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

Alan G. Hevesi
COMPTROLLER

NEW YORK RACING ASSOCIATION, INC.

AUDIT OF THE ANNUAL FRANCHISE FEE FOR CALENDAR YEARS 2000 AND 2001

2002-S-31

DIVISION OF STATE SERVICES

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110 State Street

11th Floor

Albany, NY 12236

Alan G. Hevesi
COMPTROLLER

Report 2002-S-31

Mr. Barry Schwartz
Chairman and Chief Executive Officer
New York Racing Association, Inc.
P.O. Box 90
Jamaica, NY 11417

Dear Mr. Schwartz:

The following is our audit report addressing the New York Racing Association's annual franchise fee for calendar years 2000 and 2001.

This audit was conducted pursuant to the State Comptroller's authority as set forth in Article V, Section 1 and Article X, Section 5 of the State Constitution, 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

September 17, 2003

EXECUTIVE SUMMARY

NEW YORK RACING ASSOCIATION, INC. AUDIT OF THE ANNUAL FRANCHISE FEE FOR CALENDAR YEARS 2000 AND 2001

SCOPE OF AUDIT

The New York Racing Association, Inc. (NYRA) is a not-for-profit organization franchised by New York State to conduct racing and pari-mutuel wagering at the State's three major thoroughbred racetracks: Aqueduct, Belmont Park and Saratoga. The amounts wagered on races held at these tracks are subject to a special State pari-mutuel tax. In 2001, the State's revenue from this tax totaled about $10 million. Capital improvements at the tracks may be funded by loans received from the New York State Thoroughbred Racing Capital Investment Fund. The loans are to be repaid, in part, from the annual franchise fee assessed on NYRA by the State. This fee, which is to be calculated in a manner prescribed by the State Racing Law, is generally a portion of NYRA's net income for the year and may include certain other amounts. Upon the expiration of NYRA's franchise, title to the three tracks transfers to the Capital Investment Fund. As long as NYRA maintains the franchise, it is required by the Racing Law to operate in an economical manner.

Each year, NYRA reports its calculation of the annual franchise fee. The Racing Law requires that the fee be certified by the Office of the State Comptroller. Our audit addressed the following questions about NYRA's financial operations for calendar years 2000 and 2001 (At the time of our audit fieldwork, complete information for 2002 was not available.):

- Do adequate controls exist over NYRA's financial reporting operations, and does NYRA staff apply the statutory franchise fee calculation methodology accurately?

- Is NYRA adhering to sound budgetary and financial operating practices?

- Are NYRA expenses, which are included in the franchise fee calculation, ordinary and necessary to NYRA operations, and supported by sufficient documentary evidence?

AUDIT OBSERVATIONS AND CONCLUSIONS

We determined that the franchise fees calculated by NYRA for 2000 and 2001 were understated by a combined total of at least $11.6 million and perhaps as much as $15.3 million. We also concluded that weaknesses, control deficiencies and compliance issues existed over NYRA's wagering revenues, budgeting process, and its operating expenses.

NYRA reported total wagering revenue of $3.3 billion for 2000 and $3.5 billion for 2001. If the amounts reported by NYRA are to be relied on, they must be supported by an appropriate system of internal controls. However, recent investigations found that serious weaknesses existed in controls over NYRA's revenue. In fact, these investigations identified criminal activities involving NYRA's revenue. The State Attorney General's Office determined that, during calendar years 1998 and 1999, NYRA Mutuel Department employees routinely misappropriated cash that they handled. For example, cash shortages were common among tellers. In addition, tellers performed money laundering to exchange wagering receipts for funds from criminal activities. The control deficiencies contributing to these problems were found to exist during our audit period. The amounts of misappropriated and mishandled revenues discussed in the investigations, though not definitively determined, were immaterial in relation to NYRA's multi million dollar annual revenue. However, any inaccuracy in NYRA's reported revenue results in a dollar-for-dollar inaccuracy in the franchise fee. Given these circumstances and other facts that came to our attention during the audit, we did not rely on NYRA's internal controls and we performed additional audit tests to assess the accuracy of NYRA reported revenues. These tests included reconciling selected bank transactions to NYRA's books of record, comparing bank deposits to reported revenues and performing a trend analysis of NYRA's reported revenues since 1997. These tests did not provide any indication of further misappropriation or mishandling of NYRA revenues. However, given the investigative results and the related deficiencies in NYRA's internal controls, we conclude that revenues may be understated. Therefore, our audited calculation of the franchise fee may be conservative. (See pp. 5-7)

NYRA's net revenues have steadily increased since 1997. However, NYRA's overall financial condition has deteriorated, because its operating expenses have increased by a greater rate than its net revenues. As a result, NYRA's accumulated deficit grew by 21 percent, increasing from $42.5 million at the end of 1997 to $51.5 million at the end of 2001. NYRA's operating expenses are to be controlled through a formal budgeting process specified in the Racing Law. However, NYRA did not fully comply with this process. For example, there was inadequate evidence that NYRA's Board of Trustees formally approved its annual operating budget, as required by the Racing Law. In addition, during our audit period, NYRA's actual operating expenses exceeded the budgeted expenses, which NYRA asserted were approved by the Board, in most of the major expense categories used by NYRA. We recommend that NYRA improve its budgeting

practices, develop a formal plan for improving its financial condition, and actively monitor the progress made in achieving the plan. (See pp. 9-14)

We also recommend that NYRA suspend financing its discretionary supplemental pension plan that may not be appropriate for an entity in poor financial health, like NYRA. We determined that most payments from the plan, which totaled $459,139 during our two-year audit period, went to just five individuals, who were paid $352,369. (See pp. 12-14)

NYRA reported a franchise fee of $6.1 million for 2000, including a $2 million allocation to stakes and purses, and a franchise fee of $0 for 2001. We audited these amounts and determined that the franchise fee for these periods were understated by a combined total of at least $11.6 million, and perhaps as much as $15.3 million. The fees were understated because some expenses were overstated, and certain adjustments required by the Racing Law were not made. For example, for calendar year 2001, NYRAs actual operating expenses when compared to allowable expenses were such that, pursuant to statute, the franchise fee should be increased by $10.9 million. We recommend that NYRA correct the errors that caused its franchise fees to be understated, and make the payments necessitated by the noted franchise fee adjustments. (See pp. 15-19)

RESPONSE OF NYRA OFFICIALS

NYRA officials disagreed with our observations and conclusions, and believe that no additional franchise fee payments for the period covered by the audit are due. After careful consideration and review of NYRA's response, we continue to believe our observations and conclusions are well founded, and supported by the evidence delineated in our report. Accordingly, NYRA should remit the additional franchise fee obligation to the Capital Investment Fund as determined by our audit, and as required by law, and should take appropriate actions as recommended, to address the financial and operating deficiencies noted therein.

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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. NYRA's franchise, which has been extended twice by the State Legislature, is scheduled to expire on December 31, 2007. (If by March 1, 2004, the State Division of the Lottery certifies that NYRA is operating video lottery gaming at Aqueduct Racetrack, then the franchise is extended to December 31, 2013.) At that time, unless the franchise is further extended, title to the three tracks transfers to the Capital Investment Fund. To help NYRA maintain the physical condition of the tracks, in 1983 the State Legislature created the New York State Thoroughbred Racing Capital Investment Fund (Capital Investment Fund). The Capital Investment Fund, which is financed by a portion of the revenue generated by races at the tracks, provides secured loans to NYRA for approved capital expenditures.

In return for its exclusive franchise, NYRA is required to provide certain revenue to New York State. 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's revenue is generated primarily from wagering (also referred to as the "handle") on races held at the three racetracks. Some of this wagering is done at the track where the race is actually held (the on-track handle), and some is done at other locations, such as Off Track Betting parlors and other racetracks both in and out of state (simulcasting). On-track wagering revenue is subject to a pari-mutuel tax assessed by New York State. The tax, which totaled about $10 million in 2001, is calculated as a percentage of NYRA's handle. This pari-mutuel tax revenue accounts for most of the revenue provided to the State by NYRA. NYRA is also required to remit an annual franchise fee to the Capital Investment Fund as

repayment for prior loans, and any accumulated remittances in the Fund in excess of $7 million are to be transferred to the State's treasury. As of December 31, 2001, NYRA reportedly owed the Fund $64.6 million for prior loans and related interest.

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, which are 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 no franchise fee to the Capital Investment Fund is to be paid for that year. According to Section 208 of the Racing Law, NYRA's fee is to be certified by the Office of the State Comptroller.

Audit Scope, Objectives and Methodology

We examined NYRA's financial reporting operations, associated internal controls and selected supporting records for calendar years 2000 and 2001. (At the time of our audit fieldwork, complete information for 2002 was not available.) The objectives of our audit were to determine the adequacy of controls over NYRA's financial-reporting operations; the accuracy of the methodology NYRA used to calculate the franchise fee; and the appropriateness of, and support for, the expenses used in the franchise fee calculation. In addition, we also assessed NYRA's financial condition and evaluated the appropriateness of certain financial practices, such as financing NYRA's Supplemental Employee Retirement Plan.

To accomplish our audit objectives, we tested the internal controls in place over NYRA's financial reporting systems; interviewed appropriate NYRA officials and staff; selected a sample of expense transactions and tax return deductions for supporting documentation, propriety and compliance with accounting principles and the Federal tax code; reviewed relevant statutes of the Racing Law governing the franchise fee; and consulted with interested third parties (the New York State Attorney General's Office, United States Treasury Department, New York State Racing and Wagering Board, and New York

State Thoroughbred Racing Capital Investment Fund) regarding issues relevant to the franchise fee.

We conducted our audit in accordance with government auditing standards generally accepted in the United States of America. Such standards require that we plan and perform our audit to adequately assess the financial-related operations included in our audit scope. Further, these standards require that we understand NYRA's internal control structure, and its compliance with those laws, rules and regulations that are relevant to the operations included in our audit scope. An audit includes examining, on a test basis, evidence to support transactions recorded in the accounting and operating records, and applying such other auditing procedures as we see necessary in the circumstances. An audit also includes assessing the estimates, judgments, and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk-based approach when selecting activities to be audited. This approach focuses our audit efforts on those operations identified through a preliminary survey as having greatest probability for needing improvement. Consequently, by design, we use finite audit resources to identify where and how improvements can be made. Thus, we devote little audit effort to reviewing operations that may be relatively efficient or effective. As a result, our audit reports are prepared on an "exception basis." This report, therefore, highlights those areas needing improvement and does not address activities that may be functioning properly.

Internal Control and Compliance Summary

Our consideration of NYRA's internal control structure identified weaknesses, control deficiencies, and compliance issues over wagering revenue, NYRA's budgeting process and determination of the franchise fee. We provide details of these matters throughout the report.

Response of NYRA Officials to Audit

A draft copy of this report was provided to NYRA officials for their review and comment. Their comments, as appropriate, have been considered in preparing this report, and are included

as Appendix B. In addition, State Comptroller's Notes in response to NYRA's comments are included as Appendix C.

NYRA officials disagreed with our observations and conclusions, and believe that no additional franchise fee payments for the period covered by the audit are due. After careful consideration and review of NYRA's response, we continue to believe our observations and conclusions are well founded, and supported by the evidence delineated in our report. Accordingly, NYRA should remit the additional franchise fee obligation to the Capital Investment Fund as determined by our audit, and as required by law, and should take appropriate actions as recommended, to address the financial and operating deficiencies noted therein.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Chairman of the New York Racing Association shall 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 where recommendations were not implemented, the reasons therefor.

REPORTED WAGERING REVENUE

NYRA maintains a comprehensive computerized accounting operation, supervised by NYRA's controller, 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 on, they must be supported by an appropriate system of internal controls. However, we concluded that NYRA's controls over its wagering revenue were undermined by a number of serious weaknesses, identified by various law enforcement and regulatory bodies prior to the initiation of our audit.

These weaknesses were recently revealed as a result of the following investigations and criminal activities:

- An investigation performed by the State Attorney General's Office determined that, during calendar years 1998 and 1999, wagering revenue had routinely been misappropriated and handled inappropriately by NYRA employees. Identified cash shortages, although not material for financial reporting purposes, were common among tellers and currency was exchanged to launder funds from criminal activities. We note however, that any inaccuracy in NYRA's reported revenue results in a dollar-for-dollar inaccuracy in the franchise fee. The investigation also determined that NYRA employees engaged in illegal gambling, loan sharking, tax fraud, forgery and various crimes against NYRA's customers.

- An audit performed by the State Racing and Wagering Board identified serious weaknesses in NYRA's controls over wagering revenue.

- An investigation performed by the United States Treasury Department focused on money laundering, thefts, and tax fraud.

- The automated wagering system used at NYRA's three tracks, which is owned and operated by a contractor, was compromised when a former employee of the contractor was able to access the system without authorization and alter certain wagers after the races took place, resulting in millions of dollars in fraudulent payouts. We note that an audit report issued by the contractor's own auditor disclaimed an opinion on the effectiveness of the contractor's controls over access to the automated wagering system.

NYRA's financial statements are audited annually by a certified public accounting firm. According to this independent auditor, the financial statements for 2000 and 2001 fairly presented NYRA's financial operations. To determine whether we could rely on the assessments of the independent auditor, we attempted to review the working papers supporting these assessments, as we have routinely done in our prior audits of NYRA's franchise fee calculations. This is a standard audit procedure to avoid unnecessary and duplicative audit work.

However, NYRA's auditing firm for 2000 and 2001 was dissolved and accused of inappropriate auditing practices. As a result, during our audit fieldwork, we were able to review only a limited number of the working papers for 2001. We were able to review a significant number of working papers for 2000, because copies were possessed by the State Attorney General's Office and the State Racing and Wagering Board, both of which were performing investigations of NYRA at the time. The Board's review of these working papers noted several deficiencies in the audit work performed by NYRA's independent auditor. For example, the working papers did not contain evidence of supervisory review and did not show that the auditor had performed a comprehensive review of NYRA's internal controls. In particular, the working papers did not indicate that the controls over NYRA's simulcasting revenue had been adequately reviewed. We therefore conclude that we cannot rely on the assessments made by NYRA's independent auditor for 2000 and 2001.

NYRA reported total wagering revenue of $3.3 billion for 2000 and $3.5 billion for 2001. In light of these serious control weaknesses and other facts that came to our attention during the audit, we did not rely on NYRA's internal controls and we performed additional audit tests to assess the accuracy of

NYRA reported revenues. These tests included reconciling selected bank transactions to NYRA's books of record, comparing bank deposits to reported revenues and performing a trend analysis of NYRA's reported revenues since 1997. These tests did not provide any indication of further misappropriation or mishandling of NYRA revenues. However, given the investigative results and the related deficiencies in NYRA's internal controls, we conclude that revenues may be understated. Therefore, our audited calculation of the franchise fee may be conservative.

We note that NYRA has taken steps to address some of the control weaknesses that were recently revealed. For example, 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 further note that corrective action has been taken by the contractor that operates the automated wagering system. We recommend that NYRA establish a strong and comprehensive system of internal control over all of its wagering revenue, and direct its internal audit staff to perform frequent assessments of these controls.

Recommendations

1. Establish a strong and comprehensive system of internal control over all wagering revenue.

2. Periodically, but at least once a year, evaluate the effectiveness of the controls over wagering revenue.

FINANCIAL CONDITION OF NYRA

In 1997, the State Legislature reduced the percentage(s) used to calculate the pari-mutuel tax to allow NYRA to retain a greater share of the racing handle. We spoke with the individual who was Chairman of NYRA at that time, and asked him about the reasons for this reduction in the pari-mutuel tax rates. He said that the tax rates were reduced, and the horseman's stakes and purses were concurrently increased, to make NYRA's racing card and facilities more attractive to horsemen and the wagering public, and thereby result in a financial benefit to all interested parties, including the State.

NYRA's gross handle equals the total on-track and simulcasting wagering revenues, most of which is returned to bettors in winnings. NYRA retains a statutory percentage of gross handle which is the basis for the State's pari-mutuel tax and other statutory commissions. The amount remaining is NYRA's net revenue available for operations. As is shown by the following table, according to NYRA's certified financial statements, since 1997, NYRA's total handle and net revenues have increased steadily, while the State's pari-mutuel tax revenues have been cut in half.

	(In Thousands)				
	1997	**1998**	**1999**	**2000**	**2001**
Gross Handle	$2,821,259	$2,919,312	$3,319,892	$3,277,526	$3,514,068
Pari-mutuel Tax	$18,590	$17,803	$16,981	$13,343	$9,981
Net Revenues	$135,829	$139,047	$145,326	$155,349	$160,607
Total Expenses	$136,998	$141,050	$142,675	$153,681	$171,887
Net (Loss) Income	($1,169)	($2,003)	$2,651	* $1,668	($11,280)
Franchise Fee	$268	$223	$1,829	$4,107	$0
Accumulated Deficit	($42,518)	($44,521)	($41,870)	($40,202)	($51,482)

* 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.

Thus, the reduction in pari-mutuel tax rates appears to have been at least partially successful. NYRA has made itself more

attractive to the wagering public and has benefited financially by retaining a larger portion of the enhanced wagering revenue. However, in spite of the significant increase in revenue, NYRA's overall financial condition has not improved. In fact, NYRA's financial condition has deteriorated. Its annual expenses have increased by a greater rate than its annual net revenues and, as a result, NYRA's accumulated deficit grew by 21 percent, increasing from $42.5 million at the end of 1997 to $51.5 million at the end of 2001.

An organization's expenses may be controlled through a formal budgeting 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. First, NYRA's annual operating budget must be approved by NYRA's Board of Trustees. The Board currently consists of 28 individuals, 20 of whom were nominated by NYRA's stockholders and approved by the State Racing and Wagering Board, and eight of whom were appointed by the Governor.

The Board is also required by the Racing Law to reject the operating budget if the expenses contained in the budget are excessive in relation to NYRA's expected revenues for the year. Certain calculations are to be made in determining whether the budgeted expenses are excessive, and these calculations are described in Subdivision 10, Section 208 of the Racing Law. The Racing Law further requires that these calculations, and a clear description of any unusual circumstances that resulted in a modification of the allowed percentage increase, be included in documents accompanying NYRA's annual audited financial statements.

NYRA officials told us that the annual operating budget is approved by the Board before it is adopted by NYRA. They also told us that the operating expenses in the budget do not exceed the amounts allowed by the Racing Law. However, the Board's approval of the operating budgets for 2000 and 2001 was not adequately documented by NYRA. Further, the process used in determining whether expenses were excessive in relation to expected revenues was questionable. For example, the Board of Trustees' minutes citing approval of the respective budgets did not reference the date of submission of those budgets or the numbers approved. In the absence of such documentation, there is no assurance NYRA has complied with the budgeting requirements contained in the Racing Law. There is limited

assurance the budgets we were provided with for 2000 and 2001 were the ones approved by the Board, and there is limited assurance the required process was followed in determining whether budgeted expenses were excessive.

(Subsequent to our fieldwork and, again, as part of its response to our draft report, NYRA included along with operating budgets not previously provided, the cover letter transmitting those budgets to the Board, and the associated 90 percent compliance test. However, there is still no direct link between the transmittals provided and the actual budgets approved.)

To further evaluate the adequacy of this budgeting process, we compared NYRA's actual operating expenses for 2000 and 2001 to the expenses that were budgeted for those years. As shown in the following table, actual expenses exceeded the budgeted expenses in most of NYRA's major expense categories:

OPERATING EXPENSES	2000			2001		
	BUDGET	ACTUAL	VARIANCE	BUDGET	ACTUAL	VARIANCE
RACE MEET EXPENSES	$50,712,300	$52,832,875	$2,120,575	$52,470,107	$51,380,892	$(1,089,215)
CONTRACTED SERVICES	12,745,750	14,645,363	1,899,613	13,507,900	15,344,081	1,836,181
TRADE EXPENSES	2,360,000	2,903,304	543,304	2,689,000	3,186,318	497,318
FACILITIES PURCHASES	24,451,200	26,265,201	1,814,001	25,105,200	27,669,067	2,563,867
GENERAL & ADMIN EXPENSES	26,919,750	33,968,429	7,048,679	28,511,250	47,630,696	19,119,446
TOTALS	**$117,189,000**	**$130,615,172**	**$13,426,172**	**$122,283,457**	**$145,211,054**	**$22,927,597**

During our fieldwork, NYRA officials stated that the actual general and administrative expenses were much greater than budgeted in both years, mainly because certain types of general and administrative expenses were not budgeted. Specifically, pension contributions, retiree benefits and the expenses relating to a special, non-recurring race (the 2001 Breeders' Cup) were not included in NYRA's budgets for the 2000 and 2001 years. During 2000, pension contributions and retiree benefits totaled $4.6 million; during 2001, pension contributions and retiree benefits totaled $8.7 million, while expenses for the Breeders' Cup totaled $10.3 million.

NYRA officials stated that the Breeders' Cup expenses were not included in the budget because they expected the revenue from the race to offset the expenses, and thus be a "wash." They stated that pension contributions and retiree benefits were not included because the actuarial information used in making the

related year-end adjustments was not available at the time the budgets were prepared. Neither of these reasons is consistent with sound budgeting practices. The amount of revenue to be generated by an activity is irrelevant to the question of whether or not the expenses of the activity are to be included in the operating budget. The availability of the actuarial information is also irrelevant, since most expenses in a budget are based on estimates. The pension contributions and retiree benefits could have been estimated from the amounts in prior years.

We also note that, in excluding these expenses from the operating budgets for 2000 and 2001, NYRA violated one of the requirements contained in Subdivision 10, Section 208 of the Racing Law. According to this requirement: "the appropriate officers of the association [NYRA] [are] to present to such Board of Trustees for its approval prior to the beginning of each fiscal year an operating budget covering ***all of the expenses planned to be incurred during such year*** [emphasis added]. . . ." If large expenses are excluded from the budget, the limit that is imposed on total budgeted expenses by Subdivision 10, Section 208 of the Racing Law could be circumvented. Moreover, if certain expenses are not formally included in the budget, they are less likely to be closely scrutinized and effectively controlled by NYRA managers and the Board of Trustees. In view of NYRA's deteriorating financial condition, it is especially important that all of its expenses be subject to close scrutiny.

(The budgets that NYRA provided as part of its response included certain expenses that we were previously told were not included in its budget. However, we note that these expenses were excluded from the accompanying 90 percent compliance test.)

We further note that some of the pension expenses we were told were not included in the budget are in particular need of close scrutiny, because they represent discretionary supplemental pension payments that may not be appropriate for an entity in poor financial health, like NYRA. NYRA has five defined benefit pension plans covering its various categories of employees. NYRA funds these plans through allowable contributions in accordance with governing tax law (ERISA) [Employee Retirement Income Security Act]. The plans invest in various securities and investment accounts to maximize available assets to cover projected benefit payments. In

addition to these five plans, NYRA has also established an unfunded Supplemental Employee Retirement Plan (SERP), which is financed by available operating funds. NYRA created the SERP to bypass the limitations set in ERISA.

A SERP may be justifiable for an entity that is financially healthy. However, considering NYRA's statutory responsibility to operate in a sound, economical manner, and its deteriorating financial condition, we question whether NYRA is in a position to finance such a program.

During 2000, NYRA paid $219,048 to 27 SERP participants, and during 2001, NYRA paid $240,091 to 26 SERP participants. Of these payments, 72 percent of the 2000 payments ($158,165) went to just four individuals, and 76 percent of the 2001 payments ($182,669) went to three of these same four individuals plus a different fourth individual.

NYRA officials stated that our report does not adequately recognize NYRA's total financial and economic contributions to New York State, as NYRA's employees, NYRA's vendors, the surrounding businesses and the individuals in the State's horseracing industry all benefit financially from NYRA's operations. We do not question these benefits, and conceivably they could exist whether NYRA or another entity operated New York's racing industry. However, NYRA's indirect financial contributions to the industry were not the subject of our audit and should not be lessened in any way if NYRA took appropriate actions to improve its financial condition.

Recommendations

3. Develop the annual operating budget in compliance with the requirements contained in Subdivision 10, Section 208 of the Racing Law. In particular, include in the budget all foreseeable operating expenses, calculate the total allowable expenses in the manner prescribed by the Law, and include the calculations in a document accompanying the annual audited financial statements.

Recommendations (Cont'd)

4. Enhance the documentation supporting the Board of Trustees' approval of the annual operating budget by at a minimum, referencing in the Board resolution the date of submission and the key amounts included in the budget.

5. Develop a formal plan for improving NYRA's financial condition and actively monitor the progress made in achieving the plan.

6. Suspend financing the Supplemental Employee Retirement Plan until NYRA's financial condition is strong enough to support the payments required by the Plan.

CALCULATION OF THE ANNUAL FRANCHISE FEE

Pursuant to the Racing Law, NYRA is required to file an annual franchise fee tax return with the Department of Taxation and Finance. This return is designed to illustrate NYRA's calculation of its annual franchise fee in accordance with the formula described in the Racing Law. According to that formula, NYRA must calculate its entire adjusted net income, which is defined as its Federal taxable income increased by the amount by which certain operating expenses for the current year exceed 106 percent of their level for the prior year. The law specifies which expense items (e.g., interest, real estate taxes, advertising, promotions, and certain others) are excluded from the 106 percent calculation. The law also provides for other adjustments as detailed in subsequent sections of this report. The first $2 million of the adjusted net income is to be allocated for horsemen's purses and awards, and any remaining amount is to be paid to the Capital Investment Fund.

NYRA reported a franchise fee of $6.1 million for 2000, including a $2 million allocation to stakes and purses, and a franchise fee of $0 for 2001. We reviewed NYRA's franchise fee tax forms for these two years. We traced the figures used by NYRA on the tax forms in calculating its entire adjusted net income back to NYRA's books of record and Federal income tax returns to determine whether the figures were accurately transferred. 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 reviewed select expense transactions to determine whether they were supported by adequate documentation and were appropriate for NYRA's operations.

We determined that the franchise fees calculated in 2000 and 2001 were understated by a combined total of at least $11.6 million and perhaps as much as $15.3 million. The fees were understated because some expenses were overstated, and certain adjustments required by the Racing Law were not made to account for expenses that exceeded allowable percentages.

Our adjustments to the franchise fees reported by NYRA are summarized as follows:

	2000	2001	TOTAL
Franchise Fee Reported by NYRA	**(1)** $6,107,352	$ 0	$6,107,352
Expenses Exceeding Allowable Percentages	849,481	10,949,700	11,799,181
Claimed Interest Expense Not Paid**	1,986,006	1,748,525	3,734,531
Other Adjustments **(3)**	1,666	(232,618)	(230,952)
Total Adjustments:	2,837,153	12,465,607	15,302,760
Audited Franchise Fee:	**(1)** $8,944,505	**(2)** 12,465,607	$21,410,112

(1) Includes $2 million that was paid to Stakes and Purses.
(2) Includes $2 million that should be paid to Stakes and Purses.
**Ultimately a decision to be made by the Internal Revenue Service. See Section on "Claimed Interest Expense Not Paid".
(3) Difference between Federal Corporate Taxable Income and NYRA's Franchise Fee worksheet.

Expenses Exceeding Allowable Percentages

Pursuant to the Racing Law, NYRA is required to file an annual franchise fee tax return with the Department of Taxation and Finance. This return is designed to illustrate NYRA's calculation of its annual franchise fee in accordance with the formula described in the Racing Law. According to that formula, NYRA must calculate its adjusted net income, which is defined as its Federal taxable income increased by the amount by which certain operating expenses for the current year exceed 106 percent of their level for the prior year. The law specifies which expense items (e.g., interest, real estate taxes, advertising, promotions, and certain others) are excluded from the 106 percent calculation. When we applied this test to the years covered by our audit, we found that NYRA's expenses for 2000 exceeded those for 1999 by 106.75 percent, resulting in an addition of $849,481 to the franchise fee.

The Racing Law confers considerable significance on NYRA's annual operating budget. It explicitly states that all foreseeable operating expenses are to be included in the budget and the total of these expenses should not exceed 90 percent of the anticipated revenues available to NYRA for its operations. If the total budgeted expenses exceed this maximum allowable percentage, the Racing Law states that NYRA's Board of Trustees should reject the budget.

The Racing Law also indicates that the annual operating budget may have to be taken into account in the calculation of the annual franchise fee. Specifically, the Racing Law states that, "In any year in which the actual operating expenses are greater than the operating expenses allowed (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."

As was discussed in the prior section of this report, NYRA officials stated that their operating budgets for 2000 and 2001 were prepared in accordance with the provisions of the Racing Law. NYRA's actual operating expenses exceeded the total amounts budgeted in both years, and, moreover, for 2001 exceeded the maximum percentage allowed by the Racing Law.

Thus, this amount should be added back to the franchise fee for that year.

OPERATING EXPENSES*	2001			
	BUDGET	ALLOWABLE	ACTUAL	EXCESS
	$140,580,857	$144,546,300	$155,496,000	$10,949,700

* Excludes Taxes, Fees and Special Assessments

Thus, in accordance with the Racing Law, $10.9 million should be added to the franchise fee for 2001.

Claimed Interest Expense Not Paid

According to NYRA's financial statements for 2001, as of December 31, 2001, $47.5 million in loans from the Capital Investment Fund for improvements at track facilities had not been repaid by NYRA. NYRA is required by the Racing Law to repay, on an installment basis, the loan principal and interest, which together totaled $64.6 million as of that date.

According to the Federal tax code, a corporation using the accrual basis of accounting – such as NYRA – may deduct expenses, such as interest, even if not yet paid at the time of tax return preparation, providing the expense has been accrued and the expense amount can be reasonably estimated, unless there

is no substantial expectation that payment would be made or could be made.

NYRA deducted interest expenses on its loans from the Capital Investment Fund in both 2000 and 2001. The deductions were made on its Federal corporate income tax returns for those two years, and accordingly, were reflected in the calculations shown on its franchise fee tax returns for the two years. The amount deducted for 2000 totaled $1,986,006, and the amount deducted for 2001 totaled $1,748,525.

We determined that, as of May 31, 2003, NYRA had yet to make these interest payments to the Fund, and had not even worked out a formal repayment agreement with the Fund. While a determination as to the allowability of a tax deduction lies with the Internal Revenue Service, it is our position that these deductions by NYRA may be inappropriate in view of the fact that the record indicates that NYRA has not made any interest payments to the Capital Investment Fund since 1993, and that the Capital Investment Fund has failed in its attempts to secure a repayment agreement with NYRA. In addition, based upon NYRA's current financial condition and revenue and expense trends, barring any substantial improvement in its financial condition, it appears unlikely that NYRA will be able to repay these loans out of operating funds. As a result, we recommend that this matter be referred to the Internal Revenue Service for a determination as to the allowability of these deductions. If the Internal Revenue Service determines that the deductions should be disallowed, then we would further recommend that the $3.7 million in claimed interest expenses be added back to NYRA's taxable income for 2000 ($2 million) and 2001 ($1.7 million), and the franchise fees for those two years be adjusted accordingly. It is possible that similar adjustments may need to be made for years prior to 2000; however, any such adjustments were outside the scope of this audit. We have been informed that the Internal Revenue Service is reviewing this matter as it pertains to NYRA's Federal Corporate Income Tax Return.

Recommendations

7. Increase the franchise fee for 2000 and 2001 by a combined amount of $11,568,229. In accordance with this adjustment, remit $9,568,229 to the New York State Thoroughbred Racing Capital Investment Fund and allocate $2 million for horsemen's stakes and purses.

8. In future franchise fee calculations, add any excess expenses (i.e., the amounts by which actual operating expenses exceed the allowable percentages) to taxable income to arrive at the entire adjusted net income as required by Section 208 of the Racing Law.

9. Abide by the determination of the Internal Revenue Service's review of the allowability of NYRA's interest expense deductions. If it is determined that these deductions are improper, NYRA should make the appropriate franchise fee adjustments for these years.

MAJOR CONTRIBUTORS TO THIS REPORT

William Challice

Frank Patone

Barry Mordowitz

Peter Schmidt

Zenaida Bhuiyan

Anthony Carlo

John Ames

Diane Jackson

Jean Estime

Dana Newhouse

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

PATRICK L. KEHOE
VICE PRESIDENT AND GENERAL COUNSEL

August 24, 2003

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: Draft Audit Report 2002-S-31

Dear Mr. Challice:

On behalf of the New York Racing Association Inc. ("NYRA") we provide this letter in response to your draft audit (2002-S-31) of NYRA's annual franchise fee (the "Draft Audit") for the calendar years 2000 and 2001 (the "Audit Period").

I. SUMMARY

This letter outlines in detail NYRA's responses to the Draft Audit. In preparing this letter, NYRA has worked closely with various experts on the issues raised in the Draft Audit, including Davis Polk & Wardwell, NYRA's outside counsel, and SafirRosetti, consultants retained by NYRA's Board of Trustees to monitor the efficacy of NYRA's internal controls. These experts, having reviewed NYRA's finances and the applicable statutes and regulations, agree with the conclusions set forth below:

(1) NYRA remitted to the State of New York the proper amount in franchise fees for the years 2000 and 2001 and no additional money is owed to New York State.

(a) The Draft Audit concludes that NYRA understated its franchise fee for 2001 by $10.9 million. This conclusion is premised on the finding that NYRA's actual operating expenses 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. The Draft Audit mistakenly uses Generally Accepted Accounting Principles ("GAAP") expenses and revenue, which are found in NYRA's audited financial statements, for its calculation. 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. As detailed below, when the correct amounts (*i.e.*, income tax expenses and revenue) are used, it is clear that NYRA's operating expenses during 2001 did not exceed its allowable expenses under the Racing Law and, accordingly, that there was no understatement of its franchise fee.

* Note 1

(b) The Draft Audit contends that NYRA may owe New York State an additional $3.7 million in franchise fees because NYRA may not have been entitled to deduct the interest accrued on monies it owes to the New York State Thoroughbred Racing Capital Investment Fund (the "CIF"). The Draft Audit reaches no conclusion on this issue but, rather, defers a decision on the permissibility of this deduction to the Internal Revenue Service (the "IRS"). The IRS, however, would have no basis to conclude that these deductions were improper. As the Draft Audit acknowledges, NYRA, which uses accrual basis accounting for both financial statement and income tax purposes, should deduct interest expenses at the time they are accrued, even if they are not yet paid. The Draft Audit asserts that NYRA has no intention of repaying the CIF and, therefore, that a deduction for the interest accrued on this debt may be improper. This assertion is inaccurate. NYRA fully intends to fulfill its obligations to the CIF. Indeed, NYRA actually made substantial payments on its loans to the CIF during the Audit Period ($1,829,543 in 2000 and $4,107,352 in 2001) and continues to make payments to the CIF whenever it is statutorily permitted to do so. In addition, NYRA has a number of projects planned that will provide additional sources of revenue from which it can repay the CIF, such as the video lottery terminals ("VLTs") at Aqueduct. Moreover, NYRA's debt to the CIF is secured by a mortgage lien on the Aqueduct racetrack real property, which is worth hundreds of millions of dollars – an amount far greater than NYRA's debt to the CIF. Finally, even if there were some doubt as to NYRA's ability to repay the CIF, case law establishes that an interest expense should be deducted in the year it is accrued unless it can be "categorically said" that the interest will not be paid. That is certainly not the case here. Indeed, NYRA's continued efforts to repay the CIF unequivocally demonstrate that it fully intends to repay this debt. Accordingly, NYRA's deduction of the interest accrued on monies it owes to the CIF is proper.

* Note 2

(c) The Draft Audit recommends that $62,811 in advertising expenses be added back to the franchise fee for 2000 because NYRA's documentation of these expenses was insufficient. Complete documentation for those expenses is attached to this response.

* Note 3

(d) The Draft Audit asserts that NYRA's franchise fee during the Audit Period may not be accurate because NYRA did not write off expired checks in the proper manner. The Draft Audit contends that checks that are outstanding for more than one year must be voided and included as miscellaneous income in the year in which they expired. This is not the case, and the one-year rule advanced by the Comptroller's Office is not a requirement of the Internal Revenue Code (the "Code") or the U.S. Department of Treasury ("Treasury") regulations. The generally accepted tax rule is that amounts with respect to unclaimed checks must be included in income in the year that they are

* Note 4

* See State Comptroller's Notes, Appendix C

charged to profit and loss on a company's books, which is what NYRA did in 2002.[1]

(2) The Draft Audit asserts that NYRA's financial condition is poor. This reflects a misunderstanding of NYRA's unique financial situation. NYRA is a private association that is required, by statute, to pass all of its profits on to the State in the form of a franchise fee and to New York horsemen in the form of purses. Therefore, unlike other businesses, NYRA cannot keep a cash reserve. Instead, NYRA contributes vast sums, both directly and indirectly, to New York State's economy through, among other things, its pari-mutuel tax, real estate and admissions taxes, and by fostering the thoroughbred racing industry in New York State. The Draft Audit makes the following three criticisms regarding NYRA's financial condition:

* Note 5

(a) First, the Draft Audit concludes that weaknesses in NYRA's budgeting process caused there to be insufficient control over its operating expenses. As explained below, and as the attached documents demonstrate, this conclusion is based on a misunderstanding by the Comptroller's Office.

(b) Second, the Draft Audit recommends that NYRA suspend certain supplemental pension payments that it contends may not be appropriate because NYRA is allegedly in poor financial health. This recommendation is inadvisable as a business matter, and implementing it may well expose NYRA to legal claims by the recipients of these benefits. The ability to offer such benefits has enabled NYRA to lure top racing and business executives to its tracks. Such benefits are especially critical because NYRA executives receive modest compensation when compared to executives at other major non-profit organizations in the metropolitan New York area. Moreover, even if NYRA wanted to suspend these pension payments, it simply cannot do so because the terms of NYRA's Supplemental Employee Retirement Plan ("SERP") prevent NYRA from decreasing accrued benefits.

(c) Third, the Draft Audit recommends that NYRA recover $51,855 in pension benefits from an individual who is alleged not to have been entitled to these benefits. The individual in question is former Chairman, CEO, and President of NYRA, Kenneth Noe, who was in fact entitled to these benefits and NYRA has no legal basis for recovering them from Mr. Noe. The Draft Audit asserts that Mr. Noe acted as a consultant for NYRA during the latter part of his tenure at NYRA, and not as an employee, and therefore was not entitled to receive SERP payments from NYRA. But, Mr. Noe was an employee of NYRA during the 1970s and, again, from 1995 through late 1997. Based on his status as an employee during these periods, Mr. Noe is entitled to the value of the pension benefits he received from NYRA.

* Note 3

[1] *See, e.g., Charleston & W.C. Ry. Co. v. Burnett*, 50 F.2d 342 (1931); *Chicago, Rock Island & Pacific Ry. Co.*, 47 F.2d 990 (1931).

Furthermore, even apart from Mr. Noe's status as an employee, he was entitled to receive the payments in question because the Compensation/Pension Committee of NYRA's Board passed a resolution entitling him to those payments.

(3) The Draft Audit concludes that serious weaknesses existed in internal controls over NYRA's wagering revenues during the Audit Period. The weaknesses referred to in the Draft Audit, however, were not observed by the Comptroller's Office but, instead, appear to be taken second-hand from a public report regarding another investigation. Moreover, much of the alleged conduct identified in the Draft Audit occurred before the Audit Period. In any event, these weaknesses (most of which have long been remedied) could not have had any impact (material or otherwise) on the franchise fee that NYRA remitted to the State.

* Note 6

II. NYRA'S FRANCHISE FEE WAS NOT UNDERSTATED

A. Section 208(10) of the Racing Law and the 2001 Franchise Fee

The Draft Audit concludes that NYRA understated its franchise fee by $10.9 million in 2001 because NYRA's actual operating expenses for that year exceeded 90% of NYRA's operating revenues for that year and, therefore, that amount must be added back into NYRA's adjusted net income in calculating its franchise fee pursuant to Section 208(10) of the Racing Law. This conclusion, however, is based on a misunderstanding of Section 208(10). A correct reading of the Racing Law reveals that, in fact, NYRA properly calculated its franchise fee for 2001.[2]

* Note 1

Section 208 of the Racing Law governs the calculation of NYRA's annual franchise fee, and subsection (10) of that provision is intended to act as a limitation on NYRA's operating expenses.[3] To that end, it effectively prohibits NYRA from spending more than

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[2] The preliminary draft audit issued to NYRA on May 30, 2003, took the position that NYRA's franchise fees for 2000 and 2001 were understated by $11,061,227 because section 208(10) requires NYRA to include in its taxable income the excess of its *actual* expenses over its *budgeted* expenses. After discussions with NYRA, it appears that the Comptroller's Office has abandoned this position.

[3] Section 208(10) provides:

If at any time, the total expenses of [NYRA] . . . exceed or are anticipated during the ensuing year to exceed ninety per centum of the revenues available to such association for its operations, pursuant to section two hundred twenty-nine of this chapter, then such board of trustees shall thereafter disapprove any proposed operating budgets which provide for operating expenses in excess of a percentage of such expenses during the prior year with such percentage to be equal to the percentage which total revenue from the conduct of such facilities, racing meetings, races and pari-mutuel betting in the current year is projected to bear to such revenue during the previous year provided that such latter percentage may be modified to reflect unusual or nonrecurring circumstances occurring during either such year . . . . In any year in which the actual operating expenses are greater than the operating expenses allowed, the amount by which such actual expenses exceed such allowed expenses

90% of its operating revenues in any given year. The provision creates a strong incentive for NYRA to comply with this 90% limitation by treating any expenses in excess of 90% of NYRA's revenues as taxable income, which, in turn, means that such amount must be paid to the State as part of NYRA's annual franchise fee.

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Note
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Critical to understanding how the limitation on expenditures set forth in Section 208(10) is calculated, is an appreciation of the distinction between GAAP reporting for financial statement purposes and income tax reporting. While GAAP is typically used to calculate a company's profit and losses for certain reporting purposes, it is not used to calculate a company's taxable income. Rather, the Code and the regulations promulgated by the U.S. Treasury Department govern the calculation of taxable income.

Section 208 of the Racing Law makes clear that the spending limitation set forth in subsection (10) of that provision must be calculated using tax reporting principles, not GAAP. Indeed, in defining how the franchise fee should be calculated, Section 208 incorporates the core tax reporting concept of "taxable income." *See* N.Y. Racing Law § 208(1)(b). The franchise fee NYRA is required to pay the State is equal to NYRA's "entire adjusted net income" (less two million dollars for purses). *See* Racing Law § 208(1)(a). "Entire adjusted net income," in turn, is equal to NYRA's "taxable income," (not including taxable income imputable to NYRA by the extension of debt). *See* Racing Law § 208(1)(b). Similarly, Section 208(10) states that the amount by which NYRA's expenses exceed 90% of its operating revenues "shall be added to taxable income in computing [NYRA's] 'entire net adjusted income' for use in calculating the franchise fees due." *See* N.Y. Racing Law § 208(10).

The Racing Law is clear that, for these purposes, "taxable income" means NYRA's federal taxable income. Indeed, 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 commission [of the change and] . . . the tax commission may issue an assessment of any additional tax due." (emphasis added).

Indeed, in Audit Report 98-S-6 (the "1998 Audit Report"), the Comptroller's Office appears to acknowledge that NYRA must apply federal income tax reporting principles to calculate its franchise fee. (Tab 1 at 1, 7). The Executive Summary of the 1998 Audit Report expressly states that "[t]he criteria for assessing allowable expenses for franchise fee purposes are based on the Federal IRS Tax Code." Thus, just as NYRA uses tax accounting principles to calculate its federal taxable income, it must also use tax accounting principles – not GAAP – to calculate its annual franchise fee.

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shall be added to taxable income in computing 'entire adjusted net income' for use in calculating the annual franchise fee . . . .

(Tab 27). Prior versions of the franchise fee statute are attached as Tabs 20-26.

While tax reporting principles have some overlap with GAAP, there are many differences between tax and GAAP (also known as "book") accounting. The United States Supreme Court has explained the vastly different rules and objectives of financial (*i.e.*, GAAP/book) and tax accounting.[4] Indeed, proof of these differences is evident in the Code itself. The Code devotes an entire subchapter – over thirty sections – to accounting periods and methods of accounting. In addition, the U.S. Treasury Department has promulgated hundreds of pages of regulations that relate to those Code sections. If taxable income were the same as GAAP income, there would be no need for any of those rules. Because it is clear that the computation of taxable income is based on tax accounting, not GAAP, it follows that the computation of revenues and expenses, each a component in calculating taxable income, must also be based on tax accounting, not GAAP.

* **Note 1 Cont'd**

As noted above, the use of GAAP versus income tax reporting principles can result in substantial differences. At the start of each audit conducted by the Comptroller's Office, NYRA has provided a copy of the differences between its GAAP and income tax expenses to the Comptroller's staff. (Tab 2 (2001 Schedule)). The differences between NYRA's GAAP expenses and income tax expenses are also disclosed in its audited financial statements. The GAAP to tax differences in 2001 totaled $11,020,000. (Tab 3 at 7 (Audited Financial Statements of NYRA issued by Deloitte & Touche for the years ended December 31, 2002 and 2001)). Thus, NYRA's tax expenses were $11,020,000 less than its GAAP expenses for 2001. This difference is due to depreciation, bad debts, non-deductible travel and entertainment expenses, pension costs, and other expenses. There were no differences between GAAP and tax revenue in 2001.

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[4] In *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 542-44 nn.19-22 (1979), the Supreme Court commented:

> The primary goal of financial accounting is to provide useful information to management, shareholders, creditors and others properly interested; the major responsibility of the accounting is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principal 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 . . . . This difference in objectives is mirrored in numerous differences of treatment . . . . [A] presumptive equivalency between tax and financial accounting would create insurmountable difficulties of tax administration. Accountants long have recognized that 'generally accepted accounting principles' are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions. 'Generally accepted accounting principles,' rather, tolerate a range of 'reasonable' treatments, leaving the choice among alternatives to management . . . . Variances of this sort may be tolerable in financial reporting, but they are questionable in a tax system . . . . If management's election among 'acceptable' options were dispositive for tax purposes, a firm, indeed, could decide unilaterally – within limits dictated only by its accountants – the tax it wished to pay. Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable.

* See State Comptroller's Notes, Appendix C

The Draft Audit relies on GAAP to make the calculation required by Section 208(10). By doing so, it erroneously concludes that NYRA's operating expenses in 2001 exceeded the allowable amount (90% of its revenue) by $10.9 million. The proper calculation, using tax reporting principles, demonstrates that NYRA's operating expenses equaled 89.57% of its revenues in 2001. (Tab 4). Accordingly, NYRA's franchise fee for 2001 was properly calculated and no additional money is owed to the State.

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Note
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Finally, NYRA notes that it has performed the 90% calculation required by the Racing Law (using income tax reporting principles) for many years. During each of the Comptroller's audits, NYRA has provided its calculations to the Comptroller's staff, but the Comptroller's Office has not previously taken exception to NYRA's method of performing this calculation.

B. NYRA Did Not Understate the Franchise Fee By Deducting Interest Owed to the CIF

At the outset, we would like to point out that NYRA's financial statements are audited and its tax returns are prepared each year by professional accounting firms (initially Ernst & Young, later Arthur Andersen, and now Deloitte & Touche). None of these professional firms has ever raised any concerns regarding NYRA's federal tax treatment of its CIF transactions. Moreover, despite the fact that NYRA has taken a deduction for interest owed to the CIF in each of the last ten years, the Comptroller's Office has never before raised this issue.

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Note
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As noted above, the Draft Audit states that NYRA may have improperly deducted the interest accrued (but not paid) on its obligations to the CIF during the Audit Period, but defers decision to the IRS. The IRS, however, would have no basis to challenge NYRA's deduction of the interest accrued on the CIF loans. Federal income tax law permits NYRA to deduct accrued interest on debt obligations unless it can be categorically said at the time the deductions are claimed that payment would not be made. The Comptroller's Office acknowledges this, albeit in slightly different words, when it states that NYRA may deduct such expenses "unless there is no substantial expectation that payment would be made or could be made." Draft Audit at 16. In any case, NYRA clearly satisfies the test for deductibility of accrued interest expenses.

1. *Summary of Applicable Federal Income Tax Law*

An accrual method taxpayer, such as NYRA, is allowed to take interest deductions in the year the interest is accrued. This is true even if there were some question as to whether the interest will ultimately be paid, so long as the taxpayer's default is not virtually certain.

Section 461(a) of the Code provides that any deduction allowed under the Code should be taken for the taxable year "which is the proper taxable year under the method of accounting used in computing taxable income." Under the accrual method of accounting, a liability is generally taken into account in the taxable year "in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the

liability."[5] With respect to interest, economic performance occurs as the interest cost economically accrues rather than as payments are made.[6] Case law establishes that, even if there is a likelihood that the interest will not be paid, deduction for accrued interest is proper. As the Tax Court stated in *Cohen v. Commissioner*, 21 T.C. 855 (1954):

* Note 2 Cont'd

> The rule which emerges from the decisions of this Court is that deductions for accrued interest are proper where it cannot be categorically said at the time these deductions were claimed that the interest would not be paid, even though the course of conduct of the parties indicated that the likelihood of payment of any part of the disallowed portion was extremely doubtful.[7]

Thus, even assuming there were some doubt as to NYRA's ability to repay the CIF – which, for the reasons set forth below, there should not be – NYRA is entitled to deduct its interest obligations in the year such obligations are accrued under federal income tax law.

2. *NYRA's Repayment of the CIF Loans*

NYRA fully intends to – and will eventually – repay the CIF in full. First, in 2000 and 2001, NYRA made payments to the CIF of $1,829,543 and $4,107,352, respectively, as the attached schedule shows. (Tab 5). Those amounts also exceed the amounts borrowed from the CIF in those years by $1,574,085 and $430,368, respectively. Moreover, from 1985 through 2001, NYRA has made debt payments to the CIF totaling $37,432,932, comprising $9,507,478 in interest and $27,925,454 in principal. (Tab 5). NYRA continues to repay the CIF; in 2003, NYRA repaid the CIF $1.6 million. (Tab 3 at 3). In addition, NYRA has undertaken various projects that are designed to enable it to fully repay the CIF, most notably, the plan to operate VLTs at Aqueduct. Moreover, if necessary, NYRA could sell non-racing-related real estate to raise cash to repay the CIF, although NYRA would have to obtain the State's permission to sell any of its land.[8]

It is also important to note that nowhere in the statutory provisions governing the CIF is the CIF authorized to *grant* or *give* funds to NYRA. *See* New York State Thoroughbred Racing Capital Investment Fund Act of 1983, Racing Law §§ 251-268 (the "CIF Act") (Tabs

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[5] Treas. Reg. Sec. 1.461-1(a)(2).

[6] Treas. Reg. Sec. 1.461-4(e) ("In the case of interest, economic performance occurs as the interest cost economically accrues, in accordance with the principles of the relevant provisions of the Code.").

[7] *See also, e.g.*, Rev. Rul. 70-367, 1970-2 C.B. 37 (accrued interest deductible by financially troubled debtor, even though there was "no reasonable expectancy" that the debtor would pay the accrued interest in full).

[8] The Draft Audit contends that "[u]pon the expiration of NYRA's franchise, the ownership of the three tracks reverts to the State." Because a detailed explanation of the legal ownership of the tracks is beyond the scope of this letter, we would simply note that property cannot "revert" to an entity that has never owned it and that NYRA strongly disagrees with the contention of the Draft Audit.

* See State Comptroller's Notes, Appendix C

40-57). In fact, wherever the CIF Act speaks of transfers of cash from the CIF to NYRA, it speaks in terms of loans, or presupposes that such transfers would take such a form.[9]

* Note 2 Cont'd

Finally, the loans from the CIF are clearly bona fide loans. They are secured by fixed assets created with the loan proceeds. (Tab 6). Furthermore, the loans are also secured by a mortgage lien on the Aqueduct racetrack real property, which is worth hundreds of millions of dollars – an amount far greater than NYRA's debt to the CIF. (Tab 6). Should NYRA ever default on its debt to the CIF, the mortgage guarantees that the CIF will be paid what it is owed.

In sum, it certainly cannot be said – much less "categorically said" – that NYRA will not ultimately pay the CIF the interest amounts it deducted during the Audit Period.

3. *NYRA Is Repaying the CIF in Accordance With Its Statutory Obligations.*

As set forth above, NYRA has repaid the CIF to the extent that the Racing Law and its financial position have allowed it to do so. Prior to the adoption in 1997 of the current version of Section 208(1), in those instances when NYRA did not have the money to repay its debt to the CIF, it applied for, and received, deferral of those payments from the CIF in accordance with Racing Law Section 258(1). Since 1997, NYRA has made payments to the CIF in accordance with its obligations under Section 208(1).

Should NYRA and the CIF come to an agreement on a repayment schedule that differs from that provided for in the Racing Law, an amendment of that law would be required. Until such an event, NYRA will continue to make payments to the CIF in accordance with the governing statutory regime (as evidenced by the $1.6 million payment NYRA made to the CIF earlier this year).

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[9] *See* CIF Act §254(7) (The CIF shall have power to "*extend credit or make loans* to [NYRA] for the costs of any capital improvements . . . ."); CIF Act §255(1) ("The [CIF] is hereby authorized to provide, *in accordance with the procedures established by subsection two* of this section [authorizing the CIF to make "secured loans" but nothing else], for the *financing* of capital improvements . . . ."); CIF Act §255(2) ("The [CIF] is hereby authorized to make *secured loans* to [NYRA] . . . . As a condition to and as consideration for the provision of such *loans by the [CIF]* . . . .); CIF Act §257(4) (The CIF "is hereby authorized to approve . . . *deferrals of the payments due to it* . . . .); CIF Act §258(1) (The submission of a capital improvement plan by NYRA to the CIF "shall not relieve the director of the budget of his responsibilities . . . from determining that any *borrowings* contemplated to finance [NYRA's capital improvement plans] can reasonably be expected to be repaid by [NYRA] within the term of its franchise and the provisions of existing law."). *See also* Racing Law §208(1)(a) ("In consideration for any franchise granted pursuant to this section [NYRA] shall pay to the [CIF] in order to reduce such *debt obligations* which [NYRA] may have incurred in accordance with [the CIF Act] . . . an amount equal to the 'entire adjusted net income' of [NYRA] . . . .) (emphases added).

C. Advertising Expenses

The Draft Audit recommends that $62,811 be added back to the franchise fee for 2000 because NYRA's documentation for an advertising expense in this amount was allegedly insufficient. NYRA has provided documentation to the Comptroller's Office for this, as well as certain other, advertising expenses. We have attached copies of the documentation for these expenses at Tab 7. Accordingly, no such expense should be added to NYRA's franchise fee for 2000.

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Note
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D. Expired Checks

The Draft Audit recommends that certain expired checks be included in NYRA's taxable income for purposes of calculating its franchise fee during the Audit Period. The Draft Audit asserts that issued checks that are outstanding for a period of one year must be voided and included as miscellaneous income at that time. The one-year rule advanced by the Comptroller's Office, however, is not required by the Code or Treasury regulations. The generally accepted tax rule is that amounts with respect to unclaimed checks must be included in income in the year that they are charged to profit and loss on NYRA's books.[10] In accordance with this rule, NYRA recorded these expired checks as income in 2002, when they were charged to profit and loss on NYRA's books. NYRA is certainly willing to discuss this issue with the Comptroller's Office in order to adopt a mutually satisfactory methodology for the treatment of expired checks.

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Note
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In sum, NYRA's franchise fees for the Audit Period were properly calculated.

III. NYRA'S FINANCIAL CONDITION HAS NOT DETERIORATED

A. NYRA's Unique Financial Position Prevents It from Saving

The Draft Audit contends that although "NYRA's net revenues have steadily increased since 1997 . . . NYRA's overall financial condition has deteriorated, because its operating expenses have increased by a greater rate than its net revenues." Similarly, the Draft Audit suggests that NYRA's alleged inability to repay promptly its debt to the CIF demonstrates that NYRA's finances have been mismanaged. These assertions reflect a misunderstanding of NYRA's unique situation.

NYRA is a quasi-public, non-profit association that has been enfranchised by New York State. It is heavily regulated and subject to a unique statutory taxing regime. The Racing Law, which has been amended several times since 1955, dictates what NYRA does with its earnings and how it pays its New York State taxes. The various amendments made

[10] *See, e.g.*, *Charleston & W.C. Ry. Co. v. Burnett*, 50 F.2d 342 (1931); *Chicago, Rock Island & Pacific Ry. Co.*, 47 F.2d 990 (1931).

* See State Comptroller's Notes, Appendix C

by the State to the Racing Law have come in response to NYRA's financial situation and the priorities of the State. The provisions of the Racing Law governing NYRA's payment obligations, along with the relevant amendments, are included in the attached binder. (Tabs 20-57).

Since its inception, NYRA has been required to pay a pari-mutuel tax ("PM Tax") to New York State equal to a percentage of its "handle" (the amount of gross receipts taken in by NYRA from wagers). In addition, NYRA paid a franchise fee to the State based on net income. Since 1976, this tax regime has ensured that, while NYRA would have enough cash for operations, it would not be permitted to retain any meaningful amount of its profits.[11] Although NYRA is not statutorily forbidden to make capital improvements, this taxation regime effectively prevented it from doing so.[12] By 1983, NYRA's physical plant had deteriorated to a point that, without significant capital improvements, it would not be able to continue its operations.

The State created the CIF in order to ensure that NYRA would be able to draw on funds to undertake capital maintenance and improvements. In conjunction with the creation of the CIF, New York State amended the Racing Law in 1983 to change NYRA's tax regime. Under the amendment, NYRA's PM Tax was still calculated as a percentage of the handle and was still paid directly to the State. The State, however, required NYRA to allocate certain portions of its income to be paid directly to the CIF in order to fund it.[13]

In essence, the primary purpose of the CIF is to act as a fund, established through payments from NYRA, from which NYRA can then later borrow money to make capital improvements. Since the creation of the CIF, New York State has changed NYRA's tax regime slightly. However, the thrust of the regime has remained the same: NYRA itself has not been permitted to retain any meaningful net income from operations but instead has had to pay over substantially all of its income to either the CIF or the State itself.

* Note 5

One result of this taxation regime is that NYRA's financial health – and, in particular, its debt to the CIF – cannot be evaluated in the same way that the financial health of other

[11] In 1976 the PM Tax was reduced in order to ensure that NYRA had enough revenues for operations. The quid pro quo for this reduction was a change in the calculation of the franchise fee. Since 1976, NYRA's franchise fee has been calculated as a percentage of whatever NYRA's federal taxable income would be prior to the consideration of the franchise fee. In 1976, for instance, the franchise fee was calculated as the greater of (a) 90% of NYRA's federal taxable income prior to NYRA taking a deduction from its federal income taxes for the franchise fee or (b) $50,000 per day for each day during the year in which one or more races is actually run. The per diem rate was never the greater of the two. Although there have been changes since 1976 to the franchise fee, the basic calculation has always involved payment by NYRA of a very high percentage of its federal taxable income.

[12] Because capital improvements do not create a current tax deduction, had NYRA undertaken any capital improvements, it would have been unable to pay its franchise fee because it would have used cash for an expenditure that did not reduce it taxable income and, therefore, did not reduce its franchise fee.

[13] *See* Racing Law, effective April 1, 1983, §§ 208(1)(a), 229(1)(b).

businesses is evaluated. Other businesses typically pay a small fixed percentage (now, generally, 7.5% for most New York companies) of their taxable income to the State. In contrast, NYRA pays virtually all of its taxable income to the State.

Not only does the State tax system cause NYRA to operate on a shoestring budget, but the State has also at times effectively taken valuable assets from NYRA. In 1992 and 1993, NYRA was effectively obliged, by statute, to sell substantial real estate holdings (a $40 million sale in 1992 and a $13.6 million sale in 1993) and immediately turn the money over to New York State as a special franchise fee.[14] The motivation for the sales came from the State; indeed, NYRA was informed of the deals only after they had already been arranged. The sales were designed to use NYRA assets to close short-term budget gaps that had nothing to do with horse racing. (Tab 8). If NYRA had been permitted to retain these funds, it would have had approximately $35 million, which it could have used to pay down its debt to the CIF.

*
Note 7

B. <u>The Reduction in Take-Out</u>

The Draft Audit notes that NYRA's direct payments to the State have decreased in recent years. This decrease is not, however, attributable to mismanagement on the part of NYRA but, instead, is the result of a policy decision made by the State Legislature. The Legislature determined that it was in the best interest of New York to reduce the pari-mutuel taxes paid by NYRA in order to increase the amount of money flowing to horse owners, horse breeders and bettors and thereby increasing the substantial indirect benefits that NYRA provides to the State through jobs, economic activity, and tourism.

For each bet, NYRA takes out a percentage – which is called the "take-out" – and returns the rest to the betting pool. The take-out is then divided between (1) New York State, in the form of a pari-mutuel tax; (2) the horsemen, in the form of purses; (3) New York horse breeders, in the form of a contribution to the New York Breeding and Development Fund; and (4) NYRA, to take care of operational costs including, for example, nearly $18 million in real property taxes each year.

In September 1999, the State Racing Law changed the take-out split, reducing the percentage of the take-out going to New York State in the form of pari-mutuel taxes, and increasing the percentage going to horsemen and breeders. In April 2001, the take-out split was again changed by statute, further reducing the amount of the take-out given to the State in the form of pari-mutuel taxes and again giving that cut to horsemen and breeders. In July of 2001, the take-out itself was reduced by statute, giving more money back to bettors, and resulting in less money being retained by NYRA per bet for its operational costs. Accordingly, the recent drop in taxes on wagers is a direct result of a decision by the State Legislature to reallocate the money brought in through NYRA wagering, and is in no way a result of mismanagement.

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[14] Laws of NY 1992, ch. 304, § 1.

* See State Comptroller's Notes, Appendix C

In order to fairly assess NYRA's performance over the last several years, the appropriate figure to look at is not the pari-mutuel taxes NYRA pays – which, as noted, have been decreasing because of statutory changes – but rather the handle. The handle is the total amount of money bet each year on NYRA races and on simulcast races shown at NYRA tracks and New York OTB outlets, from which NYRA collects revenue. The total handle has been steadily increasing over the last several years:

1997 - $2.8 billion

1998 - $2.9 billion

1999 - $3.3 billion

2000 - $3.3 billion

2001 - $3.5 billion

2002 - $3.6 billion

As the handle figures demonstrate, NYRA continues to grow significantly as a company and attract more money to its operations. Any drop in tax revenue for New York State over the last several years represents nothing more than a decision by the legislature to allocate more of NYRA's revenue to New York's horsemen, breeders, and betting customers, rather than the State.

In sum, the Draft Audit's suggestion that NYRA is in poor financial health is based on a misunderstanding of NYRA's unique financial situation.

C. The 2000 and 2001 Budgets Were Properly Approved

The Draft Audit also asserts that NYRA did not comply with the budgeting process specified in Section 208(10) of the Racing Law during the Audit Period. In particular, the Draft Audit states that there was "inadequate evidence that NYRA's Board of Trustees formally approved its annual operating budget, as required by the Racing Law." NYRA has provided the Comptroller's Office with a copy of the Minutes of the Board of Trustees Meeting held on December 8, 1999. Page 3 of those Minutes indicates that the Board of Trustees approved the operating budget for 2000 presented by NYRA's management and that the Board found that the proposed budget satisfied the requirements of Section 208(10). NYRA has also provided the Comptroller's Office with a copy of Minutes of the Board of Trustees Meeting held on December 13, 2000, where the Board similarly approved the proposed 2001 operating budget. We have attached copies of those minutes. (Tabs 9-10). In order to demonstrate that its budgets were properly approved, NYRA has also attached to this response a complete breakdown of the budget and the 90% calculation for 2000 and 2001, which were provided to the NYRA Board in advance of their approval of the budgets for those years. (Tabs 11-12).

*
Note 8

The Draft Audit also criticizes NYRA for allegedly failing to include certain expenses associated with the Breeder's Cup in its 2001 budget and certain pension and retiree benefit related expenses in its 2000 and 2001 budgets. The 2001 budget approved by the NYRA Board of Trustees included projected expenses of $8,840,500 for "Other-BCL, Bad Debts, Non-deduct T&E." (Tab 12, Schedule D). "BCL" refers to the Breeder's Cup, and approximately $8.8 million of the budgeted amount was for expenses associated with the Breeder's Cup. Certain pension and retiree benefit expenses were not included in the 2000 and 2001 budgets approved by the NYRA Board of Trustees because such expenses are not recognized as expenses for purposes of income tax reporting. The Board of Trustees must review a budget prepared in accordance with tax reporting principles in order to perform the 90% test it is required by statute to perform each year. If NYRA had included such expenses in these budgets, it would have misrepresented the amount of its expenses and prevented the Board of Trustees from performing the required 90% test accurately.

*
Note 8

D. NYRA's Supplemental Pension Payments Were Appropriate

The Draft Audit recommends that NYRA suspend certain supplemental pension payments that the Comptroller's Office believes may not be appropriate expenditures for NYRA because it is allegedly in poor financial health. NYRA simply cannot, and should not, suspend such payments.

The pension and retirement payments with which the Draft Audit takes issue are paid under NYRA's Supplemental Employee Retirement Plan ("SERP"), which is an excess benefit plan that NYRA created to supplement payments made under its qualified plans. It is very common for employers to provide employees benefits under excess benefit plans such as NYRA's. For further information about NYRA's SERP and such plans generally, see Tab 13 (Statement of Milliman USA).

In the "1998 Audit Report" of NYRA, the Comptroller's Office noted that it had made two recommendations regarding NYRA's SERP during its 1995 audit of NYRA's franchise fee: (1) that NYRA reassess the terms of the SERP in comparison to its intended purpose and consider limiting benefits as appropriate; and (2) that NYRA review the benefit calculation methodology utilized in determining SERP benefits payable to former NYRA employees. (Tab 1 at 13). The 1998 Audit Report expressly states that NYRA complied with these requests: "During our current audit, we determined that NYRA officials have implemented the two recommendations regarding SERP. They supplied us with documentation of their having revisited the purpose of SERP and their compliance therewith, and had their actuarial consultant re-attest to the individual benefit calculations." (Tab 1 at 13-14). Thus, it appears that the Comptroller's Office has previously reviewed, and expressed satisfaction with, NYRA's SERP.

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Note 9

Under the terms of its SERP, NYRA cannot terminate or reduce accrued benefits of participants. (Tab 14 at 8). As a result of certain changes in federal tax law, however, a number of benefits that were previously paid under NYRA's SERP are now paid under NYRA's qualified plans. Indeed, NYRA's SERP expenses have recently been significantly reduced. The Draft Audit notes that NYRA paid $219,048 to its 27 SERP participants in 2000, and $240,091 to its 26 SERP participants in 2001. Draft Audit at 11. In 2003, by

contrast, NYRA expects to pay 19 SERP participants only $160,436. The Draft Audit takes issue with payments made to five individuals. Of those five individuals, one is no longer a SERP participant, and the SERP payments for three of the four others have been substantially reduced. The payments made to the fifth individual, Mr. Kenneth Noe, are discussed below.

Furthermore, the SERP retirement benefits NYRA provided to its employees during the Audit Period were an essential part of the compensation package that lured top racing and business executives to NYRA. Compared to executives at other major non-profit organizations in the metropolitan New York area, NYRA executives are paid relatively little. For example, in 2003, NYRA's president will receive a salary of $350,000. The list of salaries paid to executives at other non-profit organizations during 2001 or 2002, which is at Tab 15, amply demonstrates that NYRA is not overly generous to its executives. The salaries of these executives all exceed that of NYRA's president, even though NYRA brings more revenue and tourists to New York State than any of these other organizations. (*See, e.g.*, Tab 16) (Report by Barents Group LLC stating that each year the New York horse industry "produces goods and services valued at $1.7 billion.").[15]

E. Kenneth Noe Was Entitled to SERP Benefits During the Audit Period

The Draft Audit specifically takes issue with the provision of SERP benefits to Kenneth Noe, NYRA's former president and Chairman. In particular, the Draft Audit suggests that Mr. Noe was not entitled to these payments because he was not an employee, but instead a consultant, during the latter part of his tenure at NYRA, when NYRA authorized the payment of SERP benefits to him.

* Note 3

First, Mr. Noe was an employee of NYRA from 1972 through 1979 and again from 1995 through 1997, as evidenced by the attached tax assessment issued for those years by the New York State Department of Taxation and Finance to NYRA relating to Mr. Noe. (Tab 18).[16] The payments Mr. Noe receives under the SERP are based only on the salary he earned during those years. When Mr. Noe left NYRA in 1979, he accrued a vested benefit under the terms of NYRA's qualified pension plan. Mr. Noe's return to NYRA as an employee in 1995 entitled him to accrue additional credits. Second, even apart from the fact that Mr. Noe was an employee of NYRA, he was authorized to receive SERP benefits

[15] This Report also notes that "258,100 New Yorkers are involved in the industry as horse owners, service providers, employees and volunteers." (Tab 16). Furthermore, due to the increased popularity of NYRA's races, its significant contributions to the State Thoroughbred Breeding and Development Fund, and the efforts of the New York State government, there has been a dramatic increase in the number of horse farms in New York. Currently, there are over 400 working horse farms in the State. A 2001 report by the American Horse Counsel indicates that New York's horse industry contributes $4.8 billion annually to the national economy. (Tab 17).

[16] Also attached at Tab 18 is a letter dated June 18, 1998, from Frank Houston of the Comptoller's Office indicating that, based on information provided by the New York State Department of Labor, the Comptroller's Office was of the view that Mr. Noe was an employee, not a consultant, of NYRA for the years 1995, 1996, and 1997.

because the Compensation/Pension Committee of NYRA's Board of Trustees passed a resolution approving such payments to Mr. Noe. A copy of this resolution is attached. (Tab 19). Accordingly, NYRA is contractually and legally bound to provide Mr. Noe with the pension benefits he receives – benefits to which he clearly is entitled. Therefore, NYRA has no legal basis for recovering the pension benefits paid to Mr. Noe or refusing to make such payments in the future.

IV. THE ALLEGED CONTROL WEAKNESSES DID NOT AFFECT NYRA'S FRANCHISE FEE CALCULATION

The Draft Audit expressly states that, "[o]ur audit addressed . . . questions about NYRA's financial operations for calendar years 2000 and 2001." Nevertheless, as support for the conclusion that "serious weaknesses existed in internal controls over NYRA's wagering revenues," the Draft Audit cites conduct detailed in a report prepared by the Attorney General, much of which occurred *before* the Audit Period. For example, the improper cash shortages noted in the Attorney General's report and referred to in the Draft Audit were effectively eliminated by NYRA at the outset of 2000. Accordingly, this alleged weakness did not exist during the Audit Period. Moreover, as the Draft Audit acknowledges, the amounts of monies alleged to have been mishandled in Attorney General's Report were "immaterial." *See* Draft Audit, Executive Summary, Audit Observations and Conclusions.

* Note 6

Furthermore, the Draft Audit expressly states that the actual testing conducted by the Comptroller's Office to assess the accuracy of NYRA reported revenues "did not provide any indication of further misappropriation or mishandling of NYRA revenues." *Id.*

NYRA notes that it has taken a number of steps to improve its internal controls. NYRA has recently hired several highly qualified individuals who are capable of, and committed to, ensuring the integrity of NYRA's mutuel operations.

In April 2002, NYRA hired Jim Gallagher to oversee the mutuel department. Mr. Gallagher has an impeccable reputation in the racing industry and over 20 years of regulatory experience with the New York State Racing and Wagering Board. He also served as the executive director of the National Thoroughbred Racing Association's Integrity and Drug Testing Task Force. In January 2003, Mr. Gallagher was promoted to vice president of regulatory compliance, a new senior management position created by NYRA.

In January 2003, NYRA hired Patrick Mahony as its vice-president of pari-mutuels. Mr. Mahony brings 37 years of pari-mutuel expertise to NYRA and is widely regarded as one of the best mutuel managers in the country. He has tremendous experience in all aspects of pari-mutuel operations, and has lectured frequently at industry conferences and national seminars. Mr. Mahony is also a member of the National Thoroughbred Racing Association's wagering technology working group, and has served as a pari-mutuel consultant for Breeders Cup Ltd.

In January 2003, NYRA also hired Robert Zambreny as assistant director of mutuels to supervise banking and accounting activities in the money room. Mr. Zambreny is a certified public accountant with more than 25 years experience in cash controls, having

* See State Comptroller's Notes, Appendix C

served as vice-president of finance at Gulfstream Park and Bay Meadows, and having also worked in various pari-mutuel operations positions at Pimlico, Laurel, Freestate, and Rosecroft Raceways.

Under the leadership of these individuals, NYRA has implemented several initiatives designed to prevent and deter improper conduct by employees and patrons. In 2002, NYRA instituted new count-out and balance procedures. Pursuant to these procedures, each clerk is counted out every day to ensure the integrity of the tallying process. Since the new count-out procedures of clerks were adopted, NYRA has also conducted dozens of random audits of its minidealers. These audits have revealed only a single instance of any discrepancy – and that was an overage of $1.00. Nonetheless, NYRA has also recently implemented daily count-outs of its minidealers as well.

NYRA has issued a new, consolidated policy manual and a Mutuel Operations Organization Manual that clearly set forth the rules and regulations governing mutuel employees, as well as their duties and responsibilities. NYRA has also implemented a training program pursuant to which it conducts several training seminars for bay supervisors and mutuel clerks each year. NYRA has also instituted strict initiatives which are among the toughest in the nation to prevent fraud with respect to IRS winnings at its tracks.

As stated in the Draft Audit, NYRA has already addressed many of the control issues that were detailed in the Attorney General's Report. But NYRA also recognizes that there is always room for improvement, and its Board of Trustees has hired the firm of SafirRosetti, headed by former New York City Chief of Police Howard Safir. SafirRosetti has entered into a long-term engagement with NYRA to ensure the continued public confidence in the integrity of NYRA's operations and to provide a daily, full-time presence at NYRA in order to assist NYRA in its compliance with all applicable laws and regulations. The work of SafirRosetti includes evaluating and supplementing the security operations, cash handling, supervisory training and other procedures for NYRA. SafirRosetti will also be conducting periodic audits to ensure the continued effectiveness of NYRA's control measures and will be reporting directly to NYRA's Board.

NYRA has also created a Special Oversight Committee of its Board of Trustees to ensure that NYRA appropriately addresses concerns raised by law enforcement and NYRA's regulators.

Accordingly, the Draft Audit's recommendations that NYRA "establish a strong and comprehensive system of internal control over all wagering revenue" and "at least once a year, evaluate the effectiveness of the controls over wagering revenue" have already been implemented.

We hope that the detailed responses included in this letter and the attached exhibits sufficiently address the concerns raised in the Draft Audit. NYRA looks forward to continuing to work with the Comptroller's Office in a constructive and cooperative manner.

If you require any additional information, please do not hesitate to contact us.

Sincerely yours,

Patrick Kehoe/ay

Patrick L. Kehoe
Vice President and General Counsel

* See State Comptroller's Notes, Appendix C

State Comptroller's Notes

1. Pursuant to section 208(10) of the Racing Law, NYRA has an affirmative obligation 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 government".[1] This statute attempts to ensure NYRA's compliance with the foregoing duty by limiting NYRA's "total expenses" (less certain exclusions) to 90% of "the revenues available to such association for its operations"[2], and by requiring that NYRA's franchise fee obligation to the State be increased by an amount equal to the operating expenses in excess of that percentage. NYRA does not dispute that section 208(10) is intended to act as a limitation on its operating expenses or that the statute restricts such expenses to no more than 90% of its operating revenues in any given year by requiring that its franchise fee obligation be concomitantly increased by the amount of the excess. The operative language employed here – "total expenses" and "revenues available" – is readily distinguished from language used elsewhere in the same subdivision -- "taxable income" -- to describe different calculations. Use of terms that do not include tax concepts to describe the allowable expense formula is clearly deliberate and is consistent with the purpose of the provisions. Nevertheless, NYRA has taken the position that the spending limitation set forth in subdivision 10 of section 208 must be calculated using Federal tax reporting principles and not Generally Accepted Accounting Principles (GAAP).

   In order to understand the deficiencies of NYRA's response, it is useful to review, in its totality, the requirements set forth in the Racing Law with respect to both the computation of NYRA's franchise fee and the computation of the add-on to that fee. Pursuant to section 208 (1)(a) of the Racing Law, NYRA is to pay an annual franchise fee equal to the "entire adjusted net income" of NYRA (as defined in Section 208(1)(b) of the Racing Law), less $2 million. Under section 208(1)(b) of the Racing Law, NYRA's "entire adjusted net income" is computed by adding to NYRA's taxable income the amount by which NYRA's operating expenses in a given year exceeds 106% of NYRA's operating expenses during the prior year (for purposes of this response, the amount yielded by multiplying NYRA's operating expenses during

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[1] "Any non-profit racing association which is franchised pursuant to this section shall 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 government. In carrying out these responsibilities, the board of trustees of such association shall require the appropriate officers of the association to present to such board of trustees for its approval prior to the beginning of each fiscal year an operating budget covering all of the expenses planned to be incurred during such year and a plan of operation. The form of such plan of operation shall be subject to an agreement between the board and a non-profit racing association. *** "

[2] The revenues available for NYRA operations is determined by combining NYRA's share or retainage of the total on-track and simulcasting wagers and other income (principally interest income), which excludes payouts on winning wagers, and subtracting therefrom certain statutory take-outs: (i) stakes and purses, (ii) the pari-mutuel tax paid to the State, (iii) payments made to the NYS Thoroughbred Breeding and Development Fund, and (iv) payments made to the Finger Lakes Race Track.

the prior year by 106% shall hereinafter be referred to as the "Allowable 1(b) Expenses"). Section 208 (1)(b) expressly defines the term "operating expenses" for purposes of that section to "include all expenses of [NYRA] for such year except: (i) charges for stakes, purses, interest, real estate taxes, extraordinary nonrecurring charges, and depreciation, (ii) promotional costs incurred in connection with specific events; (iii) costs incurred in the purchase of advertising services; and (iv) for calendar years 1986 and 1987, liability insurance costs."

As stated above, section 208(10) of the Racing Law imposes restrictions on the amount of operating expenses NYRA may incur in a given year. This section requires that NYRA's board of trustees disapprove any proposed operating budget "[i]f at any time, the total expenses of [NYRA], except taxes, fees or special assessments levied by the State of New York or by any instrumentality of the state or by any political subdivision of the state or by any agency or instrumentality thereto, exceed or are anticipated during the ensuing year to exceed ninety percentum of the revenues available to [NYRA] for its operations…." This limitation on NYRA's expenditures is enforced by subsequent language set forth in section 208(10), which provides "[i]n any year in which actual operating expenses are greater than the operating expenses allowed pursuant to the provisions of this subdivision, 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 due to the [S]tate…" (emphasis added).

Therefore, if NYRA's total expenses during a given year, less taxes, fees or special assessments (which sum constitutes NYRA's "actual operating expenses" for purposes of calculating the addition to NYRA's franchise fee under section 208(10)) exceed the dollar figure that is 90% of NYRA's available revenues, the amount of that excess is added to the amount of NYRA's taxable income for purposes of calculating the franchise fee (which franchise fee, as discussed earlier, is first calculated by adding (i) NYRA's taxable income to (ii) the amount, if applicable, that NYRA's operating expenses during that given year exceeds the Allowable 1(b) Expenses). Essentially, a "penalty" requirement is imposed to the extent that NYRA's expenses are excessive; that is, to the extent they exceed the statutory formula.

It is NYRA's position that because the Racing Law uses Federal taxable income as the starting basis for the calculation of the franchise fee and that since applicable tax reporting principles are applied to calculate NYRA's Federal taxable income, such rules - not GAAP - must also be used in the computation of "operating expenses" pursuant to section 208(10). Thus, in its simplest terms, NYRA's contention is that Federal tax reporting principles should overlay all of the provisions of the Racing Law concerning the calculation of the franchise fee and that the proper revenues and expenses to be used in the calculation required under section 208(10) (i.e., to determine whether NYRA exceeded the 90% operating expense limitation) are those that were reported on its Federal income tax return.

Although creative, NYRA's argument fails in the face of the express language of section 208(10). Moreover, NYRA's effort to characterize the issue as centering on the distinction between tax reporting and GAAP principles accomplishes nothing more than just to obfuscate the fact that it has failed to comply with the duty imposed by that statute to act in a fiscally prudent manner. Clearly, there are differences. We recognize that and see no need to engage in a debate on that question. We believe that the Legislature expressly and deliberately chose to employ a formula to define excessive spending using language that is not based on tax concepts. The fact that tax concepts are used elsewhere in the same law (e.g., to calculate the base amount for calculation of the franchise fee obligation) demonstrates that this choice of language was intentional. NYRA argues the opposite; that the difference in terms employed by the Legislature should be ignored and that tax principles should be imported or overlaid because they are utilized in calculations that serve a different purpose. The issue is not the distinction between tax reporting principles and GAAP accounting but rather proper statutory interpretation and fulfilling the legislative intent of section 208(10).

NYRA states that in defining how the franchise fee should be calculated, section 208 incorporates the core tax reporting concept of taxable income.[3] However, subdivision (10) of section 208 does not expressly, nor in accordance with its most obvious and natural construction, refer to or otherwise require the incorporation of Federal tax reporting principles into the definition of operating expenses for purposes of calculating the spending limitation. Indeed, in this statute, the Legislature uses the inclusive term "total expenses of such association" – expressly excluding from such term only taxes, fees or special assessments. Since the language of this provision is clear and unambiguous and since the Legislature has specifically and expressly set forth the items of expense to be excluded from "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 this calculation.[4] Since the Legislature's omission of any requirement to use tax

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[3] NYRA erroneously states that "entire adjusted net income" is equal to NYRA's "taxable income" (Response to Draft Audit Report 2002-S-31, p.5). However, Federal taxable income is only the starting point in the calculation of the franchise fee. The Legislature makes its own adjustments to that figure to arrive at "entire adjusted net income", which is then used to compute the franchise fee.

[4] In the construction of statutes, the primary consideration is to ascertain and give effect to the intention of the Legislature (Brusco v Brown, 199 AD2d 27, 605 NYS2d 13 affd 84 NY2d 674, 621 NYS2d 291 [1993]). The legislative intent is to be ascertained from the language used, which is to be literally construed according to its most obvious and natural sense (People v Munoz, 207 AD2d 418, 615 NYS2d 730 app den 84 NY2d 938, 621 NYS2d 535 [1994]; Civil Service Employees' Ass'n v Oneida County, 78 AD2d 1004, 433 NYS2d 907 [1980]). A second pertinent rule of construction is expressio unius est exclusio alterius, which means that where a law expressly describes a particular act, thing or person to which it shall apply, an irrefutable inference must be drawn that what is omitted or not included was intended to be omitted or excluded (Eaton v NYC Conciliation and Appeals Bd., 56 NY2d 340, 452 NYS2d 358 [1982]). Thus, where a statute creates provisos or exceptions as to certain matters, the inclusion of such provisos or exceptions is generally considered to deny the existence of others not mentioned (McKinney's Cons Law NY, Book 1, Statutes, §240, p 412).

reporting principles in this context must be seen as intentional, NYRA's attempt to equate section 208(10)'s use of the term "operating expenses" with that used for purposes of Federal income tax reporting must likewise be viewed as without merit.

We also note that NYRA states in its response (Response to Draft Audit Report 2002-S-31, p. 6) that the difference between NYRA's GAAP and Federal income tax expenses for the year 2001 was approximately $11 million. NYRA asserts that this difference was due to certain expenses, including travel and entertainment expenses, which were non-deductible and therefore non-reportable for Federal tax reporting purposes. This statement, in and of itself, makes it obvious why section 208(10) should not be interpreted in the manner NYRA proposes is required by that statute.[5]

Since Federal tax reporting principles allow only limited travel and entertainment expenses to be deducted by taxpayers, under NYRA's view of section 208(10), extravagant non-deductible travel and entertainment expenses incurred by it could not be used in the calculation of total expenses under section 208(10) for purposes of the 90% limitation. Rather, those expenses would simply escape the limitation and the legislative intent, evidenced by section 208(10), to reign in NYRA expenditures in order to preserve the franchise fee payable to the State. Such an absurd result could not have been intended by the Legislature.

NYRA further attempts to buttress its argument in this regard by citing to the executive summary from our 1998 Audit Report (98-S-6) which states that "[t]he criteria for assessing allowable expenses for franchise fee purposes are based on the Federal tax code." However, a closer reading of that report makes clear that that reference to the Federal tax code was for the limited purpose of: (i) pointing out that the Federal tax code allows NYRA to deduct only "ordinary and necessary expenses" and (ii) recommending that NYRA develop a formal policy to ensure that only ordinary and necessary expenses are incurred by its staff. This language certainly did not suggest that the calculation of operating expenses for the purposes of the 90% rule found in section 208(10) should in any way be limited only to the deductible expenses authorized by the Federal tax code. To reiterate, section 208(10) is neither related to nor dependent on the Federal tax code. Rather, it is a State statute which evidences a legislative concern with NYRA spending and which operates to contain that spending by imposing sanctions through the mechanism of the franchise fee when NYRA exceeds the statutory limits.

Finally, NYRA asserts in its response that it has performed its section 208(10) 90% calculation for many years and that the Comptroller's Office has never taken

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[5] Even subdivision (1)(b) of section 208 does not exclude travel and entertainment expenses from the computation operating expenses.
We would also note that when we applied our methodology to NYRA's 2000 fiscal year, we obtained the same section 208(10) percentage, as did NYRA's approach. This result further supports our audit finding that 2001 was a year in which NYRA's operating expenses exceeded acceptable limits.

exception to NYRA's method of calculation in prior audits (Response to Draft Audit Report, p. 5). While we are not certain whether NYRA is arguing for some type of estoppel by its assertion in this regard, we would point out that we have not criticized this practice before for the reason that we did not ask for information during prior audits relating to the 90% limitation and, therefore, did not previously examine NYRA's methodology relating to this calculation. Although we audit NYRA on a biennial basis, each audit does not examine every practice or expenditure of the auditee. The scope of each audit depends upon a risk assessment performed prior to the audit. The purpose of the risk assessment is to determine potential problem areas of the auditee which then allows us to focus our audit resources optimally and thereby provide the greatest benefit from an audit perspective. In this particular case, information came to our attention prior to the onset of the audit which led us to focus on significant NYRA losses for 2001. Subsequently, in the preliminary phase of the audit, certain tests were performed to assess areas of risk which resulted in the identification of our audit areas, one of which concerned the expenses of NYRA used in the calculation of the 90% limitation in section 208(10). The fact that we may not have reported on this particular area in the past is not an extraordinary occurrence and clearly does not preclude us from examining this issue in the current audit.

2. NYRA asserts in its response to the audit that it did not understate its franchise fee obligation by deducting interest owed (but not paid) to the New York State Thoroughbred Racing Capital Investment Fund ("CIF") on its Federal tax returns for 2000 and 2001. The fact remains, however, that NYRA took these interest deductions on its Federal tax returns for 2000 and 2001 without having made any annual interest payments to CIF since 1993, up to and including the present. In fact, by NYRA's own accounting, at the end of 2001 its accrued interest liability to CIF was $17,012,958.[6] The practical effect of the 2000 ($1,986,006) and 2001 ($1,748,525) deductions is that, in each year, NYRA derived both a Federal tax benefit and corresponding decrease in its franchise fee obligation to CIF.

   NYRA attempts to justify these interest deductions by summarizing the legal standard for the taking of interest deductions by accrual basis taxpayers and then diverting the reader's attention to its purported current ability to "repay the CIF in full," i.e., repay the principal. (Response to Draft Audit 2002-S-31, at p.8.) In general, "deductions for accrued interest are proper where it can not be 'categorically said at the time these deductions were claimed that the interest would not be paid.' " Cohen v. Commissioner, 21 T.C. 855, 857 (1954) (internal citations omitted). NYRA dedicates three pages of its response to this matter without providing any evidence that, at the time these deductions were claimed each year, it had any ability or intention to actually make the accrued interest payments to the CIF. For example, NYRA attempts to show its intent to "repay the CIF in full" (Response to Draft Audit 2002-S-31, at p.8.) by misleadingly citing to payments

[6] Currently, NYRA's accrued interest liability is significantly greater given the fact that NYRA has not made any interest payments to the Fund from 2001 to the present date.

made in 2000 and 2001[7] in the amounts of $1,829,543 and $4,107,352. (Response to Draft Audit 2002-S-31, at p.8.) However, these payments are nothing more than payments of franchise fees that are attributable to payments of principal, and are not payments of interest.

NYRA then attempts to bolster its argument that it intends to "repay the CIF in full" by stating, "[m]oreover, from 1985 through 2001, NYRA has made debt payments to the CIF totaling $37,432,932, comprising $9,507,478 in interest and $27,925,454 in principal." (Response to Draft Audit 2002-S-31, at p.8.) However, what NYRA conveniently fails to mention is that the $9,507,478 in interest payments it is referring to represents interest payments made from 1985-1993. Accordingly, NYRA acknowledges implicitly that it has made no payments of interest whatsoever to the CIF since 1993. NYRA's response goes on to state that it repaid the CIF $1.6 million in 2003. (Response to Draft Audit 2002-S-31, at pp.8-9.) This is true—but this $1.6 million was a payment of principal; no portion of it was used to pay down interest.

Finally, NYRA proceeds to mention projects it has "planned that will provide additional sources of revenue from which it can repay the CIF" and the fact that "NYRA's debt to the CIF is secured by a mortgage lien on the Aqueduct racetrack real property, which is worth . . . an amount far greater than NYRA's debt to the CIF." (Response to Draft Audit 2002-S-31, at pp.2, 8-9.) These "planned" projects and the default contingency may in fact provide a source of repayment to the CIF in the future. However, NYRA's statutorily obligated payment of principal or purported permissive deferral of those payments prior to 1997 is not the issue in dispute. (Response to Draft Audit 2002-S-31, at p.9.) The fact remains that in 2000 and 2001 NYRA deducted interest owed to the CIF, and received a corresponding reduction in its Federal tax liability, without actually having paid one penny of that interest, thereby decreasing its franchise fee obligation.

NYRA concludes this section of its response with the statement, "[i]n sum, it certainly cannot be said—much less 'categorically said' — that NYRA will not ultimately pay the CIF the interest amounts it deducted during the Audit Period." (Response to Draft Audit 2002-S-31, at p.9.) In actuality, the issue of whether NYRA could or would make the interest payments at the time these deductions were claimed is as unclear as ever. However, when the wheat is separated from the chaff in NYRA's response to this issue, all that is left is NYRA's acknowledgement of its utter failure to pay any interest to the CIF since 1993. We will leave it to the Internal Revenue Service to determine whether this failure meets the legal standard to disallow deductions of interest for taxpayers utilizing the accrual basis of accounting. To the extent the IRS disallows these deductions, the amount of the disallowance (up to the $3.7 million in claimed [but unpaid] interest expenses) should be added back to

[7] Franchise fee payments for each calendar year are actually made in the subsequent calendar year. NY CLS Racing & Wagering, § 208(1)(a). Therefore, the payments made in 2000 and 2001 relate to franchise fee obligations incurred in 1999 and 2000.

NYRA's taxable income for 2000 and 2001 and the franchise fees for those two years adjusted accordingly.[8]

3. As a result of additional documentation submitted by NYRA in its response, we have removed our finding related to this issue.

4. Upon further review of this matter, we have determined that other legal requirements may have a bearing on how NYRA treats outstanding checks. Therefore, we have removed the finding and related recommendation from this report. We will address this matter in a subsequent audit.

5. NYRA attributes its low cash reserves to its mandated responsibility to dedicate all but $2 million of its profits to CIF. As our report points out, it has not been NYRA's payments to CIF that have left it cash poor. Rather, it is that NYRA's expenses often exceed its revenues. As this and past Comptroller's reports demonstrate, NYRA could curtail overly generous pension, travel and entertainment expenses and adopt additional revenue-generating initiatives to achieve a positive financial position. However, NYRA's inefficient financial practices have resulted in extensive borrowing and minimal payments to CIF over the past two decades. Between 1984 (CIF's inception) and 2001, NYRA has accumulated an outstanding loan and interest balance of more than $60 million.

6. Certain matters addressed in the draft report were revised or deleted in the final report. Therefore, some of NYRA's comments included in Appendix B may relate to matters no longer contained in this report. We note, however, that while many of the deficiencies cited in our report were identified prior to the audit period, corrective measures were not fully in place during the period covered by our audit. In fact, according to the Regulation Report issued by the State Racing and Wagering Board on April 23, 2003, the same control deficiencies relating to Mutuel Department activities observed in 1998, still existed in August 2001. Further, the personnel changes noted in NYRA's response, all took place in 2002 and 2003, subsequent to our audit period.

7. NYRA officials responded they operate on a shoestring budget. This assertion is unsubstantiated when considering NYRA's significant annual expenses. As demonstrated in our report, between 1997 and 2001, NYRA's annual expenditures ranged from a low of $137 million to a high of nearly $172 million. Over the same five-year period, NYRA's annual expenses increased by nearly 25 percent while its revenues increased by only 18 percent. Consequently, NYRA continually operates with a deficit. In 2002 alone, NYRA increased its net capital deficiency by nearly $12 million, raising its accumulated deficit to approximately $70 million as of 2003.

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[8] As noted in the Audit Report, "[i]t is possible that similar adjustments may need to be made for years prior to 2000; however, any such adjustments were outside the scope of this audit." (Audit of the Annual Franchise Fee for Calendar Years 2000 and 2001, 2002-S-31, at p.17.)

8. We revised our report to reflect the fact that NYRA's response included information not provided to us during our audit fieldwork. However, for the reasons explained in our report, we maintain that the additional information provided still offers only limited assurance that those budget submissions were in fact, the one's approved by the Board. Further, we note that, certain expenses were excluded from the 90 percent compliance test.

9. Our current audit does not question the purpose of SERP, nor the actuarial methodologies applied, or the payment of accrued benefits. Instead, we question the discretionary financing of SERP in light of NYRA's deteriorating financial condition.