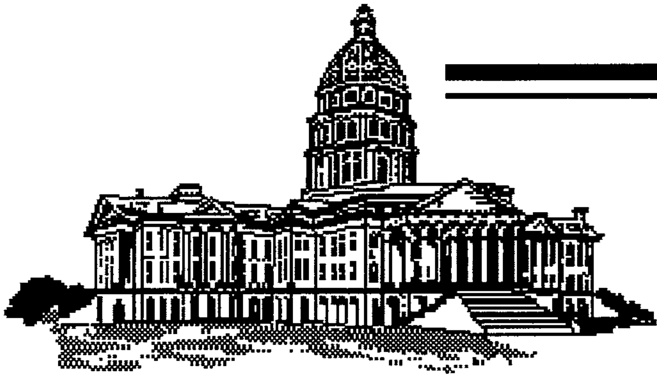

PERFORMANCE AUDIT REPORT

Reviewing Racing Commission Records Regarding Race Track Operations

A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
April 1993

93-42

Legislative Post Audit Committee

Legislative Division of Post Audit

THE LEGISLATIVE POST Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about $6 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by Legislative Post Audit helps provide that information.

We conduct our audit work in accordance with applicable government auditing standards set forth by the U.S. General Accounting Office. These standards pertain to the auditor's professional qualifications, the quality of the audit work, and the characteristics of professional and meaningful reports. The standards also have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

The Legislative Post Audit Committee is a bipartisan committee comprising five senators and five representatives. Of the Senate members, three are appointed by the President of the Senate and two are appointed by the Senate Minority Leader. Of the Representatives, three are appointed by the Speaker of the House and two are appointed by the Minority Leader.

Audits are performed at the direction of the Legislative Post Audit Committee. Legislators or committees should make their requests for performance audits through the Chairman or any other member of the Committee. Copies of all completed performance audits are available from the Division's office.

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PERFORMANCE AUDIT REPORT

REVIEWING RACING COMMISSION RECORDS REGARDING RACE TRACK OPERATIONS

OBTAINING AUDIT INFORMATION

This 100-hour audit was conducted by Randy Tongier, Financial-Compliance Audit Manager, of the Division's staff. If you need any additional information about the audit's findings, please contact Mr. Tongier at the Division's offices.

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REVIEWING RACING COMMISSION RECORDS REGARDING RACE TRACK OPERATIONS

Summary of Legislative Post Audit's Findings

Do the periodic reports the tracks have submitted to the Racing Commission indicate that the tracks have been having financial problems? Audit reports submitted by the tracks show that the tracks have been profitable, but that their debt and cash flow situations could make them susceptible to financial problems very quickly if their revenues declined. This situation may have been aggravated by significant distributions of cash by the tracks to their stockholders. In addition, the reports show that the tracks have had a significant number of financial transactions with their own stockholders. Some of those transactions could have resulted in track expenses being higher than they would have been if those transactions had been with independent parties. Within the scope of this audit, we did not attempt to determine if track expenses actually were higher than needed.

This report recommends that the Racing Commission improve its review and consideration of the tracks' annual audit reports. This report also recommends a performance audit of the Racing Commission's oversight of transactions between the tracks and their stockholders and the transactions themselves.

We would be happy to discuss these recommendations or any other items in the report with legislative committees, individual legislators, or other State officials.

Barbara J. Hinton

Barbara J. Hinton
Legislative Post Auditor

REVIEWING RACING COMMISSION RECORDS REGARDING RACE TRACK OPERATIONS

The Kansas Racing Commission regulates dog and horse race track activities, including the conduct of races, parimutuel wagering, and collection and payment of applicable taxes. As part of its regulatory activities, the Commission monitors the financial operations of the tracks.

The 1993 Legislature has passed Senate Bill 78, which reduces a scheduled increase in the parimutuel tax that was to have gone into effect this year. In addition, the Racing Commission's recent budget requests have asked that, if seven new veterinarian technician positions are approved, the cost for those positions be shifted from the tracks to the State. In connection with these matters, legislative concerns have been raised about reports from existing tracks that those tracks are having financial problems. These concerns focus on the question of whether financial reports the tracks file with the Racing Commission reflect financial problems.

To address these concerns, the Chairman of the Legislative Post Audit Committee authorized the Legislative Division of Post Audit to conduct a special, 100-hour audit of this situation. The audit addresses the following question:

Do the periodic reports the tracks have submitted to the Racing Commission indicate that the tracks have been having financial problems?

To answer this question, we determined the financial reporting requirements the Racing Commission has placed on the tracks. In addition, we reviewed the Commission's procedures for reviewing and acting on these reports. Finally, we determined whether past financial reports indicated the tracks were having financial problems. In conducting this audit, we followed all applicable government auditing standards set forth by the U.S. General Accounting Office, except that the supervisory review of workpapers was performed after the draft report was sent for agency review.

In general, we found that State law requires annual, independent audits of the tracks' financial statements. The tracks must file the resulting audit reports with the Commission. In addition, the Commission's staff requires the tracks to submit monthly financial statements.

Audit reports submitted by the tracks show that the tracks have been profitable. Although their debt and cash-flow situation could make them susceptible to financial problems if their revenues declined, this situation has been aggravated by the fact that the tracks have distributed $5 million in profits to their stockholders over the years. The reports also show that the tracks have had a significant number of financial transactions with their own stockholders. Besides raising the question of potential conflict of interest, such transactions could have resulted in track expenses being higher than they would have been if those transactions had been made with independent parties. Within the scope of this audit, we did not attempt to determine if track expenses actually were higher than needed. Finally, we noted that the Racing Commission's procedures for reviewing and acting on the tracks' audit reports are somewhat limited. These findings are described following a brief background section on racing and parimutuel operations in Kansas.

Background on Racing and Parimutuel Operations in Kansas

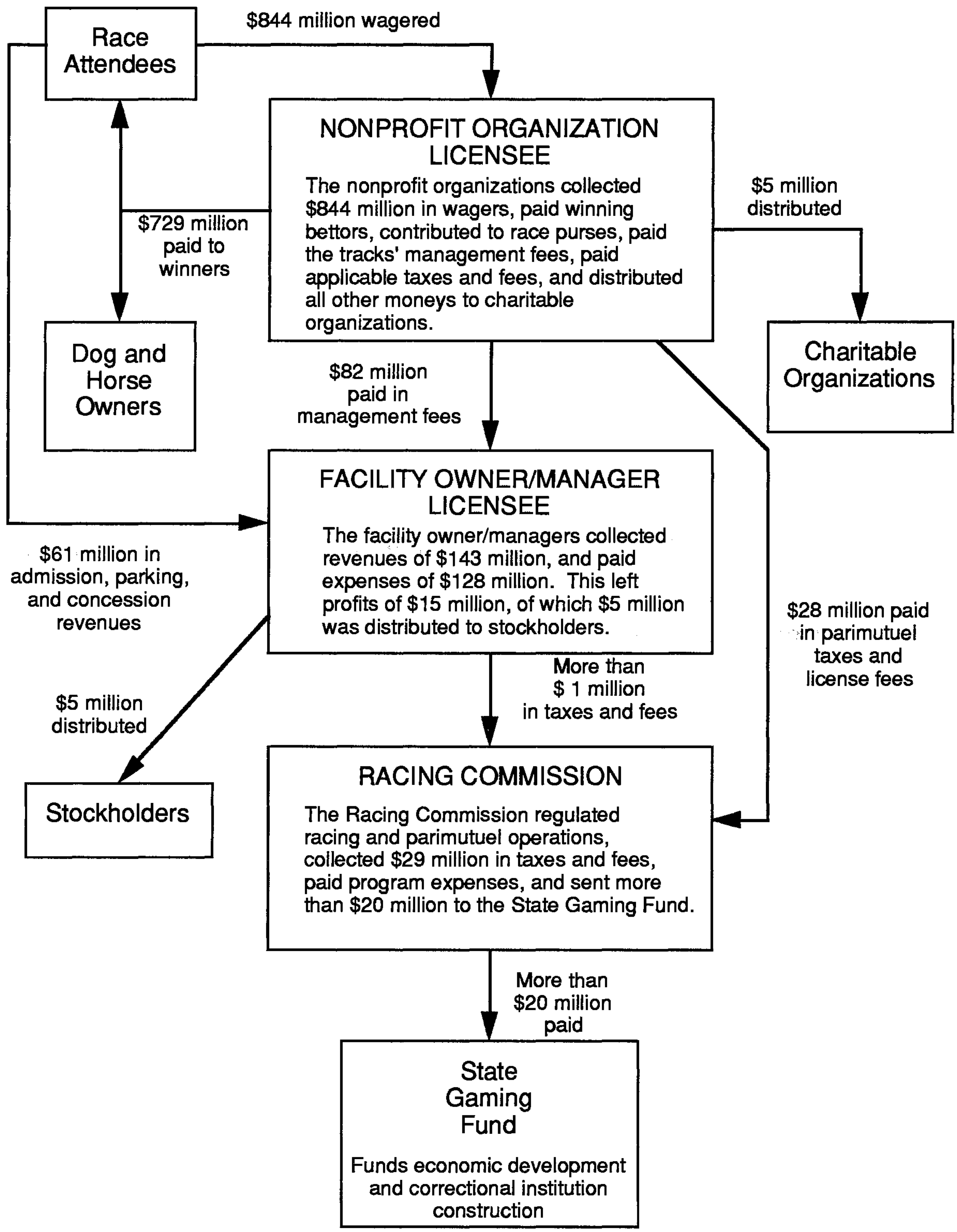
The State of Kansas currently has two operating race tracks with parimutuel wagering—one in Kansas City and one in Wichita. The Kansas City track has both horse and dog racing, while the Wichita track has only dog racing. Both tracks began operations in the Fall of 1989.

Each track operation comprises a nonprofit organization licensed to operate racing and parimutuel wagering, and a facility owner/manager licensed to own and operate the track facility itself. The nonprofit organization collects wagers, and from those moneys it pays winning bettors, contributes to race purses, pays management fees to the facility owner/manager, pays applicable taxes to the Racing Commission, pays its own operating expenses, and distributes all remaining moneys to charitable organizations as specified by statutory requirements. In addition to receiving management fees, the facility owner/manager collects admission, parking, and concession revenues. From those moneys, it pays operating expenses and taxes and fees to the Racing Commission, and may distribute a portion of its profits to stockholders.

The racing and parimutuel operations of the tracks are regulated by the Kansas Racing Commission. The Commission comprises five members appointed by the Governor and confirmed by the Senate. The Commission's regulatory activities include the following:

- The Commission licenses all nonprofit organizations operating races and parimutuel wagering, track facility owners, and track facility managers (if separate from owners).
- The Commission licenses all people in occupations related to the operation of a race track, such as trainers, grooms, jockeys, concession employees, mutuel employees, security personnel, veterinarians, and maintenance workers.
- The Commission reviews and approves all contracts entered into by the nonprofit organizations licensed to operate racing and parimutuel wagering, and by the facility owner/managers.
- The Commission obtains and reviews monthly financial reports for the nonprofit organizations and the facility owner/managers.
- The Commission conducts an annual review of each nonprofit organization and facility owner/manager for compliance with legal requirements.

RACING AND PARIMUTUEL FINANCES
Through Calendar Year 1992



- The Commission requires each nonprofit organization and facility owner/manager to obtain an annual independent audit by a certified public accountant. The resulting report is filed with the Commission.

The graphic on the preceding page summarizes the State's basic racing and parimutuel finances through calendar 1992. As the graphic shows, the nonprofit organizations have collected $844 million in wagers. Those organizations paid out $729 million to winning bettors and winning horse and dog owners, $82 million in management fees to the facility owner/managers, and $28 million in taxes and license fees to the Racing Commission. In accordance with statutory requirements, the remaining $5 million was distributed to qualified charitable organizations.

The graphic also shows that, in addition to the $82 million in management fees, the facility owner/managers have collected an additional $61 million in admissions, parking fees, concessions, and other revenues. From those moneys, the owner/managers have paid expenses, including more than $1 million paid to the Racing Commission in admissions taxes and license fees. From their $15 million in profits, the owner/managers have distributed $5 million to their stockholders.

Finally, the graphic shows that the Racing Commission has collected about $29 million in taxes and fees. The Commission also has collected moneys from breakage and unclaimed winning tickets. (Breakage is the amount collected in wagers that is left over after payoffs have been calculated and paid to an even $.10.) From these moneys, it has paid the costs of its various programs, and transferred more than $20 million to the State Gaming Revenue Fund. The Fund provides moneys for economic development and correctional institution construction.

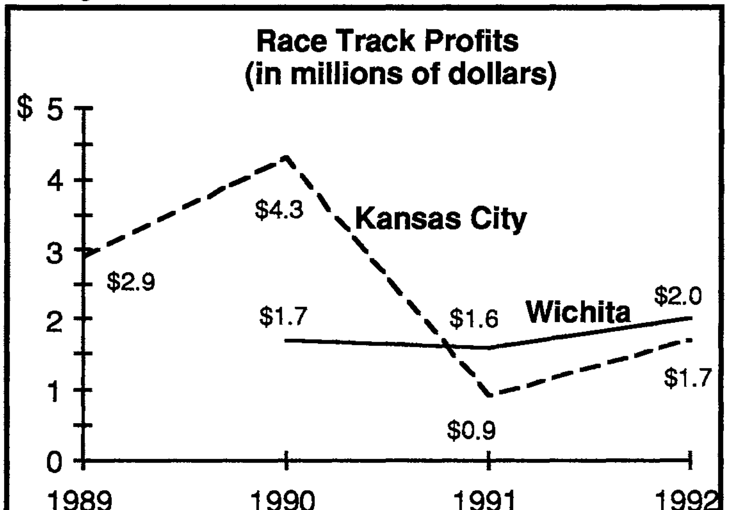
Do the Periodic Reports the Tracks Have Submitted to the Racing Commission Indicate that the Tracks Have Been Having Financial Problems?

The financial reports submitted for 1989 through 1992 do not indicate that the tracks have been having financial problems. They show that both tracks have been profitable every year. However, the reports also indicate that both tracks have large amounts due each year for principal and interest on their long-term debt. In addition, both tracks' current financial needs generally have exceeded their current financial resources. Although both tracks have been able to meet their debt-service requirements, these last two factors could make it difficult for the tracks to survive for long in the event of a significant downturn in revenues. This cash-shortage situation has been aggravated by the tracks making significant distributions of cash to their stockholders. Finally, a significant number of transactions between the tracks and their stockholders may have resulted in costs that were higher than they would have been if those same transactions had been with independent parties. These findings are discussed below.

From 1989 Through 1992, Both Race Tracks Had Profitable Operations

Each track operation comprises a nonprofit organization licensed to operate racing and parimutuel wagering, and a facility owner/manager licensed to own and operate the track facility itself. The nonprofit organization's financial operations are largely determined by the amounts wagered and the legal requirements for the distribution of those amounts—to winning bettors, race purses, the Racing Commission, the track owner/manager, and charitable organizations. These organizations' operating expenses are minimal, and they distribute all revenues in excess of expenses. For that reason, we focused our review on the facility owner/managers' financial situations.

Our analysis was based on audited financial statements covering 1989, 1990, and 1991. For 1992, we used unaudited preliminary financial statements provided by the tracks to the Racing Commission. These figures may have been adjusted by the time the 1992 audit reports are available. The Wichita track reported its 1989 operations (three months) together with 1990 operations in its 1990 financial statements. As a result, we show no 1989 financial figures for the Wichita track.



This figure shows that the Wichita and Kansas City race tracks have made a profit each year since their inception.

Both tracks made a profit in each of the years under review. The accompanying figure shows that net incomes (revenues less expenses) reported for the Kansas City track reached a peak of $4.3 million in 1990, but the track was still profitable in 1991 and 1992. Its 1992 profits totaled about $1.7 million. The figure also shows that net incomes reported for the Wichita track were consistently between $1.6 million and $2.0 million.

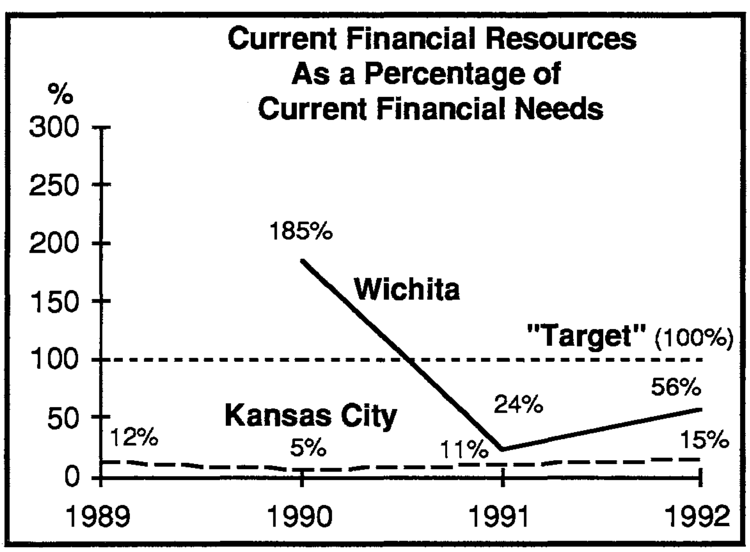
Both Tracks Have Large Annual Commitments to Pay Principal and Interest on Long-Term Debt

Our review included not only the past profitability of the tracks, but also situations that might affect their future profitability and their ability to meet financial commitments. One such situation is their annual commitments to pay principal and interest on long-term debt. That situation is important because, in case of a business downturn, the tracks can reduce operating expenses to some extent but cannot easily reduce that commitment to debt service. That lack of flexibility means that even a moderate reduction in revenues could hamper the tracks' ability to meet financial commitments.

We found that both tracks have large annual commitments to debt service. At the end of 1992, the Wichita track owed about $10 million in long-term debt, with annual amounts due of about $2.5 million. At that same time, the Kansas City track owed about $50 million, with annual amounts due of about $5 million. Although both tracks have been making the required payments on their long-term debt, the future obligation to pay the principal and interest on those large debts could be cause for concern if revenues drop significantly in future years. At the Wichita track, revenues have declined from $18.5 million in 1990 to $12.2 million in 1992. At the Kansas City track, revenues declined to $26.8 million in 1991, but rebounded to $29.6 million in 1992.

Both Tracks' Current Financial Needs Generally Exceeded Their Current Financial Resources

Another situation that might affect the tracks' future ability to meet their financial commitments is how well their near-term cash needs match their cash available in the near term. As a general rule of thumb, businesses should have at least as much cash available in the near term (generally within one year) as they need during that period. That "target" could be stated as the tracks having cash available (cash on hand and moneys owed to them) for the near term of at least 100 percent of the near-term cash needs (cash obligations coming due within a year). If a business does not have sufficient near-term cash to meet its near-term cash needs, even a short-term business slump can quickly put that business behind in paying its bills.



We made that comparison for 1989 through 1992, and found that both tracks generally fell short of that target. The figure at the bottom of the previous page shows that the Wichita track's percentage of near-term cash available to near-term cash needs was below 100 percent two of the three years under review. The figure also shows that the Kansas City track's percentage was well below 100 percent for each of the four years under review. That means that the tracks have not had the money on hand (or owed to them) to pay their near-term bills and loan obligations, and have relied on the fact that they would collect sufficient amounts of money over the near-term to pay those bills.

Both Tracks Distributed Significant Amounts of Cash to Stockholders During the Review Period

The situation described in the previous section may have been aggravated by the the fact that both tracks have distributed significant amounts of cash to their stockholders during the review period. The Wichita track distributed $3.2 million to its stockholders, and the Kansas City track $2.0 million to its stockholders. These amounts equal more than three times the average stockholders' equity for the Wichita track during the review period, and about 25 percent of the average stockholders' equity for the Kansas City track.

Our Review Also Disclosed a Significant Number of Financial Transactions Between the Tracks And Their Stockholders

During the review period, both tracks obtained goods and services from stockholders or other related parties. In addition, the Kansas City track borrowed money from one of its stockholders. Because these transactions are not "arm's-length" transactions, the tracks may not get full value for their money. They may pay more than they need to for goods and services, they may pay for "services" that have no real value, or they may borrow money at a higher interest rate than they need to.

Any of these possible scenarios would hurt their profits, and may endanger their ability to continue operations. Conversely, the tracks may obtain goods and services at a cost less than the fair value. That situation would aid the tracks' profits, but it may result in a conflict-of-interest situation in some future dealing with the related party.

According to Racing Commission personnel, the Commission approves all contracts entered into by the tracks. That approval process, if effective, should help ensure that the tracks get full value for their money. In this audit, we did not attempt to determine if this type of transaction resulted in track costs being higher than they needed to be. However, we did note that the Kansas City track's note payable to one of its stockholders had an interest rate of 14 percent. In comparison, that track's bank loan had a variable interest rate that appeared to average less than 10 percent, and the Wichita track's bank loan had an interest rate of 6.5 percent.

To adhere to accounting principles, the annual financial statements must report related party transactions such as those discussed above. To meet applicable auditing standards, the track's auditors must ensure that these transactions are reported. The annual audit reports list the following related-party transactions through 1991. (Any such transactions for 1992 should appear in the tracks' annual audited financial statements for that year.)

Wichita Track

- A stockholder of the Wichita track, who was the President of the track at the time and a member of the track's Board of Directors, also served as legal counsel for the track. That stockholder was paid $140,750 in legal fees and severance pay through 1991.

- The Wichita track entered into a consulting agreement with a business whose stockholders are also stockholders of the track. The track paid $528,000 in consulting fees and $4,000 in related expenses to this business through 1991.

- One stockholder of the Wichita track has guaranteed the track's long-term debt. The track paid this stockholder $135,000 in "guarantee fees" through 1991.

Kansas City Track

- The Kansas City track was provided office space and accounting services at no charge by a company partially owned by one of its stockholders.

- The Kansas City track purchased goods and services amounting to nearly $1.7 million from stockholders and "related parties" through 1991.

- The Kansas City track owes almost $15 million to one of its stockholders. The related note has an interest rate of 14 percent.

At a minimum, such transactions suggest the potential for a conflict of interest. They also indicate that some stockholders have receive far more money than just the distribution of profits by the tracks.

The Racing Commission's current procedures for reviewing the annual independent audit reports are limited. The Commission's Inspector of Parimutuel receives the annual audit reports on each nonprofit organization and track operator. The financial statements in these reports show the tracks' financial positions and results of operations. The Inspector reviews the reports, and provides the Commission and its Executive Director with the information he thinks necessary. We found no indication in the Commission's minutes that those reports had been presented to or discussed by Commission members.

Because the Commission is responsible for regulating the operations of the audited organizations, we think Commission members should receive copies of the audit reports, and their consideration of those reports should be documented in the Commission minutes and supported by formal documentation of the information presented by the Inspector of Parimutuel.

Conclusion

The Wichita and Kansas City race tracks both are profitable, but both have large debt requirements and limited current financial resources compared to their current financial needs. Those situations could subject them to financial problems if a downturn in revenues occurs. One factor contributing to the tracks' limited current financial resources is a pattern of large cash distributions to the tracks' stockholders.

Another concern relates to the numerous transactions between the tracks and their stockholders. During the review period, the tracks paid more than $2.5 million to stockholders and "related parties" for goods and services, and one track borrowed about $15 million from a stockholder at 14 percent interest. If these expenses are higher than needed, the tracks' profits have been affected. Within the scope of this audit, we couldn't determine if these expenses were higher than necessary. These transactions also raise the question of conflicts of interest. Because the Racing Commission's review of the tracks' annual audit reports is limited, we cannot be certain that the Commission has provided adequate oversight in this area.

Recommendations

1. To ensure that the Racing Commission adequately considers the annual audit reports on the race tracks, the Racing Commission's staff should do the following:

   a. Provide a copy of each annual audit report to each Commission member.

   b. Document the presentation of these reports to the Commission by the Inspector of Parimutuel.

   c. Document the Commission's consideration of the audit reports in the Commission's meeting minutes.

2. To help ensure that the State's oversight of race track operations is effective, the Legislative Post Audit Committee should direct Legislative Post Audit to conduct a performance audit reviewing the Racing Commission's oversight of racing and parimutuel operations in Kansas. As part of this audit, the Commission's oversight of "related-party" transactions, and the transactions themselves, should be examined.

Appendix A

Agency Response

On March 26, we provided copies of the draft audit report to the Racing Commission. Their written response is included as this Appendix.

STATE OF KANSAS

KANSAS RACING COMMISSION
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April 1, 1993

RECEIVED
APR 1 1993
LEGISLATIVE POST AUDIT

Ms. Barbara J. Hinton
Legislative Post Auditor
Merchants Bank Tower
800 SW Jackson, Suite 1200
Topeka, KS 66612-2212

RE: Response to draft copy of 100-hour audit concerning racing commission

Dear Ms. Hinton:

Thank you for allowing commission staff to review the draft audit report prepared for the legislative post audit committee.

The commission particularly agrees with recommendation number one, which provides for a more formalized review of annual audit reports filed by racetrack licensees. Because of the language in K.S.A. 74-8813(i) and K.S.A. 74-8815(h), the commission has traditionally considered the financial audits of racetrack licensees at the time of the annual review. The annual review is a commission audit of the licensee's overall compliance with commission regulations and the racing act. Even though these statutory provisions suggest that the financial audits should be considered with the other annual review matters, the recommendation is sound that the commission should give independent and more formalized consideration to these audit reports. One other good reason for an independent consideration of these reports is that the annual reviews do not necessarily coincide with the submission of the audits and issues may "fade" without timely review.

It was during such an annual review of the Wichita racetrack that the commission itself became concerned with financial transactions between the track and its stockholders. As a result of the ensuing investigation, the parties entered a stipulation stating, among other matters, the following: a buy-out of two stockholders' interests in the track; a condition that all agreements for services or goods with related parties shall provide for reasonable compensation commensurate with that paid to a disinterested third party for the same goods and services and identification of the transaction as an "affiliate agreement;" a condition that dividends would be made to shareholders in an amount sufficient to allow them to pay their respective federal income tax obligations on their pro rata share of net income; a condition that any vendor doing business with the track and supplying goods and services in excess of $25,000 per year shall be required to enter into a "master service agreement" with the racetrack; a condition that all books and records of the track shall be kept at the facility in Wichita and shall not be removed without written permission of the commission; and a condition that every effort should be made to use in-state vendors for goods and services provided comparable prices and quality may be obtained. A review of these stipulations certainly suggests the commission's agreement with the audit comments concerning related transactions.

In a related matter, the audit report notes that the Kansas City racetrack's note payable to one of its stockholders had an interest rate of 14%. That interest rate is higher than those for the bank loans in Wichita and Kansas City. That 15 million dollar loan was identified in the original licensing order as equity and considered a favorable finding further justifying insurance of the license. The commission's inspector of parimutuels has stated that since this is a subordinated debt it may justify a higher rate of interest due to the increased risk factor.

Finally, the report addresses distributions made to racetrack stockholders. The inspector of parimutuels explains that many of the distributions to stockholders were related to tax liabilities incurred due to the subchapter-S tax status. This status was reported to the commission and reviewed by it before approval of the financing plan.

The commission offers these comments as supplement to and not as disagreement with the audit report. The audit is important, and, even without further requirement, staff intends to formalize commission consideration of the financial audits submitted by the racetrack licensees.

Respectfully,

Janet A. Chubb

Janet A. Chubb
Executive Director

93JAC59-dpb

cc: Kansas racing commissioners

APPENDIX B

Additional Information Provided by Representatives of the Race Track Operations

Legislative Post Audit received the following letters regarding this audit. At its meeting on April 27, 1993, the Legislative Post Audit Committee directed that the letters be included in all subsequent copies of the report. The letters provide information in response to concerns raised by the audit about certain transactions between the tracks and their stockholders.

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W. A. KAHRS
(1904-1989)
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DARRELL D. KELLOGG
(1931-1992)

April 20, 1993

Representative James E. Lowther, Chairman
Legislative Post Audit Committee
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Topeka, Kansas 66612-2212

RECEIVED
APR 22 1993
LEGISLATIVE POST AUDIT

Re: Wichita Greyhound Park Performance Audit Report

Dear Chairman Lowther:

This firm represents Wichita Greyhound Park. This letter is submitted pursuant to your recommendation to Roy Berger as a response to the Performance Audit Report (the Report), prepared by the Legislative Post Audit Committee in April, 1993.

Wichita Greyhound Park (WGP), began operation in September, 1989. Since that time, it has been a first class operation and has operated at a profit. Nevertheless, the level of business has declined over the years due to many factors that effect the industry nationally, including a soft economy, severe competition for the discretionary dollar and the advent of other forms of gaming coming to the state. It was due to these factors that WGP approached the Kansas legislature seeking tax relief. WGP did not ask that its taxes be reduced--only that parimutuel taxes not increase automatically as provided by statute, but increase on an accelerated basis if in fact business at the track increases. WGP greatly appreciates the fact that the legislature recognized the value to the state of WGP as a business and the need for the relief.

The purpose of this letter is to express WGP's concern over the tenor or emphasis of the Report. WGP has no major disagreement with the facts stated in the Report, but they do believe it over-emphasizes distributions to stockholders (who are after all seeking to have some return on their investment), and under-emphasizes the significant charitable and tax contributions made by the track. Since 1989, WGP has paid more than $2.4 million in charitable contributions--making them number one in the country in charitable grants. In addition, the track has paid over $12 million in purse money to greyhound owners and breeders. The payroll for employees of the track has exceeded $14 million. Finally, the track has paid *over $11 million in taxes*. In fact, the lion's share of the monies which you indicate were "distributed" to stockholders at Wichita was solely for the purpose of the payment of quarterly taxes by the stockholders. As you must know, Wichita Greyhound Park is an S corporation and, as such, the stockholders must pay their taxes on the profits of the corporation, even though they may receive no other distributions. The other monies "distributed" at Wichita are accounted for as distributions made for the purpose of settling the disputes which arose in Wichita in 1990 and were used to buy out disgruntled shareholders.

We were also somewhat disturbed by the statement in the Report that the "tracks may not get full value for their money" in purchasing goods or services from stockholders or other related parties. We know of absolutely no basis for this statement. There is certainly no evidence contained within the Report to support this contention. In fact, Wichita Greyhound Park has previously undergone a long and arduous audit and investigation by the Kansas Racing Commission, costing more than $200,000 in attorney fees.[1] The fees which Wichita Greyhound Park pays for consulting or other services to related parties are far less than would be incurred by the track if outsiders with the same expertise had to be hired. It should also be noted that none of the owners of Wichita Greyhound Park receives any salary.

The Report also seems to imply that the guarantee fees paid by WGP were excessive, yet we need only refer the reader to the portion of the Report which reflects that WGP's bank loan bears an interest rate of 6.5%, compared to other racetracks which pay much higher rates of interest. Certainly, WGP would not have the favorable loan which it has, without the stockholder's guarantee. WGP believes that the payment of that extra one percent for a guarantee fee is well worth it.

WGP also disagrees with the statement that its current financial resources do not meet its current financial needs. Certainly a business should have sufficient "near-term cash to meet its near-term cash needs," but the Report defines "near-term" as a <u>one year period</u>. We question the concept that a business must have sufficient cash at all times to pay 100% of its operating expenses for a one year period, particularly a business that only began operations in 1989.

Finally, we are surprised by the statement in the Report that the auditors are not certain the Commission has provided adequate oversight in this area. As stated earlier, WGP has been

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[1]These fees were incurred by the Commission by outside legal staff, but were paid by WGP by agreement of the parties.

through an exhaustive audit and investigation by the Kansas Racing Commission. In addition, the Racing Commission devotes an entire meeting each year for the purpose of reviewing Wichita Greyhound Park. A large amount of time is devoted to discussion of the financial situation at WGP.

WGP has no disagreement with Report Recommendation 1. It is essentially met at this time by the Commission. WGP believes Report Recommendation 2 would be an unnecessary duplication of effort and an unnecessary expense to the state. Certainly, if the Recommendation is adopted, WGP will do everything it can to cooperate. Nevertheless, WGP believes that having a committee audit the Commission, which already audits the track, which reviews all track transactions, including those with related parties, could lead to tandem layers of bureaucracy which could be stifling to all.

We thank you for the opportunity to respond to the Performance Audit Report. We hope that our comments will be viewed in the constructive manner in which they are offered, and would be happy to provide any additional information requested. Thank you for your consideration.

Yours very truly,

Linda S. Parks
KAHRS, NELSON, FANNING,
HITE & KELLOGG

LSP/bw
cc: Roy Berger

P.S.

Pursuant to an agreement between Wichita Greyhound Charities and WGP, there is also an audit of WGP by the Charity. The Charity and WGP have a joint committee which meets on a quarterly basis for the purpose of reviewing the propriety of WGP's financial transactions. I thought this final point to be worthy of note, since it further demonstrates that WGP has a variety of check and balances already in place for financial review making additional review seem unduly burdensome.

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LEGISLATIVE POST AUDIT

April 22, 1993

Honorable James B. Lowther
Chairman
Legislative Post Audit Committee
Suite 182W
State Capitol
Topeka, Kansas 66612

Re: Response of Sunflower Racing, Inc. to Performance Audit Report Reviewing Racing Commission Records Regarding Trace Track Operations

Dear Chairman Lowther:

This firm is legal counsel for Sunflower Racing, Inc. and the following comments are in response to the performance audit report referred above. On behalf of my client, Sunflower Racing, I would like to thank you in advance for the opportunity to respond to the performance audit. I also must advise that my client is deeply disappointed in regard to certain editorial commentary in the report as well as certain misleading and unsupported conclusions and findings which appear in the report.

As you know, Sunflower Racing, Inc. is the owner and manager of the Woodlands racing complex in Kansas City, Kansas. Our client certainly does not dispute the conclusion in the report that the track has realized some profit margin in each of the years 1989 through 1992. Neither does the track dispute that the current debt and cash flow situation is directly susceptible to financial problems in the event of a substantial revenue decline in the near term. But the performance audit report infers that the present debt and cash flow situation at the Woodlands has been aggravated by "significant distributions of cash by the tracks to their stockholders." <u>All</u> distributions of cash to the stockholders have been previously disclosed and explained to the Kansas Racing Commission. It is also significant to note that at no time since the original incorporation of the company has any stockholder of Sunflower Racing, Inc. received a dividend profit distribution. We would also ask the Committee to note that Sunflower Racing, Inc. carries a Subchapter S designation for tax treatment of the company. This means the individual stockholders are responsible for the payment of the corporate taxes. As timely reported to the Racing Commission, the noted distributions in the report were distributions for the sole purpose of satisfying corporate tax obligations of Sunflower Racing, Inc. There were not and have never been the type of dividend profit distributions inferred by the report.

The report also refers to the $15 million debt to one of the corporate stockholders at an interest rate of 14%. The report refers to this debt as one of a "pattern of large cash distributions to the track's stockholders." Yet in the same conclusion, the audit admits that the auditor "couldn't determine if these expenses were higher than necessary." The $15 million debt in question was a debt contemplated in the original financing package. That package was formulated in 1988 and 1989 when interest rates were significantly different than the rates of today. The note is junior in priority and subordinated to the entire construction debt of the Woodlands and furthermore, the debt is unsecured and is not personally guaranteed. Again, we would respectfully suggest that consideration of the difficulty to be anticipated in attempting to refinance an unsecured subordinated note of this magnitude and the risk factor associated with a note of this type would certainly explain and justify the rate.

The report also raises inferences with regard to related party transactions which "suggest the potential for a conflict of interest." A simple inquiry would have easily explained the questions raised in the report. All salaries, fees and consulting contracts have been previously identified and reported to the Kansas Racing Commission. Additionally, in the context of construction of the Woodlands racing facilities, the company was able to make use of and/or acquire goods or equipment "at cost" or substantially discounted prices from companies in which stockholders of Sunflower Racing held an interest. In other words, the related party transactions about which the report complains were actually a cost savings for equipment or goods necessary to the construction or operation of the racetracks. In point of fact, there have been many instances when stockholders of Sunflower Racing, Inc. actually have advanced expenses of the corporation rather than received reimbursement from the corporation. As an example, R.D. Hubbard Enterprises (which is owned 100% by stockholder R.D. Hubbard) provides the salary and all travel expenses for Mr. Hubbard, Chairman of the Board of Sunflower Racing, Mr. Bruce Rimbo, who serves as President of Hubbard Enterprises and Executive Vice President of Sunflower Racing and oversees all day-to-day operational and management aspects of the Woodlands, Mr. Mark Wilson, who serves as Executive Vice President of Hubbard Enterprises and provides legal and legislative expertise to Sunflower Racing, and Mr. Ed Burger, who serves as Vice President of Finance for Hubbard Enterprises and provides financial expertise to Sunflower Racing. The point being that there is a great deal of time and expense chargeable to the company which is absorbed by the stockholders. The related party transactions posed as a concern by the report are in actuality costs of doing business and in many regards a financial benefit to the company. Finally, the annual audit of the Woodlands has in each year made all required disclosures of related party transactions and that audit has been provided to the Kansas Racing Commission.

I am sure the Committee is very aware of the numerous presentations which have been made of late before the Legislature expressing the very real concerns of the Woodlands as to the effects of state sponsored Lottery and Keno games and the projected effects of riverboat gaming, Indian gaming, etc. upon revenues at the track. There has been exhaustive analysis conducted all over the country detailing the negative impact which riverboat gaming and Indian gaming have had upon existing parimutuel racing facilities. Without exception, these forms of gaming activities have caused immediate and substantial harm to the revenues of existing track facilities. In other words, whether or not a racetrack operation showed a profit some four years ago (as analyzed by the report) is at best marginally relevant to current profitability and anticipated revenue downturns in the immediate future.

In conclusion, Sunflower Racing, Inc. strongly believes that its disclosures to the Kansas Racing Commission have both timely and adequately addressed each of the stated concerns in the performance audit report. It is very difficult to comprehend how an auditor can reach meaningful conclusions in regard to "potential" financial difficulties or inquire as to profitability of the racetracks without even inquiring of the individual tracks with respect to these questions. The end result was a report which is replete with speculative and unsupported conclusions as to what "may have been" causation for the present debt and cash flow concerns. It is indeed a misconception to infer that the stockholders of Sunflower Racing, Inc. have received some type of financial windfall in terms of distribution of profits or related party transactions. The racetrack complex known as the Woodlands had a cost of acquisition and construction which exceeded $70 million. It has been commonly stated that investors in track facilities of this type seek a 30% return on investment. Even taking into consideration the Subchapter S tax distributions which have been made from the company, the total annual disbursement to stockholders has been but a tiny fraction of the return on investment goals.

The issue of the "profitability" of racetrack operations in Kansas has been a focal issue of much legislative discussion in recent months. It is critical to the future success of racetracks in Kansas that the Legislative Post Audit Committee receive an accurate and untainted picture of the present financial condition of the racetracks in Kansas. Profitability is presently questionable and return on investment is far less than desirable. Even so, the Woodlands is facing almost certain revenue declines in the near future with the onset of riverboat gaming and potential Indian gaming. Our independent auditors, KPMG Peat Marwick, stand ready to present any additional commentary your Committee may request regarding subject matter of the report or this response. We trust the enclosed information will be beneficial to more accurately analyze the performance audit report and we would request that this response be identified and attached to the report as Appendix B. Thank you for your kind attention.

Very truly yours,

R. Scott Beeler