

**REPORT OF THE AUDIT OF THE
KENTUCKY HORSE RACING AUTHORITY**

**For The Fiscal Year Ended
June 30, 2006**



**CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS
www.auditor.ky.gov**

**105 SEA HERO ROAD, SUITE 2
FRANKFORT, KY 40601-5404
TELEPHONE (502) 573-0050
FACSIMILE (502) 573-0067**

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ATTACHMENT 1:	
KTDF SETTLEMENT AGREEMENT AND MEMORANDUM OF UNDERSTANDING AMONG KEENELAND ASSOCIATION, TURFWAY PARK, LLC, CHURCHILL DOWNS INCORPORATED AND ELLIS PARK RACE COURSE, KENTUCKY HORSE RACING AUTHORITY AND KENTUCKY THOROUGHBRED DEVELOPMENT FUND ADVISORY COMMITTEE	



CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

Kentucky Horse Racing Authority
Lisa Underwood, Executive Director
4063 Ironworks Pkwy
Building B
Lexington, KY 40511

Independent Auditor's Report

We were engaged to audit the accompanying statement of cash receipts and cash disbursements and changes in cash balances of the Kentucky Horse Racing Authority, as of and for the year ended June 30, 2006. This financial statement is the responsibility of the Kentucky Horse Racing Authority's management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 2, the accompanying financial statement is prepared on the basis of cash receipts and disbursements for the year ended June 30, 2006, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

The subsidiary accounts making up the beginning cash balance could not be substantiated because of the Kentucky Horse Racing Authority's lack of evidence supporting the amount to be reported for beginning cash. The Kentucky Horse Racing Authority's records do not permit the application of other auditing procedures to the cash balances; therefore, we were unable to perform sufficient procedures to determine the validity of the subsidiary accounts comprising the beginning cash balance.

Because the Kentucky Horse Racing Authority could not substantiate the beginning cash balances and we were unable to apply other auditing procedures to satisfy ourselves about the fair presentation of the beginning cash balances, as discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statement referred to in the first paragraph.



Kentucky Horse Racing Authority
Lisa Underwood, Executive Director

In accordance with Government Auditing Standards, we have also issued our report dated December 12, 2006 on our consideration of the Kentucky Horse Racing Authority's internal control structure over financial reporting and on our tests of its compliance with certain provisions of laws and regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be considered in assessing the results of our audit.

This report is intended solely for the information and use of the Kentucky Horse Racing Authority, and management of the Environmental and Public Protection Cabinet, and is not intended to be and should not be used by anyone other than these specified parties.

Respectfully submitted,

A handwritten signature in cursive script, appearing to read "Crit Luallen", with a long horizontal flourish extending to the right.

Crit Luallen
Auditor of Public Accounts

December 12, 2006

FINANCIAL STATEMENT

**KENTUCKY HORSE RACING AUTHORITY
STATEMENT OF CASH RECEIPTS, CASH DISBURSEMENTS
AND CHANGES IN CASH BALANCES**

For The Fiscal Year Ended June 30, 2006

	General Fund	Special Revenue Fund
CASH RECEIPTS		
Tax Receipts	\$	\$ 23,732,471
License Application Fees		1,171,062
General Assessments		1,349,500
Registration/Filing Fees		127,650
Fines		52,845
Interest Income		236,649
Abandoned Property (Unclaimed Property)		122,360
Operating Grant	509,700	
Other Fees		543,699
TOTAL CASH RECEIPTS	509,700	27,336,236
CASH DISBURSEMENTS		
Personnel	509,700	1,267,689
Premiums		6,734,162
Grants		127,815
Legal Services		35,989
Utilities		3,615
Telephone		13,517
Computer Hardware/Software/Support		488,845
Postage		12,340
Rentals		61,326
Maintenance		150,325
Printing/Advertising		8,812
Office Supplies		32,604
Insurance		2,603
Travel		211,072
Office Equipment		6,611
Laboratory Tests		1,500
Motor Vehicles		142,350
Dues/Subscriptions		39,638
Machines/Fuels		15,623
Other		39,891
TOTAL CASH DISBURSEMENTS	509,700	9,396,327
Excess of Cash		
Receipts Over Cash Disbursements	0	17,939,909
Beginning Cash	0	4,065,398
Transfers Out	0	83,700
Ending Cash Balance	\$ 0	\$ 21,921,607

The accompanying notes are an integral part of this financial statement.

**KENTUCKY HORSE RACING AUTHORITY
NOTES TO THE FINANCIAL STATEMENT**

June 30, 2006

Note 1 - Organization

On January 6, 2004, by executive order the Kentucky Horse Racing Authority (KHRA or the Authority) was created and established as an independent agency of state government charged with the responsibility of regulating the conduct of horse racing and pari-mutuel wagering on horse racing and related activities within the Commonwealth of Kentucky. KHRA administratively falls within the Department of Public Protection, Cabinet for Environmental and Public Protection.

KHRA consists of 13 members appointed by the governor. In addition to these members, the secretaries of the Environmental and Public Protection Cabinet, Commerce Cabinet, and Economic Development Cabinet serve as ex officio nonvoting members. One member is appointed to serve as chairperson of KHRA. A second member is designated to serve as vice chair of KHRA to act in the absence of the chair.

Except as otherwise provided, KHRA is responsible for the following:

- a) Developing programs and procedures that will aggressively fulfill its oversight and regulatory role on such matters as race day medications;
- b) Recommending tax incentives and other incentive options to ensure the strength and growth of the thoroughbred industry so as to preserve Kentucky's horse farms and keep them economically viable and competitive;
- c) Designing and implementing programs that strengthen the ties between Kentucky's horse industry and the state's universities with the goal of significantly increasing the economic impact of the horse industry to Kentucky's economy;
- d) Developing and supporting programs that ensure Kentucky remains on the cutting edge of equine research; and
- e) Developing and implementing programs that promote Kentucky's horse and tourism industry.

Note 2 - Summary of Significant Accounting Policies

Basis of Accounting

The Authority's accounts are maintained on a basis of cash receipts and disbursements. Revenues are recorded when received rather than when earned and expenses are recorded when paid rather than when the liability is incurred. Consequently, amounts due from licenses and amounts due to vendors are not included in the financial statements.

The cash receipts and cash disbursements are presented in the financial statements for the periods applicable for reporting transactions to the Finance and Administration Cabinet of the Commonwealth of Kentucky. These periods are as follows:

Cash Receipts	July 1, 2005 through June 30, 2006
Cash Disbursements	July 1, 2005 through June 30, 2006

**KENTUCKY HORSE RACING AUTHORITY
NOTES TO THE FINANCIAL STATEMENT
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

Note 2 - Summary of Significant Accounting Policies, (Continued)

Fund Accounting

To ensure observance of limitations and restrictions placed on the use of resources available to the Authority, the accounts of the Authority are maintained in accordance with the principles of fund accounting. This is the procedure by which resources for various purposes are classified for accounting and reporting purposes into funds established according to their nature and purpose. The Authority maintains the following funds:

- **General Fund** - a fund that accounts for financial resources appropriated by the General Assembly which are not required to be accounted for in another fund.
 - Regulation and Administration Fund
- **Agency Revenue Fund** - a special revenue fund that accounts for revenues and expenditures of restricted taxes, fees, and charges related to these particular functions or activities:
 - Equine Drug Research
 - Thoroughbred Development
 - Standardbred Development
 - Horseman's Fees
 - County Fair Purse
 - Backside Improvement
 - Thoroughbred Owners and Breeders
 - Standardbred Breeders Incentive
 - Thoroughbred Breeders Incentive
 - Other Breeds Breeders Incentive
 - Regulation and Administration
- **Fiduciary Funds** - are defined as funds that are used to report assets held in a trustee capacity or agency capacity for others, and which cannot be used to support the government's own program. The Authority maintains the following Fiduciary Fund:
 - **Kentucky Racing Health and Welfare Fund** - The Authority maintains this fund as organized by KRS 230.374, for the benefit, aid, assistance, and relief of thoroughbred owners, trainers, jockeys, and other thoroughbred racing personnel employed in connection with racing. This provision also covers spouses and children who can demonstrate financial need. KRS 230.374 requires the Authority to remit all funds to the Kentucky Racing Health and Welfare Fund, Incorporated on or before December 31 each year. As of June 30, 2006, the Authority had transferred all funds to the Kentucky Health and Welfare Fund, Incorporated resulting in a zero cash balance including any amounts held in custody for others.

**KENTUCKY HORSE RACING AUTHORITY
NOTES TO THE FINANCIAL STATEMENT
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

Note 2 - Summary of Significant Accounting Policies, (Continued)

- **Cash, Cash Equivalents, and Investments**

The Authority participates in the Commonwealth of Kentucky's cash and investment pool, which is available for use by all funds and component units under the auspices of the State Investment Commission as authorized under KRS 42.500, et al. At June 30, 2006, the carrying amount of the Authority's deposits was \$21,921,607. The Commonwealth's bank balance is covered by Federal Depository Insurance or by collateral held by the Commonwealth or the Commonwealth's agent in the state's name. The risk disclosures related to deposits and investments are reported in the Commonwealth of Kentucky's Comprehensive Annual Financial Report.

Note 3 - Breeders' Incentive Funds

KRS 230.800 establishes the Kentucky Horse Breeders Incentive Fund, and specifies that the Kentucky Horse Racing Authority administer that fund. The statute gives incentive funding to horse breeders to promote, enhance, improve, and encourage the further and continued development of the horse industry in Kentucky. The Authority collected \$12,933,786 during fiscal year 2006 as a result of the implementation of this KRS.

In addition, 810 KAR 1:070 specifies the regulations over the administration of the fund. Collections for the Breeders Incentive Fund began June 1, 2005. Distributions to qualifying breeders are required to begin January 1, 2007.

Note 4 - Related Party Transactions

During fiscal year 2006, the Kentucky Horse Racing Authority conducted business with Frank Shoop, Inc. for vehicle maintenance totaling \$3,719. An employee of the KHRA is an immediate family member of the owner. The Transportation Cabinet duly authorized all maintenance work performed by Frank Shoop, Inc.

SUPPLEMENTARY INFORMATION

COMBINING FINANCIAL STATEMENT

KENTUCKY HORSE RACING AUTHORITY
STATEMENT OF CASH RECEIPTS, CASH DISBURSEMENTS, AND
CHANGES IN CASH BALANCES - SPECIAL REVENUE FUNDS

For The Fiscal Year Ended June 30, 2006

	Regulation and Administration	Equine Drug Research Fund	Thoroughbred Development Fund
CASH RECEIPTS			
Tax Receipts	\$	\$ 444,192	\$ 6,665,301
License Application Fees	1,171,062		
General Assessments	1,349,500		
Registration/Filing Fees	4,000		
Fines	52,845		
Interest Income			
Abandoned Property (Unclaimed Property)			
Other Fees	2,226		
TOTAL CASH RECEIPTS	<u>2,579,633</u>	<u>444,192</u>	<u>6,665,301</u>
CASH DISBURSEMENTS			
Personnel	1,267,689		
Premiums			5,928,804
Grants			127,815
Legal Services	8,011	27,978	
Utilities	3,615		
Telephone	13,517		
Computer Hardware/Software/Support	308,501		
Postage	12,340		
Rentals	61,326		
Maintenance	47,852		
Printing/Advertising	4,824		2,650
Office Supplies	32,604		
Insurance	2,603		
Travel	210,156	916	
Office Equipment	6,611		
Laboratory Tests	1,500		
Motor Vehicles	142,350		
Dues/Subscriptions	20,638	19,000	
Machines/Fuels	15,623		
Other	30,511		
TOTAL CASH DISBURSEMENTS	<u>2,190,271</u>	<u>47,894</u>	<u>6,059,269</u>
Excess of Cash			
Receipts Over Cash Disbursements	<u>389,362</u>	<u>396,298</u>	<u>606,032</u>
Beginning Cash	1,169,678	1,644,065	395,936
Transfer Out	83,700		
Ending Cash Balance	<u>\$ 1,475,340</u>	<u>\$ 2,040,363</u>	<u>\$ 1,001,968</u>

KENTUCKY HORSE RACING AUTHORITY
STATEMENT OF CASH RECEIPTS, CASH DISBURSEMENTS, AND
CHANGES IN CASH BALANCES - SPECIAL REVENUE FUNDS
For The Fiscal Year Ended June 30, 2006
(Continued)

Standardbred Development Fund	Horseman's Fees	County Fair Purse Fund	Backside Improvement Fund	Thoroughbred Owners and Breeders	Thoroughbred Breeders Incentive Fund
\$ 205,683	\$	\$ 41,384	\$	\$ 208,677	\$ 12,933,786
	(460)				124,110
			3,415		186,348
	435,588	122,360	105,885		
<u>205,683</u>	<u>435,128</u>	<u>163,744</u>	<u>109,300</u>	<u>208,677</u>	<u>13,244,244</u>
67,000	399,480	156,523		182,355	
					180,344
		837	102,473		501
9,097					283
<u>76,097</u>	<u>399,480</u>	<u>157,360</u>	<u>102,473</u>	<u>182,355</u>	<u>181,128</u>
129,586	35,648.00	6,384	6,827	26,322	13,063,116
291,095	444,959	12,447	105,252	1,966	-
<u>\$ 420,681</u>	<u>\$ 480,607</u>	<u>\$ 18,831</u>	<u>\$ 112,079</u>	<u>\$ 28,288</u>	<u>\$ 13,063,116</u>

KENTUCKY HORSE RACING AUTHORITY
STATEMENT OF CASH RECEIPTS, CASH DISBURSEMENTS, AND
CHANGES IN CASH BALANCES - SPECIAL REVENUE FUNDS
For The Fiscal Year Ended June 30, 2006
(Continued)

	Standardbred Breeders Incentive Fund	Other Breeders Incentive Fund	Total
CASH RECEIPTS			
Tax Receipts	\$ 2,101,741	\$ 1,131,707	\$ 23,732,471
License Application Fees			1,171,062
General Assessments			1,349,500
Registration/Filing Fees			127,650
Fines			52,845
Interest Income	30,475	16,411	236,649
Abandoned Property (Unclaimed Property)			122,360
Other Fees			543,699
TOTAL CASH RECEIPTS	<u>2,132,216</u>	<u>1,148,118</u>	<u>27,336,236</u>
CASH DISBURSEMENTS			
Personnel			1,267,689
Premiums			6,734,162
Grants			127,815
Legal Services			35,989
Utilities			3,615
Telephone			13,517
Computer Hardware/Software/Support			488,845
Postage			12,340
Rentals			61,326
Maintenance			150,325
Printing/Advertising			8,812
Office Supplies			32,604
Insurance			2,603
Travel			211,072
Office Equipment			6,611
Laboratory Tests			1,500
Motor Vehicles			142,350
Dues/Subscriptions			39,638
Machines/Fuels			15,623
Other			39,891
TOTAL CASH DISBURSEMENTS	<u>-</u>	<u>-</u>	<u>9,396,327</u>
Excess of Cash			
Receipts Over Cash Disbursements	<u>2,132,216</u>	<u>1,148,118</u>	<u>17,939,909</u>
Beginning Cash	-	-	<u>4,065,398</u>
Transfer Out			83,700
Ending Cash Balance	<u>\$ 2,132,216</u>	<u>\$ 1,148,118</u>	<u>\$ 21,921,607</u>

AGENCY FUND

**KENTUCKY HORSE RACING AUTHORITY
STATEMENT OF CHANGES IN ASSETS AND LIABILITIES -
AGENCY FUND**

For The Fiscal Year Ended June 30, 2006

	<u>Balance</u> <u>June 30, 2005</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance</u> <u>June 30, 2006</u>
Kentucky Racing Health and Welfare Fund				
Assets				
Cash and Cash Equivalents	\$ 2,482,264	\$ 2,815,237	5,297,501	\$ _____
Total Assets	<u>2,482,264</u>	<u>2,815,237</u>	<u>5,297,501</u>	<u>_____</u>
Liabilities				
Amounts Held in Custody for Others	2,482,264	_____	2,482,264	_____
Total Liabilities	<u>\$ 2,482,264</u>	<u>\$ 0</u>	<u>2,482,264</u>	<u>\$ 0</u>

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**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND
ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF THE FINANCIAL
STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**



CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

Kentucky Horse Racing Authority
Lisa Underwood, Executive Director
4063 Ironworks Pkwy
Building B
Lexington, KY 40511

Report On Internal Control Over Financial Reporting And
On Compliance And Other Matters Based On An Audit Of The Financial
Statements Performed In Accordance With Government Auditing Standards

We were engaged to audit the Statement of Cash Receipts, Cash Disbursements, and Changes in Cash Balances of the Kentucky Horse Racing Authority (the Authority) of the Commonwealth of Kentucky, as of and for the year ended June 30, 2006, wherein we disclaimed an opinion and have issued our report thereon dated December 12, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Authority's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statement and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Authority's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statement. Reportable conditions are described in the accompanying schedule of findings and recommendations as items Finding 1 and Finding 2.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider items Finding 1 and Finding 2 to be material weaknesses.



Report On Internal Control Over Financial Reporting And
On Compliance And Other Matters Based On An Audit Of The Financial
Statements Performed In Accordance With Government Auditing Standards
(Continued)

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Authority's financial statement is free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed one instance of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and are described in the accompanying schedule of findings and recommendations as Finding 2.

This report is intended solely for the information and use of the Kentucky Horse Racing Authority, and management of the Environmental and Public Protection Cabinet, and is not intended to be and should not be used by anyone other than these specified parties.

Respectfully submitted,



Crit Luallen
Auditor of Public Accounts

December 12, 2006

FINDINGS AND RECOMMENDATIONS

**KENTUCKY HORSE RACING AUTHORITY
FINDINGS AND RECOMMENDATIONS**

June 30, 2006

FINDING 1: Subsidiary accounts making up beginning cash balances could not be substantiated.

During our audit of KHRA, we were unable to substantiate the FY 2006 beginning fund/cash balance due to the inadequacy of financial records, as well as failure by KHRA to perform necessary reconciliations of the various program budget units under its administration. Based on information provided by the Authority, this is a historical and on-going problem that pre-dates the current KHRA. In addition, the cash or fund balance has never been audited since the inception of KHRA, formerly Kentucky Horse Racing Commission.

For the year under audit, we could not ascertain that the track allocations related to the Kentucky Thoroughbred Development Fund, were accurate. Adequate records did not exist to be able to substantiate the beginning cash balance related to this fund, and determine potential amounts payable to the various horse racing tracks as required by KRS 230.400.

For FY 2006, we noted that KHRA did not verify that transfers from the Kentucky Department of Revenue (DOR) were properly credited to the appropriate program budget units. In addition, KHRA did not perform periodic audits of journal voucher transfers in order to determine the completeness of revenue collections by DOR. KHRA received 86% (\$23,385,848) of its total revenues from tax collections by the DOR during FY 2006. The sources of tax revenues include collections from Pari-Mutuel Tax Return filings (\$10,452,062) and Kentucky Sales and Use Tax Return filings (\$12,933,786). DOR transfers the required revenues to KHRA in accordance with the applicable Kentucky Revised Statutes and Administrative Regulations. The Revenue Operations Division of DOR assigns a validating number to each Pari-Mutuel tax return filed and inputs the various tax data fields, which post into the Miscellaneous Tax Division's "Mixer" database tax system. The transfers by journal voucher to KHRA may consist of several returns from various racetracks. Therefore, a review by KHRA of only the filed Pari-Mutuel returns will not substantiate the revenue transfer amounts.

Likewise, KHRA does not verify the tax collections by the Kentucky Sales and Use Tax Division for the Equine Breeders Incentive Fund. In accordance with KRS 230.800 through KRS 230.804 beginning June 1, 2005, 6% of the taxable receipts from equine breeding fees will be set aside for the Kentucky Horse Breeders Incentive Fund, with distributions beginning after January 1, 2007. Qualifying Kentucky horse breeders are required to file the Kentucky Sales and Use Tax return (Form 51A102) and the additional Kentucky Sales and Use Tax Equine Breeders Supplementary Schedule (Form 51A132). The Supplementary Schedule is used by the Sales and Use Tax Division to verify totals reported on Form 51A102 and recalculate the Net Kentucky Sales and Use Tax applicable to equine breeding fees. The tax data for the Supplementary Schedule is input into the Sales Tax System database. Once entered, the Sales and Use Tax Division sets up journal vouchers to transfer the tax funds to KHRA, whereby 80% of funds are allocated to the Kentucky Thoroughbred Breeders Incentive Fund, 13% allocated to the Kentucky Standardbred Breeders Incentive Fund, and 7% transferred to the Kentucky Horse Breeders Incentive Fund. KHRA does not receive copies of the Kentucky Sales and Use Tax Equine Breeders Supplementary Schedule or supporting documentation for the journal voucher distributions by the Sales and Use Tax Division.

**KENTUCKY HORSE RACING AUTHORITY
FINDINGS AND RECOMMENDATIONS (CONTINUED)
June 30, 2006**

FINDING 1: Subsidiary accounts making up beginning cash balances could not be substantiated. (Continued)

Failure to maintain adequate supporting financial records of the cash balance, and perform necessary reconciliations constitutes an audit scope limitation. Given our inability to ascertain the completeness of revenue totals as reported in years past, we cannot provide an opinion on the beginning cash balance for financial statement purposes.

Although our testing for FY 2006 found no discrepancies with the tax revenue transfer amounts, the failure by KHRA to obtain the necessary detailed records to support the revenue transfers from DOR (Miscellaneous Tax Division and Sales and Use Tax Division) is an internal control weakness that may prevent the detection of proper tax collections or transfer errors.

Sound internal control procedures and accounting practices require the verification of revenue sources, and formal reconciliations of all cash funds.

Recommendation:

We recommend that KHRA develop and implement accounting policies requiring verification of all journal voucher revenue transfers from the Department of Revenue. In addition we recommend that accounting policies requiring formal reconciliations of all revenues and expenditures by Program Budget Units be developed and implemented in order to properly administer the cash balance assigned to the Authority, and verify the accuracy of amounts reported in the general ledger system. The verifications and reconciliations should be done in a timely manner whereby the results from performing the reconciliations can be addressed, and corrections made as necessary.

Further, procedures should be implemented to have up-to-date comparisons of the revenues paid in by each racetrack compared to payments made to the racetracks, arriving at each racetrack's balance, or position in the fund. These balances should be reconciled in total to the fund balance in the state's financial system.

Finally, we recommend KHRA, pursuant to its statutory authority addressed in KRS Chapter 230, develop and implement a plan, in conjunction with the Department of Revenue, to perform periodic audits or reviews of payments made to various funds administered by the Authority.

Management's Response:

KHRA reconciled historical, beginning fund balances for over fifteen years. It was during the initial attempts at determining amounts payable to/receivable from the independent tracks (which make up a large portion of the Kentucky Thoroughbred Development Fund) that the KHRA requested the aid of the Office of Auditor of Public Accounts. The Kentucky Thoroughbred Development Fund's independent track allocations have since been reconciled and all involved parties have signed a KTDF Settlement Agreement and Memorandum of Understanding (Attachment I).

**KENTUCKY HORSE RACING AUTHORITY
FINDINGS AND RECOMMENDATIONS (CONTINUED)
June 30, 2006**

FINDING 1: Subsidiary accounts making up beginning cash balances could not be substantiated. (Continued)

Management's Response: (Continued)

KHRA in conjunction with the Department of Revenue (DOR) and the Kentucky horse racing tracks has developed new practices and procedures to verify pari-mutuel tax fund transfers. The new procedures include matching the track's tax forms (a copy of which is sent to the Authority by the tracks) to the amounts transferred from DOR and procedures to ensure that the taxes are set aside for the Kentucky Thoroughbred Development Fund. (See Attachment 1's Exhibit A.) It is our understanding that the agreement and these procedures will lead to unqualified, clean audit opinions in the future.

The tax returns involved with the pari-mutuel taxes are limited to a constant set of certain identifiable tax payers, which can be reconciled by the Authority. However, the breeders who submit sales and use tax returns to the DOR are not a set population. We estimate there are currently 25,000 such returns each year; however, the breeders filing returns and that number of returns filed per year are constantly changing. KHRA does not have the staff or resources to review these returns to verify accuracy, compliance or DOR's administrative functionality of associated monies. Furthermore, there is no statute or regulation which places KHRA under a duty to audit the tax returns sent by breeders to the Department of Revenue, nor does KHRA possess the authority to enforce compliance with the tax laws.

KHRA must, therefore, rely upon the Department of Revenue to accurately perform its statutory duties. KRS 131.020(1)(e) imposes upon the Department of Revenue's Division of Sales and Use Tax to administer the sales and use tax, and KRS 131.030 charges the Department of Revenue's with exercising "all administrative functions of the state in relation to the state revenue and tax laws," including the collection of taxes and the enforcement of taxpayer compliance with the law.

Auditor Reply:

We certainly agree that the KTDF balances resolution, and the implementation and performance of improved verification procedures will improve the current situation, and increase the likelihood of verifiable information. However, any future audit opinions will be the result of the facts, circumstances and results of audit testing procedures for the year under audit.

The APA reaffirms its recommendation that KHRA develop and implement a periodic audit or review of funds collected and distributed by the Authority. This recommendation can be addressed in an effective manner utilizing information already collected by DOR.

**KENTUCKY HORSE RACING AUTHORITY
FINDINGS AND RECOMMENDATIONS (CONTINUED)
June 30, 2006**

FINDING 2: Failure To Maintain Fund Allocations And Reconcile KTDF.

The Kentucky Horse Racing Authority does not have procedures in place to reconcile the Kentucky Thoroughbred Development Fund (KTDF) by racetrack. As such, financial records for the determination of funding allocations to the qualified licensed associations (i.e., horse racetracks) are inadequate and consequently indeterminable by KHRA. KHRA, therefore, is unable to comply with KRS 230.400(1) requiring that the KTDF money be allocated to each licensed association in an amount equal to the amount contributed by the association.

Although the Authority receives copies of Pari-Mutuel tax filings by the various racetracks, the Authority does not maintain an accounting of the various tax payments (including KTDF, Equine Drug Research, Standardbred Development, etc.) by racetrack, nor does the Authority verify the tax collections by the Miscellaneous Tax Division of the Department of Revenue (DOR). For the FYE June 30, 2006, the Authority received KTDF revenue transfers from DOR totaling \$6,665,301 (28% of total revenue transfers to KHRA). The tax revenue collections are from Pari-Mutuel Tax Return filings from the various horse racetracks in Kentucky. The Revenue Operations Division of DOR assigns a validating number to each Pari-Mutuel tax return filed and inputs the various tax data fields, which post into the Miscellaneous Tax Division's "Mixer" database tax system. The transfers by journal voucher to KHRA may consist of several returns from various racetracks. Therefore, a review by KHRA of only the filed Pari-Mutuel returns will not substantiate the revenue transfer amounts.

Failure to perform the necessary reconciliations of racetrack funding allocations is an internal control weakness leading to noncompliance with KRS 230.400, the result of which may lead to overpayment of racetrack supplemental purse reimbursements. Therefore, overpayment of funds to one or more racetracks may lead to KTDF deficiencies, precluding the availability of funds for payments due to other racetracks.

In addition, although we found no discrepancies with the tax revenue transfer amounts tested, the failure by KHRA to obtain the supporting detailed tax records from DOR (Miscellaneous Tax Division) is an internal control weakness that may prevent the detection of proper tax collections or transfer errors.

The KTDF was created under Kentucky Revised Statute (KRS) 230.400, with administrative responsibilities assigned to KHRA. Funding sources for KTDF are set forth in KRS 138.510. Accordingly, the various Kentucky racetracks are required to file weekly Pari-Mutuel Tax Returns with the Department of Revenue. The Pari-Mutuel tax returns include the applicable tax rates based upon total wagers, with consideration of live wagers, simulcast wagers, and anticipated average daily handle. Taxes are required to be allocated among various programs, including KTDF, and administered by KHRA. KRS 230.400 (1) requires that money from KTDF to be allocated to each licensed association in an amount equal to the amount contributed by the association.

In addition, sound internal control procedures and accounting practices require the verification of revenue sources, and formal reconciliations of all cash funds.

**KENTUCKY HORSE RACING AUTHORITY
FINDINGS AND RECOMMENDATIONS (CONTINUED)
June 30, 2006**

FINDING 2: Failure To Maintain Fund Allocations And Reconcile KTDF. (Continued)

Recommendation:

We recommend that KHRA develop and implement accounting policies facilitating the proper accountability of the KTDF. The policies and procedures should include measures necessary to maintain current fund allocations/balances by each racetrack, with a detailed accounting of tax contributions, as well as fund payments for supplemental purse reimbursements. Verification of the availability of funds by track should be assured prior to distribution in order to avoid overpayments. In addition, the policies and procedures should require that reconciliations be performed of each racetrack allocation balance, as well as to the state's general ledger system (eMARS, effective July 1, 2006). The reconciliations should be done in a timely manner whereby the results from performing the reconciliations can be addressed, and corrections made as necessary.

Management's Response:

KHRA requested the aid of the Office of Auditor of Public Accounts for an Agreed Upon Procedures to determine independent track allocations which make up a large portion of the Kentucky Thoroughbred Development Fund. These independent track allocations have been unidentifiable due to financial procedures predating fiscal year 1999 and the inception of the Kentucky Horse Racing Authority.

The Kentucky Thoroughbred Development Fund's independent track allocations have since been reconciled with all involved parties by a signed legal Settlement Agreement and Memorandum of Understanding. See Attachment 1.

KHRA has developed new practices and procedures in conjunction with the Department of Revenue and the Kentucky horse racing tracks to verify all fund transfers that are collected from pari-mutuel taxes that are set a side for the Kentucky Thoroughbred Development Fund. These new procedures will utilize the Emars system's ability to account for individual track accounts payable and accounts receivable in accordance with KRS 230.400. The new procedures are detailed in Attachment 1's Exhibit A.

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Attachment I

KTDF Settlement Agreement and Memorandum of Understanding among Keeneland Association, Turfway Park, LLC, Churchill Downs Incorporated and Ellis Park Race Course, Kentucky Horse Racing Authority and Kentucky Thoroughbred Development Fund Advisory Committee

THIS KTDF SETTLEMENT AGREEMENT AND MEMORANDUM OF UNDERSTANDING (this "Agreement"), dated as of the 18th day of December 2006, is entered into by and among Keeneland Association, PO Box 1690, Lexington, Kentucky 40588 ("Keeneland"), Turfway Park, LLC, 7500 Turfway Road, PO Box 8, Florence, Kentucky 41022 ("Turfway"), Churchill Downs Incorporated, 700 Central Avenue, Louisville, KY 40208 ("Churchill") and Ellis Park Race Course, Inc. 3300 US Highway 41 North, Henderson, Kentucky 42420, ("Ellis"), the Kentucky Horse Racing Authority, an independent agency of the Commonwealth of Kentucky, organized pursuant to the laws of the Commonwealth of Kentucky with its principal place of business located at 4063 Iron Works Pike, Building B, Lexington, KY 40511 ("KHRA"), and the Kentucky Thoroughbred Development Fund Advisory Committee, a committee established under the general jurisdiction of the KHRA with its principal place of business located at 4063 Iron Works Pike, Building B, Lexington, KY 40511 ("KTDF Advisory Committee"). Keeneland, Turfway, Churchill and Ellis shall be collectively referred to herein as the Associations or tracks.

WHEREAS, the Kentucky Thoroughbred Development Fund ("KTDF") was established in 1978.

WHEREAS, pursuant to KRS 230.400 money contributed to the KTDF is required to be allocated to each Association in an amount equal to the amount the Association contributed to the KTDF.

WHEREAS, the KTDF is funded from the tax paid by (i) the host tracks in the amount of 0.75 percent of the total live handle for thoroughbred racing and (ii) all thoroughbred tracks in the amount of 2 percent of the simulcast handle for thoroughbred racing.

WHEREAS, the amount of money each Association distributes to supplement purses has not been reconciled against the amount of money contributed to that Association's account for many years.

WHEREAS, an attempt was made in 1999 to reconcile the KTDF balances and such attempt was unsuccessful.

WHEREAS, the Associations and the KHRA desire to agree to and follow

Attachment 1

procedures to be used after the date of this Agreement.

WHEREAS, the Associations understand that the KHRA can only reimburse the Associations that amount which has been contributed to the KTDF.

WHEREAS, the Associations desire to be compensated for the amount of the invoices they have submitted to the KHRA as of October 2, 2006 in the total amount of \$ 3,032,455.94 ("Total Invoices").

WHEREAS, after a contribution of \$150,000 by the KHRA ("KHRA Contribution") and KHRA's decision not to submit the invoice by the Auditor of Public Accounts in the amount of \$ 27,084.00 to the KTDF for payment, a total of \$ 2,509,048.71 ("Total Available") exists for reimbursement to the Associations under the KTDF program.

WHEREAS, the KTDF Advisory Committee has been consulted about this Agreement and has recommended it to the KHRA for approval.

WHEREAS, the KTDF Advisory Committee will advise and assist the KHRA in the manner and method of payment of supplemental purses in connection with this Agreement, as well as other activities as directed by KRS 230.400.

INTENDING TO BE LEGALLY BOUND HEREBY, the parties hereto agree as follows:

1. Reimbursement to the Associations.
 - a. Each Association shall be reimbursed for the amount of the invoices submitted as of October 2, 2006 for that Association, less \$130,000 per Association. Each Association acknowledges that once the reimbursement amounts are paid neither the KTDF, the KHRA nor the Commonwealth of Kentucky is obligated to pay the Association any additional amount for the period prior to October 2, 2006, except as set forth in subsection 1 (c) below. The Associations submitted invoices for the following amounts as of October 2, 2006 and shall be reimbursed in the following amounts which upon receipt shall be considered to be payment in full:

<u>Track</u>	<u>Invoice</u>	<u>Reimbursement</u>
Keeneland	\$ 0	(\$130,000.00)
Turfway	\$ 502,750.94	\$ 372,750.94
Churchill and Ellis	\$ 2,529,705	\$ 2,269,705.00
<u>Rounding for Convenience</u>		<u>(\$3,407.23)</u>
Total		\$ 2,509,048.71

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- b. Invoices submitted by an Association after October 2, 2006 will be paid in full up to the amount credited to the account of the Association, except for Keeneland, which next invoice(s) will be reduced by \$130,000 before being paid.
- c. If Keeneland's KTDF Account earns funds in excess of the amount Keeneland distributes in purse money prior to December 31, 2008 Keeneland shall be reimbursed up to a total of \$130,000 which represents the total amount withheld from invoices submitted by Keeneland and agreed due by the KHRA as of October 2, 2006. If Turfway's KTDF Account earns funds in excess of the amount Turfway distributes in purse money prior to December 31, 2008 Turfway shall be reimbursed up to a total of \$130,000 which represents the total amount withheld from invoices submitted by Turfway and agreed due by the KHRA as of October 2, 2006. If Churchill's KTDF Account earns funds in excess of the amount Churchill distributes in purse money up to December 31, 2008 Churchill shall be reimbursed up to a total of \$260,000 which represents the total amount withheld from invoices submitted by Churchill and Ellis agreed due by the KHRA as of October 2, 2006. Any reimbursement under this subsection 1 (c) must be earned and requested prior to December 31, 2008 and may be earned and reimbursed sooner.
- d. Churchill owned Ellis until September 28, 2006. For purposes of this paragraph 1, Churchill shall be entitled to the reimbursement due to Ellis based on invoices submitted prior to October 2, 2006.

2. Contribution by KHRA.

The KHRA agrees that it will contribute \$150,000 to the KTDF as reimbursement for a \$150,000 fee that was paid to the former Kentucky Racing Commission during 2001. The KHRA further agrees that the KTDF will not be charged for the invoices sent by the Auditor of Public Accounts (APA) for the audit regarding the KTDF during 2006.

3. Procedures in the Future.

- a. Each Association and the KHRA agree that they will comply with the procedures attached hereto as Exhibit A from the time of this Agreement until such procedures are amended and agreed to in writing by the Association and the KHRA.
- b. The KHRA agrees to cooperate with each Association in a timely

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manner so that the records will remain in balance for each Association's KTDF account for a rolling twelve month period. In the event an individual Association requests an amount for reimbursement that is greater than the amount present in the Association's KTDF account at the time, the Association shall only be reimbursed up to the amount available in the Association's KTDF account. After January 1, 2009 or the complete reimbursement of the Association of amounts due under paragraph 1 (c) of this Agreement, whichever occurs first, the amount requested in excess of that available may be reimbursed within the following twelve month period if the Association earns more than it has distributed in KTDF purse supplements during that twelve month period.

- c. Each Association and the KHRA agree that, after following the procedures outlined in Exhibit A for at least one race meet for each Association, each Association and the KHRA will review the procedures for the administration of the KTDF in light of the intent behind KRS 230.400.
- d. Prior to finalizing a purse structure for a meet, each Association shall submit a description of its purse structure to the KTDF Advisory Committee for the Advisory Committee's advice and review. The KTDF Advisory Committee shall assist each Association in structuring a purse program intended to allow that Association to obtain a reimbursement as provided for in this Agreement and to comply with the procedures set forth in Exhibit A. The KTDF Advisory Committee shall make recommendations to the KHRA as needed.

4. Limitation of Liability.

A. EXCEPT AS OTHERWISE PROVIDED IN THIS AGREEMENT, IN NO EVENT WILL A PARTY BE LIABLE TO ANOTHER PARTY HEREUNDER FOR ANY INDIRECT, CONSEQUENTIAL, SPECIAL, EXEMPLARY, OR INCIDENTAL DAMAGES, WHETHER IN CONTRACT, TORT, NEGLIGENCE OR OTHERWISE ARISING FROM OR RELATING TO THIS AGREEMENT.

B. EACH PARTY RECOGNIZES AND AGREES THAT THE LIABILITY LIMITATIONS IN THIS AGREEMENT HAVE BEEN MATERIALLY BARGAINED FOR IN CONNECTION WITH THIS AGREEMENT AND THAT THEY HAVE BEEN TAKEN INTO ACCOUNT

Attachment 1

AND REFLECTED IN DETERMINING THE CONSIDERATION TO BE GIVEN BY EACH PARTY UNDER THIS AGREEMENT AND IN THE DECISION BY EACH PARTY TO ENTER INTO THIS AGREEMENT.

5. Notices.

A. Unless provided for otherwise, all notices required to be given pursuant to any of the provisions of this Agreement shall be in writing and shall be deemed to have been duly given or made for all purposes if sent by (i) certified or registered mail, return receipt requested, and postage prepaid, (ii) confirmed electronic means, or (iii) express mail service or other verified overnight courier service to a party at the address first above written, or at such other address as has been given in accordance with the preamble.

B. Unless provided for otherwise, the date any such notice shall be deemed to have been received is: (i) if sent by registered or certified mail, five business days following the posting of the mail, (ii) if sent by confirmed electronic means, the date when sent or the next business date following transmission if not sent on a business day, or (iii) if sent by express mail or other verified overnight courier service, two business days following delivery to the post office or other verified overnight courier service.

6. Miscellaneous.

A. Notwithstanding anything contained herein to the contrary, in the event either party to this Agreement fails to perform any obligations hereunder assumed by it and such failure is due to acts of God, injunctions, lockouts, riots or civil unrest, fires, epidemics, casualties, boycotts, technical difficulties (whether computer related or otherwise), failure of suppliers to supply data, strikes or labor disputes, acts of a governmental authority, or other interference through legal proceedings or for any other cause which is not due to the fault or negligence of such party, such failure shall not be deemed to be a breach by such party of its obligations hereunder, although such party shall use its best efforts to put itself in a position to carry out all of the obligations which, by the terms hereof, it has assumed irrespective of the occurrence of any force majeure event.

B. Nothing contained in this Agreement shall be construed to place the parties in the relationship of partners or joint venturers.

C. No waiver, modification or cancellation of any term or condition of this Agreement shall be effective unless executed in writing by the party so granting in the case of waivers or cancellations, and both parties, in the

Attachment 1

case of modifications. A waiver of any breach of this Agreement by one party to the other shall not be construed to have been given in perpetuity. A failure or delay of either party hereto to enforce at any time any of the provisions of this Agreement or to require at any time performance of any of the provisions hereof shall in no way be construed to be a waiver of any provision of this Agreement.

D This Agreement contains the entire understanding of the parties hereto with respect to the transactions contemplated hereby, and supersedes all prior agreements, understandings, and negotiations, both written and oral, between the parties with respect to the subject matter hereof.

E This Agreement shall be governed by and interpreted and enforced in accordance with, the laws of the Commonwealth of Kentucky, without regard to the conflicts of laws rules thereof. The parties hereby consent to the jurisdiction of the federal and state courts located in the County of Franklin, Commonwealth of Kentucky for the purpose of any action or proceeding brought by either of them on or in connection with this Agreement or any alleged breach thereof.

F The captions of the sections in this Agreement are inserted for convenience only and shall not affect the interpretation or construction of this Agreement.

G This Agreement may be signed in counterparts.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed as of the date first above written.

Keeneland Association

By: Leah T. Beal

Title: Director of Accounting

Turfway Park, LLC

By: _____

Title: _____

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case of modifications. A waiver of any breach of this Agreement by one party to the other shall not be construed to have been given in perpetuity. A failure or delay of either party hereto to enforce at any time any of the provisions of this Agreement or to require at any time performance of any of the provisions hereof shall in no way be construed to be a waiver of any provision of this Agreement.

D This Agreement contains the entire understanding of the parties hereto with respect to the transactions contemplated hereby, and supersedes all prior agreements, understandings, and negotiations, both written and oral, between the parties with respect to the subject matter hereof.

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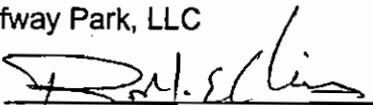
IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed as of the date first above written.

Keeneland Association

By: _____

Title: _____

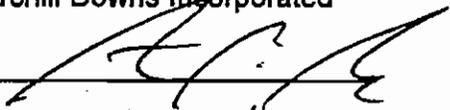
Turfway Park, LLC

By: 

Title: President / CEO

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Churchill Downs Incorporated

By: 
Title: President

Ellis Park Race Course

By: _____

Title: _____

Kentucky Horse Racing Authority

By: _____

Title: _____

Kentucky Thoroughbred Development Fund Advisory Committee

By: _____

Title: _____

EXHIBIT A

Procedures for handling KTDF reconciliation:

- All licensed pari-mutuel outlets will send a copy of the pari-mutuel tax form filed with the Department of Revenue to the KHRA along with a copy of the check submitted for each report on a weekly basis. These reports are usually filed every Friday.
- KHRA will prepare and provide an unaudited report that shows live handle, simulcast handle, track reporting, live track, the amount submitted for equine drug research, KTDF and KSDF.
- Department of Revenue sends two reports every 30 days. The first report is a mixer report that provides transaction date, group number, transaction sequence number, tax id number, track and validation number. The second report is the emars report that provides the document number of the transfer, start through end validation number, amount and group number.
- KHRA will then reconcile the weekly reports submitted by the tracks with revenues reports and deposits made every 30 days.

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Churchill Downs Incorporated

By: _____

Title: _____

Ellis Park Race Course

By: *Randy Gentry*

Title: *President*

Kentucky Horse Racing Authority

By: *Lisa E. Underwood*

Title: *Executive Director*

Kentucky Thoroughbred Development Fund Advisory Committee

By: *David Robinson*

Title: *CHAIR*

EXHIBIT A

Procedures for handling KTDF reconciliation:

- All licensed pari-mutuel outlets will send a copy of the pari-mutuel tax form filed with the Department of Revenue to the KHRA along with a copy of the check submitted for each report on a weekly basis. These reports are usually filed every Friday.
- KHRA will prepare and provide an unaudited report that shows live handle, simulcast handle, track reporting, live track, the amount submitted for equine drug research, KTDF and KSDF.
- Department of Revenue sends two reports every 30 days. The first report is a mixer report that provides transaction date, group number, transaction sequence number, tax id number, track and validation number. The second report is the emars report that provides the document number of the transfer, start through end validation number, amount and group number.
- KHRA will then reconcile the weekly reports submitted by the tracks with revenues reports and deposits made every 30 days.

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- For Keeneland and Churchill, thirty days after the end of each racing meet the KHRA will produce a report for the track that has just completed the live meet. For Turfway and Ellis, fifteen days after the end of each month during which Turfway or Ellis conducts live racing, the KHRA will produce a report for the track that has just completed the live racing month. The report will show the amount of KTDF funds accumulated during the live racing meet or month (as applicable), with a break down for each location from which the credits were earned. This will then be used to compare to the track's actual disbursements.
- KHRA will then meet with each track to verify and agree on the totals for the pari-mutuel tax forms and checks submitted to DOR, the deposits made by DOR, and the actual KTDF money paid out by the track.
- The tracks sign an agreement stating that they agree with the reconciliation prior to reimbursement of any KTDF funds.
- KHRA will then issue reimbursement checks to the track from the KTDF fund but reimbursements will not exceed the sum of amount earned by the track at the live racing meet or month completed (as applicable) plus any accumulated KTDF carryforward from previous live meets.
- Purse Structure recommendations shall be approved by the KTDF advisory committee.
- Reasonable and customary administrative charges for time spent reconciling the KTDF account will be charged by the percentage of funds generated by each track for the previous calendar year.
- Advertising charges will be paid but deducted from KTDF available balances.
- KHRA shall verify that Horse Identification Reports indicate that only registered Kentucky bred horses finishing first, second, third and/or fourth, eligible for KTDF reimbursement will be paid. Invoice details will be compared to the corresponding Horse Identification Report's KTDF Earnings column.
- KHRA shall develop and implement a record retention policy for KTDF invoices and Horse Identification Reports.
- KHRA shall verify on a limited test basis that horses listed as qualifying for KTDF awards are registered with the KTOB Kentucky Registry. KHRA will retain documentation for 3 years verifying that such limited tests have been performed.

