



A REPORT
TO THE
ARIZONA LEGISLATURE

Performance Audit Division

Performance Audit and Sunset Review

Arizona Department of Racing

Sunset Review

Arizona Racing Commission

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Debra K. Davenport
Auditor General

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AUDITOR GENERAL

STATE OF ARIZONA
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AUDITOR GENERAL

WILLIAM THOMSON
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May 30, 2007

Members of the Arizona Legislature

The Honorable Janet Napolitano, Governor

Mr. Geoffrey Gonsler, Director
Arizona Department of Racing

Mr. James N. Chilcoat, Sr., Chairman
Arizona Racing Commission

Transmitted herewith is a report of the Auditor General, a Performance Audit and Sunset Review of the Arizona Department of Racing and Sunset Review of the Arizona Racing Commission. This report is in response to a May 22, 2006, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq. I am also transmitting with this report a copy of the Report Highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, the Arizona Department of Racing agrees with all of the findings and plans to implement all of the recommendations.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on May 31, 2007.

Sincerely,

Debbie Davenport
Auditor General

Enclosure

SUMMARY

The Office of the Auditor General has conducted a performance audit and sunset review of the Arizona Department of Racing and a sunset review of the Arizona Racing Commission pursuant to a May 22, 2006, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

The Arizona Department of Racing (Department) regulates and supervises pari-mutuel racing and wagering conducted in Arizona. The Department is responsible for regulating all commercial and county fair horse-racing meetings, greyhound-racing meetings, and pari-mutuel wagering.¹ The Arizona Racing Commission (Commission) focuses its efforts on supervising the department director and approving or rejecting his policy recommendations, allocating racing dates (the specific number of days allowed for a racing meeting), and approving permits to conduct racing.

This audit focused on two aspects of the Department's operations: overseeing pari-mutuel wagering at horse and greyhound racing tracks, and testing horses and greyhounds for drugs. The audit also includes information on the revenues generated by the racing industry.

Department should improve pari-mutuel oversight program (see pages 13 through 24)

The Department should take several steps to make its oversight of pari-mutuel wagering more effective. To conduct wagering, racetracks contract with national companies to administer computerized pari-mutuel systems, called totalisator or "tote" systems. A 2002 scandal in New York focused nation-wide attention on potential manipulation of these systems and led the racing industry to propose new oversight practices. Relative to these recommended practices, the Department's procedures can be improved in several respects, both to make existing oversight activities more efficient and to incorporate additional tests and reviews. Specifically:

¹ Effective August 22, 2002, following the passage of Laws 2002, Chapter 328, §8, the Department of Racing assumed full responsibility for boxing regulation. Prior to this time, the Department was responsible only for the financial administration of the Arizona State Boxing Commission. This performance audit and sunset review focuses solely on the Department's regulation of Arizona's racing industry. The Arizona State Boxing Commission has a separate sunset date of July 1, 2011.

- **Adapting to new testing requirements**—One of Arizona’s racetracks now conducts simulcast operations with locations in Canada, allowing Canadians to wager on Arizona races and thereby increase revenue for the tracks. However, Canada’s laws require simulcasting racetracks to use a different form of pricing than Arizona’s racetracks have historically used. As a result, the Department’s auditors have to perform more tote testing calculations. To adapt to these changes, department auditors need additional audit training, and the Department needs to consider time-saving approaches used in other states.
- **Improving information technology reviews of pari-mutuel wagering systems**—The Department’s practices fall short of information technology (IT) auditing standards in such areas as monitoring changes to tote system software and reviewing controls over access to the tote systems. Proposed racing industry Model Rules for pari-mutuel wagering developed by the Association of Racing Commissioners International (ARCI) recommend that states license tote companies and require, among other things, independent assessments of tote systems as a condition of licensure. However, although the Department licenses tote companies, it lacks the statutory authority to do so and should therefore work with the Legislature to obtain this authority. If it obtains this statutory authority, the Department then should modify its rules to identify tote companies as a license category and include licensing requirements recommended in the proposed Model Rules. For example, the rules should require independent testing of controls, known as SAS 70 reviews, to be performed on tote systems. The Department’s pari-mutuel auditors should also become more familiar with the information technology controls standards that ARCI has included in its proposed additions to the Model Rules, and add some of these areas to its regular auditing practices.
- **Monitoring wagering anomalies**—Although automated systems offer a more systematic way to monitor and detect potential wagering anomalies, the Department is not using automation to any great extent, either on a real-time or post-race basis, to detect whether such anomalies have occurred. Some racing jurisdictions are investing in independent monitoring systems that allow them to monitor and detect potential anomalies. As of 2007, two organizations offer such a service to state racing regulators—ESI Integrity, a Canadian-based company that provides independent software for security and risk management, and RCI Integrity Services, a nonprofit services organization, which is a subsidiary of the ARCI. The Department should explore the feasibility of adopting automated systems to improve detection of potential wagering anomalies.

In addition to improving its oversight of the totalisator systems, the Department should explore expanding its financial analyses of the monies wagered in Arizona. This would strengthen oversight of handle (the dollars wagered) distribution to parties

that are entitled to a portion of the pari-mutuel revenues. For example, the Department does not review purse distributions on a regular basis. However, in September 2005, a department special audit found that one racing track had shorted its distributions to owners of winning greyhounds by approximately 15 percent over a 9-month period spanning August 2004 through April 2005. The Department reports that it does not have the staff resources to conduct additional financial analyses on a regular basis.

Department should continue aligning animal drug-testing practices with national standards (see pages 25 through 36)

The Department's animal drug-testing program is generally aligned with racing regulation practices, and the Department should continue taking additional steps to further strengthen its animal drug-testing practices. The Department employs the standard testing practices used in the racing industry to both initially detect and confirm the presence of drugs, and it is aligning its drug-testing practices with Model Rules developed by ARCI. These Model Rules cover such matters as drug classifications for horses and recommended penalties when violations are found, as well as drug-testing practices for horses and greyhounds.

Although the Department has not formally adopted the Model Rules, the Department is already in alignment with some of these rules and is making improvements to its drug-testing program to better align with others. Racing industry stakeholders in Arizona have expressed concerns about some of these Model Rules, and the Department is working toward gaining consensus on these matters. However, progress in the drug-testing program was set back by actions the Department took in 2006 to deal with an internal budget shortfall precipitated by unexpected expenses and mandates, such as state-wide, mandated, employee-pay increases. To deal with these unexpected expenses, the Department implemented several cost-saving measures, including reducing the number of winning horses tested for drugs. The Department reported that it reduced drug testing as a last alternative to balance its budget. This reduction went on for 2 months and did not violate any state laws, but it resulted in the Department's temporarily deviating from the Model Rules with regard to the testing of every winning horse. Although the Model Rules do not recommend the same practice for greyhounds, in response to its internal budget constraints, the Department also cut back by about two-thirds the number of greyhounds tested. Specifically, instead of sending eight to nine urine samples a day for testing, the Department reduced this to three urine samples per day.

Other pertinent information (see pages 37 through 43)

Auditors also developed information about how Arizona's racing industry was historically funded and is currently funded, legislative actions to assist the racing industry, and industry revenue sources used by some other states that are not used in Arizona.

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INTRODUCTION & BACKGROUND

The Office of the Auditor General has conducted a performance audit and sunset review of the Arizona Department of Racing and a sunset review of the Arizona Racing Commission pursuant to a May 22, 2006, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

The Arizona State Legislature created the Arizona Department of Racing (Department) in 1982 to regulate and supervise pari-mutuel racing and wagering conducted in Arizona. The Department is responsible for regulating all commercial and county fair horse-racing meetings, greyhound-racing meetings, and pari-mutuel wagering.¹ The Arizona Racing Commission (Commission) has existed since 1949, and before 1982, it performed the regulatory activities the Department now performs. By establishing the Department, the Legislature intended to strengthen racing industry regulation by placing the Department and its director in charge of day-to-day oversight of racing activities. In contrast, the Commission focuses its efforts on supervising the Department's director and approving or rejecting his policy recommendations, allocating racing dates (the specific number of days allowed for a racing meeting), and approving permits to conduct racing.

Status of Arizona's racing industry

Arizona is one of only 11 states that operate both horse and greyhound racetracks.² Horse and greyhound racing occurs at five tracks in the State: horse racing at Turf Paradise in Phoenix, Yavapai Downs in Prescott Valley, and Rillito Park in Tucson; and greyhound racing at Phoenix Greyhound Park and Tucson Greyhound Park.³ In addition to commercial racing, all 15 Arizona counties conduct horse racing in conjunction with their county fairs.⁴

¹ Effective August 22, 2002, following the passage of Laws 2002, Chapter 328, §8, the Department of Racing assumed full responsibility for boxing regulation. The Department was previously responsible only for the financial administration of the Arizona State Boxing Commission. This audit and sunset review focuses solely on the Department's regulation of Arizona's racing industry. The Arizona State Boxing Commission has a separate sunset review date of July 1, 2011.

² Review of various state statutes indicates that 16 states legally allow both horse and greyhound racing: Alabama, Arizona, Arkansas, Colorado, Connecticut, Florida, Iowa, Kansas, Massachusetts, New Hampshire, Oregon, Rhode Island, South Dakota, Texas, West Virginia, and Wisconsin. However, Connecticut, Rhode Island, and Wisconsin have no operative horse tracks, and Oregon and South Dakota have no operative dog tracks.

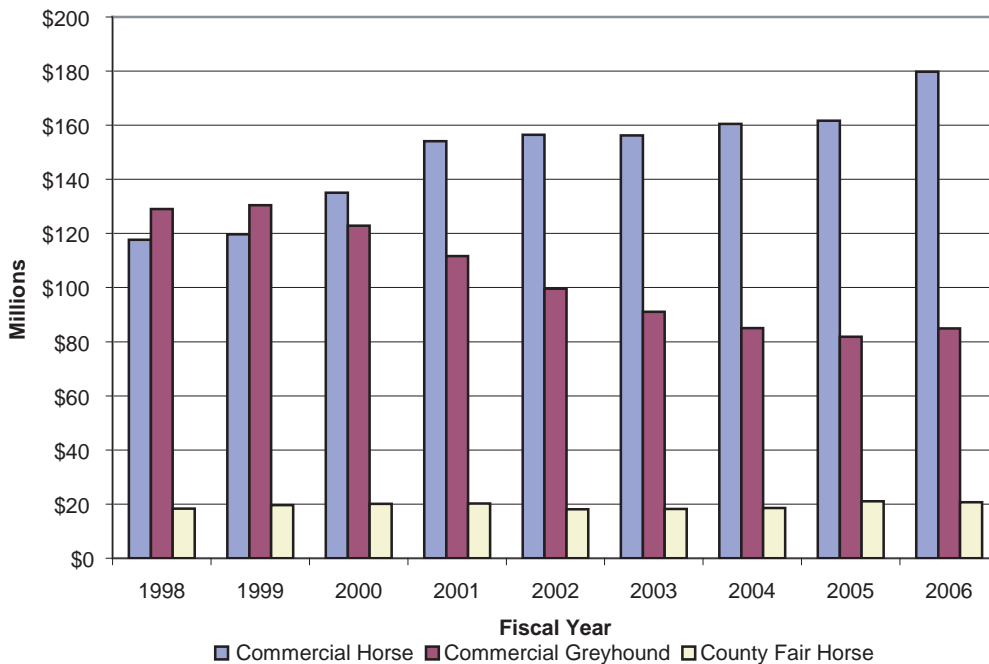
³ Fiscal year 2004 was the last year live racing was held at Apache Greyhound Park in Apache Junction, although patrons at that location can still bet on races broadcast from Phoenix Greyhound Park as well as Turf Paradise and Yavapai Downs.

⁴ Seven of Arizona's 15 counties conduct county fair racing at commercial tracks: La Paz, Maricopa, Navajo, Pinal (Turf Paradise), Pima (Rillito Park), Yavapai, and Yuma (Yavapai Downs).

The racing industry measures its success through the amount of pari-mutuel “handle,” which is the dollars wagered. The total amount of handle generated by commercial horse and greyhound racing and county fair racing in fiscal year 2006 was \$285.4 million. As Figure 1 shows, the handle for commercial horse racing has increased since fiscal year 1998, while the handle for commercial greyhound racing has decreased and the handle for county fair racing has remained relatively constant. During fiscal year 2006, commercial horse racing accounted for \$179.7 million in handle, which was more than double the \$84.9 million in handle generated from commercial greyhound racing that same year. County fair racing handle totaled about \$20.8 million.

As shown in Table 1, page 3, in fiscal year 2006, both commercial horse racing and commercial greyhound racing showed increases in handle over previous years. Approximately two-thirds of the total handle for commercial racing is generated at off-track betting sites (OTBs) instead of the actual tracks. In Arizona, OTBs are predominantly restaurants and bars that operate as satellites of the racetracks. To open an OTB, a racetrack that already has a state permit to conduct horse racing or dog racing must submit an application to operate an OTB facility to the Department of Racing. It must also receive a permit to operate as an OTB from the municipality where the site will be located and be approved by the Arizona Racing Commission. According to the Department, 83 OTBs were authorized to broadcast horse and greyhound racing in fiscal year 2006.

Figure 1: Arizona Racing Handle
Fiscal Years 1998 through 2006
(Unaudited)



Source: Auditor General staff analysis of information reported in the *State of Arizona Department of Racing 53rd Annual Report 2001-2002*, *State of Arizona Department of Racing Annual Report FY2003*, and *State of Arizona Department of Racing Annual Report FY2006*.

The recent increases in commercial horse-racing handle appear to be driven primarily by an increase in simulcast wagering—wagers that Arizona bettors make on out-of-state races as opposed to live race wagering.¹ As shown in Figure 2 (see page 4), although total handle generated at Arizona’s commercial racetracks has generally fluctuated between \$245 million and \$265 million since 1998, the actual composition of the handle has changed significantly, with simulcast handle forming a larger proportion of the total handle each year. During fiscal year 2006, 69.2 percent of handle generated was simulcast, compared to 49.1 percent of handle in 1998. However, these handle trends only capture monies wagered within the State of Arizona, and do not include wagers made on Arizona-based races that are broadcast out-of-state.

Arizona racetracks can also earn revenues in the form of commissions from broadcasting their races to non-Arizona jurisdictions. For example, during 2006, Turf Paradise took the initiative to simulcast its race signal to California racetracks that were unable to broadcast races from Louisiana because of Hurricane Katrina. In addition, they took the initiative to ensure that Canada would continue to receive its race signal after Canada changed its laws to require a different form of wagering called net pool pricing (see Finding 1, page 16).^{2,3}

Table 1: Pari-Mutuel Handle Reported by Commercial Tracks Fiscal Years 2004 through 2006 (Unaudited)

Track	2004	2005	2006
Commercial Horse			
Turf Paradise	\$133,246,398	\$131,067,082	\$146,007,413
Yavapai Downs	26,387,747	29,818,131	32,883,699
Rillito Park	<u>805,693</u>	<u>746,592</u>	<u>841,230</u>
Subtotal	<u>160,439,838</u>	<u>161,631,805</u>	<u>179,732,342</u>
Commercial Greyhound			
Phoenix Greyhound Park	58,262,630	57,674,840	60,277,043
Tucson Greyhound Park	21,514,079	20,725,277	20,551,582
Apache Greyhound Park ¹	<u>5,281,988</u>	<u>3,485,747</u>	<u>4,101,136</u>
Subtotal	<u>85,058,697</u>	<u>81,885,864</u>	<u>84,929,761</u>
Total	<u>\$245,498,535</u>	<u>\$243,517,669</u>	<u>\$264,662,103</u>

¹ Apache Greyhound Park handle for fiscal year 2004 includes both live and simulcast handle and was the last year that live races were held at that venue. Handle reported for fiscal years 2005 and 2006 was generated solely from simulcast wagering from races taking place in other jurisdictions that were broadcast to Apache Greyhound Park.

Source: Auditor General staff analysis of commercial handle information reported in the *State of Arizona Department of Racing Annual Report FY2006*.

Live Handle: Consists of dollars wagered on live Arizona racing events, either on-site at the racetrack or at an off-track betting site located in Arizona. This type of handle can only be generated from Arizona-based races.

Simulcast Handle: Consists of dollars wagered within the State of Arizona on out-of-state races that are broadcast to Arizona racetracks and off-track betting sites. This type of handle is generated only from out-of-state races.

Source: Auditor General staff interpretation of statutory definitions and other information in A.R.S. §§5-101 and 5-111(B), and information received from department officials in May 2007.

Pari-mutuel handle distributions

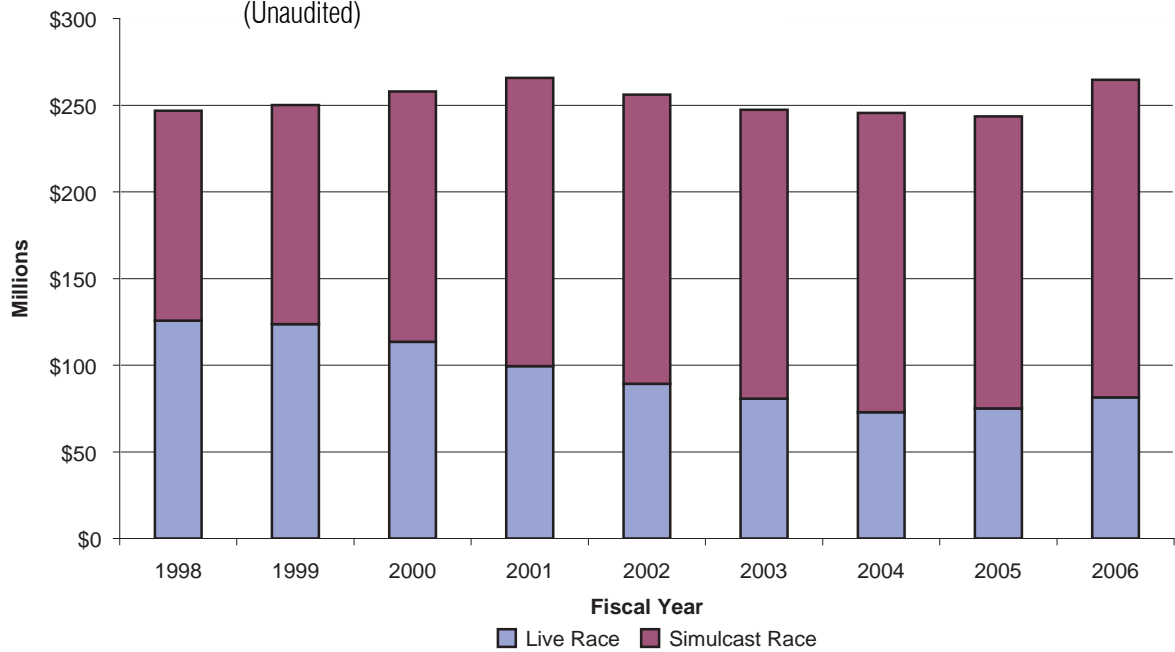
Several entities receive a portion of the pari-mutuel handle generated by commercial horse and greyhound

¹ Simulcast handle should not be confused with handle that Arizona tracks earn from OTBs. If a patron bets on a live Arizona race, it is considered “live handle,” and if it is an out-of-state race, it is considered “simulcast handle.”

² The Turf Paradise racing season typically starts in early October and ends in May.

³ According to Turf Paradise officials, tracks that did not adopt net pool pricing would not be able to send their race signals to Canada.

Figure 2: Arizona Commercial Racing Handle
Generated by Live and Simulcast Race Wagering
Fiscal Years 1998 through 2006
(Unaudited)



Source: Auditor General staff analysis of information reported in the *State of Arizona Department of Racing 53rd Annual Report 2001-2002*, *State of Arizona Department of Racing Annual Report FY2003*, and *State of Arizona Department of Racing Annual Report FY2006*.

and county fair racing: the State (pari-mutuel taxes), the racetracks (track operation revenues and out-of-state tracks), the wagering public (winnings), and others. In fiscal year 2006, the Department reported that 76.8 percent of the total \$285.4 million handle was returned to the

wagering public as winnings. Owners of winning horses and greyhounds also receive purse monies that are derived primarily from racetrack revenues.¹ The Department reported a total of \$22.3 million distributed in purses in fiscal year 2006. (See textbox).

In recent years, the amount of revenues being returned to the State in the form of pari-mutuel taxes has declined significantly. For example, in fiscal year 1998, the State collected more than \$2.9 million in pari-mutuel taxes compared to nearly \$528,000 in fiscal year 2006. Some of this is due to the decline in live handle and the corresponding growth in simulcast handle. Unlike some other states, Arizona does not tax simulcast handle.

Fiscal year 2006 pari-mutuel handle distributions

Total handle generated: \$285.4 million
Distributions:

State pari-mutuel taxes:	\$527,860
Racetrack revenues:	\$61.1 million
Purse distributions:	\$22.3 million
Return to public—Arizona (winnings):	\$219.1 million
Return to public—other states:	\$4.4 million
County fair tax rebates:	\$124,298
Wagering pool adjustments ¹	\$172,086

¹ Consists of adjustments to wagering pools that are eventually returned to Arizona's wagering public or the out-of-state wagering public.

Source: Auditor General staff analysis of fiscal year 2006 pari-mutuel handle distribution information received from Department of Racing staff in February 2007.

¹ Although purse monies are primarily derived from track revenues, other revenues, such as owners' and trainers' entry fees, also support purse distributions.

Funding of department operations

The Department's revenue, which used to come primarily from pari-mutuel taxes, now comes primarily from State Unclaimed Property Fund monies. As shown in Table 2, page 6, in fiscal year 2006, the department revenues totaled nearly \$12.8 million, but its actual operating expenditures were much lower—slightly less than \$3 million. The Department transferred or remitted most of the remaining revenue to other funds, leaving it with an end-of-year balance of about \$817,000. See Other Pertinent Information, pages 37 through 43, for a more detailed discussion of the Department's funding.

Commission and department staffing

The Arizona Racing Commission consists of five members that the Governor appoints for 5-year terms. The Commission is primarily responsible for establishing the racing regulation policy in Arizona, and it performs activities such as issuing racing dates (the specific number of days allowed for a racing meeting); preparing and adopting rules to govern racing meetings as may be required to protect and promote the safety and welfare of the animals participating in a racing meeting; protecting and promoting the health, safety, and proper conduct of those involved in racing and pari-mutuel wagering; conducting hearings on applications for racing permits, and conducting hearings and other legal procedures on matters relating to racing licensees and the racing industry.

Since fiscal year 2003, the Arizona Department of Racing has been authorized 46.5 full-time equivalent (FTE) positions to provide direct oversight of racing activities in the State.¹ The Department is organized into four divisions:²

- **Administration (16.5 FTE, 2.0 vacant):** The Department's administration division includes budgeting and strategic planning, personnel and procurement, accounting and payroll, information technology, licensing, and pari-mutuel auditing. The Department licenses all personnel involved in racing, including horse and greyhound owners, trainers, jockeys, grooms (individuals who care for horses), exercise riders, veterinarians, track management and officials, concessionaires, and pari-mutuel workers. As of March 2007, the Department reported a total of 12,269 licensees. The Department expanded the number of pari-mutuel auditors from one to two full-time auditors in fiscal year 2004.¹ These auditors are responsible for ensuring the accuracy and integrity of commercial and county fair pari-mutuel wagering. Their primary duties consist of testing the computerized systems, known as totalisators or "tote" systems, prior to the beginning of race meetings, and ensuring the integrity of wagering

¹ In 2003, the Department lost six full-time positions and more than two seasonal (part-time) positions as part of the State's overall effort to cope with a budget shortfall.

² Vacancies are as of April 2007.

Table 2: Schedule of Revenues, Expenditures, and Other Changes in Fund Balance
Fiscal Years 2005 through 2007
(Unaudited)

	2005 (Actual)	2006 (Actual)	2007 (Estimate)
Revenues:			
Unclaimed property ¹	\$ 8,706,424	\$ 9,456,217	\$ 9,500,000
State General Fund appropriations	2,506,297	2,606,784	2,750,700
Pari-mutuel taxes	460,960	527,901	530,000
Licenses, permits, and fees ²	189,682	74,281	80,000
Fines, forfeits, and penalties	80,334	49,598	65,000
Boxing taxes	29,117	39,947	30,000
Other	<u>23,828</u>	<u>26,745</u>	<u>25,000</u>
Total revenues	<u>11,996,642</u>	<u>12,781,473</u>	<u>12,980,700</u>
Expenditures: ³			
Personal services and employee-related	2,104,646	2,240,296	2,341,000
Professional and outside services	330,942	239,034	245,000
Travel	173,514	161,819	190,000
Other operating	241,761	292,473	314,000
Equipment	<u>94,922</u>	<u>16,421</u>	<u>5,000</u>
Total operating expenditures	2,945,785	2,950,043	3,095,000
Aid to organizations	861,380	826,751	1,109,200
Awards ⁴	<u>831,730</u>	<u>847,529</u>	<u>1,260,000</u>
Total expenditures	<u>4,638,895</u>	<u>4,624,323</u>	<u>5,464,200</u>
Excess of revenues over expenditures	<u>7,357,747</u>	<u>8,157,150</u>	<u>7,516,500</u>
Other financing uses:			
Transfers to other funds ⁵	1,709,861	1,706,331	2,506,100
Remittances to the State General Fund ⁶	<u>5,702,565</u>	<u>6,480,914</u>	<u>5,010,400</u>
Total other financing uses	<u>7,412,426</u>	<u>8,187,245</u>	<u>7,516,500</u>
Excess of revenues over expenditures and other financing uses	(54,679)	(30,095)	
Fund balance, beginning of year	<u>901,884</u>	<u>847,205</u>	<u>817,110</u>
Fund balance, end of year	<u>\$ 847,205</u>	<u>\$ 817,110⁷</u>	<u>\$ 817,110</u>

¹ In accordance with A.R.S. §44-313, the Department receives 20 percent of monies from unclaimed properties in the State. The monies are distributed, along with other specified revenues, to various department funds up to limits established by A.R.S. §5-113.

² License revenues fluctuate significantly because licenses are issued on a 3-year cycle. According to the Department, most licensees renew at the beginning of the cycle.

³ Administrative adjustments are included in the fiscal year paid.

⁴ Amount primarily comprises awards given to breeders or their heirs for every winning horse or greyhound foaled or whelped in Arizona in accordance with A.R.S. §5-113.F.

⁵ Amount primarily comprises monies transferred to the County Fairs Livestock and Agriculture Promotion Fund, Arizona Exposition and State Fair Fund, and Agricultural Consulting and Training Fund in accordance with A.R.S. §5-113.

⁶ Amount primarily comprises unclaimed property monies that were in excess of monies allowed to be distributed under A.R.S. §5-113 and required to be remitted to the State General Fund. Laws 2006, Chapter 363 increased the limits in 2007 allowing more unclaimed property monies to be spent and less to be returned to the State General Fund.

⁷ Amount is primarily unspent monies for the Arizona Breeders' Award Fund, Arizona County Fairs Racing Betterment Fund, Arizona Stallion Award Fund, and County Fair Racing Fund that are restricted for purposes defined in A.R.S. §5-113.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) *Revenues and Expenditures by Fund, Program, Organization, and Object* and *Trial Balance by Fund* reports for fiscal years 2005 and 2006, and department-prepared estimates for fiscal year 2007.

in Arizona. (See Finding 1, pages 13 through 24, for more information on the Department's pari-mutuel audit activities). In addition, the auditors conduct quarterly compliance inspections of racetracks and limited compliance inspections of OTBs.

- **Enforcement and Compliance (8.0 FTE, 0 vacant):** The enforcement and compliance division consists of special investigators who are responsible for investigating possible infractions committed by license applicants or licensees. Investigators are responsible for conducting background checks of license applicants and for investigating potential violations of racing regulations. During fiscal year 2006, the Department reported conducting 1,672 investigations. Nearly 60 percent involved (1) investigating license applicants who reported false information about criminal history on their license applications or (2) following up on information reported on criminal records received on licensees as part of conducting background checks. This division also has a full-time kennel inspector who conducts inspections of greyhound kennels and breeding farms throughout the State. In addition, the division has a half-time inspector who reviews OTB permit applications and sites prior to making recommendations to the Commission regarding their licensure and conducts limited OTB compliance inspections of existing OTBs.
- **Racing Services (20.5 FTE, 2.5 vacant):** The racing services division consists of race stewards and veterinary staff who supervise and regulate live horse and greyhound racing events. Race stewards are responsible for enforcing the Department's rules and statutes on-site at the tracks. State statute specifies that a track's board of stewards must be composed of two state stewards (Department of Racing employees) and one track steward (a track employee). Racing department veterinarians also work on-site at the racetracks and are responsible for activities such as animal inspections to determine whether animals are safe and physically fit to race, and collecting drug samples for animal and human drug testing. (See Finding 2, pages 25 through 36, for more information on the Department's animal drug-testing activities). The division also includes several seasonal employees who work at county fair races, such as a mutuels supervisor who supervises at county fairs pari-mutuel wagering.
- **Boxing Regulation (1.5 FTE, 0 vacant):** This division, which consists of an administrative director and secretary, supports the Arizona State Boxing Commission, a regulatory body separate from the Arizona Racing Commission, in regulating traditional boxing, kickboxing, tough man contests, and mixed martial arts.³

¹ As noted in Table 3, the Department reports that the additional auditor position was approved in May 2004. A second auditor started working for the Department in August 2004, although the employee resigned in January 2005. The position remained vacant until August 2005.

² This audit and sunset review focuses solely on the Department's regulation of Arizona's racing industry. The Arizona State Boxing Commission has a separate sunset termination date of July 1, 2011.

³ This audit and sunset review focus solely on the Department's regulation of Arizona's racing industry. The Arizona State Boxing Commission has a separate sunset termination date of July 1, 2011.

Update of previous Department of Racing and Racing Commission audits

The Office of the Auditor General reviewed aspects of the Department's and Commission's operations in a 1997 report (Auditor General Report No. 97-12). During this current performance audit and sunset review assignment, auditors followed up on several issues raised in that prior report (see Table 3, page 9).

Scope and methodology

This audit focused on the Arizona Department of Racing's and the Arizona Racing Commission's oversight of pari-mutuel wagering activities and animal drug testing. This report presents two findings and associated recommendations, as follows:

- The Department should improve its oversight of pari-mutuel wagering to be more effective. The Department should improve its procedures in several ways, both to make existing oversight activities more efficient and to incorporate additional tests and reviews. The Department should also consider expanding the scope of its financial analyses similar to activities conducted in other states (see Finding 1, pages 13 through 24).
- The Department should continue its efforts to align its animal drug-testing practices with national standards. Although the Department has made improvements, a 2006 budget shortfall, due to unexpected expenses and mandates, affected its progress. (See Finding 2, pages 25 through 36).

In addition, the report presents other pertinent information regarding how Arizona's racing industry was historically funded and is currently funded, legislative actions to assist the racing industry, and industry revenue sources used by some other states that are not used in Arizona (see pages 37 through 43). Finally, the report presents information related to the 12 sunset factors defined in A.R.S. §41-2954 for both the Arizona Department of Racing and the Arizona Racing Commission (see pages 45 through 56).

Several methods were used to study the issues addressed in the audit. Methods used in all areas included interviews with agency management and staff and other stakeholders, including representatives of the horse and greyhound racetracks throughout the State. Auditors also reviewed Arizona Revised Statutes, the Arizona Administrative Code, and the Department of Racing's policies and procedures. In addition, the following methods were used to review each specific area:

Table 3: Overview of Issues Raised in 1997 Audit Report and Status

Subject	Issues	Status
Capital Improvement Program	Auditors recommended that the Capital Improvement Program established to encourage improvements in facilities be terminated because it was not meeting its goals, and more than \$500,000 in tax credits had been improperly approved.	The program is still in place, but no new projects can be approved. The tax credits awarded improperly have not been repaid.
Protection of wagering public's money	Auditors determined that the Department did not regularly oversee pari-mutuel wagering activities at commercial tracks, and identified several steps the Department could take to better monitor pari-mutuel wagering activities, such as developing a plan to properly monitor pari-mutuel wagering at all Arizona racetracks.	The Department added a second auditor position in May 2004 and hired someone for it in August 2004. After this person resigned in January 2005, the position stayed vacant until August 2005. These auditors oversee pari-mutuel wagering activities at commercial racetracks. The current report discusses additional steps the Department can take.
Oversight of greyhound tracks	Auditors identified several steps the Department could take to improve oversight such as improving its scheduling of greyhound stewards to monitor all greyhound racing activities, and adding an additional part-time position at each track to handle the additional work.	According to the Department, its budget request for fiscal years 2008 and 2009 includes two additional part-time positions for all tracks. However, neither the Joint Legislative Budget Committee nor the Governor's Executive Budget Proposal included additional steward positions.
Collecting pari-mutuel taxes at county fairs	Under existing law, the Department should have been collecting pari-mutuel taxes from commercial tracks that conduct races at county fairs.	The Legislature has since amended state statute in 1998 to clarify its statutory intent regarding the exemption of county fairs from pari-mutuel taxes, and note that they were exempt from taxation regardless of who conducts the race meetings.
Improper payroll practices	Existing practices allowed employees at greyhound tracks to record their time as "performances" rather than actual hours worked, a method that inflated the hours worked by these employees. Since a "performance" usually required only 6 to 7 hours of work rather than 8 hours a day, greyhound track employees were receiving pay for a 40-hour workweek even though they may not have actually worked those hours.	According to the Department, it started reporting actual hours worked for these employees after the completion of the 1997 audit. The Department also reports that an internal control audit conducted by the Department of Administration in fiscal year 2003 found the Department's payroll procedures adequate.

Source: Auditor General staff analysis of findings in the 1997 Auditor General Report No. 97-12 and follow-up work with department staff to determine the status of the 1997 audit findings.

- **Pari-mutuel wagering oversight**—To gain an understanding of the pari-mutuel oversight practices, auditors observed the Department’s auditors performing a pre-racing season totalisator system test at Turf Paradise, three on-site audits during the racing season, including one at Phoenix Greyhound Park and two at Turf Paradise, and a simulcast video audit conducted at a local off-track betting site. In addition, auditors conducted follow-up interviews with the Department’s auditors in their Tucson offices to learn additional information about tote testing and other audit activities. Additionally, auditors interviewed department staff, including its pari-mutuel audit manager, assistant director of administration, and off-track betting site coordinator. Auditors also reviewed the July 2006 draft version of the Association of Racing Commissioners International (ARCI) Model Rules for Pari-Mutuel Wagering. Additionally, Auditor General information technology (IT) auditors compared the ARCI July 2006 draft Model Rules to standards recommended by Arizona’s Government Information Technology Agency as well as standards set forth by the Information Systems Audit and Control Association, known as Control Objectives for Information and Related Technology (COBIT), and the National Institute of Standards and Technology (NIST).

To obtain perspective about the Department’s pari-mutuel oversight from stakeholders in the State, auditors interviewed the general managers of Tucson Greyhound Park, Phoenix Greyhound Park, Rillito Park, Yavapai Downs, and Turf Paradise and the president of the Arizona Horsemen’s Benevolent Protection Association.

To gather comparative information from other racing jurisdictions, auditors interviewed officials and reviewed documentation from many other states’ departments of racing: California, Colorado, Florida, Illinois, Indiana, Iowa, Massachusetts, Minnesota, New York, Texas, and West Virginia, and an official from the Canadian Pari-Mutuel Agency.¹ Additionally, auditors interviewed the president of ESI Integrity Services, which is a leader in the development of independent monitoring systems, and the president and CEO of ARCI.

- **Animal drug-testing program**—To determine racing industry standards and best practices for animal drug-testing programs, auditors reviewed the ARCI Model Rules; interviewed national and international experts, including the executive director of the Racing Medication and Testing Consortium (RMTC); and the president and CEO of the Association of Racing Commissioners International (ARCI); and interviewed academics such as Dr. Scott Stanley, associate professor and racing chemist at the University of California Davis, and Steve Barham, the associate coordinator of the Race Track Program at the University of Arizona.

To determine if department practices were in compliance with national and international standards as well as best practice and the Department’s administrative rules, auditors observed sample collecting procedures for horses in the test barn at one track for one race; reviewed the Department’s

¹ The racing jurisdictions were chosen for various reasons, including recommendations from the Department’s pari-mutuel audit manager for leaders in the industry, information from industry leaders, status as a major racing state, and funding sources.

animal-drug testing invoice log for the months of March 2006 through November 2006, and its October 2004 and October 2006 contracts with its drug-testing laboratory; compared horse urine and blood sample collection logs for those dates to the Certificate of Analysis the Department received from its lab to confirm which samples noted in the collection logs had been sent in for testing; compared collection logs to the Department's copies of steward racing programs to confirm whether the samples were drawn from the winning horse; compared the Department's rules to the Model Rules established by the Association of Racing Commissioners International (ARCI) and the *ARCI Uniform Classification Guidelines for Foreign Substances and Recommended Penalties*; and evaluated drug test data for 20 randomly selected race dates from March 1 through November 30, 2006, to assess the Department's compliance with ARCI Model Rules. Additionally, auditors reviewed relevant literature related to horse drug testing.¹

To understand how the Department pays for animal drug testing and the reasons it reduced the amount of animal drug testing it performed during May and June 2006, auditors reviewed the Department's budget request documentation for fiscal years 2008 and 2009, reviewed various commission memoranda related to the drug-testing activities conducted during fiscal year 2006, and analyzed the Department's invoice logs for animal drug testing conducted in fiscal years 2004 through 2006.

- **Other Pertinent Information**—To gather information about the financial status of Arizona's racing industry and how regulation is supported in Arizona, as well as other states, auditors reviewed information published in state annual reports and relevant state statutes. Specifically, to assess the financial status of Arizona's industry, auditors reviewed information reported in the 1997 Auditor General report on the Arizona Department of Racing (Report No. 97-12), and department annual reports for fiscal years 2000, 2001, 2003, and 2006. To understand the laws that affect state racing regulation, auditors reviewed Arizona statutes, legislation proposed in the 2005 and 2006 legislative sessions, and information from the 2002 General Election regarding Proposition 201 (the Fair Gaming Act) and Proposition 202 (the Indian Gaming Self-Preservation Act). To understand funding sources used to support racing regulation in other states, auditors reviewed information reported in annual reports published by the state agencies that regulate racing in California, Colorado, Florida, Illinois, Kansas, New Mexico, New York, Texas, and West Virginia. Auditors also reviewed a January 2007 informational report published by the Wisconsin Legislative Fiscal Bureau.²
- **Introduction and Background**—Information used in the Introduction and Background was collected from the Arizona Department of Racing's annual reports for fiscal years 2002, 2003, and 2006; the 1997 performance audit and sunset review report (Auditor General Report No. 97-12); and analysis of the

¹ *National Thoroughbred Racing Association (NTRA) Racing Integrity and Drug Testing Task Force Report and Building a World-Class Drug Detection System for the Racing Industry: A National Strategic Plan.*

² *Informational paper 85, State Lottery, Pari-Mutuel Wagering and Racing, and Charitable Gaming, Wisconsin Legislative Fiscal Bureau, January 2007.*

Arizona Financial Information System (AFIS) *Revenues and Expenditures by Fund, Program, Organization, and Object* and *Trial Balance by Fund* reports for fiscal years 2005 through 2007. The follow-up information related to recommendations made in the 1997 performance audit and sunset review collected from the prior audit, and information from the Department regarding the status of the Capital Improvement Program, greyhound racing and track oversight, and payroll practices.

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Department's Director and staff, and the racing commissioners, for their cooperation and assistance throughout the audit.

FINDING 1

Department should improve pari-mutuel oversight program

The Department can take several steps to make its oversight of pari-mutuel wagering more comprehensive and effective. To conduct wagering, racetracks use computerized systems, called totalisator or “tote” systems, operated by national companies. A 2002 scandal in New York focused nation-wide attention on potential manipulation of these systems and led the racing industry to propose new oversight practices. Relative to these recommended practices, the Department’s procedures can be improved in several respects, both to make existing oversight activities more efficient and to incorporate additional tests and reviews. Finally, the Department should consider expanding the scope of its financial analyses similarly to activities conducted in other states.

Arizona racing parks contract with national companies to administer pari-mutuel wagering systems

For several decades, racetracks have used computerized totalisator systems that record the amounts of money wagered for each race, compute the odds and estimated payoff associated with each race, and calculate the payouts to the wagering public, the racetrack, and the State. Totalisator systems are essentially computers that track all the monies wagered, which is known as handle. Arizona’s racetracks contract with one of three nation-wide firms: Scientific Games (Turf Paradise, Yavapai Downs, and Arizona Counties Racing Association), United Tote (Rillito Park and Phoenix Greyhound Park), and American Tote (Tucson Greyhound Park).

Although it was once the norm for each track to have a stand-alone tote system at its facility, according to tote company officials, tote companies have used hub

Pari-Mutuel Wagering—Pari-mutuel wagering consists of bettors placing wagers that go into a wagering pool. After races are completed, the total monies wagered are distributed among the winning patrons, the tracks, purses for owners of winning animals, and the State.

Source: Auditor General staff analysis of Arizona Revised Statutes and other states’ annual racing reports.

Three major tote companies exist nationwide.

systems to process wagering data since the mid 1990s. Within the last few years, at least one tote company has developed “mega-hubs,” which serve entire sections of the country. For example, Scientific Games contracts with seven tracks to process their wagering pool data in its Western mega-hub in Sacramento, California. In Arizona, all tracks except Rillito Park use a hub system.

Wagering scandal increased focus on overseeing tote systems

A nationally known wagering scandal that occurred in 2002 contributed to an increased emphasis on ensuring tote system integrity. The scandal occurred during the 2002 Breeders’ Cup race and has come to be known as the “Pick 6” scandal. The fraudulent scheme involved a programmer for the tote company and two collaborators. Using the accounts of his two collaborators, the programmer used a touch-tone betting system to place bets through one of New York’s public OTB Corporations, and then altered the tickets within the computer system to make them winners. A delay in the transfer of Pick 6 wagering data to the host track allowed the programmer to create a winning ticket that specifically identified the first four winners, including two horses with extremely high odds against winning. In addition, the programmer printed fake tickets with the serial numbers of uncashed tickets that he found in the computer system and gave the fake tickets to his collaborators to cash at automated machines. The programmer and his collaborators carried out similar schemes earlier that month before it came to light at the 2002 Breeders’ Cup race.

The racing industry subsequently took steps to strengthen oversight of the pari-mutuel wagering system. In July 2006, the Association of Racing Commissioners International (ARCI) published proposed additions to its chapter of Model Rules for Pari-Mutuel Wagering for consideration and potential adoption by the entire racing industry.¹ The proposed additions address wagering security and put a great emphasis on information technology security controls, such as the need for racing regulators to monitor controls over tote system access and system programming changes, and are aligned with well-established information technology (IT) security standards.² Some states have already taken the initiative to update their pari-mutuel wagering standards to improve IT security and tote system controls. For example, Colorado and Texas updated previously established pari-mutuel system or tote standards, while other states, such as New York, are in the process of adopting entirely new rules that set forth new requirements.

A betting scandal in New York led to newly proposed oversight standards.

ARCI is a nonprofit corporation that is a resource for racing regulators. Its membership includes representatives from 38 racing jurisdictions in the United States.

Source: Auditor General staff analysis of information from ARCI’s Web site.

1 The entire set of ARCI Model Rules contains 25 chapters. Chapter 4 addresses pari-mutuel wagering, and the proposed additions would be added to this chapter. The latest version, 3.4, was last updated on March 29, 2006. According to ARCI’s current president and CEO, ARCI anticipates formally adopting the proposed additions at its April 2007 annual meeting.

2 Auditor General IT auditors compared the ARCI’s proposed rules to standards recommended by Arizona’s Government Information Technology Agency, as well as standards set forth by the IT Governance Institute, known as Control Objectives for Information and Related Technology (COBIT), and the National Institute of Standards and Technology (NIST).

Department could improve wagering oversight practices

The Department can improve its performance in key oversight activities. Effective oversight requires effective practices in three key areas: testing the systems to ensure the accuracy of results, ensuring compliance with standard information system security controls, and identifying unusual fluctuations in odds or wagering pools. Compared to a decade ago, the Department has expanded the scope of its audit activities. For example, a 1997 Auditor General report found that the Department's pari-mutuel auditor did not oversee commercial racetracks. Now, the Department's auditors oversee wagering at both commercial tracks and county fairs.¹ Nonetheless, review of the audit unit's actual practices found that performance in all three areas can be improved.

Pari-mutuel wagering oversight requires three key practices—Through research of ARCI's proposed addition to the pari-mutuel wagering Model Rules and other racing jurisdictions' practices, auditors found that oversight of pari-mutuel wagering systems generally consists of three activities: tote testing, ensuring tote system security, and monitoring wagering activities for anomalies:

- **Conducting tote testing:** Involves testing automated pari-mutuel totalisator systems to ensure accuracy of wagering outcomes. These tests either use predetermined wagering scenarios and outcomes or use data from live races using actual outcomes. Both types of tests are performed to ensure that the system calculates potential wagers according to the Department's administrative rules. Some states, including Arizona, choose to use in-house auditors to conduct tote testing, while others contract with third parties, such as CPA firms. According to department rules, tote testing is required prior to the start of all race meet seasons to ensure that the systems are performing wagering calculations correctly.
- **Ensuring tote system security:** Involves ensuring compliance with standard information system security controls, such as those set forth to restrict access to computer systems (access controls), programming change controls, and limiting access to rooms where computer systems are located. In the racing industry, ensuring tote security involves monitoring and verifying who has access to totalisator systems (both on-site at a racetrack as well as at a hub), and tote room surveillance to ensure restricted access.
- **Monitoring to identify potential wagering anomalies:** Involves identifying any unusual fluctuations in odds or wagering pools to protect the integrity of the wagering pools. For example, a large wager could be made to significantly change the odds and then be intentionally canceled right before the close of betting to create a false favorite and decrease the odds and the resulting

Wagering Scenario—A wagering scenario is the potential outcome of a race's or races' order of finishes. For example, the Pick 3 is the selection of the first-place finisher in each of three specified races.

Source: Auditor General staff analysis of the Arizona Administrative Code and information obtained from the American Heritage and Merriam-Webster dictionaries.

¹ Two full-time auditors supervise commercial race wagering, and a seasonal part-time employee supervises county fair wagering.

Simulcasting Arizona races to Canada requires testing under net pool pricing.

payout. These anomalies can be detected either by astute observations of odds that fluctuate on the race display board, or through automated systems that analyze the actual race results. Automated systems can perform analysis either on a real-time basis or after races have been completed.

Practices for testing tote system accuracy need to be more efficient—Although the Department was able to conduct its statutorily required tote-testing activities at each racetrack during fiscal years 2004 through 2006, new challenges make becoming more efficient important. Until September 2006, the Department’s auditors performed tote testing using only a format called standard pool pricing (see textbox). However, in 2006, two tracks requested the Department to test under a different form of pricing, called net pool pricing, so that the tracks could send their simulcast signals to the Canadian market and thereby potentially increase their handle.¹ The Department’s auditors conducted this testing for one of the tracks in 2006. According to the pari-mutuel audit manager, the auditors conducted testing for the other track in April and May 2007 before its summer race meet, and that it took them nearly twice as long to complete testing under net pool pricing than standard pricing for the 2007 testing (51.5 hours as compared to 25 hours). To meet the needs for this type of testing more efficiently, the Department should take action in the following areas:

Pari-Mutuel Wagering Pricing Methods—In pari-mutuel wagering, the total monies that racing patrons bet on a specific race are called a “common wagering pool.” All racetracks that bet into this common wagering pool are entitled to receive a commission from the total amount wagered, which is based on a specific commission rate. A commission rate is the amount taken out of the wagering pools by the tracks to help pay for operating expenses such as utilities, employee salaries, taxes, and purses. The amount that remains in this wagering pool after the tracks are paid is then distributed to winning racing patrons after calculating a specific rate per winning dollar wagered. Two pricing methods can determine payouts to tracks and winning racing patrons:

Standard Pool Pricing—In standard pool pricing, track commission rates and payouts to winning patrons are uniform. For example, all tracks that participate in the wagering pool have a 20 percent commission rate. Similarly, winning patrons at all tracks are paid the same amount for each winning dollar that they wagered. For example, if the winning payout is \$4, all winners will receive \$4 for each winning dollar wagered.

Net Pool Pricing—In net pool pricing, track commission rates are variable. For example, Track A might have a 15 percent commission rate, and Track B might have a 20 percent commission rate. The use of variable commission rates results in different winning payouts for winners at each track. Payouts to the public are higher for tracks with lower commission rates because they have more to distribute to the winning patrons.

Source: Auditor General staff analysis of the Arizona Administrative Code and industry literature.

¹ Canadian law requires simulcasting tracks to use net pool pricing.

- **Providing more general audit training and specific training in net pool pricing:** Although department management reported that the Department supports continuing education for its auditors, its auditors lack formal audit training. For example, although the Department's audit manager reports having taken accounting courses and both auditors have a background in pari-mutuel wagering, neither auditor has formal training in standard auditing techniques, such as risk-based sampling or reviewing internal controls. Without formal knowledge regarding audit techniques, the auditors' efficiency and effectiveness may be undermined. Improving their auditing knowledge would help the auditors to audit more efficiently and effectively. In addition, while the Department's auditors have no formal training in performing net pool pricing tests, there are several potential training opportunities. For example, according to an ARCI official, ARCI is developing information on how to audit systems that use net pool pricing. This official identified the ARCI annual meeting or the National Thoroughbred Racing Association Simulcast conference as additional resources.

In May 2007, department management reported that they will be sending both pari-mutuel auditors to an ARCI-sponsored continuing education conference for pari-mutuel auditors and investigators scheduled for June 2007. A preliminary agenda indicates that the conference will discuss the adequacy of tote system testing currently used by jurisdictions.

- **Reducing reliance on manual calculations:** To conduct their tests, pari-mutuel auditors rely on labor-intensive manual calculations. The number of calculations expands significantly under net pool pricing. The Department should examine ways to reduce reliance on manual calculations and implement them as appropriate. Two practices it should consider are:
 - **Testing booklets:** Texas and Colorado both use pre-printed testing booklets to enhance their tote testing's efficiency. These booklets contain the input and expected output for each test race. This can improve efficiency because the booklets provide the correct outcome for a potential wagering scenario. Therefore, the auditors merely need to make a visual comparison between the actual tote output and the booklet.
 - **Spreadsheets:** Although the Department's auditors have developed spreadsheets that could facilitate more efficient tote testing for some wagering scenarios, they do not use them during the course of their testing practices. According to the pari-mutuel audit manager, the spreadsheets were developed to reduce the auditors' reliance on manual calculations for some wagering scenarios. However, they report that they are not using these spreadsheets because they are not applicable to all wagering scenario testing that the auditors perform.

- **Developing better guidance:** The Department has not completed the development of pari-mutuel auditing policies and procedures or manuals that describe how to perform tote testing or any other aspects of the auditors' job duties. Although the Department has started to draft a policies and procedures manual, it was still in draft form as of February 2007. Department management and the pari-mutuel audit supervisor stated that the auditors follow it as a guide to perform their duties. According to the Department, the manual has not been completed because it does not have sufficient resources to finalize it.

The Department should complete the development of this policies and procedures manual and implement it, and ensure that it contains specific guidance for tote testing under both standard and net pool pricing. Other states, such as Florida and Texas, have developed and implemented policies and procedures manuals to guide tote testing and other oversight and compliance activities.

Reviews of system security need greater use of standard information technology controls—Auditor General auditors compared the system security procedures used by department auditors to ARCI's proposed additions to the Model Rules and information technology (IT) auditing standards. This comparison identified several shortfalls in the Department's current procedures.

- **Licensing tote companies and requiring independent reviews of systems:** ARCI's proposed Model Rules amendments recommend that the totalisator company be licensed by the Racing Commission in order to provide greater assurance that the tote systems are secure. According to the proposed Model Rules amendments, racing departments should include in the licensing application and renewal a requirement that they allow the Department to have testing performed on the system hardware and software. During the course of the audit, the Department reported that it will use its authority under A.R.S. §104.01 and A.A.C. R-19-2-104 and R-19-2-304 to require computer system security audits as part of the commercial tracks' annual financial audit. This will provide an analysis of the track's tote system security beginning with the 2007 reporting period.

The Department reported that it licenses totalisator companies under a "business-vendor" category. However, review of the Department's statutes indicates that it does not have statutory authority to issue business-vendor licenses, which means it does not have the legal authority to issue licenses for tote companies under this licensing category. In order to license tote companies, the Department needs to work with the Legislature to seek the necessary statutory authority.

In addition, the proposed Model Rules amendments also recommend that a Type II SAS 70 report be required of the totalisator company. Other states have

tote company licensing requirements or plan to strengthen their requirements. For example, Illinois requires that the tote company be licensed and also requires a SAS 70 review. According to an Illinois racing official, the SAS 70 review was mandated by Illinois' Racing Board effective July 2004. Also, New York's Racing and Wagering Board plans to require tote company licensure and a Type II SAS 70 or similar review as part of its efforts to revise its pari-mutuel wagering rules standards. In July 2006, the New York Racing and Wagering Board submitted proposed rule amendments that included requirements to license tote companies and request Type II SAS 70 reviews.

If the Department obtains statutory authority to license tote companies, it then should take action to modify its administrative rules to explicitly identify tote companies as a license category. In addition, the administrative rules should include specific requirements for tote company licensure, as recommended in ARCI's proposed additions to its pari-mutuel wagering Model Rules. For example, the administrative rules should require a Type II SAS 70 or similar review.

- **Programming change controls:** Consistent with well-established IT audit standards, ARCI's proposed Model Rules amendments also recommend that regulators monitor computer programming changes to ensure the appropriateness of software programming changes. Specifically, the proposed amendments contain several software requirements, including those related to totalisator system software changes. For example, the proposed amendments recommend that the tote company notify the Commission of changes to system software at least 30 days before any major revisions. Although the proposed Model Rules amendments recommend a formal communication process between the tote company and regulatory authority, the Department and Commission have not established a formal process to monitor and test major changes in tote system software. For example, according to the Department's pari-mutuel audit manager, the auditors review programming changes that the tote companies make only when they are made aware of such changes. Without a more formal process, the Department and Commission have no assurance that the tote company is communicating all major changes to state regulators.

SAS 70

A SAS 70 is a report on a service organization's internal controls and safeguards when they host or process data belonging to their customers.

Type I SAS 70—A Type I report includes the service organization's description of its controls and objectives, and an auditor's opinion on the suitable design of the controls in meeting the specified objectives. The report reflects an opinion at a specified point in time.

Type II SAS 70—A Type II report, in addition to the Type I components, includes a test and evaluation of the effectiveness of the internal controls. This test attests, with reasonable assurance, to the effectiveness of the controls in meeting specified objectives over a period of time.

Source: Tyrell, Eugene T. *SAS 70 Frequently Asked Questions*. Providence, RI: Orbidex Inc./Polar Cove, 2005.

Access Controls—The process that limits and controls access to a computer system, or a logical or physical control designed to protect against unauthorized entry or use. A logical control can include policies, procedures, organizational structure, and electronic access controls that restrict access to computer software and files. Physical controls can include a system of controlled entry to the room or other related rooms through the use of locking devices on all doors or entry points.

Access Rights—Access rights are the rights granted to users by the administrator or supervisor. Access rights determine the actions users can perform (e.g., read, write, execute, create, and delete) on computer files.

Source: Definitions obtained from the Information Systems Audit and Control Association (ISACA) Glossary and ARCI July 2006 Draft Model Rules for Pari-Mutuel Wagering.

- **Reviewing access controls:** Although in February 2006 the Department's auditors started to determine who has access to track tote systems and tote rooms, they do not routinely check access controls or access rights. IT control standards recommend that system access be limited to persons who need access to that system to perform their jobs, and that the access rights they have be limited only to the information they need to carry out their job. Consistent with established IT audit standards, ARCI's proposed Model Rules amendments recommend that the totalisator system program should be able to restrict access rights to the tote systems, have the capability to generate access logs, and restrict access to software that could be used by unauthorized users to create duplicate tickets.

Although access control standards emphasize restricting access both to the tote room and the actual computer systems, ensuring restricted access to the systems should be a higher priority. According to the Department's auditors, their oversight of tote system security is informal, and they do not have any standard security aspects that they review.

To improve how it monitors tote system security, in addition to obtaining statutory authority to license tote companies and strengthening requirements associated with the licensure of tote companies, the Department should work toward incorporating other aspects of the proposed additions to the ARCI Model Rules, including those related to monitoring programming changes and reviewing access controls into its administrative rules.

Finally, the Department's auditors should review ARCI's Model Rules related to programming changes, access controls, system security, and other IT control areas, and generally become more familiar with standard IT audit practices. Once they have become more familiar with these standards, the auditors should work with department management to incorporate these recommended practices into their pari-mutuel auditing work.

Automated auditing tools could improve monitoring of potential wagering anomalies—Auditors' review of the Department's efforts to monitor for wagering anomalies also identified potential areas for improvement. Wagering anomalies can be detected by visually observing fluctuating odds on visual display boards or by using automated systems to analyze actual race results. However, in Arizona, the chief horse, greyhound, and county fair racing stewards report that they mainly rely on people bringing such issues to their attention because they

need to focus on monitoring activities associated with live racing, such as deciding and posting the race outcomes. For example, according to one department steward, they mainly rely on track employees who oversee the pari-mutuel wagering to report unusual wagering activities.

To improve detection of potential wagering anomalies, the Department should explore the feasibility of adopting automated systems. The Department is not using automation to any great extent, either on a real-time or post-race basis. Areas for possible improvement include the following:

- **Adopting independent monitoring systems:** Some racing jurisdictions are investing in independent monitoring systems that allow them to monitor potential wagering anomalies at the same time that the races are occurring. The independent monitoring systems receive and evaluate the same data going through an actual tote system. Two types of independent monitoring system services are available—one offered through ESI Integrity, and the other through RCI Integrity Services.¹ The two differ in services and price. Specifically:
 - **ESI Integrity:** The Canadian Pari-Mutuel Agency and the Florida Division of Pari-Mutuel Wagering report using ESI Integrity’s independent monitoring systems. The system monitors and verifies every race so that if a potential anomaly occurs, alerts are generated and messages are sent to the auditors for investigation. Florida officials reported spending \$400,000 to start up the system, and annual maintenance costs are approximately \$75,000. According to ESI, the benefits of implementing this type of system include investigative capabilities to detect anomalies, validation checks to ensure valid wagers are processed according to state regulations, independent monitoring of all wagering activities as they happen, and immediate auditing of all payouts and commissions (breakage monies left over from rounding on wagers).
 - **RCI Integrity Services:** The RCI Integrity Services system is based on the system that ESI Integrity developed. The RCI system also monitors wagering data in real time to ensure that the data complies with the jurisdiction’s regulations and any corrective actions can be taken within moments of the incident. In contrast to ESI, RCI offers Monitor Plus, which is an additional component that allows regulators to analyze betting patterns. According to an RCI Integrity Services official, the initial start-up cost would be approximately \$64,000, and a nominal maintenance cost would be applied thereafter. This service only became available in January 2007.²

The Department should explore the feasibility of implementing one of these independent monitoring systems in Arizona.

¹ ESI Integrity is a Canadian-based company that provides independent software for security and risk management. RCI Integrity Services, a nonprofit services organization, is a subsidiary of Racing Commissioners International and also provides independent security testing for pari-mutuel wagering systems.

² Citing confidentiality, an official with RCI Integrity Services was unwilling to disclose whether any states have started using this system.

Department should explore expanding financial analysis practices

The Department should explore expanding its financial analyses of the monies wagered in Arizona. This would strengthen oversight of handle distribution to parties that are entitled to a portion of the handle. The Department's financial analysis practices are limited to an administrative review of the tracks' annual financial statements, compiling and verifying handle and other wagering information in its pari-mutuel database for its annual report, and, according to department management, reviewing monies distributed to the eight statutory funds.

In general, financial-related auditing duties involve tracking the monies that are distributed from the wagering pools to purses for the racing participants, special funds such as breeders' organizations and animal organizations, or special taxes. Many of these audits are done in other states as part of a regular audit schedule and are performed on a daily, monthly, annual, or cycle basis. Some other states' pari-mutuel auditors reported that they focus mainly on financial analyses. For example, some states conduct:

- **Breakage Audits:** Breakage audits determine that breakage is distributed appropriately.
- **Purse Audits:** Purse audits determine that the monies distributed by the track to the horsemen or dogmen are correct.

According to Racing Department management, other than a review of special funds distributions and reviews of the tracks' annual financial statements that are performed by the Department's administrative staff, the department staff does not perform any of the other types of audits on a regular basis. According to department management, it does not currently have the staff resources necessary to carry out other forms of financial analysis on a regular basis. To rectify this lack of resources, the Department requested four additional pari-mutuel auditors as part of its Fiscal Year 2008 Executive Budget request. According to a department official, it wanted additional auditors in order to conduct more frequent on-site audits. However, the final executive budget included resources for only one additional auditor, and the legislative budget proposal included none.

Although additional auditors may not be available, results from a one-time special purse audit completed in 2006 suggests that financial-related audits should be done on a more regular basis. Specifically, in September 2005, based on a complaint from the Arizona Greyhound Association, the Department assigned its audit supervisor to complete a special audit of purse distributions at a major racetrack. This audit found that the track had shorted purses distributed to greyhound owners by \$21,432, or approximately 15 percent, from August 1, 2004 through April 10, 2005.

A 2006 purse audit identified problems with a track shorting purses by approximately 15 percent.

Recommendations:

1. To improve tote testing, the Department should:
 - a. Train its pari-mutuel auditors on general audit practices and how to conduct tote system testing under net pool pricing.
 - b. Identify and implement ways to reduce the reliance on manual calculations, such as using testing booklets or spreadsheets.
 - c. Complete the development of the pari-mutuel auditing policies and procedures manual and implement it. The Department should ensure that it contains specific guidance for tote testing under both standard and net pool pricing.
2. The Department should work with the Legislature to obtain statutory authority to license tote companies.
3. If the Department obtains statutory authority to license tote companies, it then should:
 - a. Modify its administrative rules to identify tote companies as a license category.
 - b. Include in its administrative rules specific requirements associated with the tote company licensure as recommended in ARCI's proposed additions to its pari-mutuel wagering Model Rules.
 - c. Include in its administrative rules for tote company licensure a requirement for a Type II SAS 70 or similar review.
4. To improve how it monitors tote system security, the Department should:
 - a. Work toward incorporating other aspects of the proposed additions to the ARCI Model Rules, including those related to reviewing programming changes and access controls, into its administrative rules.
 - b. Review ARCI's recommendations related to programming changes, access controls, system security, and other IT control areas, and generally become more familiar with standard IT audit practices.
 - c. Incorporate these recommended practices into its pari-mutuel auditing work.

5. To improve monitoring of wagering systems for potential anomalies, the Department should explore the feasibility of adopting automated systems. Specifically, the Department should explore the feasibility of implementing the ESI Integrity or RCI Integrity system in Arizona.
6. The Department should explore expanding its scope of financial analyses of the monies wagered in Arizona to strengthen oversight of the distribution of handle to parties that are entitled to a portion of it.

FINDING 2

Department should continue aligning animal drug-testing practices with national standards

The Department's animal drug-testing practices are generally aligned with racing regulation practices, and the Department should ensure that it continues its efforts to align these practices with national standards. Racing regulators across the country have adopted a set of Model Rules intended to standardize animal drug-testing practices nationally. Although the Department has not formally adopted the Model Rules, most elements of the Department's animal drug-testing program are aligned with these Model Rules. However, in 2006, the Department faced significant budget constraints precipitated by unexpected expenses and mandates that resulted in the Department's temporarily reducing drug testing as a last-resort, cost-saving measure. Although the short-term reduction in testing affected the Department's ability to adhere to practices recommended in the Model Rules, it did not violate any state laws, and the Department immediately resumed its regular testing in fiscal year 2007.

National efforts to standardize animal drug-testing practices resulted in Model Rules development

For approximately the past 15 years, racing industry regulators have been in the process of standardizing animal drug-testing requirements nation-wide in order to move toward a consistent regulatory environment. Developing of Model Rules through the Association of Racing Commissioners International (ARCI) is one way in which industry regulators are attempting to standardize these requirements. ARCI has drafted and approved the Model Rules.¹ In addition, the Racing Medication and Testing Consortium (RMTC) has been a contributor to the Model Rules, specifically those relating to medicating and testing racing horses.²

Racing Medication and Testing Consortium—Governed by a board that consists of 23 racing industry stakeholder groups. One purpose of this organization is to develop policies to promote the health and welfare of race-horses and to ensure the integrity of racing.

Source: Racing Medication and Testing Consortium Web site.

¹ Version 3.4, the most recent version of ARCI pari-mutuel Model Rules, was approved by ARCI on March 29, 2006. ♦

² The RMTC model medication policy document was converted into Model Rules language and submitted for development into Model Rules in 2004.

Model Rules are intended for adoption and used by the entire pari-mutuel racing industry.

Model Rules require drug tests on every winning horse.

ARCI intends for the rules to be adopted and used by the entire pari-mutuel racing industry.¹ In order to stay current with industry developments, the Model Rules are continually updated. Specifically, new rules have been added by various industry stakeholders, including the RMTTC, through a proposal process outlined by ARCI.

ARCI guidelines pertaining to animal drug testing focus extensively on equine drug testing, but also address collecting canine samples. Specifically:

- **Equine Veterinary Practices, Health and Medication, and Classification Model Rules**—Racing regulators have established Model Rules for equine veterinary practices, health, and medication, and guidelines for the uniform classification of drugs used on horses. Drug Testing—Chapter 11 of the *ARCI Model Rules for Equine Veterinary Practices, Health and Medication* sets procedural guidelines for drug-testing racehorses. The rules provide guidelines for procedures such as sample collection, sample storage, and allowable threshold levels for Non-Steroidal Anti-Inflammatory Drugs (NSAIDs).² According to these guidelines, racing jurisdictions should conduct a drug test on every winning racehorse. Chapter 11 also includes recommended penalties for drug and medication violations. According to ARCI, the penalties listed in this document supersede those listed in the *Uniform Classification Guidelines for Foreign Substances and Recommended Penalties and Model Rule*.
- **Classification of Drugs**—The *Uniform Classification Guidelines for Foreign Substances and Recommended Penalties and Model Rule* is a set of guidelines developed by ARCI that pertain only to racehorses. It groups drugs into five classes as illustrated in Table 4, page 27. Class 1 drugs have potentially more of an effect on an animal's performance than Class 5 drugs. In general, drugs that are clearly intended for therapeutic use in horses are placed in the lower classes, such as 4 and 5. In contrast, drugs that are not clearly intended for use in horses are placed in higher classes, such as 1 and 2, particularly if they could affect the outcome of a race. Drugs that are recognized as legitimately useful in equine therapeutics but could affect the outcome of a race are placed in the middle or lower classes. For example, as illustrated in Table 4, page 27, Ketoprofen is a Class 4, nonsteroidal anti-inflammatory drug used on horses for pain relief, but could be used to mask a minor injury that may have prevented a horse from racing or racing in its best form. According to ARCI, the penalties listed in this document have been superseded by those in Chapter 11 of the *ARCI Model Rules for Equine Veterinary Practices, Health and Medication Model Rules*.

¹ According to RMTTC, as of 2006, 28 states have adopted or are in the process of adopting medication policies consistent with part of the Association of Racing Commissioners International (ARCI) Model Pari-Mutuel Rules. ARCI approved the latest version, 3.4, which contains 25 chapters, on March 29, 2006.

² Nonsteroidal anti-inflammatory drugs are used on horses for pain relief. However, the Department and Model Rules do not allow these medications to be administered on race day because they may mask a minor injury that could prevent a horse from racing or racing in its best form.

Table 4: Uniform Equine Drug Classifications, Examples, and Potential Effects
April 2005

Classification	Name	Examples, Description, and Potential Effects ¹
Class 1—Highest potential to affect a horse's race performance	Morphine	Opiate—Commonly used as a painkiller, or alternatively, when administered in small dosages, to stimulate a horse and escape detection due to the minute amount administered.
Class 2—High potential to affect a horse's race performance	Phentermine	Amphetamine—Normally used as an appetite suppressant in humans, but can be used to stimulate a horse.
Class 3—Less potential to affect a horse's race performance than Class 2 drugs	Acepromazine	Tranquilizer—Usually administered to calm a horse during transport or training, but can be administered to take the edge off an excitable horse that would normally be disqualified from a race before it ran due to its behavior in the saddling area.
Class 4—Less potential to affect a horse's race performance than Class 3 drugs	Ketoprofen	Nonsteroidal anti-inflammatory drug—Used on horses for pain relief and could be used to mask a minor injury, which may have prevented a horse from racing or racing in its best form.
Class 5—Less potential to affect a horse's race performance than Class 4 drugs	Cimetidine	Anti-ulcer medication—Used to treat horses with stomach ulcers, a common ailment afflicting racehorses. This is a therapeutic medication and is not used as a performance enhancer.

¹ The specific drug examples shown are provided for illustrative purposes only as there are hundreds of drugs that fall into the five classifications.

Source: Auditor General staff analysis of substances in the *Uniform Classification Guidelines for Foreign Substances and Recommended Penalties and Model Rules* established by the Association of Racing Commissioners International, Inc. as of April 2005, and the potential effects reported by the Racing Medication Testing Consortium.

- Canine Drug-Testing Rules**—ARCI Model Rules for canine drug testing set forth guidelines for testing greyhounds.¹ In contrast to the equine rules, these guidelines do not require every winning greyhound to be tested for drugs. Further, the Model Rules do not stipulate uniform drug classification guidelines or penalty recommendations for greyhounds as they do for racehorses. However, the rules provide guidelines on the procedural aspects of medication and drug testing on greyhounds. For example, the Model Rules stipulate who should have the authority to collect pre-race drug-testing samples.

The Model Rules do not require racing jurisdictions to conduct drug tests on every winning greyhound.

¹ The chapters in ARCI Model Rules that contain guidelines for greyhound drug testing and medication are Chapter 16—“Greyhound Prohibited Acts,” and Chapter 18—“Greyhound Welfare, Health, and Medication.”

Department's animal drug-testing program is generally aligned with racing regulators' practices

Most elements of the Department's animal drug-testing program are generally aligned with practices used by racing regulators. Specifically, the Department uses standard testing practices used by racing regulators, classifies drugs according to the classification in the Model Rules for horses, and has made some improvements to its drug-testing program for horses. However, the Department deviates in two of the four threshold levels for therapeutic drugs set forth in the Model Rules. Finally, the Arizona racing industry has expressed concern about some of the requirements under the Model Rules, and the Department is working with them to develop consensus on the requirements.

Department uses standard drug-testing practices—The primary animal drug tests the Department uses for both horses and dogs for initial detection and confirmation of positive results are considered standard practice by experts and used by many other racing jurisdictions. Specifically:

- **Initial detection**—The first phase of the Department's regular animal drug-testing program is the detection phase. This includes testing urine samples on horses and greyhounds and additional blood samples for horses. This testing phase uses two screening methods to detect a variety of drugs: Thin Layer Chromatography (TLC) and Enzyme-Linked Immunosorbant Assay (ELISA) tests. Both TLC and ELISA screening methods are commonly used among other racing jurisdictions and an industry expert also states that these screening methods are considered best practice. TLC tests can detect more drugs than ELISA tests, but are not sensitive enough to detect drugs in the minute amounts that ELISA tests can. In contrast, ELISA tests are very sensitive and thus can detect small amounts of drugs, but focus on one drug or a family of drugs, such as an opiate group.

Although each individual urine sample undergoes a TLC screening test, ELISA tests, in contrast, are conducted on pooled urine samples. Pooling refers to the co-mingling of a portion of a number of samples, and it is a cost-saving measure for racing jurisdictions because it can reduce the number of samples that are tested. If a positive result is identified in a pooled sample, each individual sample contained in the original pool is then tested and the positive individual sample is sent for confirmation testing. According to an expert in animal drug testing, no more than four samples should be combined in a pooled sample.¹ The Department is in line with this since it combines no more than three samples when testing horses and four samples when testing greyhounds.

The Department uses two screening methods, TLC and ELISA tests, on samples in its initial drug testing.

¹ Dr. Scott Stanley, Associate Professor, California Animal Health & Food Safety Laboratory (CAHFS) at the UC Davis School of Veterinary Medicine.

The Department currently uses 25 assorted ELISA tests on each horse urine sample, which translates into potentially detecting more than 75 different types of drugs. The Department also uses 5 ELISA tests on each greyhound urine sample, which translates to screening for 10 to 15 different types of drugs. This is because, generally, each ELISA test kit can detect two to three drugs. Therefore, the Department uses a combination of the TLC testing method with a number of different ELISA tests to enhance the depth and breadth of detection coverage. Although this method allows the Department to test for a wide variety of drugs, it does not cover all the drugs that could potentially be used on horses or greyhounds. According to an industry expert, the median is between 20 and 25 ELISA kits when testing horse samples for drugs.

As part of its regular testing program, the Department also tests horse blood samples to measure the level of Phenylbutazone and Oxyphenylbutazone to ensure that horses do not exceed the threshold levels established in state rule. These tests use high-performance liquid chromatography (HPLC) instrumentation. Results that return levels above the state-established threshold are reported as violations.

- **Confirmation of positive results**—The Department confirms the drug detections identified in its initial regular testing using mass spectrometry instrumentation. The Department limits the use of mass spectrometry instrumentation tests for confirmation and special testing.
- **Special testing**—Besides the initial detection and confirmation testing, the Department has the ability to conduct special tests, which target specific drugs such as Erythropoietin (EPO), or practices such as “milkshake” tests.

Department classifies drugs according to Model Rules and has made some program improvements—The Department’s drug-testing program classifies drugs according to the Model Rules. In addition, consistent with its strategic goal to enhance animal drug-testing, the Department has increased the number of tests that it performs on samples, and in 2006 it strengthened its contract with the lab that conducts animal drug testing to allow for more types of testing. Specifically:

- **Drug categories are aligned with Model Rules:** The Department’s classification of drugs relating to horse racing is consistent with the ARCI’s Uniform Classification Guidelines. Specifically, the Department has

Phenylbutazone: Also known as “bute.” A nonsteroidal anti-inflammatory drug—commonly used for pain relief for the treatment of lameness.

Oxyphenylbutazone: A metabolite of Phenylbutazone.

Source: Auditor General staff analysis of information on the Ontario Ministry of Agriculture, Food and Rural Affairs Web site and in ARCI Model Rules.

EPO—A hormone that stimulates the bone marrow to produce red blood cells, thereby increasing oxygen-carrying capacity within the circulation. Increased oxygen in the blood may enhance a horse’s performance.

Milkshake Tests—A milkshake is a drug combination that usually contains agents, such as baking soda, sugar, and other substances. It is believed to help fend off a horse’s fatigue. Milkshake tests specifically identify heightened carbon dioxide levels in horses.

Source: Auditor General staff analysis of information from the Racing Medication and Testing Consortium and the Racing New South Wales Web sites.

The Department's new drug-testing contract allows for more testing options and a greater number of tests to be conducted.

Furosemide—A drug that is also known as Lasix and is used to prevent exercise-induced pulmonary hemorrhage. This describes the condition in which tiny blood vessels in a horse's lungs rupture due to stress sustained during physical exertion. According to an industry expert, Furosemide is the only substance allowed to be administered to a horse on race day in most racing jurisdictions. Therefore, it is treated differently than other drugs and does not have a classification in the *Uniform Classification Guidelines for Foreign Substances and Recommended Penalties*.

Source: Auditor General staff analysis of expert interview and information provided from the American Association of Equine Practitioners Web site and a January 2007 interview with an ARCI representative.

promulgated rules for horse racing that classify foreign substances in generally the same manner as is set forth in the ARCI Uniform Classification Guidelines. For example, the Department's Chief Veterinarian determines threshold levels for Class 3, 4, and 5 drugs that correspond with the classifications listed in the ARCI Uniform Classification Guidelines.

- **Number of tests performed on pooled samples has increased:** The Department has increased the number of ELISA tests performed on each pooled horse drug test sample, and has provisions in place to add additional tests. Specifically, the Department increased the number of ELISA tests for horses from 15 to 25 in fiscal year 2005. By increasing the number of ELISA tests performed, the Department can increase the number of drugs detected in an animal.

The Department's new testing laboratory contract was finalized in October 2006, and it allows the Department to request even more additional ELISA tests. Specifically, this new contract allows the Department to request up to 45 ELISA tests on each horse sample. This means that a horse could be tested for 90 to 135 different drugs in initial testing. The new contract also allows the Department to request up to ten ELISA tests on each greyhound sample, which is an increase from its previous testing protocol of ELISA tests for each greyhound sample.

- **New contract allows for additional test types:** As noted above, the Department's new lab contract allows it to request that milkshake tests be performed. In addition, in contrast to its prior contract, the Department's new contract allows it to request Furosemide (Lasix) testing.¹ Moreover, the new contract allows the Department to select specific samples or batches of samples that can be unpooled if needed.

Two of Department's threshold levels for therapeutic drugs deviate from Model Rules recommendations—Of the three threshold levels for therapeutic drugs recommended in Model Rules, the Department's threshold levels match recommendations in one case and deviate in the other two. Threshold levels refer to amounts of medications that are allowable at certain levels in an animal's system. Threshold levels have been established in equine Model Rules for only three drugs and metabolites: Phenylbutazone, Ketoprofen, and Flunixin.² According to an RMTTC official, the thresholds that are listed in the Model Rules were added as a result of scientific research, and additional thresholds levels will be established for other therapeutic medications once a consensus is reached.

The Department's threshold levels for Phenylbutazone (Bute) match those set forth in the Model Rules, while its thresholds for Ketoprofen and Flunixin are five times greater. The Department's Chief Veterinarian, who has the authority to set

• 1 Furosemide (Lasix) specific gravity testing measures how diluted the urine is. Samples with a specific gravity under the set amount are subject to further testing.

2 Flunixin is a nonsteroidal anti-inflammatory drug that controls pain and inflammation in horses.

thresholds for therapeutic medications (Class 3, 4, and 5 drugs) for horses, set these thresholds. According to the Chief Veterinarian, these thresholds were set at a higher level than those in the Model Rules in response to the higher levels allowed in other racing jurisdictions. An appendix in the January 2003 edition of the *Journal of Equine Veterinary Science*, the article the Chief Veterinarian used to set Arizona's levels, supports that some states had allowed higher threshold levels for the Ketoprofen and Flunixin than those recommended in the Model Rules.¹ For example, two states allowed higher levels for Ketoprofen, and four of five states allowed higher levels for Flunixin. The Department's threshold levels for Ketoprofen are the same as one state and its Flunixin threshold levels are the same as two of the five states. The Chief Veterinarian reported that when the Department adopts the Model Rules and other racing jurisdictions also comply with the threshold levels in the Model Rules, he will adjust the threshold levels for these substances accordingly.

The Department's thresholds for Ketoprofen and Flunixin are five times higher than those in the Model Rules.

ARCI Model Rules do not address threshold levels for drugs in greyhounds. However, the Department's administrative rules specify thresholds for barbiturates and Procaine.²

Department working toward aligning its policy with Model Rules—

Although the Department has taken steps to improve its animal drug-testing practices, not all practices, such as therapeutic medication thresholds, are yet aligned with the Model Rules. Therefore, the Department should continue to move forward to more fully align its drug-testing practices with the Model Rules, and seek consensus with the industry in areas where there are concerns. The Department has received input from stakeholders regarding equine Model Rules. The Department has developed a draft report listing stakeholder recommendations regarding the Department's proposed changes to policy to align with the Model Rules. Arizona industry stakeholders recommend that the Department adopt different requirements in five areas recommended in the ARCI Model Rules. Specifically, industry stakeholders recommend that the Department change:

Industry stakeholders recommend that the Department adopt different requirements in five areas recommended in the ARCI Model Rules.

- **Foreign substance**—Stakeholders suggest changing the verbiage in the Model Rules referring to a “foreign substance” to “pharmacologically active substance.” According to the Department, this would dramatically weaken its ability to take enforcement actions against drug and medication violations because extensive and expensive tests would be required to prove that a substance is “pharmacologically active.”
- **Furosemide dosage**—Stakeholders believe the minimum dosage required in the Model Rules is too high and recommend a smaller minimum dosage requirement. In addition, stakeholders suggest that how Furosemide is administered be left to the discretion of the practicing veterinarian instead of limiting the administration route to only intravenous injections, as required in

1 Journal of Equine Veterinary Science. Appendix 7: International Threshold Regulatory Limits. November 2002. *Journal of Equine Veterinary Science* 23, no. 1 (January 2003): 37-38.

2 Barbiturates are central nervous system depressants that can produce a wide spectrum of effects, from mild sedation to anesthesia. Procaine is a local anesthetic.

Bleeder List—A list kept by the official veterinarian of each horse that has demonstrated external evidence of exercise-induced pulmonary hemorrhaging during or after a race or workout as observed by the official veterinarian. Horses put on a bleeder list are ineligible to race for a period of time determined by the number of prior bleeding incidents a horse has had. This allows the horse time to heal damaged tissue and get the medical attention needed. For example, RCI Model Rules recommend that a horse be ineligible to race 14 days after its first instance of bleeding.

Source: Auditor General staff analysis of ARCI Model Rules Chapter 11, revision 3.3, and an Arizona Racing Commissioner.

the Model Rules. A lower minimum dosage and giving veterinarians the ability to choose the administration method allows veterinarians more latitude to dispense Furosemide according to weather conditions and how the horse reacts to the substance. Arizona has extreme temperatures and when the temperatures rise, a horse needs less Furosemide. Administering a higher dose than needed can cause metabolic problems. The horse can become dehydrated, which disturbs the horse's electrolyte balance and can cause cramping. In addition, thin horses need less Furosemide and administering a higher dose than needed can have the same detrimental effect.

- **Bleeder lists**—Stakeholders recommend that the amount of time horses are ineligible to run after being placed on the bleeder list be reduced for the first occurrence from 14 to 10 days and for the third occurrence from 180 to 60 days. Industry stakeholders agree with ineligibility requirements listed in the Model Rules for second and fourth occurrences.

- **Nonsteroidal anti-inflammatory drugs**—Industry stakeholders suggest prohibiting NSAIDs from being administered before post time on race day instead of within 24 hours before post time for the race in which the horse is entered, as recommended in the Model Rules.
- **Veterinarians' reports**—Industry stakeholders recommend submitting records regarding the treatment of a racehorse only when a positive drug test has been conducted. In contrast, the Model Rules require every veterinarian licensed by the Department to provide to the Chief Veterinarian a written record of every treatment they administer on a racehorse.

The Department submitted its new proposed policy on equine drug testing and recommended penalties that encompass industry recommendations to the Commission for their endorsement at the April 2007 commission meeting. The Department recommended the adoption of the new policy to go into effect starting in September 2007. According to department staff, the Commission requested the Department to take the proposal and review it with representatives of the Horsemen's Benevolent and Protection Association, Inc. and to submit it to the Commission again for their endorsement at the May 2007 meeting.¹

The department director reported that the Department has decided to first issue a substantive policy statement, and then move forward with adopting that policy into rule.² According to the Director, the Department's practice has been to issue a substantive policy statement prior to completion of the formal rule-making process in situations that require immediate action to protect the health and safety of the

¹ Both the Commission and the Department have statutory authority to adopt administrative rules and make policy. However, according to A.R.S. §5-104(B), the Commission may approve or reject decisions of the Department's director in accordance with rules that it has established.

² A substantive policy statement is a written expression that informs the general public of an agency's current practice, procedure, or method of action based on its opinion of state or federal requirements. A substantive policy statement is advisory only and does not impose additional requirements or penalties on regulated parties.

The Department plans to implement a new drug-testing policy that closely mirrors the Model Rules.

industry. However, there is a fine line between a substantive policy statement and a rule. Because this proposed policy prescribes new drug policies that must be adhered to by all licensees and may result in penalties for failure to comply, the policy, if adopted as proposed, would be a rule that has not gone through the rule-making procedures. Consequently, the provisions in the proposed substantive policy statement cannot be enforced until they are adopted into administrative rule. Therefore, the Department should put this proposed policy into administrative rule instead of solely in department policy.

Conformity with Model Rules limited by internal budget pressure

Although the Department was making progress in strengthening its drug-testing program, the need to address unexpected expenses, such as state-wide, mandated, employee-pay increases, resulted in having to divert \$31,000 to meet other department needs in late fiscal year 2006. Although the Department did not violate any state laws, this short-term reduction affected its ability to adhere to some practices recommended in the Model Rules.

Program improvements stalled in 2006—Although the Department made progress toward improving horse drug testing between 2004 and 2005, it reduced its level of testing for both horse and greyhound drug testing in fiscal year 2006 in response to unexpected expenses and mandates as a last-resort, cost-saving measure. Specifically:

- Horse drug testing**—As noted in Table 5, the Department had increased drug testing in fiscal year 2005. During fiscal years 2004 and 2005, the Department reports that it tested every winning horse in addition to some extra horses selected by the stewards for testing. Based on the number of live horse races conducted in fiscal year 2006, the Department should have tested at least 2,394 horses and as Table 5 shows, it tested 3,149 horses, which included

Table 5: Equine Drug-Testing Statistics
Fiscal Years 2004 through 2006

	2004			2005			2006		
	Horses Tested	Live Races	Ratio ¹	Horses Tested	Live Races	Ratio ¹	Horses Tested	Live Races	Ratio ¹
Positive Tests	2,455	2,379	1.03:1	3,399	2,406	1.41:1	3,149	2,394	1.32:1
Number			44			37			48
Percentage			1.79%			1.09%			1.52%

¹ Ratio represents the average number of horses tested for each live race conducted. For example, a 1:1 ratio means one horse was tested for every live race conducted.

Source: Auditor General staff analysis of the Department of Racing's analysis of invoices received from the private drug-testing laboratory for fiscal years 2004 through 2006 and the *State of Arizona Department of Racing Annual Report FY 2006*.

The Department stopped testing every winning horse for a 60-day period in 2006.

regular tests on winning horses and special tests on extra horses. However, for a 60-day period in fiscal year 2006, from May 1 through June 30, to help avoid a potential budget shortfall, the Department reduced horse drug testing, and as a result temporarily stopped testing every winning horse during this time. Auditors reviewed the Department's horse sample logs on 10 randomly selected race dates during this period, and found that only 69 out of 91 races had samples submitted for testing on the winning horse. This is an approximate 24 percent decrease in testing of winning horses for this sample period. As a result, although it did not violate any state laws, the Department deviated from the Model Rules that require every winning horse to be tested. However, as of July 1, 2006, auditors determined that the Department had resumed testing every winning horse.

- Greyhound drug testing**—Although there were fewer races held in 2005 as compared with 2004 because live racing ended at Apache Greyhound Park, the ratio of samples tested as compared to live races was consistent—a ratio of 0.52 to 1 in 2004 and 0.54 to 1 in 2005. In 2006, while the number of live races returned to its 2004 level, the number of tests declined (0.47 to 1 ratio). Similar to horse testing, the Department reduced the level of greyhound drug tests conducted in 2006. According to the Department's Chief Greyhound Veterinarian, the Department's standard practice is to allow each track to submit no more than eight to nine greyhound urine samples for testing each race day. However, due to budget constraints during the last 2 months of fiscal year 2006, each track was limited to submitting no more than three samples each race day. According to the Department, it resumed its standard testing levels of eight to nine samples a day at the beginning of fiscal year 2007. Although equine Model Rules do require every winning horse to be tested, greyhound Model Rules do not have this same requirement. According to the Department's Chief Greyhound Veterinarian, the current state standard testing protocol does not include testing every winning greyhound.

Table 6: Greyhound Drug-Testing Statistics
Fiscal Years 2004 through 2006

	2004			2005			2006		
	Greyhounds Tested	Live Races	Ratio ¹	Greyhounds Tested	Live Races	Ratio ¹	Greyhounds Tested	Live Races	Ratio ¹
Positive Tests	5,508	10,492	0.52:1	5,105	9,372	0.54:1	4,878	10,457	0.47:1
Number			1			5			0
Percentage			0.02%			0.10%			0.00%

¹ Ratio represents the average number of greyhounds tested for each live race conducted. For example, a 1:1 ratio means one greyhound was tested for every live race conducted.

Source: Auditor General staff analysis of the Department of Racing's analysis of invoices received from the private drug-testing laboratory for fiscal years 2004 through 2006 and the *State of Arizona Department of Racing Annual Report FY 2006*.

Department reduced drug testing in 2006 to avoid budget shortfall—

According to department officials, it reduced both horse and greyhound drug testing in late fiscal year 2006 as a last-resort, cost-saving measure to avoid a potential agency budget shortfall caused by unexpected expenses and mandates. The Department had originally allocated \$300,000 for animal drug testing in fiscal year 2006. However, the Department reported that, due to the need to meet other unexpected operational expenses late in the fiscal year, it allocated approximately \$31,000 to other purposes.

Late-year unexpected expenses caused the Department to move approximately \$31,000 from animal drug testing to other operations in fiscal year 2006.

The Department reported that it faced an initial potential budget shortfall of \$156,585 for fiscal year 2006. This shortfall was the result of unexpected expenses and mandates, including:

- **Higher travel expenses:** The Department reported that the State increased mileage reimbursement rates and hotels increased the lodging rates they charged the Department, but no additional funds were provided for this purpose. Therefore, the Department reported that an additional \$16,220 was needed to reimburse racing employees for travel expenses. The Department is responsible for regulating county fair race meets that are located throughout the State. This requires department employees, such as racing stewards, to travel to remote areas of the State as part of their regulatory duties.
- **Unexpected computer programming and equipment needs:** The Department experienced unexpected computer programming and equipment needs, such as the expense of stabilizing the Department's database, for which funds were not available. The Department reported that it acquired replacement equipment and programming services at a cost of \$16,260.
- **Pay parity for county fair-funded employees:** Although legislation passed to increase state employee salaries during fiscal year 2006, the appropriations were made from the State General Fund, and thus did not provide additional resources to increase the salaries of the Department's employees who are funded through county fair monies.¹ However, the Department was required to provide these increases to all of its employees. According to the Department, the increases for these employees cost \$20,205.
- **County fair personnel and operating expenses exceed the appropriation caps established by statutes:** Rather than reduce or cancel scheduled county fair racing because the Department did not have the monies to pay the wages of its employees assigned to work at the fairs and for the operating expenses associated with the fairs, the Department reported that it used \$103,600 from its General Fund appropriation.

The Department reported that it reduced its potential shortfall by maintaining staff vacancies, promoting Web site usage, which reduced labor expenses, and other

¹ The County Fairs Racing Fund, which was established to pay for Department of Racing staff to oversee county fair racing, had a \$300,000 cap, and the County Fairs Racing Betterment and Breeders' Awards Administration Fund had a \$45,000 cap in fiscal year 2006 on the amount from revenues and transferred funds that could be distributed to those funds. Therefore, any expenses above those caps would need to be funded from other monies.

cost-saving measures. The Department resolved the remaining budget shortfall of approximately \$31,000 by reducing the number of animals tested by approximately two winning horses and five greyhounds for each race day from May 1, 2006 through June 30, 2006. The Department reports that it implemented the cost reductions in drug testing as a last alternative to balance its budget.

Starting in fiscal year 2007, the Department included increasing animal drug testing as one of its strategic goals and retained this goal in its fiscal year 2008 strategic plan. Since the Department has adopted increasing animal drug testing as a strategic goal, it needs to ensure that monies are available to support this goal.

Starting in fiscal year 2008, the Department should have more monies available for drug testing for county fair and commercial racing. According to the Department, it has been subsidizing county fair racing drug testing and other activities with General Fund monies. These General Fund monies are normally reserved for commercial racing because the county fair racing costs were higher than appropriations received from the County Fair Racing Fund and the Administration Fund. However, because the Legislature approved higher caps for two county fair racing funds during the second 2006 regular session, the Department's county fair racing appropriations could potentially increase by \$172,000 starting in fiscal year 2008, pending approval of the State's budget. This should pay for county fair animal drug testing with county fair monies, freeing up more General Fund monies for commercial animal drug testing.¹

Recommendations:

1. The Department should continue to move forward to align its drug-testing practices with the Model Rules, and seek consensus with the industry in areas where there are concerns.
2. Once finalized, the Department should put its new equine drug testing policy and penalties into administrative rule instead of solely in department policy.

¹ Pending legislative approval, starting in fiscal year 2008, the Department's total county fair racing appropriations will increase from \$345,000 to \$517,000 as a result of the Legislature increasing the statutory cap for the County Fairs Racing Fund and the Administration Fund.

OTHER PERTINENT INFORMATION

During the audit, other pertinent information was collected regarding how Arizona's racing industry was historically funded and is currently funded, legislative actions to assist the racing industry, and revenue sources used by some other states that are not used in Arizona.

Historically, racing regulation was self-funded from pari-mutuel taxes

In the past, revenues derived from the racing industry generated sufficient resources to fully fund all costs associated with racing regulation and eight statutorily established funds that the racing industry has historically supported. However, fiscal year 1995 was the last year that pari-mutuel taxes derived from the racing industry provided sufficient revenues to fully fund the eight statutorily established racing and agricultural funds, and remit revenues to the State General Fund, which more than covered the Department of Racing's operational expenditures. Specifically, in fiscal year 1995, the State collected more than \$8.5 million in pari-mutuel taxes, and contributions to the State General Fund exceeded \$5 million. The following year pari-mutuel tax collections dropped to \$2.8 million when legislatively approved tax relief went into effect, and racing revenues remitted to the State General Fund decreased to \$165,878.¹

Since tax relief legislation went into effect in 1996, pari-mutuel tax collections have continued to decline.² As shown in Figure 3 (see page 38), collections from pari-mutuel handle taxes have declined from \$2.9 million in 1998 to \$527,000 in 2006. During this same time, the cost to regulate the industry in the form of the Department's operational expenditures has increased somewhat, from \$2.65 million in fiscal year 1998 to \$2.95 million in fiscal year 2006.

The exemption of simulcast wagering from taxation appears to be a primary factor in the pari-mutuel tax collection decline since total commercial handle generated

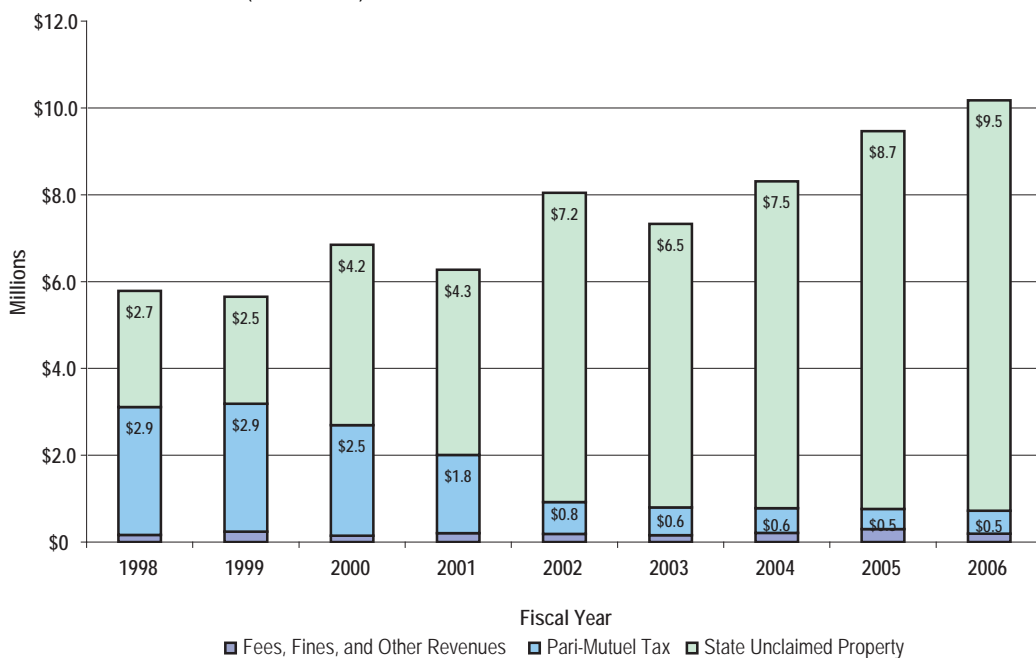
Pari-mutuel taxes have continued to decline since tax relief legislation became effective in 1996.

¹ The Auditor General's 1997 audit report presents information on the immediate effect of tax relief legislation in the Introduction and Background and Other Pertinent Information sections of that report. (See Report No. 97-12)

² State collection of pari-mutuel tax is based on a complicated formula set forth in state statute, and only live handle is subject to taxation in Arizona.

has generally remained stable over the last decade. As discussed previously (see Figure 2 in the Introduction and Background, page 4), total commercial handle generated has generally remained stable since 1998, fluctuating between \$245 million and \$265 million.¹ However, during this time, live handle has declined compared to simulcast handle, from about 51 percent of the total in 1998 compared to only 31 percent of the total in 2006. Since Arizona taxes only live handle, the generation of fewer live handle dollars translates to less pari-mutuel taxes collected.²

Figure 3: Revenue Sources by Category
Fiscal Years 1998 through 2006
(Unaudited)



Source: Auditor General staff analysis of information reported in the *State of Arizona Department of Racing Annual Report FY2000*, *State of Arizona Department of Racing Annual Report FY2003*, and *State of Arizona Department of Racing Annual Report FY2006*.

- 1 Examination of commercial handle trends before 1998 also supports that total handle generated now is nearly the same as a decade ago. For example, the racing industry generated an average \$249.5 million in commercial handle during fiscal years 1994 through 1996, which is slightly less than the \$251.2 million in average commercial handle for fiscal years 2004 through 2006.
- 2 The overall trend of increased simulcast wagering appears to be taking place only in Arizona's horse-racing industry. In fiscal year 2006, only 42.3 percent of total handle earned by the greyhound-racing industry consisted of simulcast handle, compared to 81.9 percent for commercial horse racing. Thus, the greyhound-racing industry still derives more revenue from live races than simulcast races.

Most department revenues distributed to eight special funds

The Department receives revenue from a variety of sources. The Department directly collects pari-mutuel taxes, license fees, and fines from licensees. Fines from licensees are deposited into the State General Fund, while other revenue sources are deposited into eight separate racing and agricultural funds identified in A.R.S. §5-113 and shown in Table 7. Five of these funds are administered by the Department and benefit the racing industry directly, while the other three funds benefit the Arizona State Fair, county fair, and agricultural programs. Statute entitles all of these funds to receive a certain percentage of racing-related revenues (pari-mutuel taxes and license application fees), up to a specific allowable maximum.

Since 1998, these funds have also been supported by monies from the State Unclaimed Property Fund. Unclaimed property consists of abandoned property such as bank accounts, and the Arizona Department of Revenue handles its disposition. The Legislature took this action to address revenue shortfalls for the eight statutorily established funds that occurred as a side effect of the tax relief legislation. In fiscal year 1996, as a result of that legislation, pari-mutuel taxes no longer provided sufficient resources to fully fund seven of the eight funds, which together required a total funding level of \$3.6 million. In 1996, the Legislature

Table 7: Statutory Revenue Distribution and Maximum Dollar Requirements for Racing and Agricultural Funds Specified in A.R.S. §5-113

Fund	Percentage Distributions ¹	Fund Maximums ²	
		Before December 31, 2006	Starting January 1, 2007
Racing Funds			
County Fairs Racing Betterment Fund	22%	\$800,000	\$1,200,000
Arizona Breeders' Award Fund	22	800,000	1,200,000
County Fairs Racing Fund	9	300,000	450,000
County Fairs Racing Betterment and Breeders' Awards Administration Fund	1	45,000	67,000
Arizona Stallion Award Fund	1	40,000	60,000
Agricultural Funds³			
County Fairs Livestock and Agriculture Promotion Fund	33	1,200,000	1,800,000
Agriculture Consulting and Training Fund	1	No maximum	No maximum
Arizona Exposition and State Fair Fund	11	400,000	400,000

¹ Distribution percentages represent the portion of total pari-mutuel tax receipts, license fees, and unclaimed property fund monies that can be distributed to each fund annually.

² The Arizona Legislature amended A.R.S. §5-113 in 2006 to increase the maximums for six of the eight funds.

³ These funds identified are administered by other state agencies; specifically, the Governor's Office, the Arizona Department of Agriculture, and the Arizona Exposition and State Fair Board.

Source: Auditor General staff analysis of A.R.S. §5-113 and Laws 2006, Chapter 363, amending A.R.S. §5-113.

passed House Bill 2151 (Laws 1996, Chapter 353, §5), which authorized a statutory change that allowed up to 20 percent of the revenues derived from the disposition of unclaimed property to be allocated to the eight special funds identified in A.R.S. §5-113, which historically had relied on pari-mutuel tax revenues for support. As Table 7, page 39, shows, the allowable fund maximums for six of the eight funds increased effective January 1, 2007, resulting in a higher total funding level of \$5.2 million. The higher fund maximums resulted from the Arizona Legislature amending A.R.S. §5-113 during the 2006 2nd regular session.

A.R.S. §5-113 mandates that the Department remit to the State General Fund at the end of a fiscal year any excess racing and unclaimed property revenues beyond what is necessary to fund the eight funds. Due to the higher caps, this will likely result in fewer dollars remitted to the State General Fund. As shown in Table 2 (see Introduction, page 6), the Department remitted nearly \$6.5 million to the General Fund in 2006. The Department estimates that remittances will decline to \$5 million in fiscal year 2007.

The Department's operations themselves are funded from three sources: the State General Fund, and two of the eight funds supported through revenues from the racing industry and the State Unclaimed Property Fund—the County Fairs Racing Fund, and the County Fairs Racing Betterment and Breeders' Award Administration Fund. General Fund monies support the Department's commercial racing regulation, while the two county fairs' funds support the Department's county fair racing regulation. Thus, pari-mutuel taxes are largely separated from directly supporting the Department.

Legislature has taken steps to assist racing industry

The tax relief legislation that the Legislature approved in 1994 still benefits the racing industry. Laws 1994, Chapter 370, §8, provided an assortment of tax breaks beginning July 1, 1995 and August 1, 1995. The commercial racing industry lobbied for the tax breaks as part of their efforts to deal with increased competition from Indian gaming casinos, and a possible reduction in racing profits. The tax relief laws that remain in effect today include:

- **Exemption of simulcast pari-mutuel handle from taxation**—The pari-mutuel tax does not apply to handle generated from telecasts of out-of-state races.
- **Hardship tax credit**—Provided a tax credit against pari-mutuel taxes for tracks that suffered declines in business as measured by pari-mutuel handle. To determine eligibility for this tax credit, the Department compares a track's

previous year pari-mutuel handle to a base year handle. The base year figure is the highest annual pari-mutuel handle figure reported to the Department for one of the five fiscal years between fiscal years 1990 and 1994.

- **Tax reductions for greyhound tracks**—Reduced pari-mutuel tax levied on pari-mutuel handle generated at greyhound tracks from 7.5 percent to 5.5 percent between fiscal years 1996 and 1998 for racetracks located in counties with populations higher than 1.5 million, and different rate reductions for tracks located in other counties. Statutes still set forth a 5.5 percent tax rate for all dog tracks, regardless of location or county population.

According to the Department's analysis, the total value of all tax exemptions and tax credits that the industry received between fiscal years 2001 through 2006 amounted to more than \$44 million. The simulcast wagering tax exemption composed more than \$29.2 million, or two-thirds, of this total.

More recent measures to assist racing industry have failed

In more recent years, various efforts that would have potentially allowed the racing industry to increase revenue and handle have failed. Specifically, a 2002 voter initiative that would have allowed tracks to operate slot machines failed. Similarly, proposed legislation that would have expanded race wagering options in Arizona also failed.

Voter initiative that would have allowed "racinos" failed—During the 2002 General Election, voters rejected Proposition 201, known as the "Fair Gaming Act," which would have allowed Arizona's horse and greyhound racetracks to operate slot machines. Racetracks that allow slot machines and other forms of nonracing gaming have become known as "racinos" and are legal in 11 other states, including New Mexico.¹ Some states' statutes allow using these monies to support purse distributions to horsemen. Some opponents of Proposition 201 argued that allowing tracks to operate slot machines would increase competition for gaming activities that already exist among some of Arizona's tribal communities, while others argued against it because they did not want to see gaming expanded in Arizona. Arizona voters instead approved Proposition 202, a measure known as the "Indian Gaming Preservation and Self-Reliance Act," which the majority of Arizona's Native American communities supported. This proposition does not authorize slot machines or nonracing gaming at racetracks.

¹ As of March 2007, states that legally allow racinos: Delaware, Florida, Iowa, Louisiana, Maine, New Mexico, New York, Oklahoma, Pennsylvania, Rhode Island, and West Virginia.

Legislation that would potentially increase handle failed—In more recent years, proposed legislation that would have potentially increased race wagering options in Arizona has also failed. Specifically:

47th Legislature, First Regular Session

- **Simulcast wagering legislation (SB 1474):** During the 2005 legislative session, a bill was introduced that would have provided numerous changes to the statutes governing horse and dog racing, such as eliminating existing time restrictions on horse and greyhound races, and modifying certain restrictions on the types of wagering allowed on simulcast races at off-track betting facilities. For example, it would have allowed patrons at off-track betting facilities to wager on races simulcast to racetracks whether or not the race was broadcast to the additional facility. The Governor vetoed the legislation because it did not provide the Department with additional resources to cover additional regulatory costs associated with the bill and it continued the Department's reliance on the State General Fund.

47th Legislature, Second Regular Session

- **Advance deposit wagering legislation (SB 1472 and SB 1476):** During the 2006 legislative session, two bills were introduced that would have allowed permittees to conduct "advanced deposit wagering." Advanced deposit wagering involves allowing patrons to deposit funds in advance into an account held by the racing permittee, and then use those accounts to place wagers either in person or by telephone. However, both bills died in the Senate.

Some other states still rely mainly on racing industry to support racing regulation

Auditors' research into racing regulatory funding mechanisms used by some other states, as well as a 2004 department analysis of funding mechanisms used in other states, indicates that Arizona is unique in its reliance on state unclaimed property to support the costs associated with racing regulation. Examples of revenue sources that other states use, which are not used in Arizona, include:

- **Simulcast handle taxes and fees:** Some states tax simulcast handle. For example, small racing states, such as Colorado and Kansas, tax simulcast handle, as do large racing states such as Florida, New York, and West Virginia.¹ California, rather than imposing a pari-mutuel tax, imposes a specific fee on live and simulcast wagers made by the public.

¹ Auditors have categorized states that reported generating less than \$500 million in total handle in their 2005 annual reports as "small racing states," and states that reported generating more than \$500 million in handle in their 2005 annual reports as "large racing states."

- **Other taxes:** Other states impose other forms of taxes such as admission taxes and daily taxes. For example, Florida, Illinois, and Kansas require admission taxes, and West Virginia requires a daily tax.
- **Ticket revenues:** Some states, such as New York, Texas, and Wisconsin, collect revenues from unclaimed, uncashed, or “outstanding” winning tickets, which are commonly known as “outs.”¹
- **Permittees’ license fees and other fees:** Some states collect license fees from their permittees and collect other fee types. A permittee license fee is paid by the permittees as a condition of licensure, and can be a one-time fee, a permit fee, or a per-day fee, or any combination. For example, both Florida and Texas collect daily license fees from their permittees.² Other miscellaneous fee types can include staff reimbursement fees or drug-testing fees. For example, Minnesota requires monies to be deposited into reimbursement accounts held by the State Treasurer to provide for the costs associated with stewards and veterinarians and medical testing of horses.

The Department plans to discuss and possibly propose the legislation that would eliminate the tax exemption for simulcast wagering, and also require permittees to pay \$5 for each racehorse entered in a live race and \$0.50 for each racing greyhound. According to the Department, eliminating the tax exemption on simulcast wagering would allow the State to collect additional revenues for regulating the racing industry, while animal entry fees would be used to pay for additional animal drug testing without impacting the General Fund.

¹ A review of state tax payment information contained in the New York Racing and Wagering Board’s *Annual Report and Simulcast Report 2005* indicates that New York only collects uncashed ticket revenues from OTB corporations.

² Texas calls its permittees “associations.”

SUNSET FACTORS

Arizona Department of Racing

In accordance with A.R.S. §41-2954, the Legislature should consider the following 12 factors in determining whether the Arizona Department of Racing should be continued or terminated:

1. The objective and purpose in establishing the Department.

The Legislature created the Arizona Department of Racing in 1982 to regulate and supervise pari-mutuel racing and wagering conducted in Arizona in order to protect racing participants and the wagering public. The Department is responsible for regulating all commercial and county fair horse-racing meetings, greyhound-racing meetings, and pari-mutuel wagering. Additionally, the Department collects pari-mutuel taxes and other fees for distribution to the State General Fund and eight statutorily established funds. Before the Department was created, the Arizona Racing Commission performed the regulatory activities the Department now performs.

2. The effectiveness with which the Department has met its objective and purpose and the efficiency with which the Department has operated.

The Department has generally been effective and met its purpose of regulating and supervising pari-mutuel racing and wagering by:

- Licensing all participants and officials involved in racing, including horse and greyhound owners, veterinarians, trainers, jockeys, grooms, exercise riders, track management, concessionaires, and pari-mutuel workers;
- Conducting investigations of all license applicants and potential racing violations to enforce compliance with racing statutes and rules;
- Assigning staff to supervise horse and greyhound races and other track activities, such as collecting drug-testing samples from horses and greyhounds to ensure the absence of prohibited substances that may affect the outcome of a race; and

- Conducting inspections of greyhound kennels to ensure the safety and well-being of Arizona's racing greyhounds.

However, the audit found that the Department can more effectively meet its objectives by:

- **Improving some aspects of its pari-mutuel oversight program—**Enhancements could be made to its tote system testing and oversight, tote system security, and monitoring for wagering anomalies. The Department should provide general audit training to its pari-mutuel auditors in addition to specific audit training in performing net pool pricing tests in order to enhance the auditors' efficiency and effectiveness. In addition, the Department should examine ways to reduce the auditors' reliance on manual calculations to perform the tote system testing. It could adopt tote testing tools such as automated spreadsheets or pre-printed testing documents that specify the expected outcome. Additionally, the Department should enhance its auditors' procedures for testing tote system security, which fall short of the Association of Racing Commissioners International's (ARCI) proposed additions to the Model Rules and standard information technology (IT) auditing standards. For example, the Department should work with the Legislature to obtain statutory authority to license tote companies. If it obtains this authority, it should modify its rules to identify tote companies as a license category and include licensing requirements recommended in ARCI's proposed additions to its pari-mutuel wagering Model Rules. For example, it should include a Type II SAS 70 or similar review. In addition, the Department should work toward incorporating other aspects of the proposed additions to ARCI Model Rules, including those related to reviewing program changes and access controls. Finally, it should also explore the feasibility of adopting an independent monitoring system, which could allow it to monitor wagering activities on a real-time basis.

The Department should also explore expanding its financial analyses of the monies wagered in Arizona. The Department's reviews are limited to annual reviews of tracks' financial statements, reviews of the distribution of monies to the eight statutory funds, and special reviews on an ad hoc basis. However, the Department should explore performing additional reviews, such as regular purse audits and other types of audits that other states' departments of racing perform, to ensure that all monies are correctly distributed to the racing participants and the wagering public (see Finding 1, pages 13 through 24).

- **Continuing efforts to ensure that its animal drug-testing program is aligned with ARCI's Model Rules—**Although the Department's animal drug-testing program is generally aligned with racing regulation practices, it needs to continue its

efforts to align these practices with ARCI Model Rules. Specifically, the Department uses standard testing practices used in the racing industry, classifies drugs according to the Model Rules, and has made some other improvements to its drug-testing program. However, the Department deviates in two of the three threshold levels for therapeutic drugs set forth in the Model Rules. Additionally, the progress it gained between 2004 and 2005 was temporarily stalled in 2006 when it faced a potential budget shortfall because of unexpected expenses and mandates, such as state-wide employee-pay increases. Consequently, the Department reallocated monies originally earmarked for animal drug testing as a last-resort measure to balance its budget. This reallocation resulted in the Department's temporarily not testing every winning horse as recommended by the Model Rules, but was not a violation of state statutes. The Department resumed regular testing practices at the beginning of fiscal year 2007.

3. The extent to which the Department has operated within the public interest.

The Department has generally operated in the public interest by upholding the integrity of pari-mutuel racing and wagering and protecting the health and safety of racing animals, participants, and the public. For example, the Department inspects greyhound kennels to protect the animals from unsafe and abusive conditions. In addition, the Department has a pari-mutuel oversight program that is intended to help ensure that monies wagered are distributed to the correct parties. However, the public interest could be better served if the Department improved some aspects of its pari-mutuel wagering oversight activities (see Finding 1, pages 13 through 24), and continued to improve its animal drug-testing program (see Finding 2, pages 25 through 36).

4. The extent to which rules adopted by the Department are consistent with the legislative mandate.

Based on an analysis conducted by the Governor's Regulatory Review Council (GRRRC), the Department has promulgated most, but not all, of the administrative rules mandated by statute. For example, although the Department's statutes require it to collect fees for certain temporary licenses, the Department has not adopted a rule addressing a temporary license category for special races or the fees associated with it. Specifically, the Department issues temporary licenses to owners, trainers, and jockeys who are licensed in good standing in other jurisdictions, to allow them to participate in special races, such as stakes, handicaps, or trial races. Although the Department charges a \$36, 3-year license fee for this temporary license, it is not published in rule.

In addition, a review of the Department's rules by Auditor General legal counsel determined that there are several license categories that the Department publishes on fee charts that are not specifically listed in rule. For example, the

Department's fee charts include fees for security and business-vendor licenses. However, the rules do not include these fee categories. The Department should review its statutes to ensure it has the statutory authority to promulgate rules for these other license categories, and then take action to promulgate such rules. Finally, the Department needs to ensure that its fee charts comply with state statutes. Although A.R.S. §41-1008(B) requires that an agency identify the statute that authorizes the fee on documents relating to fee collection, the Department's fee charts do not list the authorizing statutes.

5. The extent to which the Department has encouraged input from the public before adopting its rules and the extent to which it has informed the public as to its actions and their expected impact on the public.

The Department keeps the public informed about proposed rules as well as other actions it takes. Specifically, according to the Department, it provides electronic copies of proposed rules to stakeholders, including permittees and racing organizations in Arizona, and holds public meetings on the proposed rules. Additionally, according to the Department, it has made other efforts to communicate with stakeholders, such as informing them of proposed policy changes by e-mail and on its Web site.

Additionally, the Department has formed task forces comprising industry and department representatives to help it make changes to its rules. Specifically, in July 2003, the Department formed a Horse Racing Task Force, which made recommendations regarding rules pertaining to horse racing. Similarly, in March 2004, the Department formed a Greyhound Racing Task Force that helped make changes to the greyhound racing rules. For example, the Task Force recommended that the Department develop a database to include all racing greyhounds to better monitor their whereabouts.

Further, the Department has posted public meeting notices at least 24 hours in advance at the required location, made agendas available to the public, maintained meeting minutes, and has the required statement of where meeting notices will be posted on file with the Secretary of State.

6. The extent to which the Department has been able to investigate and resolve complaints that are within its jurisdiction.

The Arizona Administrative Code provides the Department with guidance to address complaints within the following areas:

- **Objections filed with stewards**—According to rule, department stewards have the authority to resolve objections made by an owner, authorized agent of an owner, trainer, or jockey. Similarly, according to rule, the Department has the following multiple options to administratively sanction participants who violate rules and regulations. First, the stewards may

impose fines up to \$1,000 and may suspend a license up to 60 days. Second, the stewards may refer the case to the Director for further action. Further, the Director may affirm, reverse, or modify the stewards' decision. Finally, the Racing Commission, upon appeal, may affirm, reverse, or modify a Director's decision. According to the Department's fiscal year 2006 annual report, during fiscal year 2006 department stewards issued 636 rulings, the Director heard 39 appeals, and the Racing Commission heard 7 appeals.

- **Complaints filed with the Department**—According to rule, the Department has the authority to receive complaints against department officials. While rule requires that a complaint against a department official must be submitted within 5 days, according to the Department, it may accept a complaint after the established time limits depending on the gravity of the matter. Additionally, the Department has implemented the recommendation from the Auditor General's 1997 performance audit report to develop and maintain a complaint log (see Report No. 97-12). According to this log, the Department disposed of 22 complaints in fiscal year 2006. However, although the 1997 report recommended that the log describe when the complaint was received, the nature of the complaint, the complainant's name, and the disposition of the complaint, the Department's 2006 complaint log does not include information on the nature of the complaint or how it was resolved.
7. **The extent to which the Attorney General or any other applicable agency of state government has authority to prosecute actions under the enabling legislation.**

According to statute, the Attorney General is the Department's legal adviser and statute provides a variety of disciplinary options for the Department to impose for actions that violate statutes. Specifically, statute authorizes the Department to revoke, suspend, and/or impose a civil penalty on licensees who violate racing rules and establishes circumstances under which individuals may be prosecuted for a Class 4 felony. For example, according to statute, altering, changing, or interfering with any equipment or device used in connection with pari-mutuel wagering is a Class 4 felony.

8. **The extent to which the Department has addressed deficiencies in its enabling statutes which prevent it from fulfilling its statutory mandate.**

According to the Department, it developed proposed legislation in fiscal year 2003 that was intended to generate additional revenues from the racing industry starting in fiscal year 2004. These proposals included increasing the pari-mutuel tax rate, taxing simulcast wagers, and allowing account wagering in the State. However, the racing industry opposed these proposals and therefore, progress on moving these proposals forward has halted.

The Department plans to discuss and possibly propose the following legislation in the future:

- **Modify the hardship tax credit**—Establish a limit on the amount of pari-mutuel taxes a permittee is allowed to offset with the hardship tax credit and eliminate the opportunity for additional hardship tax credit to accumulate in the balance of each eligible permittee.¹ The Department may propose establishing a limit of 50 percent of pari-mutuel taxes due and in this manner increase state revenues for industry regulation.
 - **Eliminate the tax exemption for simulcast wagering**—Require permittees to pay pari-mutuel taxes on wagering on out-of-state simulcasting. In this manner the State may collect additional revenues for regulating the pari-mutuel racing industry.
 - **Animal drug-testing fund and entry fee for each participating animal**—Require permittees to pay \$5 for each racehorse entered in a live race and \$0.50 for each racing greyhound. According to the Department, the purpose of this increased revenue is to pay for additional animal drug testing and increased drug-testing costs without impacting the General Fund.
9. **The extent to which changes are necessary in the laws of the Department to adequately comply with the factors listed in the subsection.**

As recommended in Finding 1 (see pages 13 through 24), the Department should work with the Legislature to seek statutory authority to license tote companies. Although the Department issues such licenses already, it does not have the statutory authority to do so.

10. **The extent to which termination of the Department would significantly harm the public health, safety, or welfare.**

Termination of the Department could adversely impact the safety and welfare of the animals and the wagering public by eliminating regulatory oversight over licensees, permittees, and animals. The absence of regulation would create a lack of accountability to state laws and rules. Specifically, the Department oversees the pari-mutuel wagering systems and without this oversight, the wagering public could be harmed financially. In addition to the potential financial harm to the public, dangers involving physical harm to licensees, such as jockeys, grooms, and trainers, could result due to lack of enforcement of rules and regulations, such as detecting a licensee being under the influence of a prohibited substance. Further, the safety and welfare of racehorses and greyhounds could be compromised without department oversight. For instance,

* 1 Permittees are allowed to claim a hardship tax credit against pari-mutuel taxes for tracks that suffered declines in business as measured by pari-mutuel handle. Statute allows the permittees to use an unused current tax credit in future periods, and thus accumulate a balance indefinitely.

the drugging or desensitizing of a horse or greyhound before a race would be detrimental to the safety of that animal and the other animals participating in the same race.

11. **The extent to which the level of regulation exercised by the Department is appropriate and whether less or more stringent levels of regulation would be more appropriate.**

For the areas that this audit reviewed, the Department's level of regulation generally appears appropriate.

12. **The extent to which the Department has used private contractors in the performance of its duties and how the effective use of private contractors could be accomplished.**

The Department uses private contractors to accomplish some of its duties and the audit did not identify any additional opportunities for the Department to use them. For example, the Department uses a private laboratory to perform all of its animal and human drug testing. Additionally, according to the Department, it is working with the Government Information Technology Agency to participate in an e-licensing initiative that is created and maintained through IBM. According to the Department, this e-licensing initiative would help enhance the efficiency of the Department's licensing process by allowing licensees to obtain their license over the Internet instead of in person at the Department's offices.

SUNSET FACTORS

Arizona Racing Commission

In accordance with A.R.S. §41-2954, the Legislature should consider the following 12 factors in determining whether the Arizona Racing Commission should be continued or terminated.

1. The objective and purpose in establishing the Commission.

The Commission was originally established in 1949 to regulate Arizona's racing industry. However, in 1982 the Legislature created the Department to regulate the industry on a day-to-day basis. As a result, the Commission is now responsible for more limited duties, including approving racing dates and preparing and adopting rules. In addition, the Commission is responsible for other activities such as conducting hearings on applications for racing permits, approving permits, and hearing appeals of the Director's decisions related to actions against licensees. Although the Department, which was established in 1982, regulates the industry on a day-to-day basis, the Commission focuses its efforts on supervising the Department's director and approving or rejecting his policy recommendations, allocating racing dates, and approving permits to conduct racing.

2. The effectiveness with which the Commission has met its objective and purpose and the efficiency with which the Commission has operated.

The Commission has generally met its objectives and purposes. For example, the Commission has set racing dates each year, has promulgated rules and regulations, most recently in 2006, has held hearings for racing permit applications, and has considered appeals of the Director's decisions related to actions against licensees.

3. The extent to which the Commission has operated within the public interest.

The Commission has generally operated within the public interest by promulgating rules to protect and promote the safety and welfare of all racing participants and to ensure the integrity of racing and pari-mutuel wagering.

4. The extent to which rules adopted by the Commission are consistent with the legislative mandate.

Based on an analysis conducted by the staff of the Governor's Regulatory Review Council (GRRRC), the Commission has promulgated most, but not all, of the rules mandated by statute. For example, although statutes require it to collect fees for certain temporary licenses, the Commission has not adopted rules addressing either these temporary licenses or the fees associated with them. Additionally, although one of the Commission's statutes requires it to report the identity of any horse or greyhound determined to be drugged to a steward and the appropriate county attorney, the Commission has not adopted a rule to address reporting this information to a county attorney.

5. The extent to which the Commission has encouraged input from the public before adopting its rules and the extent to which it has informed the public as to its actions and their expected impact on the public.

The Commission keeps the public informed about proposed rules as well as other actions it takes. With the Department's assistance, the Commission reports that it provides electronic copies of proposed rules to stakeholders, including permittees and racing organizations in Arizona, and holds public meetings on the proposed rules. According to the Commission, it has made other efforts to communicate with stakeholders, such as informing them of proposed policy changes by e-mail and on its Web site.

Further, the Commission has posted public meeting notices at least 24 hours in advance at the required location, made agendas available to the public, maintained meeting minutes, and filed the required statement of where meeting notices will be posted with the Secretary of State.

6. The extent to which the Commission has been able to investigate and resolve complaints that are within its jurisdiction.

Although the Department is primarily responsible for investigating and resolving complaints, the Commission's responsibility for investigating and resolving complaints lies primarily in the appeal of decisions made at the department level. Specifically, A.R.S. §5-104 (A)(3) allows the Commission to conduct rehearings on licensing and regulatory decisions made by the Director. The Commission heard seven such appeals in fiscal year 2006.

7. **The extent to which the Attorney General or any other applicable agency of state government has authority to prosecute actions under the enabling legislation.**

According to statute, the Attorney General is the Commission's legal adviser. The Attorney General has authority to prosecute actions that violate statutes. A.R.S. §5-115 establishes circumstances under which individuals may be prosecuted for a Class 2 misdemeanor, Class 4 felony, or Class 6 felony. Additionally, A.R.S. §5-108.2 provides circumstances under which the Commission can revoke the permit of any permittee.

8. **The extent to which the Commission has addressed deficiencies in its enabling statutes which prevent it from fulfilling its statutory mandate.**

According to the Department, it developed proposed legislation in fiscal year 2003 that was intended to generate additional revenues from the racing industry starting in fiscal year 2004. However, the Commission only partially supported the Department's proposal, and the racing industry opposed it. Thus, the Department's proposal did not move forward.

9. **The extent to which changes are necessary in the laws of the Commission to adequately comply with the factors listed in the subsection.**

Audit work did not identify any areas where changes may be needed to commission statutes.

10. **The extent to which the termination of the Commission would significantly harm the public health, safety, or welfare.**

While terminating the Commission would not significantly harm the public's health, safety, or welfare, the Commission serves a role by establishing policies to govern and regulate racing. For instance, the Commission determines who will conduct racing meetings and when they will be conducted. Additionally, the Commission provides a forum for parties to address concerns about the Department's decisions.

If the Commission were terminated, statutory responsibilities, including promulgation of rules, issuance of racing permits, and issuance of racing dates, would have to be transferred to the Department or elsewhere.

11. **The extent to which the level of regulation exercised by the Commission is appropriate and whether less or more stringent levels of regulation would be appropriate.**

The current level of regulation exercised by the Commission appears appropriate.

12. The extent to which the Commission has used private contractors in the performance of its duties and how the effective use of private contractors could be accomplished.

Because the Commission functions primarily as a policy-setting body and appeal board, there appears to be little opportunity to effectively use private contractors in the performance of its duties. Occasionally, the Commission uses court reporting services to transcribe the minutes of its public meetings and proceedings, but only for high-profile hearings. Otherwise, the Commission uses the services of the Department of Racing's Administrative Services Coordinator to transcribe meeting minutes.

AGENCY RESPONSE

ARIZONA DEPARTMENT OF RACING

JANET NAPOLITANO
GOVERNOR



GEOFFREY E. GONSHER
DIRECTOR

May 31, 2007

Ms. Debbie Davenport
Auditor General
Office of the Auditor General
2910 N 44th Street, Suite 410
Phoenix, AZ 85018

Dear Ms. Davenport:

Thank you for conducting the performance audit and sunset review of the Arizona Department of Racing. The findings of the Auditor General are agreed to, and the audit recommendations will be implemented.

We appreciate the favorable overview and positive evaluation of the progress made by the Department and welcome the Auditor General's recommendations as the basis for continuing the successful management and regulatory strategies to maintain the integrity of pari-mutuel racing in Arizona. This document will be an extremely useful resource for the following reasons:

- The report identifies significant improvements and initiatives that have been introduced by Racing during the past four years.
- The report recognizes that some of the improvements and initiatives incorporated into the agency's operations may still require continuing support and attention.
- The audit recommends improvements and initiatives that can be presented to the State Legislature for support and funding for future implementation.
- The audit identifies improvements and initiatives that can be introduced as Racing continues to strengthen its regulatory oversight of the pari-mutuel racing industry.

The past four years have been a period of transition and progress for the Department. The Department introduced several regulatory, management and operational improvements that are consistent with statutory requirements and available resources.

We look forward to continuing this progress in the future.

Sincerely,

Geoffrey E. Gonsher
Director

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INTRODUCTION

THE RACING DEPARTMENT HAS MADE SIGNIFICANT PROGRESS SINCE 2003.

In 2003, three things were apparent:

- The industry needed regulatory attention.
- The agency needed management attention.
- Both the agency and the industry were in a period of dramatic transition.

Strengthening our regulation is a major part of the change the Department has achieved as a gaming agency. In 2003, the Department had antiquated rules and regulations, an outdated organizational structure, virtually no written policies and procedures, a weak review process for permittee applications, no formal means of customer communications and an ineffective enforcement and investigations process. In many respects, the regulatory scale was out of balance favoring the industry. Our current staff has worked hard to turn this situation around.

AUDITING OVERSIGHT

DESPITE THE LACK OF RESOURCES, THE DEPARTMENT HAS INTRODUCED SEVERAL IMPROVEMENTS TO ITS PARI-MUTUEL OVERSIGHT.

The Department of Racing has been improving its pari-mutuel oversight process for the past four years. In 2003, only one position was assigned to monitor and regulate all commercial and county fair racing sites in every geographical region of the state; all required records were submitted in hard copy; and no professional training was provided to pari-mutuel staff. The following measures have been introduced to improve the oversight of pari-mutuel racing:

- An additional pari-mutuel auditor position has been created and filled.
- Auditing staff has taken advantage of the Department's Education and Training program to attend courses at Pima Community College and the Arizona Government University (AZGU).
- Hard-copy files have been supplemented with electronic files to enable the auditors to have access to information at all work locations.
- Procedural checklists were created to facilitate tote system tests and mutuel department audits.
- Verification spreadsheets have been created to eliminate hand calculations for Net Pool Pricing tote system calculations, audits, and reviews.
- An electronic procedures manual is being prepared to facilitate training for pari-mutuel auditors and to conduct the duties of the pari-mutuel auditor positions.

THE PARI-MUTUEL AUDITORS' EXPERTISE HAS BEEN DIVERTED TO OTHER CRITICAL DEPARTMENT PROJECTS.

As part of the Department's pari-mutuel oversight, the Department's auditors have been assigned several non-auditing projects because of their professional and personal ability to understand technical and financial Racing Department issues. The Department has no other staff with this experience and no funds to contract for the services. The special projects included the following:

- Reviewed the Turf Paradise permit application materials to ensure appropriate analysis of the information examined and considered by the Department for submission to the Racing Commission.
- Chaired the Greyhound Task Force Simulcast Committee to examine Department simulcasting rules.

- Reviewed proposed legislation, rule revisions, Racing Commission reports, and operational policies to provide analysis of the effect on pari-mutuel oversight.
- Reviewed allegations regarding incorrect computation of purse structures and other allegations relating to Tucson Greyhound Park.

Recognizing the Department's limited ability to conduct pari-mutuel auditing at an effective level, the Pari-Mutuel Auditing Manager recommended additional positions, greater oversight of OTB operations, automated examination of data collected through capitulation reports, and analysis of other racing-related areas that could be regulated by pari-mutuel auditors. To achieve these goals, the Department requested additional funds and additional pari-mutuel auditing positions for FY 2008 and FY 2009.

The pari-mutuel oversight recommendations submitted by the Auditor General are enthusiastically welcomed by the Department. The objective is to improve and increase pari-mutuel oversight, improve the monitoring of tote system security, incorporate automated systems into all pari-mutuel related oversight activities, and explore expanding the scope of analysis of monies wagered. Subject to funding, the Department looks forward to introducing these improvements in FY 2008 and FY 2009.

ANIMAL DRUG TESTING AND ENFORCEMENT

THE DEPARTMENT HAS BEEN PROACTIVE AND AGGRESSIVE IN ITS EFFORTS TO IDENTIFY AND ENFORCE ANIMAL DRUG VIOLATIONS.

Since March 2003, the Department has been both proactive and aggressive in its efforts to identify and enforce animal drug violations. As a result of increased testing and enforcement, recorded violations have been minimal. Nevertheless, this regulation remains an issue for which we have been and will remain vigilant.

This is a critical issue throughout the entire horse racing industry, not just Arizona. For decades, rules varied from jurisdiction to jurisdiction, which created uncertainty for owners and trainers and inconsistency in the enforcement of medication issues. Several other regulatory jurisdictions have increased their efforts in this area, and the proposed uniform model rules have been adopted by most states to unify all racing jurisdictions under one standard set of regulations.

Because the model rules, although not new to most of the industry, would be new in Arizona, the Department is recommending their adoption by a Substantive Policy Statement. In this way, both the industry and the Department can evaluate their effectiveness, monitor their impact on the industry and the Department, and analyze their appropriateness in Arizona. After one year, it would be appropriate to commence the formal rulemaking process for permanent implementation of the model rules.

Several initiatives have been taken by the Department during the past four years because drug testing is a priority.

1. More horses are being tested on a daily basis. The Department increased the minimum number of horses tested each race day from 9 to 12, including all winning horses and those identified by the Chief Veterinarian or the Chief Steward for testing.
2. More ELISA tests are being conducted for every sample drawn. The Department increased the number of Enzyme-Linked ImmunoSorbant Assay (ELISA) tests from 15 to 25 to detect new substances and those with low levels of certain substances. The new contract allows up to 45 ELISA tests for racehorses if necessary.
3. Testing for Erythropoietin (EPO) is being conducted. Periodically, four to five race days are selected, and every horse tested on those days are tested for the presence of EPO.
4. Additional GC-MS Screens are being conducted. The Department started to conduct additional Gas Chromatography-Mass Spectrometry (GC-MS) screens of selected horses to identify small amounts of substances.
5. Shock Wave Therapy reports are being submitted. A new policy requires the submission of daily reports referencing horses treated and subsequently prohibited from racing.
6. Increased testing and enforcement during High Stakes Races. The Department increases drug testing and enforcement on high profile stakes race days when purses are significantly higher and more horses are hauled in from other states and private ranches.

7. Prior Animal Medication offenders are subject to additional license review. All license applicants who have been suspended or revoked for animal drug violations are subject to additional review by the Department prior to a license application determination.
8. Off-duty Phoenix Police Officers were retained to monitor action on the Turf Paradise backside and to serve as a visual deterrent to offenders. The officers worked closely with Department investigators to increase the Department's law enforcement presence.
9. New "Detention" signs are placed on all stalls with horses scheduled for daily races at Yavapai Downs and Turf Paradise. The Department implemented the Horseracing Task Force Medication Committee recommendation to post race day signs on the stalls of horses scheduled to race.
10. The stewards' authority has been increased to impose fines up to \$1,000. A revised rule increased the Stewards' ability to fine up to \$1,000, which is consistent with several other jurisdictions.
11. The Department will be adopting new penalty guidelines for medication violations. The Department will adopt fines and penalties that are consistent with the proposed model drug rules and within the authority granted the Department.
12. Test sample pick up and delivery is more secure. To protect the integrity of the chain of custody, a new policy was established to regulate the pick up services for animal drug samples.
13. A professional procurement was conducted to select qualified, capable testing laboratories. Industrial Laboratories Company, Inc. was selected as the primary contractor, and Center for Tox Services and Truesdail Laboratories were selected as secondary contractors.
14. The new animal medication contracts allow the introduction of new testing. Furosemide specific gravity testing may be implemented in the future.
15. The Department has negotiated improved rates for animal medication testing. The cost per sample in the new contract decreased from \$58.30 to \$57.50 per horse tested and from \$16.90 to \$14.00 per dog.
16. Additional funds have been allocated from efficiency savings for horse drug testing. Since 2003, an additional \$224,000 has been designated for increased animal testing, which is an 82% increase in the number of tests. In FY 2002, \$85,340 was spent on 3,276 racehorse drug tests. In FY 2006, \$154,615 was spent for a total of 5,627 tests.
17. The Department has complied with the benchmark testing established by the National Thoroughbred Racing Association. The NTRA Racing Integrity and Drug Testing Task Force reviewed drug testing issues affecting thoroughbred and quarter horse racing and provided a benchmark for race horse testing procedures. The Department of Racing supports the recommendations and increased the number of ELISA tests, proposed uniform drug rules, developed withdrawal guidelines for commonly used therapeutic medications, and contracts with laboratories which participate in the Testing Integrity Program.
18. The Department has maintained a professional Veterinary staff with qualified and dedicated individuals. The Racing Veterinarian staff includes a Chief Veterinarian, two full-time greyhound veterinarians, three part-time greyhound veterinarians, two part-time horse veterinarians, and two full-time and two part-time employees who provide veterinarian support services.
19. Revised threshold levels will be developed. A revised Department listing of Class 3, 4, and 5 drugs was developed to identify and communicate established threshold concentrations, and these levels are consistent with the proposed Model Rules.
20. "Milkshaking" Tests will be conducted. The Department has included a provision in the new medication testing contract to allow a TCO2 testing program on selected horses to determine the existence of pre-race "milkshaking."

DEPARTMENT BUDGET AND ADMINISTRATION

THE DEPARTMENT DOES NOT HAVE SUFFICIENT FUNDING TO REGULATE THE PARI-MUTUEL INDUSTRY IN A SAFE MANNER.

One of the important issues that the Department has been proposing is a new financial structure for regulatory oversight. The Department is required by statute to submit recommendations for increasing state revenues from the regulation of the racing industry while maintaining the financial health of the industry and protecting the public interest.

The Department's recent and current budget situation emphasizes the problems we have been experiencing and communicating to the Legislature, the Racing Commission, and the pari-mutuel industry for the past four years. The Department cannot continue regulating pari-mutuel racing 365 days a year without reducing its oversight and regulatory efforts. Although a critical issue for the safety and integrity of racing in Arizona, the Department's efforts to generate revenue from the industry for regulatory purposes have not been successful.

Although enforcement, responsibilities, and priorities have increased, the Department lost eight positions in 2002, 15% of the employees. During each of the past four years, the Department sought the generation of revenue from the industry to support its statutory, administrative and regulatory duties while eliminating the need for General Fund monies.

In recent years, the Department's regulatory function and ability to adequately protect the industry has been diminished as funding has been significantly reduced. New funding mechanisms to achieve these regulatory objectives must be developed to maintain an acceptable level of safety and integrity. Consequently, the Department will continue to evaluate methods for the industry to provide sufficient funding in the same manner as other regulated industries support their agencies.

Many other Arizona regulated industries provide funding to the state so their agencies can comply with their statutory requirements. It is a common practice not just in Arizona but in almost every other racing jurisdiction in this country. We believe that the Arizona racing industry should provide revenue for this purpose.

The industry has stated that to do so would put them out of business. The financial records reveal otherwise.

- Track owners are earning millions of dollars a year in profit.
- 70% of all pari-mutuel wagering in Arizona is tax-free.
- During the past 6 years, the industry has received \$44 Million in tax exemptions and tax credits.
- Only one out of four commercial racetracks in Arizona has paid any state pari-mutuel taxes for several years.

THE BUDGET SITUATION REQUIRED REGULATORY REDUCTIONS IN FY 2006

When the Department completed the FY 2006 third quarter financial review, it became apparent that the continuation of Department activities at the existing levels would result in a significant end-of-year out-of-balance situation.

1. The Department expenditures for county fair personnel and operations exceeded the statutory appropriation caps. Rather than reduce or cancel scheduled county fair racing, the Department used \$103,600 from the general fund appropriation for county fair activities.
2. The Legislature approved a general fund salary increase for state employees but no funds were appropriated for the Department's County Fair Racing Fund and the Administration Fund. This legislation was introduced and enacted in the third quarter of the fiscal year and could not be anticipated earlier. Because most of the county fairs are scheduled during the second half of the year, this \$20,205 increase had to be absorbed by the Department.
3. The State increased the employee mileage reimbursement rates and hotels increased the lodging rates they charge the Department, but no additional funds were provided to account for this purpose. Because most of the county fairs are scheduled during the spring, and the Department's regulatory duties are in-state travel intensive, an additional \$16,220 was required to reimburse racing employees.

4. The Department experienced emergency computer programming needs for which funds were not available. To acquire replacement equipment and programming services, the Department required an additional \$16,260.

The initial potential deficit was \$156,585. This was reduced to \$55,585 by maintaining staff vacancies, ending off-duty police officer security contracts, limiting attendance at out-of-state conferences, continuing efficiency measures, and promoting website usage. The remainder was eliminated by establishing an alternative method of selecting animal samples for drug testing and reducing certain testing requirements for a brief period through June 30, 2006. This budget situation highlighted the problems we have been experiencing and communicating to the Legislature, the Commission, and the pari-mutuel industry for the past four years.

THE DEPARTMENT HAS REQUESTED FUNDING FOR INCREASED AUDITOR OVERSIGHT, TECHNOLOGY, AND COUNTY FAIR SUPPORT FOR FY 2008 AND FY 2009.

In August 2006, the Department submitted its budget and strategic planning documents for FY 2008 and 2009. It includes the following:

1. The Department needs more auditors and auditing resources to ensure the integrity of wagering.
2. Most of the Department's technology is outdated and antiquated.
3. The Department needs to support county fair racing with funds consistent with the higher revenue cap approved by the Legislature last year.

The House Appropriations, Transportation and Criminal Justice Committee did not support items number 1 and 2 above.

THE DEPARTMENT HAS REDEPLOYED EFFICIENCY SAVINGS TO CRITICAL REGULATORY OVERSIGHT.

During the FY 2002-2006 period, the Department implemented several initiatives that achieved a total of \$689,085 in efficiency savings. The Department's practice has been to redeploy the efficiency savings to other critical areas of operation. During the past four years, these savings have been used for employee salaries, benefits and retirement costs not funded by the Legislature; unfunded employee travel costs; increased security enforcement at permittee sites; increased racehorse drug testing; and improved and emergency technology.

Governor Napolitano's efficiency directive required agencies "to find practical and sensible ways for State agencies and State government as a whole to reduce costs, cut bureaucracy, eliminate duplication, and improve customer service." It is the Department's obligation and intent to continue to fully comply with this directive in every way possible. We will continue to respect the Governor's directive, monitor expenditures, generate savings, and conduct business consistent with our statutory and regulatory responsibilities.

HUMAN DRUG TESTING AND ENFORCEMENT

THE DEPARTMENT HAS INCREASED HUMAN DRUG TESTING, ENFORCEMENT, AND PENALTIES.

The Department of Racing may require licensees to submit to a drug test if there is a reason to believe that the individual is under the influence of or unlawfully in possession of a prohibited substance. This is one of the Department's most important responsibilities as it maintains the health, safety and integrity of the entire industry. An individual who uses or misuses a prohibited drug places not only himself at risk, but other individuals and the animals as well. The Department has the responsibility to monitor all permittee locations and OTB sites and properly enforce the laws of Arizona against all violations and will continue to do so in the future.

During the past four years, the Department has increased human drug testing, penalties, and enforcement activities and adopted a new Human Drug abuse Policy with the following provisions:

1. A first offense for a positive test shall result in a license suspension for up to six months and may result in a license suspension for up to one year.

2. A second offense for a positive test shall result in a license suspension for a minimum of one year and may result in a license suspension up to two years.
3. All offenses after the second positive test shall result in a license suspension for a minimum of two years and may result in additional suspension or license revocation without an opportunity to reapply for up to five years.
4. All drug abuse offenders shall be required to participate in an agency approved drug abuse program, sign a new drug agreement, and submit a negative drug test prior to reinstatement.
5. The Stewards may impose a fine up to \$1,000 for each offense, and the Director may reduce, accept, or increase the fine depending on the circumstances of the case.
6. The Stewards and the Director retain the authority and the prerogative to impose higher penalties to these guidelines if the situation requires.
7. All first-time and repeat offenders will receive a community service requirement.

DRUG-FREE ZONES HAVE BEEN ESTABLISHED AT ALL PERMITTEE LOCATIONS.

It is the Department's statutory and moral responsibility to ensure licensees, the wagering public, and animals are in a safe environment in which to conduct their business. The Department enhanced this commitment by establishing each of the permittee sites as a Drug-Free Zone. Consequently, new "Drug Free Zone" signs have been erected in permittee public areas, jockeys quarters, horsemen's offices, shed rows, kennel areas, grandstands, permittee entrances, and other appropriate areas for both the general wagering public and licensees to see. In addition, the Human Drug Abuse Policy has been provided in both English and Spanish to all permittees, horse and greyhound organizations, and Department employees for posting and distribution purposes, including the Department website.

A NEW DRUG SCREENING POLICY MANDATES PERMITTEES TO CONDUCT PRE-EMPLOYMENT DRUG TESTING

The Department of Racing is mandated by statute and rule to conduct background investigations and to fingerprint license and permit applicants. Fingerprint processing through the Arizona Department of Public Safety and the Federal Bureau of Investigation takes up to six weeks. The Department instituted procedural changes that have reduced the turn-around time, but in reality, an individual with prior criminal history who falsifies an application may be licensed to work at a racetrack until such time as the FBI report is returned and the Department makes a determination that the application has been falsified. The hearing and appeal process may extend the time the individual is still employed for several months, depending on the specific criminal history. This creates a risk for other licensees and the wagering public.

In 2005, a sample of 531 investigation files showed licensees who failed to disclose prior criminal history on their applications. These files showed 45% involved permittee employees, about 70% of the permittee employees worked for horse tracks, and 30% worked for greyhound tracks. Furthermore, 17% of the offenses were for drug-related crimes, 12% involved assault/aggravated assault incidents, and 10% included outstanding warrants and failure to appear warrants.

To prepare investigation reports, prepare and send notices of hearing, conduct hearings and prepare Director's rulings is a time consuming, labor intensive process for the Department. It involves special investigators, stewards, licensing staff, administrative support, the Director and assistance from the Attorney General's Office. The process is governed by statute and requires adequate notice; communication; evidence gathering; hearing preparation; conducting a hearing; decision-making; preparing an order; dissemination of the order; and administrative record-keeping.

This is a very important issue for the Department because there is significant data to show that the permittees have regularly hired employees who have serious criminal background histories. This problem is compounded by no permittee review of applicants' backgrounds prior to hiring. This creates an unsafe environment for all the tracks and OTBs that places the public, other permittee employees, and Department staff at risk, in addition to the real loss of financial assets and potential manipulation of the wagering system.

In order to more effectively manage this process and reduce the number of licensees who may have failed to disclose prior criminal history, the Department adopted a Permittee Pre-Employment Screening Policy. The policy requires the permittees to inform job candidates about the Department's requirements and to contract with a Department-approved company to conduct pre-employment drug screening of all employees who come in contact with animals or humans participating in live racing, who operate machinery, handle money, or serve or sell alcoholic beverages.

The new policy will enable the Department to do the following:

1. Reduce the likelihood of permittees hiring employees with criminal records.
2. Reduce the number of false applications, resulting in cost savings for the State.
3. Enable Department staff to be redeployed to other areas of administration, enforcement and regulation.
4. Reduce the risk of endangerment and liability for the permittees.
5. Strengthen the integrity of pari-mutuel racing.

ENFORCEMENT AND COMPLIANCE

SIGNIFICANT PROGRESS HAS BEEN MADE IN STRENGTHENING DEPARTMENT ENFORCEMENT AND COMPLIANCE POLICES, PERSONNEL, AND RESPONSIBILITIES.

The Department has restructured the Enforcement and Compliance Division with a professional law enforcement approach to conducting business. An impressive foundation of new policies, procedures, practices, and personnel supports the achievement of successful enforcement activities.

1. Assigned investigators to tracks for backside surveillance on dark days to ensure appropriate monitoring and to serve as a deterrent.
2. Instituted new practice to send all human drug test samples to Southwest Laboratories for confirmation of results.
3. Requested permittee daily security reports to be submitted to the Stewards and Director for review.
4. Developed a Department of Racing visitor pass to be provided to all visitors at permittee locations.
5. Reviewed personnel files of permittee security staff to ensure appropriate law enforcement credentials.
6. Instituted requirement that all permittee security licensees, including former law enforcement personnel, are fingerprinted to identify prior criminal history.
7. Developed access to the Arizona Criminal Justice Information System (ACJIS); identified a Department System Security Officer and trained staff to use system.
8. Introduced several fingerprinting procedures and scheduled FBI training to reduce the Arizona Department of Public Safety rejection rate to 5% from 35%.
9. Required Special Investigators to arrange time with trainers, stewards, and veterinarians to observe their daily routines, share information and maintain an open line of communication.

THE DIRECTOR HAS INCREASED REVIEW OF SERIOUS STATUTORY AND CODE VIOLATIONS.

Historically, the Director scheduled hearings once a month and heard only routine matters. The Director's monthly calendar contained an average of 12 cases which required minimal time. In an effort to ensure full compliance with the law, more hearings are scheduled each month, averaging about 30 cases. The 150% increase in caseload is because of increased enforcement of drug and alcohol-related offenses, greater attention to altercation cases, increased focus on prior criminal histories and greater oversight of unlicensed individuals. With greater enforcement, we are also seeing more respondents

represented by legal counsel. In addition, the appeal bond has been replaced with an appearance bond to facilitate the appeal process.

One of the reasons more Director hearings are conducted is because more Stewards' rulings are scheduled for a Director's review. These cases are reviewed because the Stewards' maximum authority to impose a fine or penalty (\$1,000 and/or 60 days suspension) is not sufficient discipline for serious violations. For example, the Stewards do not have the authority to revoke a license, and some cases warrant this action. In a Director's hearing, the respondents have another opportunity to present their case, testify, call witnesses, and provide evidence. This administration's practice has been to review all Stewards' rulings, focusing specifically on human drug violations, altercations, failure to disclose prior criminal history, and serious animal medication issues.

THE DEPARTMENT INTRODUCED A STRICTER POLICY FOR LICENSE APPLICANTS WHO FAIL TO DISCLOSE PRIOR CRIMINAL HISTORY.

The Department is responsible for maintaining the safety, security and integrity of pari-mutuel racing in Arizona. Failure to disclose criminal history in submitting an application to the Department is unacceptable. Individuals who misrepresent, for whatever reason, their background do not reflect positively on the industry. The Department has been diligent in monitoring these abuses and has increased enforcement action and penalties in this regard. Neither the Department nor the industry should tolerate criminal behavior. Individuals submitting false applications should be subject to a sanction, or should not be allowed to retain a license.

Since FY 2004, Director's hearings have been conducted for 465 individuals who failed to disclose their prior criminal history regarding arrests, outstanding warrants, convictions or pending criminal charges when submitting an application for a license. The omissions included felony and misdemeanor offenses such as assault, possession and sale of drugs/drug paraphernalia, receiving/possession of stolen property, theft/burglary, sexual misconduct, homicide, bookmaking, domestic violence, smuggling illegal aliens, driving while under the influence, etc. In many cases, there was more than one incident that was not revealed by the applicant. The failure to accurately and completely disclose this information is a serious violation.

It is hard to accept that an individual who was arrested and charged with the violations mentioned above, and who in many cases was fined, incarcerated, required to complete rehabilitation programs, or placed on probation, would fail to remember them for inclusion on the license application. The questions on the application are very clear and even highlighted in a separate section for response. To ignore these questions or falsely respond to them is unacceptable.

A NEW THREE-YEAR FINGERPRINT REQUIREMENT REVEALS UNDETECTED AND UNDISCLOSED PRIOR CRIMINAL HISTORY.

Historically, the Department has required license applicants to submit fingerprints every other three-year licensing cycle. This meant that many criminal incidents were undetected and not disclosed for up to six years. Consequently, the Department has increased its vigilance in conducting background investigations of license applicants and concluded that the current submission schedule was inadequate to meet our mission to protect racing participants, the wagering public and the State of Arizona.

The Department has adopted a new policy for fingerprint submission. The following are the guidelines:

1. Fingerprints will be submitted by applicants each three-year licensing cycle, effective January 1, 2008.
2. The Department will allow applicants to submit FBI-approved fingerprint cards from other racing jurisdictions or authorized law enforcement agencies.
3. The Department will continue to accept fingerprint submissions associated with an approved National Racing Compact license.
4. The Department will accept a valid Arizona DPS Fingerprint Clearance Card that has been issued in cooperation with state agencies who employ, license or certify individuals who have contact with children or vulnerable adults.

A NEW PENALTIES POLICY STRENGTHENS STATUTORY AND ADMINISTRATIVE CODE VIOLATIONS AND ENFORCEMENT.

Since FY 2003, the Director has experienced a 150% increase in the number of cases heard. In reviewing these types of cases, the Department has attempted to be fair and equitable by imposing consistent penalties. There were, however, no written guidelines for these serious violations, and a new policy was adopted to include the following:

- **Progressive Penalties.** Except in cases in which a summary suspension is made by the Board of Stewards, first time offenders may be suspended “up to” a period of time. This enables the Stewards and the Director to consider the circumstances of each case.
- **Flexibility for Rulings.** The policy provides flexibility for the stewards and the Director in making determinations depending upon the circumstances of each case; i.e. age of respondent, effect on other horse and greyhound owners and trainers, etc.
- **Education Requirement.** The policy includes an education requirement (e.g. anger management classes), where appropriate, for first-time and repeat offenders. This provides an opportunity for offenders to learn how to control their emotions and actions in various situations.
- **Community Service Requirement.** The policy includes a community service option for all first-time and repeat offenders. This provides an opportunity for offenders to make amends to the racing community for committing the offense.

LICENSING

THE LICENSING PROCESS IS MORE EFFICIENT AND CUSTOMER FRIENDLY.

The Department conducted a comprehensive review of the Department of Racing licensing process to develop a revised system that was effective and efficient for both customers and employees. The following is a summary of the improvements to date:

Customer Service

- Joined the National Racing Compact which increased license reciprocity.
- Redesigned the Department website to include licensing forms, procedures, licensing locations, fees, frequently asked questions, industry links and an on-line customer service survey.
- Provided bi-lingual information signage at all licensing locations.
- Provided complaint/suggestion boxes at all county fair sites.
- Established procedures for contacting licensees regarding non-compliance, hearings and rulings.
- Adopted a policy for licensing individuals hired for special events at permittee locations.

Licensing Database

- Purchased new equipment to stabilize licensing database.
- Worked with the Government Information Technology Agency (GITA) to develop a new licensing system that will eventually replace the current licensing database.
- Created databases for officials and stewards.

Licensing Staff Efficiency

- Instituted cross-training and software training for licensing employees.
- Evaluated positions, centralized jobs, redistributed assignments, and initiated position manuals.
- Developed forms, checklists, tracking systems and procedures to increase efficiency, streamline operations, and ensure accuracy and completeness.
- Provided additional equipment and furniture at field locations to enhance task performance and eliminate the need to move equipment from one field location to another.
- Brought in Department of Administration auditors to evaluate and make recommendations regarding internal controls.

A REVISED LICENSE APPLICATION PROVIDES INCREASED INFORMATION FOR REGULATORY PURPOSES.

As the Department has made efforts to improve the licensing application process, our staff noted that the license application was outdated and required revision. It did not include several of the required Arizona Administrative Code and Department policy revisions. The Department consequently revised the document to reflect the following changes:

- Includes new information about Workers' Compensation, citizenship, permanent address, cell phone number, and e-mail address to improve communications with licensees.
- Expands and clarifies prior criminal history questions to include reference to specific judicial actions and criminal violations.
- Provides a Notice of Incomplete License Application, with a comprehensive list of submission deficiencies and explains the review process to the applicant.

LICENSE APPLICATIONS WITH PREVIOUS SUSPENSIONS OR REVOCATIONS REQUIRE ADDITIONAL REVIEW.

All license applicants who have been suspended or revoked by the Director during the prior three years require additional review by the Department prior to final determination. This includes individuals who have been suspended or revoked for animal medication violations, individuals who have had a human drug violation, and individuals who failed to accurately and completely provide prior criminal history information.

PERMITTEE OVERSIGHT

THE COMMERCIAL PERMITTEE APPLICATION PROCESS IS MORE EFFICIENT AND CUSTOMER FRIENDLY.

Both the Department and the permittees worked together to improve the permit application process. The following changes were made to the application process:

- Revised the application form to eliminate unnecessary questions, rearrange the questions in an organized manner, and delete questions that are not relevant to racing.
- Revised the request for the submission of tax information, contracts, and other documents that have previously been submitted and are on file with the Department.
- Required the filing of affidavits regarding accuracy and completeness in lieu of initialing every page of the application.
- Revised the billing process to include monthly statements, additional details of costs, and a limitation on the total amount charged for review and investigation. In addition, a notice of financial responsibility is provided with the application.
- Allowed related corporate entities to consolidate information into one submittal.
- Accepted electronic or CD file of permit application.

THE DEPARTMENT CONDUCTS AN INTENSIVE AND EXTENSIVE ADMINISTRATIVE AND SUBSTANTIVE PERMITTEE APPLICATION REVIEW TO PROTECT RACING PARTICIPANTS AND THE WAGERING PUBLIC.

Another responsibility of the Department is to review all permit applications so the integrity of the pari-mutuel racing industry can be protected through regulatory means.

Conducting a thorough substantive review process is very important considering the applicants request permits that authorize the State of Arizona to approve multimillion-dollar commercial racing operations. Applications of this magnitude require extensive review and analysis before the Department is in a position to provide a recommendation to the Racing

Commission. The ultimate decision made by the Commission significantly impacts the pari-mutuel industry in Arizona plus several thousand people, their employees, and their families.

Historically, the Department had been a rubber stamp for permittee reviews and approvals. In 2003, the Department began conducting more extensive and substantive permit application reviews. The reviews now ensure the submission of all materials required by statute and code, with specific attention to three critical areas: financial position, business continuity and property/ownership structure.

Turf Paradise. In 2004, Turf Paradise improved its short-term and long-term financial position. by providing for capital infusion of \$2 million, increasing the equity by \$1.9 million, and increasing the annual cash flow by \$300,000.

Turf Paradise also assured the operation of the track for the term of the permit by providing the Department a \$300,000 bond to pay the state, purses, salaries, breeders, vendors and others in accordance with the statutory requirements; submitting a letter of intention to continue racing operations under normal conditions at the current location for the duration of the permit; and submitting a letter guaranteeing to notify the Department of any and all zoning and land use actions a minimum of 30 days in advance. The real estate essential to Turf Paradise's operations was also restructured in a manner that ensures ownership operational decisions without encumbrance.

In 2006, the Department concluded that Jerry Simms, Turf Paradise Owner, 1) is unfit to receive renewal applications based on his inappropriate and corrupt personal and business history; 2) that Simms established a dangerous pattern of disregard for the Department of Racing regulatory authority; 3) that Simms placed horsemen, racehorses, jockeys, other licensees and Department employees at physical risk by ignoring the timely and complete correction of health and safety property and operational problems; 4) that Simms continuously ignored and neglected stakeholder needs; 5) that Simms consistently failed to comply with the regulatory requirements of other state and local jurisdictions; 6) that Simms failed to act responsibly during the current permit term; 7) that Simms failed to comply with permit background investigation statutory requirements; and 8) that Simms revealed a personal relationship with the Racing Commission Chairman that creates an impression of impropriety. Although the Department recommended the application be denied, the Racing Commission approved a three-year permit without conditions or requirements for problems to be rectified.

Yavapai Downs. In 2005, the Department mandated the following additional requirements to protect racing participants and the wagering public:

1. The Yavapai financial relationship with Achieve Academy was restructured through formalized agreements to provide for committed reimbursement of management and financial services, rent, utilities and other expenses. In addition, these formalized agreements support financial projections documenting Yavapai's plan to reduce debt and increase cash flow.
2. Yavapai adopted a formal resolution that requires full disclosure and Board of Director approval of all related-party transactions in excess of \$10,000 and other transactions in excess of \$150,000.
3. Yavapai adopted a formal resolution that mandates no funds be borrowed from employees or relatives of employees without an adequate repayment plan and at a prevailing market rate of interest, approved by the Board of Directors.
4. Yavapai obtained confirmation from National Bank of Arizona to permanently waive the current ratio restructure covenant to avoid violation of its loan agreement.
5. Concerns about the condition of the Yavapai Downs track were addressed with continued oversight, increased maintenance, and regular communications with horsemen organizations, jockey representatives, and the Department.
6. Yavapai adopted formal rules, regulations, and policies to ensure the separation and protection of Achieve Academy students under the age of 16 during the racing season.

Phoenix Greyhound Park/Apache Greyhound Park. The review of the Phoenix Greyhound Park and Apache Greyhound Park permit applications included no issues or significant areas of concern. It was noted that the Company's financial presentation was strong, there was a strong management team in place, and profits were positive.

Tucson Greyhound Park. In 2005, the review noted that TGP shareholders had never filed Arizona individual income tax returns and C&Z Management, L.L.C. had never filed Arizona partnership income tax returns. The shareholders communicated their desire to properly address this issue and to be in compliance with all appropriate Arizona tax laws. Consequently, TGP submitted documentation that they are working with the Arizona Department of Revenue to clarify and rectify any outstanding Arizona tax issues.

THE ANNUAL REVIEW OF THE PERMITTEE FINANCIAL STATEMENTS HAS REVEALED TRACK OWNERS ARE PROFITING MILLIONS OF DOLLARS A YEAR.

Turf Paradise. The total racing earnings to the Turf Paradise partners since 2001 was \$10.6 Million. In 2006, Turf Paradise's net income was \$2.95 Million. In addition, Turf Paradise has received a total of \$12.5 Million in tax credits and tax exemptions from the State of Arizona during the past six years.

Yavapai Downs. Yavapai Downs has experienced a total loss of \$33,219 during the past six years. In addition, Yavapai Downs has received a total of \$3.45 Million in tax credits and tax exemptions from the State of Arizona during the past six years.

Rillito Park. Rillito Park has experienced a total loss of \$39,376 over the last six years. In addition, Rillito Park has received a total of \$86,100 in tax credits and tax exemptions over the last six years.

Phoenix Greyhound Park. The management fee paid to Phoenix Greyhound Park's ownership corporation, Delaware North Corporation, was \$8.1 Million since 2001. In 2006, American Greyhound Racing, Inc., for Phoenix Greyhound Park net income was \$312,000. In addition, Phoenix Greyhound Park has received a total of \$18.5 Million in tax credits and tax exemptions from the State of Arizona during the past six years.

Tucson Greyhound Park. The total management fee paid to Tucson Greyhound Park's owners through a contract with ZapCon over the past six years was \$2.2 Million. In addition, Tucson Greyhound Park has received a total of \$7.6 Million in tax credits and tax exemptions from the State of Arizona during the past six years.

A NEW ADMINISTRATIVE POLICY REQUIRES SUFFICIENT TIME FOR DEPARTMENT PERMITTEE REQUEST REVIEW AND DETERMINATION.

The Department identified operational, statutory and customer service issues relating to requests from permittees for permit amendments, changes in officials, adding/deleting races and changes in wagering formats. The issues resulted from last-minute requests that did not allow sufficient time for thorough and accurate Department review.

Historically, the Department approved these requests as soon as possible following the receipt of the request. Because of limited staff, increased workloads and enhanced regulatory activities, Department staff could not process these requests as quickly as in the past. The Department experienced the following challenges:

- Adequate staff time was not available to thoroughly review the request a day or two before the need. Some requests required review by several individuals, including the Attorney General's Office.
- Rushing to prepare responses opened the door for errors and incomplete review of the request. Some requests had been received on Friday for weekend implementation.
- Sufficient background and reasons for the request were not always provided with the request. This information was very important for the Department to make a determination.

Consequently, the Department developed a new Permittee Requests Policy that provides general guidelines for requests submitted for both Department of Racing and Racing Commission consideration and identifies exceptions to the general timeframes. Timeframes set for a specific type of request by statute, rule, or policy and procedure, supersede the general policy.

OTB OVERSIGHT

THE DEPARTMENT HAS INCREASED REGULATION OF OTB OPERATIONS.

One of the Department's major responsibilities is to review, approve, and oversee all OTBs and conduct periodic inspections to ensure full compliance with all statutes and regulations. OTBs are an extension of the pari-mutuel racing activities at the permittee locations, and the Department must be diligent in its oversight of the conditions, operation, and personnel involved in the activities.

A review of prior criminal history cases revealed a significant number of OTB licensees who failed to disclose their prior criminal history on their applications. Consequently, the Department created an OTB application for consistent, complete and accurate information to be submitted by permittees. In addition, OTB recommendations submitted to the Commission now include relevant Department of Liquor information, report of on-site inspections, photographs and layout design of the property and facility, plan of operation, and written approval of local governing body.

The Department needs more auditors to ensure the integrity of wagering at OTB locations. The two current auditor positions cannot effectively monitor all the tracks and wagering locations. Consequently, there is inadequate oversight of more than 80 OTBs. During the past year, the Department has been made aware of incidents of internal theft and corruption. In addition, since 2005, the Department has brought to hearing and sanctioned several OTB employees who failed to disclose prior criminal history on their license applications. These individuals have been arrested for serious crimes including drug-related offenses, assaults, domestic violence, property damage, obstruction of justice, outstanding warrants, fraud and larceny, prostitution, and DUIs.

The Department has required permittees to do the following:

- Inform the Department immediately of any calls to law enforcement agencies for incidents that occur at an OTB site. This should include those that occur within the OTB operation and any other location on the property.
- Provide a written report to the Department within 48 hours, including actions taken by the permittee, police reports, and any internal reports relating to the incident.
- Consider personnel actions for any OTB employee at the location who may have contributed to the offense by not following appropriate policies and procedures, including reimbursement of funds, suspension, or termination.
- Provide the Department of Racing all policies and procedures for the operation of OTB sites.
- Schedule orientation and periodic education sessions for all OTB employees.

FINDINGS AND RECOMMENDATIONS

PARI-MUTUEL OVERSIGHT PROGRAM

Recommendation 1. To improve tote testing, the Department should:

- a. Train its pari-mutuel auditors on general audit practices and how to conduct tote system testing under net pool pricing.
- b. Identify and implement ways to reduce the reliance on manual calculations, such as using testing booklets or spreadsheets.
- c. Complete the development of the pari-mutuel auditing policies and procedures manual and implement it. The Department should ensure that it contains specific guidance for tote testing under both standard and net pool pricing.

Racing Department Response. The finding of the Auditor General is agreed to and the audit recommendations will be implemented.

Recommendation 2. The Department should work with the Legislature to obtain statutory authority to license tote companies.

Racing Department Response. The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Recommendation 3. If the Department obtains statutory authority to license tote companies, it then should:

- a. Modify its administrative rules to identify tote companies as a license category.
- b. Include in its administrative rules specific requirements associated with the tote company licensure as recommended in ARCI's proposed additions to its pari-mutuel wagering Model Rules.
- c. Include in its administrative rules for tote company licensure a requirement for a Type II SAS 70 or similar review.

Racing Department Response. The finding of the Auditor General is agreed to and the audit recommendations will be implemented.

Recommendation 4. To improve how it monitors tote system security, the Department should:

- a. Work toward incorporating other aspects of the proposed additions to the ARCI Model Rules, including those related to reviewing and programming changes and access controls, into its administrative rules.
- b. Review ARCI's recommendations related to programming changes, access controls, system security, and other IT control areas, and generally become more familiar with standard IT audit practices.
- c. Incorporate these recommended practices into its pari-mutuel auditing work.

Racing Department Response. The finding of the Auditor General is agreed to and the audit recommendations will be implemented.

Recommendation 5. To improve monitoring of wagering systems for potential anomalies, the Department should explore the feasibility of adopting automated systems. Specifically, the Department should explore the feasibility of implementing the ESI Integrity or RCI Integrity system in Arizona.

Racing Department Response. The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Recommendation 6. The Department should explore expanding its scope of financial analyses of the monies wagered in Arizona to strengthen oversight of the distribution of handle to parties that are entitled to a portion of it.

Racing Department Response. The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

ANIMAL DRUG TESTING PRACTICES

Recommendation 1. The Department should continue to move forward to align its drug-testing practices with the Model Rules, and seek consensus with the industry in areas where there are concerns.

Racing Department Response. The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Recommendation 2. Once finalized, the Department should put its new equine drug testing policy and penalties into administrative rule instead of solely in department policy.

Racing Department Response. The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

SUNSET FACTORS

Racing Department Response. The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Performance Audit Division reports issued within the last 24 months

05-02	Department of Administration— Financial Services Division	05-16	Department of Revenue Sunset Factors
05-03	Government Information Technology Agency (GITA) & Information Technology Authorization Committee (ITAC)	06-01	Governor’s Regulatory Review Council
05-04	Department of Economic Security—Information Security	06-02	Arizona Health Care Cost Containment System— Healthcare Group Program
05-05	Department of Economic Security—Service Integration Initiative	06-03	Pinal County Transportation Excise Tax
05-06	Department of Revenue—Audit Division	06-04	Arizona Department of Education—Accountability Programs
05-07	Department of Economic Security—Division of Developmental Disabilities	06-05	Arizona Department of Transportation—Aspects of Construction Management
05-08	Department of Economic Security—Sunset Factors	06-06	Arizona Department of Education—Administration and Allocation of Funds
05-09	Arizona State Retirement System	06-07	Arizona Department of Education—Information Management
05-10	Foster Care Review Board	06-08	Arizona Supreme Court, Administrative Office of the Courts—Information Technology and FARE Program
05-11	Department of Administration— Information Services Division and Telecommunications Program Office	06-09	Department of Health Services—Behavioral Health Services for Adults with Serious Mental Illness in Maricopa County
05-12	Department of Administration— Human Resources Division	07-01	Arizona Board of Fingerprinting
05-13	Department of Administration— Sunset Factors		
05-14	Department of Revenue— Collections Division		
05-15	Department of Revenue— Business Reengineering/ Integrated Tax System		

Future Performance Audit Division reports

Arizona Department of Transportation—Highway Maintenance

Arizona School Facilities Board