A REPORT BY THE NEW YORK STATE OFFICE OF THE STATE COMPTROLLER

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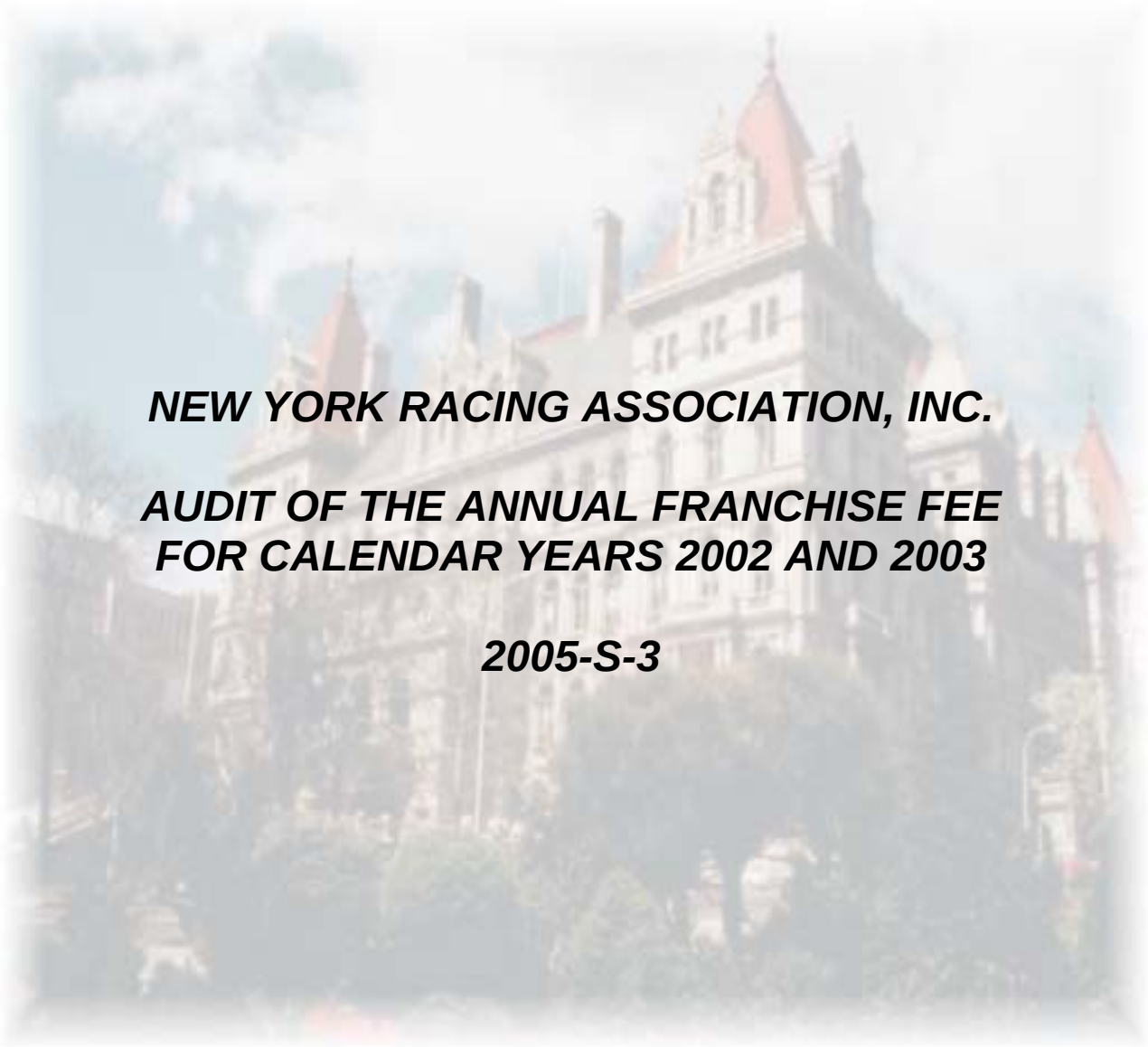

NEW YORK RACING ASSOCIATION, INC.

AUDIT OF THE ANNUAL FRANCHISE FEE FOR CALENDAR YEARS 2002 AND 2003

2005-S-3

DIVISION OF STATE SERVICES

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Report 2005-S-3

Mr. Charles Hayward
President and Chief Executive Officer
New York Racing Association, Inc.
P.O. Box 90
Jamaica, NY 11417

Dear Mr. Hayward:

The following is our audit report addressing the New York Racing Association's annual franchise fee calculation and associated operations for calendar years 2002 and 2003.

This audit was performed pursuant to the State Comptroller's authority as set forth in Article V, section 1 of the State Constitution, Article II, section 8 of the State Finance Law, and section 208 of the New York State Racing, Pari-Mutuel Wagering and Breeding Law. Major contributors to this report are listed in Appendix A.

Office of the State Comptroller
Division of State Services

February 17, 2006

EXECUTIVE SUMMARY

NEW YORK RACING ASSOCIATION, INC.

AUDIT OF THE ANNUAL FRANCHISE FEE FOR CALENDAR YEARS 2002 AND 2003

SCOPE OF AUDIT

The New York Racing Association, Inc. (NYRA), organized in 1955 and governed by a 28 member Board of Trustees (Board), is a not-for-profit racing association franchised by New York State to conduct racing and pari-mutuel betting at the Aqueduct, Belmont Park and Saratoga racetracks. NYRA's franchise will expire on December 31, 2007 and will be rebid utilizing a Request For Proposal process. Section 208 of the Racing, Pari-Mutuel Wagering and Breeding Law (Racing Law) requires NYRA to operate in a sound, economical, efficient and effective manner to produce reasonable revenue for the State.

The Racing Law defines the calculation of the franchise fee, which repays loans from the New York State Thoroughbred Racing Capital Investment Fund (CIF). NYRA owed CIF $67.8 million for loans and related interest as of December 31, 2003 and $72.5 million as of December 31, 2004. The Racing Law requires the Office of the State Comptroller (Comptroller) to certify the franchise fee. Our prior audit of the franchise fee (*Report 2002-S-31, issued September 17, 2003*) found NYRA underpaid its fee for 2000 and 2001 by a total of between $11.6 and $15.3 million. NYRA paid franchise fees of $1.6 million in 2002 and $0 in 2003.

In prior audits, the Comptroller found NYRA overstated expenses and underpaid the associated fees. In a 2003 report, the Comptroller concluded NYRA needed significant reform, and recommended the appointment of an Independent Private Sector Inspector General. Several government investigations, including one by the New York State Attorney General's Office, found extensive criminal activities at NYRA tracks. An investigation by the U.S. Attorney's Office for the Eastern District of New York (USAO) resulted in NYRA's indictment on various Internal Revenue Code violations. NYRA entered into a Deferred Prosecution Agreement in December 2003 on the condition that it would undertake reforms and hire new management to direct the reforms. An Independent Private Sector Inspector General was appointed on March 1, 2004 as the Federal Monitor. The Court imposed monitorship ended on July 24, 2005. The Monitor stated in a September 13, 2005 report that NYRA had complied with the Deferred Prosecution Agreement. The U.S. Attorney's Office recommended dismissal of the indictment against NYRA, and on the same date, the Federal Court

dismissed the indictment. The Federal Monitor's responsibilities included overseeing NYRA's reform efforts and its compliance with relevant laws, and making recommendations for NYRA's long-term structural reform. The Agreement required the Federal Monitor to report to and take direction from the Comptroller, the USAO and the Federal District Court. The Federal Monitor worked closely with the Comptroller's Division of Investigations during its term. During this time period, NYRA made significant structural reform.

Our audit addressed the following questions about NYRA's franchise fee calculations and related operations for 2002 and 2003, and its financial trends for the five years ended December 31, 2004:

- What are NYRA's financial trends, and how do they impact the franchise fee?
- Does NYRA have adequate controls over its financial reporting operations?
- Did NYRA calculate its franchise fee appropriately in 2002 and 2003?

AUDIT OBSERVATIONS AND CONCLUSIONS

Over the past five years, NYRA's financial condition has continued to deteriorate; as of December 31, 2004, NYRA's accumulated deficit totaled $102.2 million. Without immediate improvement, NYRA's ability to pay the franchise fee, and indeed, its financial viability, is in jeopardy. We found NYRA's new management had strengthened controls over financial reporting, including addressing revenue control weaknesses in the Mutuel Department that had allowed criminal acts to occur in the past. However, we also determined that NYRA calculated its franchise fee inappropriately. As a result, NYRA underpaid the franchise fees it owed for 2002 and 2003 by a total of at least $25.7 million, and by as much as $27.7 million, depending on the resolution of the unpaid CIF interest issue detailed below. Recently enacted legislation replaced CIF with the Non-profit Racing Association Oversight Board (Racing Oversight Board) established by the Governor.*

NYRA is required to operate in a sound and economical manner so it can produce reasonable revenue for the State. However, NYRA has made little effort to produce realistic budgets or to reign in its expenses. For example, the operating budgets NYRA submits for Board approval are based on federal tax-basis expenses, which, in NYRA's case, are much lower than its actual operating expenses. Thus, Board members do not get a true picture of NYRA's expenses, or its financial health. Such practices contribute to NYRA's accumulated deficit which has increased from $40.2 million in 2000 to $102.2 million in 2004. We recommend that NYRA officials produce budgets based on actual expenses. (See pp. 17-19)

* As noted, CIF has been replaced by the Racing Oversight Board. However, throughout this report we still refer to CIF, as that was the entity in existence during the scope of the audit.

The Racing Law requires NYRA to calculate its annual franchise fee by determining its adjusted net income. This figure, less $2 million for purses, is the franchise fee. NYRA's adjusted net income is its Federal taxable income for the year, adjusted upward to account for excessive expenses. Expenses are considered excessive when they are more than 6 percent higher than in the prior year (the 106 percent test), and more than 90 percent of NYRA's revenues (the 90 percent test). The Racing Law states that certain expenses (e.g., promotional; extraordinary and nonrecurring) are excluded from the excess expense tests. Our audit found NYRA inappropriately calculated the franchise fees it owed. For example, NYRA reduced its taxable income in 2002 and 2003 by deducting unpaid CIF interest expense of $1.98 million and $1.94 million, respectively, on its 2002 and 2003 tax returns. NYRA has not paid CIF interest since 1993, and has made no arrangements to pay it in the future. We objected to this practice in prior audits, and remain opposed to it; in our opinion, NYRA is not entitled to deduct an expense when there is no substantial expectation of payment. This NYRA practice results in an unwarranted reduction in the franchise fee. Pursuant to the Deferred Prosecution Agreement, NYRA referred this matter to the Internal Revenue Service (IRS) for determination. If the IRS disallows this deduction, NYRA should no longer deduct unpaid CIF interest on its Federal Corporate Tax return. (See pp. 27-30)

NYRA officials also used Federal tax-basis expenses to calculate NYRA's excess expenses and develop its adjusted net income. Since NYRA's tax-basis expenses were significantly lower than its operating expenses, NYRA's methodology understated its franchise fees. In our prior audit, we reported that, in our opinion, using tax-basis expenses was inappropriate, since the Legislature's clear intent in the design of the franchise fee calculation was to limit NYRA's expenses. We reiterate this argument in our current audit. Our calculation of the 90 percent test using operating expenses determined NYRA owed an additional $23.7 million in franchise fees for 2002 and 2003. NYRA officials should revise the 2002 and 2003 fees based on our calculations, and use actual expenses in calculating future franchise fees. (See pp. 30-32)

Finally, NYRA inappropriately categorized certain expenses as promotional or extraordinary and nonrecurring, and improperly excluded these costs from the tests for excess expenses. In our opinion, promotional expenses should reasonably be limited to expenses NYRA incurs to popularize and publicize racing with the betting public. However, NYRA officials, who have not defined these expense types, improperly included operational expenses, such as about $844,000 for trophies, in this category. NYRA also classified certain legal expenses and consulting fees, both of which NYRA pays on a regular basis, as extraordinary and nonrecurring. When we applied the 106 percent test to all pertinent NYRA expenses, we determined NYRA owed an additional $5.6 million for its 2003 fee. NYRA should develop guidelines for categorizing such expenses. (See pp. 32-34)

COMMENTS OF NYRA OFFICIALS

NYRA's response outlines a series of measures it has taken to improve its financial position, some of the results of which are reflected in its 2004 financial statements. Of note, NYRA will resume construction of a video lottery facility this Fall at Aqueduct Racetrack, which NYRA estimates will contribute about $400 million annually to education.

NYRA officials continue to disagree with our methodology for calculating the franchise fee, and with certain of the disallowances we have taken as part of that calculation. The specific positions of both NYRA and the Office of the State Comptroller are spelled out in both this report and our prior audit (Audit of the Annual Franchise Fee For Calendar Years 2000 and 2001 - Report No. 2002-S-31, issued September 13, 2003). These differences of opinion are critical and need to be resolved. Collectively, for Calendar Years 2000 to 2003, we estimate that NYRA underpaid the franchise fee owed to CIF by at least $37.3 million and by as much as $43 million, a significant portion of which ($30 million to $36 million) goes to the State treasury pursuant to statute. NYRA's franchise ends on December 31, 2007 and the State plans to put it up for bid. Among other powers, the Racing Oversight Board has the authority to settle all debts owed to CIF on terms it deems to be "reasonable and just". We believe this issue needs to be addressed and resolved by the Board.

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INTRODUCTION

Background

The New York Racing Association, Inc. (NYRA), organized in 1955, is a not-for-profit racing association franchised by New York State to conduct racing and pari-mutuel betting at New York State's three major thoroughbred racetracks: Aqueduct, Belmont Park and Saratoga. In return for its exclusive franchise, NYRA is required to provide the State with certain revenue in the form of a pari-mutuel tax and a franchise fee, and, effective 2003, a regulatory fee to the New York State Racing and Wagering Board (Racing and Wagering). Moreover, NYRA is required by Section 208 of the Racing, Pari-Mutuel Wagering and Breeding Law (Racing Law) to "take such steps as are necessary to ensure that it operates in a sound, economical, efficient and effective manner so as to produce a reasonable revenue for the support of (State) government."

NYRA is governed by a Board of Trustees (Board). Section 202 of the Racing Law, in conjunction with NYRA's by-laws, sets the number of NYRA trustees at 28: of this number, eight trustees are appointed by the Governor; the remaining 20 trustees, who are elected by the Board, are involved in the racing industry as owners, trainers and breeders. Trustees are not compensated, but the Racing Law allows trustees appointed by the Governor to be reimbursed for actual and necessary expenses they incur in the performance of their duties.

NYRA's franchise, which has been extended twice by the State Legislature, is scheduled to expire on December 31, 2007 and will be rebid utilizing a Request For Proposal process.

NYRA's revenue is generated primarily from on-site and off-site wagering on races held at its three racetracks, as well as wagering at NYRA facilities for races held at off-site racing facilities. Wagering done at a NYRA facility is classified as "on-track" handle, and wagering done at other locations, such as Off Track Betting parlors and other racetracks both in and out of state is classified as simulcasting. On-track handle is subject to a pari-mutuel tax assessed by New York State, which is calculated as a percentage of NYRA's handle. For 2002 and 2003, the pari-mutuel tax totaled $10.1 million and $9.3 million,

respectively. This tax revenue accounts for most of the revenue provided to the State by NYRA. Effective beginning in calendar year 2003, NYRA is also assessed a regulatory fee payable to the New York State Racing and Wagering Board based on a percentage of on-track handle.

In 1983, the State Legislature created the New York State Thoroughbred Racing Capital Investment Fund (CIF) to help NYRA maintain the physical condition of its track facilities. Recently enacted legislation replaced CIF with the Non-profit Racing Association Oversight Board (Racing Oversight Board) established by the Governor.* NYRA was required to remit an annual franchise fee to CIF to repay prior loans and to finance future capital projects. Any accumulated remittances to CIF in excess of $7 million are to be transferred to the State Treasury. As of December 31, 2003, NYRA reported that it owed CIF $67.8 million for prior loans and related interest. As of December 31, 2004 the debt grew to $72.5 million.

NYRA's annual franchise fee is to be calculated in accordance with provisions stated in the Racing Law. According to these provisions, the fee is to consist of NYRA's entire adjusted net income for the calendar year, as defined in the Racing Law, less $2 million, which is to be allocated for horsemen's purses and awards paid to the owners of the winning horses. If the adjusted net income for the year is less than $2 million, the entire amount is to be allocated for horsemen's purses and awards, and NYRA pays no franchise fee that year. According to Section 208 of the Racing Law, NYRA's annual franchise fee is to be certified by the Office of the State Comptroller (Comptroller).

Our prior audits of the franchise fee have consistently identified necessary revisions to the fee, as calculated by NYRA officials, due to the inappropriate use of tax-basis expenses when determining statutory adjustments to the franchise fee and, unsupported or inappropriately categorized expenses. Our prior audit of the franchise fee (*Report 2002-S-31, issued September 17, 2003*) identified a fee underpayment of at least $11.6 million, and as much as $15.3 million for calendar years 2000 and 2001. In a 2003 report (*The New York Racing Association: The Case for Reform*), the Comptroller concluded there was a need to reform NYRA, and called for the appointment of an Independent Private Sector Inspector General (IPSIG).

* As noted, CIF has been replaced by the Racing Oversight Board. However, throughout this report we still refer to CIF, as that was the entity in existence during the scope of the audit.

In addition to the Comptroller's audits and policy reports, investigations by the United States Attorney's Office for the Eastern District of New York (USAO), the New York State Attorney General's Office, the Division of State Police, and the New York State Office of the Inspector General uncovered extensive money laundering and other criminal activities at NYRA-operated racetracks. On December 4, 2003, NYRA was indicted by the USAO for several crimes, including one count of conspiracy to defraud the United States in violation of Title 26 of the Internal Revenue Code (Tax Code), and three counts of aiding and abetting false tax filings in violation of the Tax Code. On December 10, 2003, NYRA entered into a Deferred Prosecution Agreement (Agreement) with the USAO on the condition that it would undertake reforms, including the appointment of an IPSIG. Pursuant to that Agreement, NYRA acknowledged its guilt with respect to charges filed in the indictment. Six NYRA employees were also charged with crimes in the indictment and subsequently pled guilty. Overall, 25 NYRA employees (including the aforementioned six) have pled guilty in the various Federal and State indictments.

On March 1, 2004, the United States District Court for the Eastern District of New York appointed an IPSIG (the law firm of Getnick & Getnick) as the Federal Monitor responsible for overseeing NYRA's reform efforts and monitoring compliance with the Agreement, NYRA's compliance with all Federal, State and local laws; and also to suggest structural reforms to help ensure NYRA's compliance with these laws. The Federal Monitor's tenure was initially scheduled to end on July 1, 2005 but was extended by the Federal District Court to July 24, 2005 to coincide with the end of Belmont's Spring racing season. The terms of the Agreement required that the Federal Monitor report to and take direction from the Comptroller, the USAO, and the Federal District Court. The Monitor stated in a September 13, 2005 report that NYRA had complied with the Deferred Prosecution Agreement. The U.S. Attorney's Office recommended dismissal of the indictment against NYRA, and on the same date, the Federal Court dismissed the indictment. The Comptroller's Division of Investigations worked closely with the Federal Monitor on a variety of issues, including the development of an enhanced Code of Ethics for all NYRA employees. Our franchise fee audit scope covers a period before the Federal Monitor was appointed.

The terms of the December 10, 2003 Agreement required NYRA to continue to restructure its senior management by March 31, 2004, a process NYRA had already begun before its indictment in response to earlier criticism by various entities, including the Comptroller. The former Chairman was appointed in October 2000, and also served as the Chief Executive Officer until November 4, 2004. (The Chairman in place as of December 10, 2003 remained Chairman until the end of 2004.)

Additionally, between April 2002 and June 2004, NYRA hired new managers for a number of positions, including the following: Chief Financial Officer and Senior Vice President; Controller; Assistant Controller; Vice President for Mutuel Operations; Senior Vice President and General Counsel; Vice President of Human Resources and Labor Relations; and Vice President of Regulatory Compliance. Further, NYRA's Internal Audit Department was dissolved on March 31, 2004, and an external accounting firm had performed NYRA's internal audit functions from that time until the recent hiring of a new Director of Internal Audit who has since engaged his own staff. In addition, a new President/Chief Operating Officer was hired on November 4, 2004, and two Board members began serving elected terms as Co-Chairmen of the Board on January 1, 2005. These new management officials were brought in to correct and improve NYRA operations and, ultimately, to complete a reform agenda, pursuant to the December 2003 Agreement.

In addition to the work it performed with the Federal Monitor, the Comptroller's Office is conducting a series of audits at NYRA. This audit examined NYRA's franchise fee calculation and associated operations for 2002 and 2003. Two recently completed audits examined NYRA's Travel and Entertainment Expenses and its Contracting and Procurement Operations. Subsequent audits will address NYRA's Backstretch Operations, and Capital Program.

Audit Scope, Objectives and Methodology

We examined NYRA's franchise fee calculations and associated operations for calendar years 2002 and 2003, and analyzed NYRA's financial trends for the five years ended December 31, 2004. The objectives of our financial audit were to assess the adequacy of controls over NYRA's financial-reporting operations; the methodology used by NYRA to calculate the annual franchise fee; and to determine whether NYRA used the appropriate methodology to calculate the

annual franchise fee (including the appropriateness of, and support for, selected expenses used in the franchise fee calculation). In addition, we reviewed specific controls in place at NYRA's Mutuel Department, where significant deficiencies were previously identified by Racing and Wagering, and the New York State Attorney General's Office.

To accomplish our audit objectives, we tested the internal controls in place over NYRA's financial reporting systems; interviewed appropriate NYRA officials and staff; and reviewed provisions of the Racing Law governing the franchise fee. To determine whether NYRA's tax deductions were supported by documentation and in compliance with governing accounting principles and the Tax Code, we reviewed a judgmental sample of 23 deductions (14 on the 2002 return and 9 on the 2003 return), and traced each one to the relevant year end trial balance and supporting payment documentation. The basis of our judgmental selection was the deduction's high-dollar value and/or high risk of being recorded incorrectly. In addition, we selected a sample of 50 expenses, classified by NYRA as promotional, to determine whether their individual classifications were supported and reasonable. Our judgmental sample of promotional expenses was drawn from various NYRA accounts that contained these expenses, and was selected (based on high-dollar value and expense description) to include transactions at high risk for misclassification as a promotional expense. Further, we reviewed the working papers prepared by NYRA's independent auditor in support of its opinion on NYRA's Statement of Operations and Accumulated Deficit (Income Statement); available third-party reports of NYRA's wagering operations (e.g., Autotote); and selected bank deposits of wagering revenue for the audit scope period. We also met with the Federal Monitor, Racing and Wagering and the CIF regarding issues relevant to the franchise fee.

We conducted our audit in accordance with generally accepted government auditing standards. Such standards require that we plan and do our audit to adequately assess those procedures and operations included within the audit scope. Further, these standards require that we understand NYRA's internal control systems and compliance with those laws, rules and regulations that are relevant to NYRA's procedures and operations that are included in our audit scope. An audit includes examining, on a test basis, evidence-supporting transactions recorded in the accounting and operating records and applying such other auditing procedures, as we consider necessary in the

circumstances. An audit also includes assessing the estimates, judgments and decisions made by management. We believe our audit provides a reasonable basis for our findings, conclusions and recommendations.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State, several of which are performed by the Division of State Services. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds, and other payments. In addition, the Comptroller appoints members to certain boards, commissions and public authorities, some of whom have minority voting rights. These duties may be considered management functions for purposes of evaluating organizational independence under generally accepted government auditing standards. In our opinion, these management functions do not affect our ability to conduct independent audits of program performance.

Internal Control and Compliance Summary

Our consideration of NYRA's internal control structure identified weaknesses, control deficiencies, and compliance issues for many of the areas addressed in this audit. We provide details of these matters throughout the report.

Response of NYRA Officials to Audit

A draft of this report was provided to NYRA officials for their review and comment. Their comments were considered in preparing this report, and are included as Appendix B.

NYRA's response outlines a series of measures it has taken to improve its financial position, some of the results of which are reflected in its 2004 financial statements. Of note, NYRA will resume construction of a video lottery facility this Fall at Aqueduct Racetrack, which NYRA estimates will contribute about $400 million annually to education.

NYRA officials continue to disagree with our methodology for calculating the franchise fee, and with certain of the disallowances we have taken as part of that calculation. The specific positions of both NYRA and the Office of the State Comptroller are spelled out in both this report and our prior audit

(Audit of the Annual Franchise Fee For Calendar Years 2000 and 2001 - Report No. 2002-S-31, issued September 13, 2003). These differences of opinion are critical and need to be resolved. Collectively, for Calendar Years 2000 to 2003, we estimate that NYRA underpaid the franchise fee owed to the former CIF by at least $37.3 million and by as much as $43 million, a significant portion of which ($30.3 million to $36 million) goes to the State treasury pursuant to statute. NYRA's franchise ends on December 31, 2007 and the State plans to put it up for bid. In August 2005, an Oversight Board was created to monitor and review NYRA's business practices. Among other powers, the Board has the authority to settle all debts owed to CIF on terms it deems to be "reasonable and just". We believe this issue needs to be addressed and resolved by the Board.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Chairman and Chief Executive Officer of the New York Racing Association shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising of the steps that were taken to implement the recommendations it contained, and/or the reasons certain recommendations were not implemented.

NYRA'S FINANCIAL TRENDS

NYRA is required by the Racing Law to operate in a sound, economical, efficient and effective manner so as to produce a reasonable revenue (i.e., the pari-mutuel tax and the franchise fee) for the support of (State) government. However, NYRA is not operating in a sound and economical manner, as demonstrated by our most recent audits, and by NYRA's own certified Income Statement. Since NYRA's deteriorating financial trends, if uncorrected, will ultimately affect its ability to continue in operation, much less pay its franchise fee, it is appropriate that we address this issue first in our report. We had also addressed this issue in our prior audit of the franchise fee for calendar years 2000 and 2001 (Report 2002-S-31, issued September 17, 2003).

As detailed below, NYRA's dismal financial trends illustrate an organization that, without immediate and dramatic change, may not be able to continue operating as a going concern. NYRA's accumulated deficits grew from $51.5 million as of January 1, 2002, to $86.2 million as of December 31, 2003. (See *Table 1* below)

Table 1: NYRA's Financial Trends (in thousands)

	2000	2001	2002	2003	2004 (4)
Total Wagering	$3,277,526	$3,514,068	$3,627,573	$3,603,816	$3,687,573
Pari-mutuel Tax	$13,343	$9,981	$10,138	$9,348	$8,754
Racing and Wagering Fee (5)	N/A	N/A	N/A	$1,393,000	$1,795,000
Net Revenues *	$155,349	$160,607	$152,663	$151,758	$152,943
Total Expenses	$153,681	$171,887	$159,449	$173,892	$168,931
Net (Loss) Income	(1) $1,668	($11,280)	($6,786)	($22,134)	($15,988)
Franchise Fee Paid (2)	$4,107	$0	$1,599	$0	$0
Accumulated Deficit (3)	($40,202)	($51,482)	($58,268)	($86,167)	($102,155)

Notes:

* After payouts to winning bettors, commissions and other statutory payments.

(1) NYRA would have reported a net loss of $9.4 million for calendar year 2000 had it not been for a one-time $11 million real estate tax settlement.
(2) The franchise fee is calculated by a formula stated in the Racing Law, as described later in this report.
(3) Accumulated expenses in excess of revenues received over a corresponding period.
(4) Presented for informational purposes only.
(5) Regulatory fee effective beginning calendar year 2003.

An organization's expenses can be controlled through a formal budget process. NYRA is required by the Racing Law to follow such a process, and is further required to comply with a number of specific budgetary requirements. The Board is also required by the Racing Law to reject the operating budget submitted to it if the expenses it contains are excessive relative to NYRA's expected revenues for the year. According to NYRA officials, their annual operating budget is approved by the Board, and their operating expenses, as stated in the budget, do not exceed statutory limitations. However, as explained later in this report, NYRA officials used anticipated tax-basis expenses (those expenses which are deductible on its Federal Corporate Tax Return) - instead of NYRA's anticipated total (book) expenses prepared in accordance with generally accepted accounting principles and ultimately certified to by NYRA's independent public accounting firm - when they prepared the budgets they submitted to the Board. Due to limits imposed on certain expenses by the Tax Code, NYRA's tax-basis expenses have been consistently lower than actual expenses. Thus, Board members do not get a true picture of the extent of NYRA's expenses unless they reviewed the annual certified Income Statement, when it would be obviously too late to make necessary adjustments to work toward a profit for the year in question.

NYRA officials must adopt a realistic and reasonable budget approach that reports total, rather than tax-basis expenses so the Board can make timely and informed decisions. After bringing this matter to the attention of NYRA officials, we were informed that commencing with calendar year 2005, they have begun to provide their Board with book-basis as well as tax-basis expenses for budgeting purposes.

Also, according to NYRA officials, they cut expenses by nearly $5 million during calendar year 2004. Undoubtedly, the noted cuts are a step in the right direction and certainly necessary to help avoid a financial crisis. However, according to NYRA's audited financial statements for 2004, NYRA still ran a $16 million loss, increasing its accumulated operating deficit to $102.2 million. NYRA officials must continue to reduce expenses and take other steps as necessary to increase revenue.

NYRA officials indicated that, despite NYRA's bleak financial picture, they expect the recent legislative approval to install

video lottery terminals (VLT) at Aqueduct to bring NYRA an influx of new business and substantial new revenue. We agree that VLT revenue could be used to reduce NYRA's deficit. However, as noted above, NYRA's fiscal track record is not good: although its total handle has increased in four of the five past years, NYRA's spending has continued to outpace revenues. Thus, even if VLTs are installed in the future, and produce the extra revenue for NYRA, without effective internal controls over all its operations, including competent controls over spending, VLT revenues may not be sufficient to restore NYRA to good financial health.

NYRA'S INTERNAL CONTROL STRUCTURE

As a not-for-profit entity with an exclusive franchise to conduct racing and betting at the State's major racetracks, NYRA must comply with the Racing Law's requirements for sound and economical operation, Tax Code rules related to the tax deductibility of expenses and NYRA policies that promote compliance with the Racing Law and the Tax Code. NYRA management is responsible for establishing and maintaining appropriate systems of internal control to help ensure that compliance. However, over the last several years, various investigations and audits determined that NYRA's weak controls over its financial activities and operations (e.g., Mutuel Department functions) were ineffective in preventing fraud and other criminal acts. Correcting these deficiencies required the investment of significant staff time and NYRA financial resources. Our current audit concluded that NYRA's new management have improved controls over its financial-related operations, specifically in the Mutuel Department. However, NYRA still has inadequate controls over its expenses and the calculation of the State franchise fee.

Our recently completed audits of NYRA's Travel and Entertainment Expenses (*2004-S-40, issued January 10, 2005*) and NYRA's Contracting and Procurement Operations (*2004-S-61, issued June 15, 2005*) identified control weaknesses in practically all facets of the areas these audits examined. These weaknesses ranged from a lack of written control procedures, to poor communication of existing controls, to non-enforcement of written controls. As noted below, our current audit found that similar control weaknesses contributed to NYRA's incorrect calculation of its franchise fee. We found NYRA officials inappropriately categorized certain expenses as promotional and/or non-recurring; and had no written guidelines for classifying these expenses. Further, we concluded that NYRA officials incorrectly calculated statutory adjustments to the franchise fee because they used an inappropriate methodology to calculate the fee. As a result, NYRA under-calculated its franchise fee in both 2002 and 2003.

The 2002 franchise fee calculations were prepared by NYRA's former management, and the 2003 calculations were done by

NYRA's newly appointed management. Both calculations used the same methodology we concluded to be statutorily incorrect in our prior audit of NYRA's franchise fee. In the audit, we reported a cumulative franchise fee underpayment for 2000 and 2001 of at least $11.6 million, and potentially as much as $15.3 million. Our current audit found that NYRA's continued use of this methodology in 2002 and 2003 resulted in a cumulative fee underpayment for these years of $25.7 to $27.7 million. We conclude that, despite its recent improvements in controls over revenues, NYRA will continue to underpay its franchise fee unless NYRA: establishes effective controls over all its operations; develops and follows guidelines for properly categorizing NYRA expenses; uses the appropriate figures when calculating the franchise fee; and conforms to budgets that are based on NYRA's total anticipated expenses. Details of our findings related to this underpayment are contained in the remaining sections of this report.

Controls Over Financial Reporting

NYRA maintains a comprehensive computerized accounting operation, supervised by NYRA's controller, the data from which is used to prepare NYRA's annual financial statements and tax returns. An elaborate chart of accounts details all of NYRA's balance sheet and income statement items, including revenue from on-track and off-track wagering. If the amounts recorded in these accounts are to be relied upon, they must be supported by an appropriate system of internal controls. However, as noted above, NYRA's controls over its wagering revenue prior to our audit scope period were undermined by a number of serious weaknesses. These control weaknesses, which were identified by various law enforcement entities and regulatory bodies prior to the initiation of our current audit, allowed certain criminal activities to occur, as described below.

- An investigation by the State Attorney General's Office determined that, during calendar years 1998 and 1999, wagering revenue was routinely misappropriated and misused by NYRA employees. The identified cash shortages, which were common among tellers, were not material for financial reporting purposes. However, it should be noted that these shortages did result in inaccurately reported NYRA revenue figures, and a dollar-for-dollar inaccuracy in NYRA's franchise fee. The investigation also determined that NYRA employees

engaged in money laundering, illegal gambling, loan sharking, tax fraud, forgery and various crimes against NYRA's customers.

- In March 2003, a Racing and Wagering audit identified serious weaknesses in NYRA's controls over wagering revenue.

As part of our audit, we performed a walk-through of the controls over financial reporting operations, with a focus on the Mutuel Department, to assess the adequacy of NYRA's current revenue controls. We traced selected revenue items on NYRA's Federal corporate income tax return to NYRA's books of record and associated supporting documents; analyzed selected NYRA bank deposits; and reviewed the working papers prepared by NYRA's independent auditor (CPA firm) in support of its opinion on NYRA's Income Statement.

We conclude that, except for the issue related to CIF interest noted below, NYRA's Income Statements for the years 2002 and 2003 are a fair representation of its revenues and expenses based on generally accepted accounting principles.

We believe it is inappropriate for NYRA to deduct an expense for interest due to CIF, since NYRA has not paid interest to CIF in over ten years, and, based on financial trends and spending practices, may not be able to pay the interest it owes at any future date. By deducting this interest expense, NYRA over-reported its expenses for each year of the audit period. We objected to NYRA's deduction of this unpaid interest expense in our prior audit of the franchise fee, but NYRA officials continued this practice in 2003 and 2004. As detailed later in this report, this issue has been referred to the Internal Revenue Service (IRS) for review and determination.

Mutuel Department

To assess Mutuel Department controls during the audit period, we reviewed the newly developed controls over Mutuel Department cash collection procedures, cash counts and periodic revenue reconciliations. We found that NYRA has developed a Mutuel Department Rules and Regulations Manual, which revised policies and procedures for controls over wagering revenues. Further, NYRA enhanced its policy for recovering cash shortages from tellers, and installed video

surveillance systems at Aqueduct and Belmont Park to better monitor cash handling activities. We also noted that the contractor that operated NYRA's automated wagering system during our audit period acted to correct deficiencies that allowed improper access to the system. Upon expiration of this contract, in October 2004, a new contractor was selected to operate NYRA's automated wagering system, through a process of competitive bidding. In addition, NYRA's internal audit staff has been instructed to perform frequent assessments of Mutuel Department controls, records and practices.

We performed a walk-through of these procedures and retained copies of sample reconciliations to determine whether they were implemented as designed. Our testing found that NYRA's newly developed controls and practices described above are in effect.

NYRA's Independent Auditors

As noted above, NYRA's financial statements (Income Statements, Balance Sheets and related footnotes) are audited annually by a CPA firm. According to this firm, the financial statements for 2002 and 2003 fairly presented NYRA's financial operations and condition for the stated periods.

We reviewed the CPA firm's working papers as they pertain to NYRA's Income Statements for the audit period, both to determine whether their opinion thereon is adequately supported, and to avoid potentially duplicative audit work. (Our audit testing did not include verification of NYRA's Balance Sheets or related footnotes as they have no direct relationship to the franchise fee calculation. As such, we do not express an opinion on the sufficiency of the work performed by the firm in this area.)

To further corroborate the CPA firm's opinions on NYRA's Income Statements for the audit period, we selected a sample of pari-mutuel on-track revenue for three months (one month from each of NYRA's three racetracks) and compared NYRA's bank deposits with the revenues calculated according to NYRA's Mutuel Cash Receipt Vouchers. We also considered the results of our recently completed audits of NYRA's Contracting and Procurement Practices; and Travel and Entertainment Expenses, both of which covered the same audit period.

According to our review, we conclude that NYRA's CPA firm did sufficient work to render its unqualified opinions on NYRA's Income Statements, and that their related footnotes adequately disclose known relevant issues pertaining to NYRA's revenue and expense-related operations for the audit period.

However, subsequent to the firm's certification of NYRA's financial statements for the audit period, the Federal Monitor brought to our attention certain concerns regarding NYRA's depiction of cash and related liabilities for 2002, 2003, and 2004 Balance Sheets. As noted above, these observations do not affect our calculation of the franchise fee.

We note that the Balance Sheets contained in NYRA's final certified financial statements for 2004, which were issued on August 2, 2005, were revised to address the above-noted concerns expressed by the Monitor. Additionally, NYRA's comparative Statement of Operations and Accumulated Deficit (Income Statement) for 2003, which are included therein for comparative purposes, was also revised to reflect certain adjustments made by NYRA to comply with statutory requirements pertaining to mandated reserves for Stakes and Purses, and payments to the NYS Breeding and Development Fund which were originally under-calculated by NYRA. These revisions resulted in a decrease of net revenues and an increase in operating expenses as compared to the originally issued statements for 2003. As a result, the audited franchise fee as initially determined in our draft report increased accordingly.

CALCULATION OF THE ANNUAL FRANCHISE FEE

According to Section 208 of the Racing Law (Racing Law), NYRA is required to pay an annual franchise fee to CIF. To demonstrate that NYRA properly calculated its entire adjusted net income for the purpose of paying the fee, NYRA's controller prepares an annual franchise fee worksheet. The Racing Law defines NYRA's entire adjusted net income (adjusted net income - *illustration follows*) as its Federal corporate taxable income, increased by the amount by which NYRA's operating expenses for the current year, less certain exceptions (e.g., interest, real estate taxes, advertising, promotional, extraordinary nonrecurring expenses), exceed 106 percent of their level for the prior year. The Racing Law also requires NYRA to add to its taxable income the amount by which actual operating expenses for the year (less certain taxes and special assessments) exceed 90 percent of the year's revenues to arrive at its adjusted net income. The first $2 million of NYRA's adjusted net income is allocated for horsemen's purses and awards; any remainder is paid to CIF as the annual franchise fee. CIF moneys in excess of $7 million are subsequently remitted to the State Treasury.

Computing NYRA's Entire Adjusted Net Income (Franchise Fee)

NYRA's Federal Corporate Taxable Income

\+ **Excess Expenses:**

(a) Operating expenses (excluding certain expense categories) that are more than 6 percent higher than they were in the prior year (106 percent test); and

(b) Actual operating expenses (less certain expenses) that are more than 90 percent of NYRA's actual revenues for the year (90 percent test)

= **NYRA's Entire Adjusted Net Income**

NYRA reported a franchise fee of approximately $1.6 million for 2002, after $2 million was allocated to stakes and purses. NYRA reported a franchise fee of $0 for 2003. We reviewed NYRA's franchise fee work sheets for these two years. To assess the accuracy of the work sheet figures, we traced selected revenue

and expense items reported on NYRA's Federal corporate tax returns to its certified Income Statement and books of record to determine whether the figures were correctly transferred considering appropriate adjustments. We also reviewed the mathematical accuracy of the actual calculation, and the propriety of the expenses excluded from the 106 percent ceiling. In addition, we determined whether NYRA had properly arrived at its adjusted net income by accounting for operating expenses that exceeded 90 percent of revenues.

We determined that the franchise fees calculated by NYRA officials for 2002 and 2003 were understated by a combined total of at least $25.8 million and perhaps by as much as $27.8 million, depending on the resolution of the unpaid CIF interest issue detailed below. These franchise fee obligations were understated because NYRA:

- overstated some expenses (i.e., interest paid to the CIF) on its Federal corporate tax returns;
- used tax-basis expenses rather than actual (total) operating expenses in figuring the statutory adjustments used to calculate the fee; and
- inappropriately categorized certain expenses used in applying the 106 percent test.

Our adjustments to NYRA's franchise fees for the audit period are summarized in *Table 2*.

Table 2: Audit Adjustments to NYRA Franchise Fee for 2002 and 2003

	2002	2003	Total
Franchise Fee Reported by NYRA	(1) $3,599,000	$ 0	$3,599,000
Adjustments per 106 percent test	0	5,581,060	5,581,060
Adjustments per 90 percent test	4,859,300	18,873,800	23,733,100
Claimed Interest Expense Not Paid (3)	1,982,000	1,938,475	3,920,475
Audited Franchise Fee	6,841,300	(2) (4) 24,454,860	(4) 31,296,160
Total Fee Increase	$3,242,300	$24,454,860	$27,697,160

(1) This figure includes $2 million that was paid to Stakes and Purses.
(2) This figure includes $2 million that should be paid to Stakes and Purses.
(3) A decision on this issue will ultimately be made by the IRS. See the section on "Unpaid CIF Interest Expense."
(4) Even though NYRA deducted the CIF interest, the amount of taxable loss in 2003 would negate its effect on the franchise fee calculation.

The provisions requiring that NYRA's excess expenses be added to taxable income for purposes of calculating the franchise fee are intended to discourage NYRA from engaging in excess spending. By requiring that the amount of excess expenses be added to taxable income to arrive at its franchise fee obligation, NYRA is effectively penalized for any excessive spending. In any year in which NYRA has a net operating loss, our calculation treats taxable income as zero so as not to allow the organization to benefit from its excessive spending and inappropriately reduce the franchise fee. We believe this prevents the intent of the Racing Law from being subverted.

Unpaid CIF Interest Expense

As of December 31, 2003, according to NYRA's certified Balance Sheet, NYRA reported $67.8 million in outstanding loans and interest due to the CIF loans for capital improvements at track facilities. The Racing Law required NYRA and CIF to enter into a restructured repayment agreement. However, to date, no such agreement has been executed, and now any agreement would be with the newly created Racing Oversight Board.

According to the Tax Code, a corporation that uses the accrual basis of accounting, as does NYRA, may deduct an expense, such as interest, even if it has not yet been paid at the time of tax return preparation, as long as the expense has been accrued and the amount of the expense can be reasonably estimated. The Tax Code permits this deduction unless there is no substantial expectation that payment would be made.

As noted in our prior audit of the franchise fee, it has been NYRA's practice to deduct accrued CIF loan interest on its Federal corporate tax returns, even though it did not pay the interest expense either before or after its returns were prepared. NYRA continued this practice during calendar years 2002 and 2003. Since NYRA's taxable income is the basis for calculating its adjusted net income, these deductions are also reflected in NYRA's calculation of the franchise fees for the audit period. The amount NYRA deducted for interest expense totaled $1,982,000 and $1,938,475, respectively, in 2002 and 2003.

In our prior audit, we recommended that this matter be referred to the IRS for a determination regarding the allowability of these deductions. Pursuant to the Deferred Prosecution Agreement

NYRA entered into with the USAO, it agreed to seek, and has in fact sought, an advisory opinion from the Internal Revenue Service (IRS) regarding the proper accounting and tax treatment of funds that it receives from and pays to CIF, including accrued interest. The IRS is now looking into this matter. It is our position, however, that these deductions are inappropriate: NYRA has not made any interest payments since 1993; in addition, based upon NYRA's financial condition and revenue and expense trends as noted above, and barring any substantial improvement in its financial condition, it appears unlikely that NYRA will ever be able to repay these loans out of operating funds. If the Internal Revenue Service determines that these deductions should be disallowed, then the franchise fees for the audit scope period, as well as for eligible prior years, must be adjusted accordingly.

Tax-Basis Expenses vs. Actual Expenses

Contrary to the recommendations we made in our prior audit of the franchise fee, NYRA officials continue to use Federal tax-basis expenses in calculating adjustments to taxable income in arriving at its entire adjusted net income. Since NYRA's tax-basis expenses are significantly lower than its actual expenses, NYRA's calculation resulted in understated franchise fees for 2002 and 2003. In our prior audit, we reported that using Federal tax-basis expenses in these formulas is statutorily incorrect. We reiterate this statement in our current audit.

According to a recent narrative prepared by NYRA officials, they continue to contend that using tax-basis expenses is the appropriate way to calculate both the 106 percent test and the 90 percent test in determining the franchise fee. NYRA also asserted this argument in its formal response to our previous audit of the franchise fee. According to NYRA officials, since NYRA's Federal corporate taxable income is the starting point for the franchise fee, all statutory adjustments pertaining to the fee should be calculated using tax-basis figures.

NYRA states that it does not make sense under Section 208(10) of the Racing Law to add expenses based on generally accepted accounting principles (book expenses) rather than expenses determined under tax accounting principles to its taxable income figure to arrive at an "increased taxable income figure." Further, NYRA officials state that, in each of the years at issue, they and the Board agreed on a budget in which

operating expenses were computed in accordance with tax accounting principles. NYRA officials argue that imposing what they view as an additional franchise fee based on expenses recorded pursuant to generally accepted accounting principles would penalize a taxpayer who complied with a budget prepared in accordance with the statute.

It is important to note that the purpose of these statutory adjustments is to calculate the franchise fee to be remitted to the State, not to determine or increase NYRA's Federal taxable income nor prescribe how it should prepare its budget. As we stated in our prior audit, it is not proper for NYRA to limit its operating expenses for purposes of the 106 percent test or the 90 percent test to the expenses reported on its Federal income tax return. In no section of the Racing Law does it expressly refer to or otherwise require the incorporation of Federal tax reporting principles into the definition of operating expenses for the purpose of calculating the spending limitation.

The Legislature uses the inclusive terms "operating expenses" and "total expenses", and it expressly excludes certain categories of expenses from the definition of these terms. Since the language of this provision is clear and unambiguous, and since the Legislature has specifically and expressly set forth the items which are to be excluded from "operating expenses" or "total expenses" in calculating NYRA's operating expense limitation, the inference must be drawn that there was no intent that Federal tax reporting principles be imported into the calculation.

For example, under Federal tax reporting principles, only limited travel and entertainment expenses may be deducted by the taxpayer. As a consequence, a significant portion of NYRA's travel and entertainment expense would not be included on their Federal income tax return and would therefore, under NYRA's interpretation of Section 208, not be included in the calculation of either the 106 percent test or the 90 percent test.

It is clear that the legislative intent behind the imposition of the above tests was to limit the expenses NYRA incurs. Using only the expenses reported on the Federal tax return allows a major portion of such expenses to escape the limitation, and does not achieve the Legislative purpose of reigning in NYRA's expenditures. Such a result could not have been intended by the Legislature.

We also question NYRA's use of tax-basis expense data from a governance perspective. In our opinion, the Board cannot properly assess the results of NYRA's operations, or determine its overall financial condition, by examining only tax-basis expenses. As noted above, until 2005, the annual budgets NYRA officials have traditionally submitted to the Board for its approval contain tax-basis expense figures only. We believe it is irresponsible to use such expenses in budgeting, particularly in NYRA's case, since its tax-basis expenses are significantly lower than its actual expenses. Logically, managers must use actual revenue and expense data when they compare expenses from year to year and prepare their operating budgets. Using deflated tax-basis expense figures can make operating results appear much healthier than they really are. To illustrate, NYRA's income tax returns show a loss in 2003 of $4.7 million, while its certified income statement reports a loss of $22.1 million for the same period - a difference of $17.4 million.

106 Percent Test

The Racing Law specifies which expense items (e.g., interest, real estate taxes, advertising, promotional, and certain extraordinary nonrecurring expenses) are excluded from the 106 percent calculation. As noted above, NYRA officials inappropriately used tax-basis expenses instead of actual expenses in applying the formula intended to identify NYRA's excess expenses. As a result, NYRA under-calculated statutory adjustments necessary to determine the appropriate fee.

We also believe NYRA inappropriately categorized certain expenses as promotional or extraordinary and nonrecurring, thereby excluding them from the 106 percent test. NYRA has no written guidelines that define "promotional" and "extraordinary nonrecurring" expenses. In the absence of such guidelines, NYRA officials have broadly interpreted these categories to include expenses that do not appear to fit either classification.

For example, NYRA classified expenses totaling $8.3 million and $7.9 million in 2002 and 2003, respectively, as promotional in nature. Among the expense categories NYRA identified as promotional was "Trophies," for which expenses totaled $844,000 in each of the above years. NYRA, like many other thoroughbred racing facilities, routinely awards trophies to the owners and trainers of winning horses. In our view, NYRA promotional expenses would include NYRA efforts to popularize

and publicize racing with the betting public. Since the award of trophies has no tangible relationship to attracting more bettors, or to increasing the amounts these bettors wager, trophy-related expenses are ordinary NYRA operating expenses, not promotional expenses. In another example, we found NYRA classified the annual Belmont Breakfast as a promotional expense. The Belmont Breakfast, for which NYRA spent $16,500 in 2002 and about $25,000 in 2003, is provided to owners and trainers and is used as a forum to select post positions for the Belmont Stakes. NYRA also classified its expenses of $28,161 for rental of a tent, plywood flooring, an air conditioning unit and a restroom trailer during the Belmont Stakes week as promotional. These additional facility-related expenses are necessary to accommodate the increased crowds drawn to the Belmont Stakes.

In 2003, NYRA also categorized $4.2 million in expenses as extraordinary and nonrecurring. The expenses in this category included certain legal expenses, severance pay for outgoing executives and fees paid to a consultant. In order to be exempted from the 106 percent test, the Racing Law requires such expenses must be both "extraordinary" and "nonrecurring". We conclude that the legal expenses and fees to a consultant do not satisfy the test of extraordinary and nonrecurring. NYRA generally incurs the foregoing types of expenses annually, and incurred the particular expenses at issue over a period of years. As such, they are clearly not nonrecurring in nature. In addition, because they are normal business expenses incurred by NYRA every year, they are not extraordinary. However the severance pay paid to its former President, Controller and Director of Internal Audit whose separation from NYRA was mandated pursuant to a Deferred Prosecution Agreement would meet the test as extraordinary and nonrecurring. However, we make no representation as to the propriety of the amounts paid since there were no severance agreements for these former officials until their actual separation from service.

We performed the 106 percent test for the audit scope period using actual certified expenses and adjusting for the inappropriately categorized promotional and extraordinary nonrecurring expenses noted above. As a result of our recalculation, NYRA’s adjusted net income, and likewise its franchise fee, was increased by $5.6 million for calendar year 2003.

90 Percent Test

The Racing Law confers considerable significance on NYRA's annual operating budget. It explicitly states all foreseeable operating expenses are to be included in the budget. Further, the total of these expenses (less certain taxes, fees and special assessments) is not to exceed 90 percent of the anticipated revenues available for NYRA operations. NYRA's Board, which is responsible for approving NYRA's budget, is required by the Racing Law to reject the budget if budgeted expenses exceed this maximum allowable percentage.

The calculation of the franchise fee is impacted by the extent to which NYRA's actual expenses exceed 90 percent of actual revenues for the year. According to Section 208(10) of the Racing Law, "(I)n any year in which actual operating expenses are greater than 90 percent of available revenues, the amount by which such actual expenses exceed such allowed expenses shall be added to taxable income in computing 'entire adjusted net income' for use in calculating the franchise fee."

In 2002 and 2003, NYRA's actual operating expenses exceeded both thresholds; that is, in each of these years, NYRA's actual expenses exceeded both the expenses budgeted for the year, as well as 90 percent of NYRA's actual revenues for the year. Therefore, following the formula stated in the Racing Law, we calculated the amounts to be added to NYRA's adjusted net incomes for 2002 and 2003, respectively. The following table (*Table 3*) shows NYRA's budgeted expenses for 2002 and 2003; the allowable expenses for these years (i.e., 90 percent of revenues based on reasonably sound budgeting); NYRA's actual operating expenses; and the difference. This difference represents NYRA's excess expenses in 2002 and 2003, according to the Racing Law, and a corresponding increase in NYRA's franchise fee.

Operating Expenses *	Table 3: Excess NYRA Operating Expenses in 2002 and 2003			
	Budgeted	Allowable	Actual	Difference (Excess)
2002	$135,849,000	$137,396,700	$142,256,000	$4,859,300
2003	$137,508,000	$136,582,200	$155,456,000	$18,873,800

* Excludes Taxes, Fees and Special Assessments

Recommendations

1. Establish and maintain an effective system of internal controls over all aspects of NYRA operations, including competent controls over NYRA expenses.

2. Continue to search for ways to enhance NYRA revenue and to further decrease expenses.

3. Periodically revisit the newly designed controls over NYRA's cash receipts and automated revenue operations to ensure their proper application and effectiveness. Revise and/or strengthen these controls as necessary.

4. Should the IRS disallow the deduction of unpaid CIF interest, discontinue expensing CIF interest accordingly.

5. Revise NYRA's respective franchise fees for 2002 and 2003 based on our calculations, as illustrated in this report.

6. Use actual anticipated expenses rather than "tax-basis" expenses to develop a realistic budget for submission to the Board.

7. Develop guidelines for NYRA accounting staff to follow when categorizing expenses (e.g., promotional, extraordinary nonrecurring, etc.). Conform to these guidelines in identifying expenses that can legitimately be excluded from NYRA expenses subject to the 106 percent test.

8. Use total actual expenses to calculate both the 106 percent and 90 percent tests.

MAJOR CONTRIBUTORS TO THIS REPORT

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Charles E. Hayward
President
Chief Executive Officer

September 12, 2005

Mr. William P. Challice
Audit Director
Office of the State Comptroller
Division of State Services
State Audit Bureau
123 William Street - 21st Floor
New York, New York 10038

Re: Draft Audit Report 2005-S-3

Dear Mr. Challice:

On behalf of The New York Racing Association Inc. ("NYRA"), we provide this letter in response to your draft audit report (2005-S-3) of NYRA's annual franchise fee (the "Draft Audit") for calendar years 2002 and 2003.

In the Draft Audit, your office has expressed concern about NYRA's future financial viability. As you are aware, NYRA has restructured its management team and has hired a new President/Chief Executive Officer, Chief Financial Officer, Senior Vice President of Human Resources, Controller, Director of Internal Audit, Vice President of Mutuels and Director of Contracts and Procurement. In addition, virtually all of the key financial personnel have been replaced including the Assistant Controller and the Accounts Payable Manager.

NYRA has also taken measures to improve its financial position. As reflected in the 2004 audited financial statements, NYRA's total revenue grew by $4.0 million from 2003, with a corresponding increase in net revenue of $1.2 million. In addition, NYRA's total expenses for 2004 were approximately $5.0 million lower than in the prior year.

NYRA, under its new management team, will continue to produce improved financial results. To that end, NYRA is undertaking several initiatives to help improve its financial position (See Recommendation #2 of the Draft Audit). Such initiatives include:

- In the summer of 2004, NYRA worked in collaboration with the New York Thoroughbred Horsemen's Association (NYTHA) to secure a landmark business deal with the Television Games Network (TVG). This pivotal deal, made possible by the collaboration between NYRA, NYTHA, the New York City Off-Track Betting's (OTB) and the New York State Racing and Wagering Board (NYSRWB), benefited the entire New York racing industry by buttressing NYRA financially, enhancing NYRA's product placement in the national market place, and providing NYRA with the financial means to fund the NYRA horsemen's bookkeeper accounts maintained by NYTHA's membership.

NYRA's new cooperative partnership with its horsemen has produced other landmark developments in New York racing in the past year as well, including but not limited to: Race Day Monitoring Barns; race day CO2 testing; improvements to backstretch living conditions; and enhanced medical benefits for all backstretch workers.

- Starting next year, NYRA will partner with ESPN-ABC Sports in a lucrative agreement for the presentation of many of NYRA's key graded stakes races on national television, including the television ratings phenomenon – the NYRA Belmont Stakes.

- NYRA has reached out to its partners who operate the State's six regional off-track betting corporations to look beyond statutory structural flaws and work collaboratively to find projects of common interest that will benefit all parties. For the first time ever, NYRA has submitted a joint proposal with the Nassau and Capital regional OTB's to the NYSRWB for the creation of a player's reward program that will allow each entity to better market and capitalize on its individual account wagering businesses.

- In the near future, NYRA will work to expand its partnership with the New York OTB's: to consolidate and enhance account wagering services; expand and improve in-home television programming; and launch joint-marketing initiatives that will promote thoroughbred racing as one of New York's most storied, valuable, and accessible domestic products.

- The Breeders Cup Ltd., has selected NYRA's Belmont Park to serve as the host for the 2005 Breeders Cup Championship in October 2005, which will drive NYRA's handle, showcase NYRA's Belmont Park Racetrack, and further promote NYRA as a leader in the racing industry.

- NYRA has targeted sponsorship revenue as a significant new revenue source. For the first time, NYRA secured Argent Mortgage Company, LLC as the presenting sponsor for the 2005 Belmont Stakes for a fee of $500,000. A new position of Director of Sponsorship, Group Sales and Special Events has been created to grow this revenue opportunity.

- NYRA will resume construction this fall of a world-class video lottery (VLT) facility at Aqueduct Racetrack in conjunction with its partner MGM Mirage. The combination of world-class racing with world-class casino management will make NYRA's Aqueduct Racetrack a premier gaming destination located in the heart of the largest gaming feeder market in the nation. Success for NYRA will spell success for its partners, namely the

horsemen, the State of New York and the New York agriculture and racing industries at large. NYRA projects that it will contribute more than $400 million annually to fund education in the State of New York from VLT revenues and will enhance purse payments to horsemen and breeders by more than $50 million.

- NYRA's new management is focusing on what NYRA does better than any other racing company in the nation – the provision of world class thoroughbred racing 250-plus days a year, and through the employment of solid business analysis, better business practices, and progressive marketing, we will be able to correct and overcome the revenue deficiencies apparent in this draft audit.

Calculation of Franchise Fee (See Recommendations #5, 6 and 8 of the Draft Audit)

According to the provisions of the New York State Racing Law, NYRA has remitted to the State of New York the proper amount of franchise fees for 2002 and has calculated the franchise fee correctly for 2003; therefore, we must respectfully submit that no additional funds are owed to the State of New York.

The Draft Audit concludes that NYRA understated its franchise fee for 2002 and 2003 by $27.8 million. This conclusion is premised on the foundation that NYRA's actual operating expense exceeded its allowable expenses under Section 208(10) of New York's Racing, Pari-Mutuel Wagering and Breeding Law (the "Racing Law"). This premise, however, is incorrect because the Draft Audit assumes that the calculation pursuant to section 208(10) requires the use of Generally Accepted Accounting Principles ("GAAP") for determining expenses and revenues. The Racing Law, however, requires that this calculation be made using tax reporting expenses and revenue, which are found in NYRA's federal income tax return.

This position has been confirmed by NYRA's outside counsel and was expressed in a letter to you in response to Note 1 of the Audit Report 2002-S-31, dated March 21, 2005. NYRA has attached this letter hereto.

NYRA must also respectfully disagree with your premise that the franchise fee should be calculated from a starting basis of zero for the year 2003 for both the 90 percent and 106 percent tests. As stated in Section 208 of the Racing Law, "Entire adjusted net income shall be completed by adding to taxable income . . ." NYRA's taxable income for 2003 was a loss of $4,718.059. Therefore, the appropriate starting basis for these calculations is negative $4,718.059, not zero as your audit suggests.

Moreover, the audit seeks to disallow approximately $4 million in extraordinary and non-recurring items during the audit period. As we explained to your auditors, NYRA incurred these expenses in the course of legal representation during the investigations related to the indictment by the United States Attorney's Office ("USAO") and the investigations carried out by the New York Attorney General during the same time-period. As such, these expenses constitute extraordinary and non-recurring expenses because they are not expenses incurred in the normal operation of a racetrack. NYRA does not anticipate incurring these types of extraordinary expenses after its legal issues with the USAO have been resolved.

In addition, NYRA must respectfully disagree with the audit's disallowance of certain promotional items. Although unique to NYRA's operations, both the trophies and the Belmont Draw Breakfast are promotional in nature. The trophy presentations are an integral part of horse racing and the presentation of heirloom-quality trophies is the industry standard for top graded stakes races at premier racing facilities such as those owned and operated by NYRA. These trophy presentations attract sponsors who pay NYRA to be associated with the trophy presentations, attract top owners and trainers to participate in NYRA racing, and lend themselves to the promotion of future horse racing events far in excess of the cost of the trophy itself. In addition, special media events, such as the Belmont Stakes Draw Breakfast, attract national media coverage, which promotes the public's interest in the Belmont Stakes -- NYRA's biggest race of the year.

CIF Interest (See Recommendation #4 of the Draft Audit)

The IRS is currently conducting an audit for the period of 2000 to 2003. NYRA will comply with the findings of the IRS in regards to the deductibility of the CIF interest.

Internal Controls

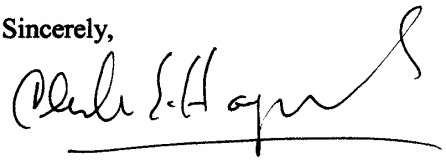
As indicated in the Draft Audit, NYRA has already begun presenting both GAAP and tax-based budgets to its Board of Trustees. NYRA will continue to provide the Board of Trustees these budgets, as well as the budgeted 90 percent and 106 percent test calculations performed on a tax basis, consistent with the relevant provisions of the Racing Law. (See Recommendation #6 of the Draft Audit).

NYRA is also in the process of working with an independent auditing firm to better document and strengthen its internal controls, consistent with best commercial practices. Moreover, NYRA has worked closely with your office in preparing its new Travel and Entertainment Policy and its Purchasing Policy and Procedures Manual. Included in these

policies will be guidelines for categorizing promotional, extraordinary and non-recurring items. (See Recommendations #1, 3 and 7 of the Draft Audit). NYRA's Internal Audit Department will conduct audits of the internal controls to ensure their proper application and effectiveness.

We hope that this detailed response addresses the concerns raised in the Draft Audit. NYRA looks forward to continuing to work with the State Comptroller's office in a constructive and cooperative manner.

Sincerely,



Charles E. Hayward

Attachment: 1. Letter to William P. Challice dated March 21, 2005

cc: Governor George E. Pataki
Joseph L. Bruno
Sheldon Silver
David A. Paterson
Charles Nesbitt
Honorable Owen H. Johnson
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WILLIAM BYRNE
SENIOR VICE PRESIDENT
CHIEF FINANCIAL OFFICER

March 21, 2005

Mr. William P. Challice
Audit Director
Office of the State Comptroller
Division of State Services
State Audit Bureau
123 William Street – 21st Floor
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Re: Audit Report 2002-S-31 - Note 1

Dear Mr. Challice:

In connection with your audit of the annual franchise fee of The New York Racing Association Inc. ("**NYRA**") for calendar years 2003 and 2004, you have asked for a response to Note 1 ("**Note 1**") in Appendix C of your audit report relating to calendar years 2000 and 2001 (the "**Audit Report**"). In Note 1, the agent writing the report (the "**Agent**") argues that NYRA should have used generally accepted accounting principles ("**GAAP**") rather than tax accounting principles to increase its taxable income by any expenses determined to be excessive pursuant to Section 208(10) of the Racing Law. NYRA contends that the approach espoused in Note 1 is inconsistent with the governing law and that increases to taxable income should be determined in accordance with tax accounting principles and not GAAP.

The overall structure of the franchise fee provisions in the Racing Law supports NYRA's position. Section 208(1) provides that the franchise fee that NYRA is required to pay the State is equal to NYRA's "entire adjusted net income" less two million dollars, which must be set aside and used exclusively to increase purses awarded to horses in races conducted by NYRA. "Entire adjusted net income" for this purpose is equal to NYRA's "taxable income (not including taxable income imputed to NYRA by the extension of debt)".[1] The words in the statute are "taxable income," not "net income before taxes," the analogous figure in GAAP.

[1] As discussed below, Section 208(1) provides for an addition to taxable income equal to any "operating expenses" in excess of 106% of the prior year's "operating expenses."

Aqueduct
Belmont Park
Saratoga

Confirming this conclusion, Section 208(2)(b) provides that "[i]f the taxable income of [NYRA] as returned to the United States treasury department is changed or corrected by the commissioner of internal revenue, or if an amended federal return is filed, [NYRA] shall notify the [state tax] commission [of the change and] . . . the tax commission may issue an assessment of any additional tax due." (emphasis added). By linking "taxable income" to amounts "returned" to the United States treasury, the statute makes clear that "taxable income" must be determined by reference to federal income tax accounting principles. Thus, the Audit Report does not dispute that the expenses taken into account in determining taxable income under Section 208(1) are necessarily those expenses that are deductible under federal income tax accounting principles. Indeed, in its own 1998 audit report (98-S-6 at 1, 7), the Comptroller's Office acknowledged that the "criteria for assessing allowable expenses for franchise fee purposes are based on the Federal IRS Code."

The Racing Law contains two express limitations on NYRA's expenses, both of which provide that NYRA's "taxable income" must be increased by the amount of excess expenses. The first, in Section 208(1), generally increases taxable income by operating expenses in excess of 106% of prior year operating expenses. The second, which is at issue in Note 1, is contained in Section 208(10). That provision limits NYRA's "total expenses" (excluding certain taxes) to 90% of the "revenues available to such association for operations pursuant to" Section 229. There are at lease three reasons for concluding that "total expenses" in Section 208(10) refers to expenses determined under tax accounting principles and does not include expenses that are recognized for purposes of GAAP but not tax accounting.

First, as the Agent concedes in Note 1, Section 208(10) provides that the amount by which actual expenses exceed allowed expenses "shall be added to the *taxable income* in computing 'entire adjusted net income' for use in calculating the franchise fees . . ." (emphasis added). It does not make sense to add GAAP expenses to a taxable income figure for purpose of arriving at an increased taxable income figure. If the statute intended such an apple-to-oranges approach, it would have had to make an express provision for that. It did not.

Second, Section 208(10), requires NYRA to prepare an annual budget "covering all the expenses planned to be incurred during such year and a plan of operation" and requires that the "form of such plan of operation shall be subject to an agreement between the board [of trustees of NYRA] and [NYRA itself]." NYRA agrees each year on its budget for expenses with its Board of Trustees, [8 out of the [28] of whom are appointed by the Governor.] In each of the years at issue, NYRA and its Trustees agreed on a budget in which both NYRA's operating expenses under Section 208(1) and its "total expenses" under Section 208(10) were computed in accordance with *tax* accounting principles. Imposing an additional franchise fee based on the use of GAAP would penalize a taxpayer that complied with a budget prepared in accordance with the statute.

Third, using GAAP expenses to determine an addition to "taxable income", would create a bias toward taxation at a rate of greater than 100%, a result the Legislature could not have intended. This is because even in cases where the taxpayer incurs no excess expenses as

determined under tax accounting, Section 208(1) effectively imposes a 100% tax: the only portion of taxable income that is not paid over to the state in the form of a franchise fee is the two million dollars that has to be set aside for the horsemen's purse. Any additional expense added back to taxable income will push the tax rate over 100%. In most years, GAAP will result in a higher expense figure than tax because it requires the accrual of expenses, such as for pensions and other retiree benefits, that are not yet sufficiently certain to occur to be deductible for tax purposes.[2] Consequently, if NYRA stays within the budget approved by its Board and Section 208(10) is interpreted in accordance with tax accounting principles, it will pay an effective tax of 100% and no more. If Section 208(10) is interpreted to require adding excess GAAP expenses to taxable income, there frequently will be a risk of double taxation, first under Section 208(1) and again under Section 208(10), resulting in taxation at a rate of greater than 100%.

In Note 1, the Agent mistakenly argues that the "Legislature expressly and deliberately chose to employ a formula to define excessive spending using language that is not based upon tax concepts." The Agent overlooks the fact that, as noted above, the statutory language in Section 208(10) does in fact expressly "use language . . . based upon tax concepts" – by incorporating into Section 208(10) the terms "entire adjusted net income" and "taxable income," terms from Section 208(1) that the Agent concedes are based on tax concepts. In addition, the discussion in Note 1 does not identify any "express" reference to GAAP accounting in Section 208(10) or elsewhere in Section 208.

The Agent contends that "total expenses" must include GAAP expenses because the only exclusions from "total expenses" are "taxes, fees or special assessments." The Agent makes a similar argument with respect to "operating expenses." The argument appears to be that "total expenses" includes all expenses under any system of accounting and that since GAAP expenses were not expressly excluded, they must have been included. The difficulty with this argument is that "total expenses" is a concept that is used *within* both tax accounting and GAAP. "Total expenses" in tax accounting by definition does not include expenses as defined in GAAP and "total expenses" in GAAP does include expenses as defined in tax accounting. The same is true of the term "operating expenses." The use of the terms "total expenses" and "operating expenses" thus is not evidence of an intent to determine expenses under GAAP. The fact that

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[2] As the United States Supreme Court has observed, consistent with its purpose of preventing investors and others from being misled as to the amount of income and in contrast to tax accounting, GAAP tends to understate income and, implicitly, overstate expenses:

> [F]inancial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light . . . .

Thor Power Tool, Co. v. Comm'r, 439 U.S. 522, 542 (1979).

GAAP expenses are not listed along with "taxes, fees or special assessments" is not evidence that they were intended to be included.

The Agent observes that federal income tax law limits the deductibility of "travel and entertainment" expenses and concludes on this basis that those expenses would escape the limitation under Section 208(10) if NYRA's position were correct. The Agent is mistaken. 50% of travel and entertainment expenses are allowed for federal income tax purposes, and that portion of the expenses is fully subject to the Section 208(10) limitation under NYRA's interpretation. The non-deductible portion of the expenses is subject to discipline under Section 208(1). The fact that it is not deductible means that, even though it is an out-of-pocket cost, it does not reduce taxable income – or NYRA's franchise fee – under Section 208(1). Thus, in a profitable year, NYRA is out-of-pocket twice for the non-deductible portion of the expense even before Section 208(10) is applied: once to pay the expense itself and again to pay the franchise fee under Section 208(1). To impose another increase under Section 208(10) would result in double tax, for which there is no evidence of Legislative intent.

It also is worth noting that the travel and entertainment expenses, which the Audit Agent focuses on, account for less than 1% of the difference between book and tax expenses. Most of the GAAP-tax difference in the years 2000 and 2001 is attributable to pensions and retiree benefits. As discussed above, adding those GAAP expenses to taxable income results in double taxation at a rate of greater than 100%, even where the taxpayer stays within a budget prepared in accordance with the statute, a result the Legislature cannot have intended.

The Agent's reliance on maxims of statutory construction is misplaced. *See* Audit Report at C-3, n. 4. NYRA agrees that primary consideration is to ascertain and give effect to the intention of the Legislature and that legislative intent is to be ascertained from the language used, which is to be literally construed according to its most obvious and natural sense. But, there is no evidence in the language of Section 208 that the Legislature intended to shift back and forth between accounting systems or to create a bias toward double taxation at a rate of greater than 100%. The overall structure and express language of Section 208 and Section 208(10) incorporate federal income tax accounting concepts. "Total expenses" in Section 208(10) should be determined in accordance with tax accounting principles.

Sincerely,

J. William Byrne

cc: Charles Hayward
Patrick L. Kehoe
Neil Getnick
Richard Dircks