,350,953	\$106,048,125
Farmland Tax Credit	<u>13,252,418</u>	<u>23,516,869</u>
Total Credits	<u>\$131,603,371</u>	<u>\$129,564,994</u>

13. EMPLOYEE RETIREMENT PLAN

Permanent, full-time employees of the Wisconsin Lottery are participants in the Wisconsin Retirement System, a cost-sharing, multiple-employer, defined benefit plan governed by Chapter 40 of Wisconsin Statutes. State and local government public employees are entitled to an annual formula retirement benefit based on: 1) the employee's final average earnings, 2) years of creditable service, and 3) a formula factor. If an employee's contributions, matching employer's contributions, and interest credited to the employee's account exceed the value of the formula benefit, the retirement benefit may instead be calculated as a money purchase benefit. The Wisconsin Retirement System is considered part of the State of Wisconsin's financial reporting entity. Copies of the separately issued financial report that includes financial statements and required supplementary information 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 are 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. The liquidation of the State's prior service liability resulted in credits being granted to state agencies for amounts already paid in 2003. In addition, state agencies are required to make future contributions to fund the bond payments. The Wisconsin Lottery's contribution to fund bond payments was \$35,418 for FY 2003-04.

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 \$386,391 for FY 2003-04 and \$418,916 for FY 2002-03. The relative position of the Wisconsin Lottery in the Wisconsin Retirement System is not available because the Wisconsin Retirement System is a statewide, multi-employer plan.

14. COMPENSATED ABSENCES

Compensated absence activity for the fiscal years ended June 30, 2004, and June 30, 2003, 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>
2003-04	\$271,258	\$175,100	\$(127,016)	\$319,342	\$146,791
2002-03	214,901	177,145	(120,788)	271,258	127,016

15. TRANSFERS TO THE GENERAL FUND

A. 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 state agencies. The Wisconsin Lottery transferred \$132,935 to the General Fund in FY 2003-04 for the bond debt service principal and interest payments.

Section 9160(3f) of 2003 Wisconsin Act 33 required a fifth-week vacation lapse of \$2,100 that was transferred to the General Fund in FY 2003-04.

B. Section 9159 of 2001 Wisconsin Act 109 created a sick leave conversion credit of \$99,155 that was transferred to the General Fund in FY 2002-03.

16. RESTATEMENT OF FY 2002-03 FINANCIAL STATEMENTS

A. Accrued payroll decreased and accounts payable increased by \$42,423 to correct an error in the classification of the FY 2002-03 accrued payroll. There is no effect on ending net assets.

B. An adjustment was made to reclassify \$449,121 as current grand prize deposit and \$7,461,782 as noncurrent grand prize deposit. There is no effect on ending net assets.

Supplementary Information ■

Reconciliation of Lottery General Operations Expenses to the Budgetary Basis of Accounting—FY 2003-04

SALARIES AND FRINGE BENEFITS

Per Financial Statement	\$ 5,576,760
Adjustments to Financial Statement Balance:	
Cash paid in FY 2003-04 but expensed in FY 2002-03	289,989
Cash paid in FY 2004-05 but expensed in FY 2003-04	(381,952)
Reclass fringe benefits to transfer out to General Fund	121,371
	121,371
Budgetary Basis—Salaries and Fringe Benefits	\$ 5,606,168

SUPPLIES AND SERVICES

Per Financial Statement:	
On-line telecommunications charges	\$ 2,976,463
Product information costs	4,597,224
Instant ticket printing costs	3,347,743
Supplies and services	3,812,638
Instant ticket delivery costs	593,867
Depreciation expense	62,534
	62,534
Total per Financial Statement	15,390,469
Adjustments to Financial Statement Balance:	
Depreciation expense	(62,534)
Cash paid in FY 2002-03 but expensed in FY 2003-04	(1,040,322)
Cash paid in FY 2003-04 but expensed in FY 2002-03	28,627
Cash paid in FY 2003-04 but expensed in FY 2004-05	1,217,879
Cash paid in FY 2004-05 but expensed in FY 2003-04	4,248
Noncash revenue transaction expensed in FY 2003-04	(150,000)
	(150,000)
Budgetary Basis—Supplies and Services	\$ 15,388,367

CAPITAL ASSETS

Per Financial Statement	\$ 0
Adjustments to Financial Statement Balance:	
FY 2003-04 permanent property capitalized	(21,100)
FY 2003-04 disposal of permanent property	21,100
Cash paid in FY 2003-04 but expensed in FY 2004-05	6,195
	6,195
Budgetary Basis—Capital Assets	\$ 6,195

Statutorily Defined Lottery Administrative Expenses for the Years Ended June 30, 2002 through 2004

	<u>Year Ended June 30, 2004</u>	<u>Year Ended June 30, 2003</u>	<u>Year Ended June 30, 2002</u>
ADMINISTRATIVE EXPENSES			
Instant and On-Line Vendor Services	\$ 12,383,706	\$ 12,464,364	\$ 12,344,833
Salaries and Fringe Benefits	5,576,760	5,399,940	5,038,051
On-Line Telecommunications Charges	2,976,463	3,093,877	3,090,190
Supplies and Services	3,812,638	4,181,717	4,296,796
Product Information Costs	4,597,224	4,579,937	4,520,065
Instant Ticket Printing Costs	3,347,743	3,117,049	3,625,080
Instant Ticket Delivery Costs	593,867	554,808	545,253
Depreciation Expense	<u>62,534</u>	<u>63,688</u>	<u>114,573</u>
Total Administrative Expenses as Determined in Accordance with s. 25.75(3)(b), Wis. Stats.	<u>\$ 33,350,935</u>	<u>\$ 33,455,380</u>	<u>\$ 33,574,841</u>
Gross Lottery Operating Revenues	<u>\$ 483,223,734</u>	<u>\$ 435,119,501</u>	<u>\$ 427,666,243</u>
Administrative Expenses as a Percentage of Lottery Operating Revenues	6.90%	7.69%	7.85%

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. Retailer commissions are not included as an administrative expense in the calculation.

Summary of Prize Expenses for the Years Ended June 30, 2000 through 2004

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

	Fiscal Year 2003-04		
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$ 170,353,872	\$ 270,286,747	63.0%
On-Line Games	104,825,472	212,633,592	49.3
Total for Fiscal Year	\$ 275,179,344	\$ 482,920,339	57.0

	Fiscal Year 2002-03		
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$ 158,065,880	\$ 249,467,428	63.4%
On-Line Games	90,443,737	185,570,386	48.7
Total for Fiscal Year	\$ 248,509,617	\$ 435,037,814	57.1

	Fiscal Year 2001-02		
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$ 150,658,770	\$ 238,214,016	63.2%
On-Line Games	90,940,299	189,336,327	48.0
Total for Fiscal Year	\$ 241,599,069	\$ 427,550,343	56.5

	Fiscal Year 2000-01		
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$ 149,827,633	\$ 237,944,206	63.0%
On-Line Games	83,071,579	163,244,349	50.9
Total for Fiscal Year	\$ 232,899,212	\$ 401,188,555	58.1

	Fiscal Year 1999-2000		
	<u>Prize Expense</u>	<u>Ticket Sales</u>	<u>Prize Expense as a Percentage of Sales</u>
Instant Games	\$ 152,238,914	\$ 241,040,895	63.2%
On-Line Games	80,983,868	165,629,273	48.9
Total for Fiscal Year	\$ 233,222,782	\$ 406,670,168	57.3

NOTE: The above amounts are based on an 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, 2004 and 2003, and have issued our report thereon dated April 22, 2005. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audits, we considered the Wisconsin Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements, and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing

their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

COMPLIANCE AND OTHER MATTERS

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

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

April 22, 2005

LEGISLATIVE AUDIT BUREAU
by 
Julie Gordon
Audit Director

Appendices ■

Appendix 1

National Lottery Sales

FY 2002-03

Jurisdiction	Year Lottery Operations Began	Sales (in Millions)	Per Capita Sales	Per Capita Sales Rank
Arizona	1981	\$ 322.3	\$ 57.50	37
California	1985	2,781.6	78.40	29
Colorado	1983	391.5	85.10	27
Connecticut	1972	865.3	247.20	9
Delaware	1975	628.1	785.10	2
District of Columbia	1982	237.9	396.50	6
Florida	1988	2,868.0	168.70	17
Georgia	1993	2,451.8	281.80	7
Idaho	1989	98.2	70.10	33
Illinois	1974	1,565.0	123.20	25
Indiana	1989	664.4	107.20	26
Iowa	1985	187.8	64.80	36
Kansas	1987	202.9	75.20	31
Kentucky	1989	673.5	164.30	19
Louisiana	1991	311.5	69.20	34
Maine	1974	164.6	126.60	23
Maryland	1973	1,322.2	240.40	11
Massachusetts	1972	4,191.1	654.90	3
Michigan	1972	1,681.6	166.50	18
Minnesota	1990	351.7	69.00	35
Missouri	1986	708.1	124.20	24
Montana	1987	34.7	38.60	39
Nebraska	1993	80.9	47.60	38
New Hampshire	1964	221.2	170.20	16
New Jersey	1970	2,075.5	241.30	10
New Mexico	1996	137.0	72.10	32
New York	1967	5,396.0	281.00	8
Ohio	1974	2,078.3	182.30	13
Oregon	1985	853.5	237.10	12
Pennsylvania	1972	2,133.0	172.00	15
Rhode Island	1974	553.7	503.40	5
South Carolina	2002	724.3	176.70	14
South Dakota	1987	646.9	808.60	1
Texas	1992	3,130.7	141.70	21
Vermont	1997	79.4	132.30	22
Virginia	1988	1,135.7	153.50	20
Washington	1982	460.4	75.50	30
West Virginia	1986	1,081.9	601.10	4
Wisconsin	1988	435.0	79.10	28

Source: La Fleur's 2004 World Lottery Almanac

Appendix 2

Affiliated Instant Lottery Games
(By Fiscal Year of Introduction)

FY 1998-99	FY 1999-2000	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04
Pepsi® & Cash	Betty Boop™	Let It Ride®	Slingo®	Bonus Slingo®	The Price is Right®
Holiday Harley®	Let's Make a Deal®	TNN® Outdoors	Elvis®	Harley-Davidson®	Double Up Slingo®
Jacks or Better®	Race for Cash	Hot Slots			
		Be My Boop™			
		Ray Charles			
		Ballpark Fever			
		Beetle Bailey®			
		CMT® Jammin' Country			
		Tabasco® Hot Cash			



State of Wisconsin ● DEPARTMENT OF REVENUE

2135 RIMROCK ROAD ● P.O. BOX 8933 ● MADISON, WISCONSIN 53708-8933 ● 608-266-6466 ● FAX 608-266-5718 ● <http://www.dor.state.wi.us>

Jim Doyle
Governor

Michael L. Morgan
Secretary of Revenue

May 2, 2005

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

Dear Ms. Mueller:

The Department of Revenue thanks you for the opportunity to comment on the Legislative Audit Bureau's annual financial audit and biennial program evaluation of the Wisconsin Lottery.

The program evaluation makes three recommendations. The recommendations, and the department's responses are set forth below:

- Recommendation No. 1: Develop formal review criteria to evaluate, on an annual basis, GTECH's performance in complying with the current systems and services contract.

Response: Consistent with good contract management, the Lottery negotiated an annual performance review as part of its contract with GTECH. The first anniversary of the contract is June 25, 2005; a performance review has been scheduled for shortly thereafter.

- Recommendation No. 2: Develop a written methodology to analyze costs and revenues for all instant games, including affiliated games.

Response: As the audit notes, instant ticket sales have increased to \$270.3 million in FY 03-04, up 8.3% from the previous year. Formalizing our existing informal methodology for instant ticket games and instituting a formal review of individual game performance will provide additional rigor to the Lottery's game analysis and selection methodology and help to ensure continued profit growth.

- Recommendation No. 3: Require all vendor contracts to provide guarantees that will protect it in the case of nondelivery of products.

Response: This recommendation is a good business practice which the Lottery will implement on all future contracts.

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

Sincerely,

Michael L. Morgan
Secretary, Department of Revenue