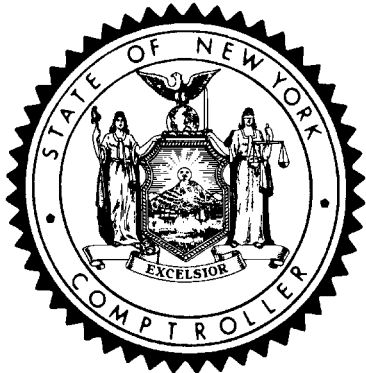


State of New York
Office of the State Comptroller
Division of Management Audit

**NEW YORK CITY OFF-TRACK
BETTING CORPORATION**

**STAFF STUDY: ALLOCATION OF
ADMINISTRATIVE OVERHEAD AND
ITS EFFECT ON BRANCH
PROFITABILITY**

REPORT 96-N-10



H. Carl McCall
Comptroller



State of New York Office of the State Comptroller

Division of Management Audit

Report 96-N-10

Mr. Allie Sherman
President
New York City Off-Track Betting Corporation
1501 Broadway, 10th Floor
New York, NY 10036-5575

Dear Mr. Sherman:

The following is our staff study of the New York City Off-Track Betting Corporation's method of allocating administrative overhead for fiscal year 1995 and its effects on branch profitability.

We did this study according to the State Comptroller's authority as set forth in Article 10, Section 5 of the State Constitution and Article 3, Section 33 of the General Municipal Law. We list major contributors to this report in Appendix A.

*Office of the State Comptroller
Division of Management Audit*

April 3, 1997

Executive Summary

New York City Off-Track Betting Corporation Staff Study: Allocation Of Administrative Overhead And Its Effect On Branch Profitability

Scope of Study

The New York City Off-Track Betting Corporation (OTB or Corporation) was created by the State Legislature. Its statutory authority is defined in Article VI, Section 603 of the Racing, Pari-Mutuel Wagering and Breeding Law. It is a public benefit corporation established to operate an off-track pari-mutuel betting system in New York City. Its primary purposes are to obtain a reasonable revenue for the support of government, and to prevent and curb unlawful bookmaking and illegal wagering on horse races. In fiscal year 1995, OTB reported total revenue of \$198 million and total expenses of \$99.8 million, including \$21.4 million of administrative overhead.

Our study addressed the following questions about the New York City Off-Track Betting Corporation's method of allocating administrative overhead for fiscal year 1995 (July 1, 1994 through June 30, 1995):

- Does the Corporation properly allocate administrative overhead expenses when it determines the profitability of its branches?
- Does OTB's calculation of administrative overhead include expenses that should be charged directly to branches?

Study Observations and Conclusions

The New York City Off-Track Betting Corporation's calculation of administration overhead includes all expenses that are not charged directly to individual branches. These costs are then allocated to each branch in proportion to the branch's operating revenue. We found that this methodology is recognized as an acceptable practice. However, we noted that the allocation of administrative overhead based on sales or revenue results in a disproportionate amount of overhead to the more-profitable branches and tends to mask the performance of unprofitable branches. In effect, the more-successful revenue-generators subsidize the less-profitable branches.

To obtain an additional perspective on branch profitability, we used an alternative method, reallocating administrative overhead based on branch expenses which is also a generally accepted methodology. OTB's Fiscal Year 1995 Branch Profitability Report indicated that just one of its 83 branches was unprofitable; but our analysis, based on our alternative method of calculation, indicated that 17 of those branches were unprofitable. We believe that applying our alternative method can alert management to the possibility that certain branches may be unprofitable and may need greater management

attention. OTB indicated that it will “explore a number of other methods of allocating overhead.” At the time of our audit, OTB’s computer system could not specifically identify the expenses that should be included in administrative overhead. According to OTB officials, a new computerized system, currently being installed, will both improve the Corporation’s reporting capabilities and provide it with more flexibility in data presentation. (See pp. 3-5)

**Comments of
Corporation
Officials**

Draft copies of the matters contained in this report were provided to Corporation officials for their review and comment. Their comments have been considered in preparing this report. OTB officials responded that “The allocation of administrative overhead based upon the amount of operating revenue earned by each cost center is the best method for reviewing the profitability of the Corporation.” However, they also stated that OTB will “explore a number of other methods of allocating overhead.”

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Appendix A	Major Contributors to This Report
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Introduction

Background

The New York City Off-Track Betting Corporation (OTB or Corporation) was created by State law as a public benefit corporation to operate an off-track pari-mutuel betting system in New York City. Its statutory authority is defined in Article VI, Section 603 of the Racing, Pari-Mutuel Wagering and Breeding Law. Its primary purposes are to obtain revenue for the support of government, and to prevent and curb unlawful bookmaking and illegal wagering on horse races. Another objective is to ensure that off-track betting is conducted in a manner compatible with the well-being of the horse racing and breeding industries in this state. In fiscal year 1995, OTB reported total revenue of \$198 million and total expenses of \$99.8 million, including \$21.4 million of administrative overhead.

In the same year, after making mandated distributions to the racing industry, local governments where the races originated, and New York State, OTB provided \$22.9 million to New York City. A 5-percent surcharge (or tax) imposed on winning wagers accounted for \$19.4 million of this amount; the remaining \$3.5 million consisted of residual revenues or actual OTB profits.

On April 4, 1996, and May 25, 1996, OTB permanently closed two branches that had been performing poorly. In July 1996, it had 75 branch offices throughout the five boroughs, as well as three teletheatres and a telephone betting center that operates out of corporate headquarters. In November 1996, the Corporation closed four additional branches.

Study Scope, Objectives and Methodology

One of our objectives was to determine whether OTB had allocated administrative overhead properly when it calculated the profitability of its branches. Another was to ensure that OTB's calculation of administrative overhead did not include expenses that should have been charged directly to branches. Our study focused on the allocation of overhead for fiscal year 1995 (July 1, 1994 through June 30, 1995).

To accomplish these objectives, we reviewed OTB's policies and procedures and the Fiscal Year 1995 Branch Profitability Report. To ensure that administrative overhead did not include expenses that should have been charged directly to branches, we judgmentally selected three branches to determine whether salaries, rent, and real estate taxes had been charged correctly to the branches.

Comments of Corporation Officials

Draft copies of the matters contained in this report were provided to Corporation officials for their review and comment. Their comments have been considered in preparing this report and have included them as Appendix B.

OTB officials responded that “The allocation of administrative overhead based upon the amount of operating revenue earned by each cost center is the best method for reviewing the profitability of the Corporation.” However, they also stated that OTB will “explore a number of other methods of allocating overhead.”

Within 90 days after final release of this study, the President of the New York City Off-Track Betting Corporation should report to the State Comptroller, advising what actions were taken by Corporation management in response to the observations made and issues raised in the study.

Method of Allocating Administrative Overhead

The broad objective for allocating costs is to provide management with a tool for cost control and income measurement. Expenses that cannot be identified with a specific cost center can be allocated by several widely-recognized methods, including allocations based on sales or costs. OTB calculates administrative overhead as the total of all corporate expenses minus all expenses that are charged directly to its individual branches. Administrative overhead is then allocated to each branch according to its operating revenue — that is, net revenue less branch expenses and mandated distributions to the racing industry and New York State.

OTB's allocation of overhead based on sales or revenue, while recognized as an acceptable practice, distributes a disproportionate amount of overhead to the more-profitable branches and tends to mask the performance of unprofitable branches. Branches with high operating revenue absorb more overhead expenses than do branches with low operating revenue. In effect, the larger revenue-generators subsidize the less profitable branches. For example, OTB will assign 2 percent of administrative overhead to a branch that generates 2 percent of its revenues.

To obtain an additional perspective on branch profitability, we used an alternative method, reallocating administrative overhead based on branch expenses. OTB's Fiscal Year 1995 Branch Profitability Report indicated that just one of its 83 branches was unprofitable; but our analysis, based on our alternative method of calculation, indicated that 17 of those branches were unprofitable. The contrasting results of the two methods are illustrated in the following table:

**Impact of Allocation Method on Branch Profitability
Fiscal Year 1995**

Branch Number	(a) Operating Revenue per OTB Branch Profitability Report	Administrative Overhead		Branch Profitability	
		(b) OTB Allocation Based on Operating Revenue	© OSC Allocation Based on Branch Expenses	(a-b) Allocated Based on Operating Revenue	(a-c) Allocated Based on Branch Expenses
11	(\$34,455)	\$1,321	\$156,068	(\$35,776)	(\$190,523)
67	246,969	112,663	390,117	134,306	(143,148)
*7	80,350	37,599	201,279	42,751	(120,929)
114	76,147	39,837	195,636	36,310	(119,489)
**179	46,734	24,848	149,366	21,886	(102,632)
84	169,714	79,159	234,730	90,555	(65,016)
128	122,799	57,046	187,409	65,753	(64,610)
182	143,289	66,089	196,739	77,200	(53,450)
130	160,864	75,525	202,384	85,339	(41,520)
***150	126,257	58,000	167,292	68,257	(41,035)
107	154,348	73,449	194,205	80,899	(39,857)
65	119,847	54,613	150,154	65,234	(30,307)
33	220,757	105,773	240,600	114,984	(19,843)
171	162,864	72,569	179,055	90,295	(16,191)
***29	162,950	78,379	175,680	84,571	(12,730)
60	143,533	65,344	156,180	78,189	(12,647)
106	171,677	81,270	183,374	90,407	(11,697)

* Branch No. 7 was closed in April 1996.

**Branch No. 179 was closed in May 1996.

*** Branches No. 150 and 29 were closed in November 1996.

We do not suggest that branches should be closed merely because they appear to be unprofitable under this analysis. As OTB officials indicated in their response, many factors must be considered when determining the viability of a branch, including the demographic trends in the neighborhood surrounding the branch, the length and terms of the lease, and the physical condition of the facility. However, we believe that this additional allocation method can enable management to identify potentially-unprofitable branches, which can then be analyzed more carefully and be given greater management attention. In fact, four of the 17 branches shown in the table have since been closed.

OTB officials responded that “The allocation of administrative overhead based upon the amount of operating revenue earned by each cost center is the best method for reviewing the profitability of the Corporation.” However, the response also stated that OTB will “explore a number of other methods of allocating overhead” after it completes the installation of a new computerized financial system. We believe OTB management should have several perspectives on branch profitability using expense-based and revenue-based allocation methodologies.

Issue To Be Considered

1. Should the New York City Off-Track Betting Corporation management consider using an overhead allocation methodology based on branch expenses and be provided with an additional measure of branch profitability?

Verification of Overhead Charges

OTB officials advised us that the calculation of its administrative overhead is based on a computer program that adds up all expenses, and then subtracts expenses that are charged directly to individual branches. Because OTB is not able to update its current computer program, some complicated manual calculations and journal entries had to be made to determine the final overhead figure. The officials indicated that the computer does not provide an audit trail to support the overhead calculation. As a result, OTB could not provide us with a list of the specific items included in overhead, and we were unable to verify the reported administrative overhead amount on the Fiscal Year 1995 Branch Profitability Report. OTB officials advised us that the Corporation is in the process of installing a new computerized financial system that “will greatly improve both the reporting capabilities and the flexibility of how the data is presented and it will greatly eliminate the need for manual calculations.” In response to our draft report, OTB officials also indicated that, “as there has been in the past, there will be an adequate audit trail to support future overhead calculations.” We are pleased to note that OTB has taken action to improve the audit trail supporting its calculations of overhead. However, based upon the results of our study, we continue to believe that the system in place at the time of our fieldwork did not provide adequate support for OTB’s overhead calculations.

To ensure that administrative overhead did not include expenses that should be charged directly to branches, we judgmentally selected three branches (Branch No. 11, Branch No. 179, and the Telephone Betting Operations) to determine whether salaries, rent, and real estate taxes — the most material branch expenses — were charged correctly to the branches.

The costs attributable to certain headquarter-based services, such as training, custodial services, and administrative support for branch operations, are charged directly to branch operations. We also tested to determine whether these costs had been allocated properly to the sampled branches. Except for some immaterial differences, our limited testing verified that all of the tested expenses had been charged correctly to the branches.

For example, by tracing the expenses from the Branch Profitability Report to the General Ledger and comparing them with the actual checks paid and the journal entries made for accrued expenses, we verified that the rent and real estate taxes for branches No. 11 and No. 179 had been charged correctly for fiscal year 1995.

We also reviewed the calculations for Telephone Betting Operations (TBO), whose employees share space with OTB headquarters staff at 1501 Broadway. TBO’s rent and real estate taxes are calculated based on the square footage

of office space it occupies, but since OTB had maintained TBO's space utilization data only for the month of June 1995, we were able to verify the allocated rent and real estate expenses only for that one month.

We did verify that OTB had charged payroll expenses correctly to the three sample branches as well as the direct support departments for June 1995, but we could not review Payroll Expense Summary reports for the previous months in fiscal year 1995 because they had been discarded.

Issue To Be Considered

2. Does the new accounting system software provide an audit trail to support the overhead calculation and eliminate the need for manual calculations?

Major Contributors to This Report

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October 28, 1996

Ms. Christine Chu
Office of the State Comptroller
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Re: Preliminary - Report of A-2-97
Determination of Branch Profitability and Allocation of Overhead

Dear Ms. Chu,

Introduction

I have reviewed your preliminary audit report # A - 2 - 97 titled, "Allocation of Overhead and Determination of Branch Profitability." The report examined the acceptable method of allocating administrative overhead which is presently used by NYCOTBC and offers an alternative method for future study. I will discuss each point of your letter of October 11, 1996 and present the Corporation's reply.

New York City Off-Track Betting Corporation (OTB) was created in 1970 by the State Legislature under Article V: Section 518 which states the objective of Off-track pari-mutuel betting as: " it being the purpose of this article to derive from such betting, as authorized by this article, a reasonable revenue for the support of government, and to prevent and curb unlawful bookmaking and illegal wagering on horse races. It is also the intention of this article to ensure that off -track betting is conducted in a manner compatible with the well-being of the horse racing and breeding industries in this state, which industries are and should continue to be major sources of revenue to the state and local governments and sources of employment for thousands of state residents." This threefold purpose for OTB is not properly reflected in this preliminary report.

Alternative Methods of Allocating Administrative Overhead

The New York City Off-Track Betting Corporation has examined various methods of allocating administrative overhead to its cost centers: the 75 branch offices; three teletheaters; and the telephone betting center. The allocation of administrative overhead based upon the amount of operating revenue earned by each cost center is the best method for reviewing the profitability of the Corporation. Operating Revenue takes into consideration the net handle of the branch less the branch expenses and legislatively mandated distributions to the racing industry, local

governments and New York State. By using operating revenue as the standard in allocating administrative overhead, it results in a more accurate picture of the operating results of each branch office. The branch's profitability should be primarily judged on its handle less direct expenses and legislatively mandated distributions. A branch's profitability is the first but not the only consideration in determining the future business viability of that particular facility. Management must examine the demographic trends in the market that a particular branch serves, the physical conditions of the facility with the anticipated capital expenditures necessary to upgrade the branch to maintain the present customer base and to attract new bettors, the length and terms of the lease and the projected future configuration of the branches in that Borough. After reviewing all these factors, Management determines whether a branch fits into the future business plans of the Corporation. As we discussed at our last meeting, OTB has conducted such a review and has determined that four branches should be closed in the present Fiscal Year.

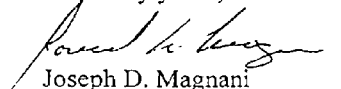
It should be pointed out that a branch has neither control nor influence on the amount of corporate overhead that it is allocated. It is inferred by your report that if a branch becomes unprofitable after the allocation of overhead then it should be closed in order to increase the profitability of the Corporation. This assumes that the expenses (fixed, operational and allocated overhead) attributable to the branch would terminate with the closing of the branch. This would not be the case with administrative overhead expenses since they are incurred on a corporate level, and if an unprofitable branch is closed, the overhead expenses would be reallocated to other branches and would only reduce the profitability of the remaining facilities.

Verification of the Accuracy of Overhead Allocations

As we have informed you, OTB is in the process of installing a new computerized financial system which will include a branch profitability section. This new system will greatly improve both the reporting capabilities and the flexibility of how the data is presented and it will greatly eliminate the need for manual calculations. Once this new computerized financial package is operational, it is the Corporation's intention to explore a number of other methods of allocating overhead. While our present method of allocating overhead has been deemed acceptable by internal and external auditors, the New York City's Comptroller, the New York State Racing and Wagering Board, and various other State and City officials, we are constantly examining different methods of reviewing the profitability of the Corporation.

On behalf of the Corporation, I would like to express our appreciation for the work done by your auditors in examining our method of administrative overhead allocation.

Sincerely yours,



Joseph D. Magnani

cc: Robert L. Flusser, OTB