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OFFICE OF THE
NEW YORK STATE COMPTROLLER

DIVISION OF STATE
GOVERNMENT ACCOUNTABILITY

NEW YORK RACING ASSOCIATION, INC.

AUDIT OF THE ANNUAL FRANCHISE FEE FOR CALENDAR YEARS 2004 AND 2005

Report 2006-S-111

AUDIT OBJECTIVE

The objective of this audit was to determine whether the New York Racing Association Inc. (NYRA) operated and calculated its annual franchise fee, for calendar years 2004 and 2005, in compliance with the Racing, Pari-Mutual Wagering and Breeding Law (Racing Law).

AUDIT RESULTS - SUMMARY

NYRA is required to pay an annual franchise fee to the State and operate in a sound, economical, and efficient manner. Our prior audits of the franchise fee have consistently identified deteriorating financial conditions at NYRA, underpayments of the franchise fee, and unsupported or inappropriately categorized expenses. We found similar conditions in this audit.

The franchise fee is to be calculated in accordance with provisions outlined in the Racing Law. The fee consists of NYRA's adjusted net income less $2 million, which is to be allocated for horsemen's stakes and purses. If the adjusted net income for the year is less than $2 million, the entire amount is to be allocated for horsemen's stakes and purses, and NYRA pays no franchise fee to the State that year. For calendar year 2004, NYRA officials calculated the franchise fee to be $0. For calendar year 2005, NYRA officials calculated the franchise fee to be $3.34 million and allocated $2 million of this amount as required for stakes and purses. However, NYRA did not remit the remaining $1.34 million as required for the franchise fee. [Page 5]

We have historically disagreed with the methodology NYRA employs to calculate the annual franchise fee. Our major area of disagreement focuses on NYRA's use of tax basis expenses versus actual expenses when determining allowable expenses for the "106 percent" and "90 percent" tests, which are components of the franchise fee calculation. Using actual expenses, we determined that the franchise fees calculated by NYRA officials for 2004 and 2005 were understated by a combined total of $10.9 million. [Pages 7-8]

According to statute, NYRA is to perform certain year-end tests of expenses (106 and 90 percent tests) to determine its entire adjusted net income. NYRA officials continue to use tax-basis expenses when calculating statutory adjustments to the fee which allows a significant amount of NYRA expenses to escape the budget and expense limitations set forth in statute. For example, on NYRA's Federal corporate tax return for 2004, it listed total tax-basis operating expenses of $161.6 million, while it's certified financial statements for this period reported actual total operating expenses of $168.9 million, a difference of $7.3 million. Likewise, for calendar year 2005, NYRA's tax-basis operating expenses totaled $146.4 million, while it's certified actual operating expense totaled $167.3 million, a difference of $20.9 million. It was NYRA's actual, and not tax basis, expenses which have resulted in its current dire financial condition. [Pages 8-9]

According to its certified financial statements, as of December 31, 2005, NYRA owed $74.5 million to the Non-Profit Racing Association Oversight Board for prior Thoroughbred Racing Capital Investment Fund (CIF) loans and accrued interest. It has been NYRA's practice to deduct accrued CIF interest on its annual Federal corporate tax returns even though it has not been paying such interest. The amount of accrued interest deducted by NYRA for calendar years 2004 and 2005 totaled $2.6 million and $2.7 million, respectively, contributing to a corresponding reduction in taxable income. Based upon NYRA's financial condition and revenue and

expense trends 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. In fact, on November 2, 2006, NYRA filed a petition for bankruptcy protection. Further, the State loaned NYRA more than $31 million to enable it to continue operating while under the protection of the U.S. Bankruptcy court, and pursuant to a proposed "Memorandum of Understanding" (MOU) between the State and NYRA, will give an additional $75 million and other financial consideration to enable it to emerge from bankruptcy and continue its racing operations until other revenues become available, if the franchise is re-awarded and the proposed MOU is approved by the Legislature. [Pages 12-13]

One of our prior audits questioned the appropriateness of NYRA's deduction of CIF interest expense and recommended that NYRA obtain an IRS ruling on this matter. If the IRS disallowed the deductions, the effect would be to increase NYRA's Federal corporate taxable income for calendar years 2000 through 2003 by $7.6 million. There would be no impact on NYRA tax liability or the franchise fee for 2004 and 2005 because of the effect of a multi-million dollar reported net loss for the 2004 tax return and because of the effect of a multi-million dollar carry forward operating loss for the 2005 tax return. [Page 12]

In 2003, at a time when the IRS initiated its own multi-year comprehensive audit of NYRA's Federal corporate tax returns, NYRA did, in fact, seek an IRS ruling on the deductibility of the interest. According to an IRS Notice of Proposed Adjustment(s) issued in the summer of 2007, the IRS agrees that NYRA should not have deducted the CIF interest on any of its Federal corporate tax returns prepared after 1993. Although the Notice acknowledged the Office of the State Comptroller's position that the interest is not deductible because it appeared that NYRA had no intention of paying it, the IRS ultimately concluded that the underlying debt did not exist after 1993. Overall, the effect of this Proposed Adjustment is to increase NYRA's taxable income by about $23 million for 2000 through 2005. [Page 12]

Initially, the IRS imposed additional adjustments upon NYRA's prior years tax returns which adjustments would have increased NYRA's total outstanding Federal corporate tax liability to $1.6 billion, including interest and penalties. However, the IRS has recently advised NYRA that it anticipates that its claim against NYRA will fall below $25 million. [Page 12]

Because NYRA is in a bankruptcy proceeding and had previously indicated that it was appealing the IRS' initial ruling, its final liability to the IRS remains unclear. [Pages 12-13]

In September 2007, the Governor proposed a Memorandum of Understanding (MOA) between the State and NYRA, which, if approved by the Legislature, would re-award the racing franchise to NYRA, for a period of 30 years, with forgiveness of any existing debt NYRA owes to the State. [Page 13]

Our audit report contains six recommendations.

This report, dated December 7, 2007, is available on our website at: http://www.osc.state.ny.us.
Add or update your mailing list address by contacting us at: (518) 474-3271 or
Office of the State Comptroller
Division of State Government Accountability
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BACKGROUND

The New York Racing Association, Inc., 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 revenues in the form of a pari-mutuel tax and a franchise fee. As of calendar year 2003, NYRA has also been required to remit a regulatory fee to the New York State Racing and Wagering Board (Racing and Wagering), NYRA's State regulator. 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."

Under its current structure, NYRA is governed by a 28 member Board of Trustees. Of the current 20 trustees, seven were appointed by either the Governor or the State Legislature and the remaining 13 trustees were elected by the Board. Most trustees 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.

During 2001 and 2002, NYRA, as an organization, and about 20 members of its management and staff, were the subject of investigations performed by the State Attorney General and the United States Department of Justice. In December 2003, NYRA was allowed to enter into a Deferred Prosecution Agreement on the condition that it would undertake significant administrative and fiscal reforms and hire a new management team to direct the reforms. On March 1, 2004, an Independent Private Sector Inspector General was appointed by a Federal Judge as NYRA Monitor. The Court imposed monitorship ended on July 24, 2005 at which time all criminal charges against NYRA were dismissed.

NYRA's franchise, which has previously been extended twice by the State Legislature, is scheduled to expire on December 31, 2007. A Request for Proposal process was used to solicit bids for the new franchise, and on September 4, 2007 the Governor announced that NYRA was his choice, subject to legislative approval, to retain the racing franchise. According to a Governor's Office press release, the Governor proposes awarding the franchise for the Video Lottery Terminals at the track facilities to a separate operator, which would also be subject to legislative approval.

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 non-NYRA tracks (e.g., Santa Anita). Wagers placed at a NYRA facility are classified as "on-track" handle, and wagers placed at other locations, such as Off Track Betting parlors and other racetracks both in and out of state, are classified as off-track handle. On-track handle is subject to a pari-mutuel tax assessed by New York State, which is calculated as a percentage of wagers. For 2004 and 2005, NYRA's pari-mutuel tax totaled $8.8 million and $8 million, respectively. This tax revenue accounts for most of the direct revenue provided to the State by NYRA.

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 via loans to finance approved capital projects (e.g., roof repairs, ventilation systems, etc.). According to statute, 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, 2005, NYRA reported that it owed $74.5 million in long-term obligations to CIF for prior loans and related interest. In 2005, legislation was enacted to replace CIF with a non-profit Racing Association Oversight Board (Oversight Board). The Oversight Board assumed all CIF responsibilities including collection of the franchise fee.

NYRA's annual franchise fee is to be calculated in accordance with provisions outlined in the Racing Law. According to these provisions, the fee consists of NYRA's entire adjusted net income (defined below) less $2 million, which is to be allocated for horsemen's stakes and purses. If the adjusted net income for the year is less than $2 million, the entire amount is to be allocated for horsemen's stakes and purses, and NYRA pays no franchise fee to the State 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. For calendar year 2004, NYRA officials calculated the franchise fee to be $0. For calendar year 2005, NYRA officials calculated the franchise fee to be $3.34 million. However, it limited its actual payment to the $2 million purse contribution. It did not remit the remaining $1.34 million to the Oversight Board as it classified this portion of the fee as pre (bankruptcy) petition debt.

Our prior audits of the franchise fee (for calendar years 2000 and 2001 - Report 2002-S-31, issued September 17, 2003; and for calendar years 2002 and 2003 - Report 2005-S-3, issued February 17, 2006) have consistently identified a deteriorating financial condition at NYRA, underpayments of the franchise fee due to NYRA's calculation methodology, and unsupported or inappropriately categorized expenses.

On November 2, 2006, seeking relief from its mounting debt, NYRA filed a petition for bankruptcy protection. Under Court supervision, NYRA hopes to develop a plan to reorganize and emerge from bankruptcy. According to the Governor, the State will assist NYRA in this endeavor.

AUDIT FINDINGS AND RECOMMENDATIONS

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 for the support of (State) government. To this end, provisions in the Racing Law prescribe certain budget restrictions and franchise fee adjustments based on excess spending. In our prior audits of the franchise fee, we addressed NYRA's continuously deteriorating financial condition and found NYRA was not operating in a sound, economical and efficient manner. As a result, NYRA operations consistently result in a deficit. As illustrated in Table 1, NYRA's financial condition has continued to deteriorate resulting in a bankruptcy petition. Further, to date, the State loaned NYRA more than $31 million in financing to enable it to continue operating while under the protection of the U.S. Bankruptcy court, and pursuant to a proposed "Memorandum of Understanding"(MOU) between the State and

Table 1: NYRA's Financial Trends (in thousands)					
	2002	**2003**	**2004**	**2005**	**2006**
Total Wagering	$3,627,573	$3,603,816	$3,687,573	$3,450,493	$3,455,809
Pari-mutuel Tax	$10,138	$9,348	$8,754	$8,005	$7,763
Racing and Wagering Fee	N/A	$1,393	$1,795	$1,969	$2,087
Net Revenues (1)	$152,663	$151,758	$152,943	$152,222	$143,466
Total Expenses	$159,449	$173,892	$168,931	$167,256	$161,296
Net (Loss) Income	($6,786)	($22,134)	($15,988)	($15,034)	($17,830)
Franchise Fee (2)	$3,599	$0	$0	$3,344	$4,061
Accumulated Deficit (3)	($58,268)	($86,167) (4)	($102,155)	($117,189)	($135,019)

N/A - Not Applicable

Notes:

(1) Total wagers less payouts to winning bettors, commissions and other statutory payments.
(2) Includes $2 million dedicated to stakes and purses. Franchise fees calculated by NYRA for 2005 and 2006 and illustrated above are greater than the actual amounts paid.
(3) Accumulated expenses in excess of accumulated revenues received over a corresponding period.
(4) Includes prior-period adjustment of ($5,765.00).

NYRA, will give an additional $75 million and other financial consideration to enable it to emerge from bankruptcy and continue its racing operations until other revenues become available, if the franchise is re-awarded and the proposed MOU is approved by the Legislature.

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 obligated to comply with a number of specific budgetary requirements. The Racing Law also requires NYRA's Board of Trustees to reject NYRA's proposed operating budget if budgeted expenses exceed certain statutory limitations.

During the audit period, NYRA's trustees approved the operating budgets for both 2004 and 2005 since NYRA's budgeted expenses as presented did not exceed the noted statutory limitations. However, as explained later in this report, until 2005, NYRA's budgets have only included budgeted tax-basis expenses (those expenses which are deductible on its Federal corporate tax return) - instead of NYRA's actual expenses prepared in accordance with generally accepted accounting principles (GAAP). Due to limits imposed by the Tax Code on certain expenses, NYRA's tax-basis expenses, in the aggregate, have been consistently lower than its actual expenses. Thus, until 2005, NYRA's trustees did not get an accurate picture of NYRA's budgeted expenses in the budget proposal.

In addition, NYRA officials do not exclude statutory payments, such as stakes and purses, from gross revenues to determine their available revenues. Statutory payments are

based on a percentage of handle mandated by law and are not available to NYRA officials as revenue. Instead, NYRA officials add their anticipated statutory payments to proposed operating expenses further distorting the required expense to revenue ratio test submitted for budget approval. In fact, had NYRA officials used anticipated actual expenses and excluded statutory payments from anticipated available revenues when calculating their required expense to revenue ratio, NYRA's trustees should not have approved the operating budget for calendar year 2004 without performing the additional tests outlined in the Law.

According to NYRA officials, they consider some statutory allotments, such as stakes and purses, to be available revenue until a final year-end calculation of required payments is made. They note that actual payments may differ slightly from the statutory allotment due to unforeseen events, such as rain-outs, where scheduled racing does not take place. They do agree, however, that most, if not all, of the statutory allotments will eventually be paid and therefore not available to them as revenue.

Our prior audits recommended that NYRA officials adopt a realistic budget approach that reports actual, rather than tax-basis, expenses so the trustees can make informed decisions when reviewing NYRA's budgets. We found that commencing with the calendar year 2005 budget, the second year of our audit scope, NYRA officials now illustrate anticipated actual (GAAP) expenses in their budget application to the Trustees for informational purposes. However, they continue to use budgeted tax-basis expenses and incorrectly categorize statutory payments, when performing the required expense to revenue ratios necessary for budget approval.

Calculation of Annual Franchise Fee

The Racing Law defines NYRA's franchise fees as its entire adjusted net income which is calculated as follows:

<u>Computing NYRA's Entire Adjusted Net Income (Franchise Fee)</u>

NYRA's Federal Corporate Taxable Income
+ Excess Expenses defined as:

(a) Operating expenses (excluding specific expense categories such as interest, real estate taxes, advertising, promotional, extraordinary and nonrecurring) that exceed 106 percent of prior year expenses (106 percent test); and

(b) Operating expenses (less taxes and special assessments) that exceed allowable expenses as defined during the budget approval process (90 percent test).

= NYRA's Entire Adjusted Net Income

The following table illustrates the franchise fees calculated by NYRA for the audit period as well as the revised fees calculated as a result of our audit:

Table 2: Audit Adjustments to NYRA Franchise Fee for 2004 and 2005			
	2004	2005	Total
Franchise Fee Reported by NYRA (1)	$0	$3,344,000	$3,344,000
Adjustments per 106 percent test	$0	$0	$0
Adjustments per 90 percent test (2)	$14,268,000	$0	$14,268,000
Audited Franchise Fee (3)	$14,268,000	$0	$14,268,000
Total Fee Increase/Decrease	$14,268,000	$(3,344,000)	$10,924,000

(1) 2005 figure includes $2 million paid to stakes and purses.
(2) See subsequent text for details of 90 percent test calculation and methodologies used for 2004 and 2005.
(3) This figure includes $2 million that should be paid to Stakes and Purses for 2004.

We have historically disagreed with the methodology NYRA uses to calculate the annual franchise fee. Our major area of disagreement focuses on NYRA's use of tax-basis expenses versus actual expenses when determining allowable expenses for the 106 and 90 percent tests. The audited franchise fee illustrated in the previous table recalculates the fee using actual expenses in the 106 and 90 percent tests. As a result of our audit and recalculation, we determined that the franchise fees calculated by NYRA officials for 2004 and 2005 were understated by a combined total of $10.9 million.

Tax-Basis Expenses vs. Actual Expenses

According to statute, NYRA is to perform certain year-end tests of expenses (106 and 90 percent tests) to determine its entire adjusted net income. The tests were designed to help ensure a reasonable revenue for the support of (State) government by preventing excessive expenses. Contrary to the recommendations in our prior audits of the franchise fee, NYRA officials continue to use tax-basis expenses when calculating statutory adjustments to the fee.

According to a narrative prepared by NYRA officials, using tax-basis expenses is the appropriate way to calculate both the 106 percent test and the 90 percent test in determining NYRA's entire adjusted net income. According to these 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 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 (e.g. NYRA) who complied with a budget prepared in accordance with the statute (as interpreted by NYRA).

We disagree with NYRA's assertions. It is clear that the legislative intent behind the imposition of the 106 and 90 percent tests (illustrated in detail below) was to limit the amount of expenses incurred by NYRA. Using only tax-basis expenses allows a significant amount of NYRA expenses to escape the budget and expense limitations set forth in statute. For example, on NYRA's Federal corporate tax return for 2004, it listed total tax-basis operating expenses of $161.6

million, while its certified financial statements for this period reported total operating expenses of $168.9 million, a difference of $7.3 million. Likewise, for calendar year 2005, NYRA's tax-basis operating expenses totaled $146.4 million, while its certified operating expense totaled $167.3 million, a difference of $20.9 million. It was NYRA's actual, and not tax basis, expenses which have resulted in its current dire financial condition. Such a result could not have been intended by the Legislature.

106 Percent Test

The 106 percent test is intended to control operating expenses that are within NYRA's managerial discretion exclusive of those expenses intended to enhance revenue. The Racing Law specifies which expense items (e.g., interest, real estate taxes, advertising, promotional, and certain extraordinary and nonrecurring expenses) are excluded from the 106 percent calculation.

According to statute, NYRA is to compare its operating expenses for the current year, after exclusions, to operating expenses incurred during the immediate prior year. If current year expenses exceed 106 percent of the prior year's expenses, the excess is to be added on to NYRA's Federal corporate taxable income toward arriving at NYRA's franchise fee. Due to its financial condition, NYRA has been reducing its overall spending each year during the audit period. As a result, the 106 percent tests for both 2004 and 2005 did not result in any additions to the franchise fee using either tax-basis or actual expenses. However, we did identify several improvement opportunities for NYRA's categorizing of expenses relevant to the test.

By definition, promotional expenses, such as advertising, are those incurred to promote/enhance business income. Extraordinary and nonrecurring expenses are those that are not incurred in the normal course of business and only happen rarely as a result of unusual circumstances.

Our prior reports have criticized NYRA for not having guidelines for staff to follow when recording and categorizing such expenses. We note that NYRA has made some progress in this area by establishing specific ledger accounts that by definition should include only promotional and advertising-related expenses (e.g., web site maintenance, public relations, etc.). However, by not providing examples of specific expenses that should be included in these accounts, there is still room for staff misinterpretation of what expenses should be charged to these accounts. Further, NYRA continues to categorize Horsemens Trophies and Press Lunches as promotional. As noted in our prior reports, neither of these expenses is addressed to, nor otherwise affects, the wagering public.

In addition, NYRA has yet to prepare any written guidelines defining extraordinary and nonrecurring expenses. For example, in 2005, NYRA categorized $207,800 for a consultant as extraordinary and nonrecurring. NYRA utilizes the services of consultants on a continuous basis. Thus, these particular expenses are clearly neither extraordinary nor nonrecurring. NYRA officials need to develop clear guidelines for categorizing expenses to ensure proper application of the 106 percent test in future years where the amounts of such expenses may affect the franchise fee calculation.

90 Percent Test

According to the Racing Law: "In any year in which actual operating expenses are greater than the operating expenses allowed … 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."

The process of determining "allowable" expenses begins during the budget approval process. As noted above, NYRA management must submit an annual budget to its Board of Trustees for approval. To obtain Trustee approval, in general, budgeted expenses (less taxes, fees and special assessments) may not exceed 90 percent of anticipated available revenues. For calendar years 2004 and 2005, as well as for the four years covered in our two immediate prior audits (2000 through 2003), as noted previously, NYRA used tax-basis expenses when performing this test. For each of these years excluding 2005, the illustrated budgeted expenses did not exceed 90 percent of the anticipated available revenues. Thus, NYRA's Board of Trustees systematically approved the budgets for each of these years, and the year-end tests of allowable expenses were performed by multiplying actual year end revenues by 90 percent. Any year-end expenses above that amount would be added to the franchise fee. Using tax-basis expenses, NYRA's year-end 90 percent test calculations for these periods did not result in any franchise fee add-ons. Since projected actual expense figures were not presented with NYRA's budget proposals for 2000 through 2004, we concluded that we could not perform an accurate budgeted expense to anticipated available revenue test for these years. As such, we assumed for budget purposes, that actual expenses did not exceed anticipated available revenues and similarly to NYRA compared year-end expenses to 90 percent of year-end revenues to determine whether any franchise fee add-ons were necessary. However, unlike NYRA, we used NYRA's year-end certified actual expenses for each of these years resulting in the $14.3 million adjustment noted in the following table for 2004, and the multi-million dollar adjustments noted in our prior reports.

Where budgeted expenses exceed 90 percent of anticipated available revenues when preparing NYRA's proposed budget, additional tests must be satisfied before the Board of Trustees can approve the budget. In this case, the percentage increase in budgeted expenses when compared to the prior year's actual expenses may not exceed the percentage increase in anticipated available revenues when compared to the prior year's actual available revenue. Further, year-end allowable expenses would be calculated by multiplying the actual expenses for the prior year by the percentage increase in anticipated available revenues when compared to prior year's actual available revenues. Any year-end expenses exceeding this amount would be added to the franchise fee.

The following table illustrates our audit calculation of the year-end 90 percent test. As illustrated, NYRA should have increased its franchise fees for 2004 by $14.2 million.

	Calendar Years	
	2004	2005
Budgeted Expenses	Only Tax-basis Figures Available	$151,943,000
Anticipated Available Revenue	$151,055,000	$157,524,000
Budgeted expenses as a percentage of anticipated available revenues	Could Not Determine	96.5%
Pass 90% Test	Not Applicable	No
Prior Year (Unaudited) Actual Expenses for Budget Test Purposes	$141,752,000	$153,570,000
Percentage increase - budgeted expenses to actual prior year expenses	Only Tax-basis Figures Available	-1%
Prior Year (Unaudited) Actual Available Revenue for Budget Test Purposes	$152,893,000	$154,491,000
Percentage increase - anticipated available revenues to prior year actual available revenues	Not Applicable	+2%
Should budget have been approved?	Could Not Determine	Yes
Year-End Allowable Expenses	$137,604,000	$156,641,000
Certified Actual Year End Expenses	$151,872,000	$153,288,000
Excess Expenses	$14,268,000	-0-

Unpaid CIF Interest

As of December 31, 2005, according to NYRA's certified financial statements, NYRA owes $74.5 million to the Oversight Board for prior CIF loans and accrued interest. It has been NYRA's practice to deduct accrued CIF interest on its annual Federal corporate tax returns even though it has not been paying it. The amount of accrued interest deducted by NYRA for calendar years 2004 and 2005 totaled $2,573,652 and $2,690,374, respectively, contributing to a corresponding reduction in taxable income.

According to the U.S. Tax Code, which governs Federal tax return preparation, 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. To qualify for such deduction, the expense has to be actually owed and reasonably estimated. If both of these conditions are met, the Tax Code permits this deduction unless there is no substantial expectation that payment would or could be made.

NYRA has not made any payments on this accrued interest since 1993, clearly illustrating that NYRA has no intention of making these payments. In addition, based upon NYRA's financial condition and revenue and expense trends noted previously, 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. In fact, on November 2, 2006, NYRA filed a petition for bankruptcy protection. Further, the State loaned NYRA more than $31 million in financing to enable it to continue operating while under the protection of the U.S. Bankruptcy court.

One of our prior audits questioned the appropriateness of NYRA's deduction of CIF interest expense and recommended that NYRA obtain an IRS ruling on this matter. If the IRS disallowed the deductions, the effect would be to increase NYRA's Federal corporate taxable income for calendar years 2000 through 2003 by $7.6 million. There would be no impact on NYRA tax liability or the franchise fee for 2004 and 2005 because of the effect of a multi-million dollar reported net loss for the 2004 tax return and because of the effect of a multi-million dollar carry forward operating loss for the 2005 tax return.

In 2003, at a time when the IRS initiated its own multi-year comprehensive audit of NYRA's Federal corporate tax returns, NYRA did, in fact, seek an IRS ruling on the deductibility of the interest. According to an IRS Notice of Proposed Adjustment(s) issued in the summer of 2007, the IRS agrees that NYRA should not have deducted the CIF interest on any of its Federal corporate tax returns prepared after 1993. Although the Notice acknowledged the Office of the State Comptroller's position that the interest is not deductible because it appeared NYRA had no intention of paying it, the IRS ultimately concluded that the underlying debt did not exist after 1993. Overall, the effect of this Proposed Adjustment is to increase NYRA taxable income by about $23 million for 2000 through 2005.

Initially, the IRS had imposed additional adjustments against NYRA's prior years tax returns which would have increased NYRA's total outstanding Federal corporate tax liability to $1.6 billion, including interest and penalties. However, the IRS has recently advised NYRA that it anticipates that its claim against NYRA will fall below $25 million.

Because NYRA is in a bankruptcy proceeding and had previously indicated that it was appealing the IRS' initial ruling, its final liability to the IRS remains unclear.

In September 2007, the Governor proposed a Memorandum of Understanding between the State and NYRA which, if approved by the Legislature, would re-award the racing franchise to NYRA, for a period of 30 years, with forgiveness of any existing debt NYRA owes to the State.

Recommendations

1. Use anticipated actual, not tax-basis, expenses when preparing NYRA's annual budgets for Trustee approval.

2. Exclude appropriate amount of statutory payments (e.g., stakes and purses) when calculating available revenues.

3. Reject proposed budgets where GAAP-based expenses exceed the limitations outlined in the Racing Law.

4. Use actual expenses when performing the 106 and 90 percent tests.

5. Develop guidelines for NYRA accounting staff to follow when categorizing expenses (e.g., promotional, extraordinary nonrecurring, etc.) detailing specific examples of allowable expenses and excluding unrelated expense categories. Conform to these guidelines when performing the 106 percent test.

6. Revise NYRA's respective franchise fees for 2004 and 2005 based on our calculations, as illustrated in this report.

AUDIT SCOPE AND METHODOLOGY

We examined NYRA's franchise fee calculations and associated operations for calendar years 2004 and 2005, and analyzed NYRA's financial trends for the five years ended December 31, 2006. The objectives of our financial audit were to determine whether NYRA operates and calculates its annual franchise fee in compliance with the Racing Law.

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 traced each major account on NYRA's tax return to the relevant year end trial balance and supporting payment documentation. In addition, we statistically selected a sample of 50 paid expense transactions to determine whether they were supported and categorized appropriately. We also 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) for the audit scope period and met with the Oversight Board regarding issues relevant to the franchise fee. Lastly, we recalculated NYRA's franchise fee obligation for the audit period using our audit results.

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. 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 functions do not affect our ability to perform independent audits.

AUTHORITY

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.

REPORTING REQUIREMENTS

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 A.

NYRA officials continue to disagree with our methodology for calculating the franchise fee. The specific positions of both NYRA and the Office of the State Comptroller are spelled out in this report and our prior audits (Audit of the Annual Franchise for Calendar Years 2002 and 2003 - Report No. 2005-S-3, issued February 17, 2006; and Audit of the Annual Franchise Fee for Calendar Years 2000 and 2001 - Report No. 2002-S-31, issued September 17, 2003).

Within 90 days of the final release of this report, we request that NYRA officials report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and, if not, the reasons therefor.

CONTRIBUTORS TO THE REPORT

Major contributors to this report include William Challice, Frank Patone, Stu Dolgon, Sal D'Amato, Ira Lipper, Anthony Carlo, Elijah Kim and Sue Gold.

APPENDIX A - AUDITEE RESPONSE

THE NEW YORK RACING ASSOCIATION INC. P.O. Box 90, Jamaica, New York 11417-0090

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CHARLES E. HAYWARD
PRESIDENT
CHIEF EXCUTIVE OFFICER

December 4, 2007

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 2006-S-111

Dear Mr. Challice:

On behalf of The New York Racing Association Inc. ("NYRA"), we provide this letter in response to your draft audit report (2006-S-111) of NYRA's annual franchise fee (the "Draft Audit") for calendar years 2004 and 2005.

The Draft Audit misrepresents the funding provided to NYRA by the State. The Draft Audit states "Further, the State has given NYRA more than $31 million in financing to enable it to continue operating while under the protection of the U.S. Bankruptcy court, and pursuant to a proposed "Memorandum of Understanding" (MOU) between the State and NYRA, will give an additional $75 million if the franchise fee (sic) is re-awarded and the proposed MOU is approved by the Legislature." This statement is inaccurate. The State loaned NYRA $31 million which is due in June 2008. This loan is secured by all of NYRA interests, including the land. NYRA was prepared to move forward with private financing, however the State objected to such financing. Furthermore, the MOU states clearly that the State will recoup these funds from the Video Lottery Terminal Operator. *1

The Draft Audit states "…we addressed NYRA's continuously deteriorating financial condition financial condition and found NYRA was not operating in a sound, economical and efficient manner." This is statement cannot be further than the truth. On page 9 of the Draft Audit, it states that "…NYRA has been reducing its overall spending each year during the audit period." Furthermore, NYRA has demonstrated to The Office of the State Comptroller, that the business model has moved from 100% of on-track wagers in 1955 to 12% of on-track wagers today, yet the statutory distributions have not changed as the business changed. NYRA has also demonstrated to the Office of the State Comptroller that over 50% of NYRA expenses are fixed in nature. Examples of such expenditures are real estate tax, health benefits, union pensions, and utilities. NYRA, during the audit period, has operated in a responsible sound economical manner by finding new revenue sources and cutting expenses. *2

*See State Comptroller's Comments on page 21.

Aqueduct *Belmont Park* *Saratoga*

Calculation of Franchise Fee (See Recommendations #1, 2, 4 and 6 of the Draft Audit)

According to the provisions of the New York State Racing Law, NYRA has calculated the franchise fee correctly for 2004 and 2005; 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 2004 and 2005 by $10.9 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.

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 #3 of the Draft Audit).

As indicated in the Draft Audit, NYRA has revised its Accounting Policies and Procedures to include the promotional items to be excluded from the 106 percent test calculations. The policy includes the account number and the description to eliminate any confusion that may arise. (See Recommendation #5 of the Draft Audit).

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

ADDENDUM TO APPENDIX A

THE NEW YORK RACING ASSOCIATION INC. P.O. Box 90, Jamaica, New York 11417-0090 (718) 641-4700

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
New York, NY 10038

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.

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[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."

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

APPENDIX B - STATE COMPTROLLER COMMENTS ON AUDITEE RESPONSE

1. We have revised our report to reflect NYRA's comments.

2. While overall spending has gone down, as indicated on page 6 of the report, NYRA continues to operate at a deficit. Such a deficit is not reflective of operating in a sound and economical manner.

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