Internal Audit Report

Lease & Concession Audit

HMS Host

Food and Beverage Agreement (#435)
& Duty Free Agreement (#436)

January 1, 2009 – December 31, 2011

Issue Date: October 1, 2013
Report No. 2013-12

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Transmittal Letter

Audit Committee
Port of Seattle
Seattle, Washington

We have completed an audit of the lease and concession agreements with HMS Host (formerly Host International).

We reviewed information relating to the lease and concession agreements with HMS Host from January 1, 2009 – December 31, 2011.

We conducted the audit in accordance with Generally Accepted Government Auditing Standards and the International Standards for the Professional Practice of Internal Auditing. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We extend our appreciation to the staff of Aviation Business Development and Accounting and Financial Reporting for their assistance and cooperation during the audit.

Kirangi

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Executive Summary

Audit Scope and Objective The purpose of the audit was to determine whether:

1. The reported concession is complete, properly calculated, and remitted timely.
2. The lessee complied with significant provisions of the lease and concession agreements.

The scope of our audit covered the period from January 1, 2009 – December 31, 2011.

Background HMS Host operates a food and beverage concession at Sea-Tac International Airport. Although the agreement is between HMS Host and the Port, HMS Host also uses seven subtenants (Airport Concessionaire Disadvantaged Business Enterprises (ACDBE)) to carry out the service of this concession agreement. While the concession agreement allows subleasing with Port's consent, the Port is not a party to such sublease agreements.

Until August 2011, Host also operated a duty-free concession for the Port. Both the food and beverage concession and the duty-free concession agreements require a specific percentage of gross receipts be paid to the Port. The concession fee depends on the category of the gross receipts, including: non-branded food and beverage, branded food and beverage, alcohol, advertising, and merchandise.

Audit Result Summary HMS Host did not properly report the concession owed to the Port. Specifically, certain concession amounts were reported at the lower branded food and beverage concession rate when the gross receipts did not meet the criteria defined by the agreement. In addition, HMS Host did not provide the auditor with the requested accounting records and did not provide documents in a reasonable timeframe.

Background

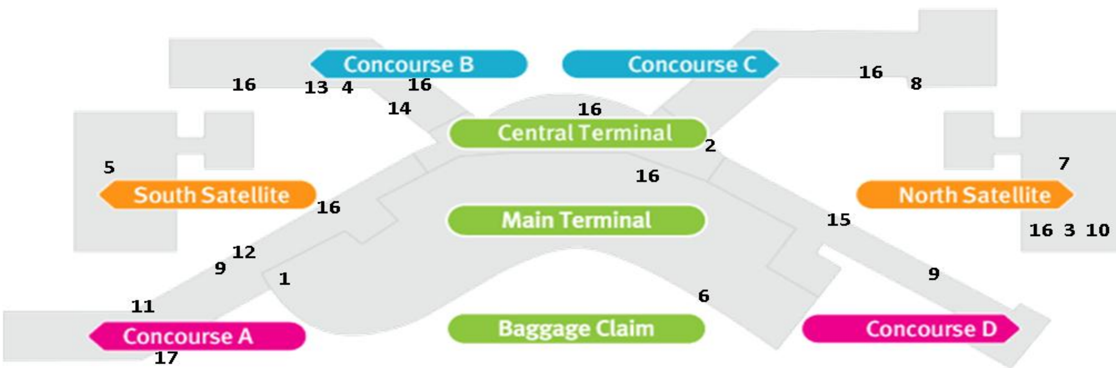
HMS Host operates a food and beverage concession at Sea-Tac International Airport. Although the agreement is between HMS Host and the Port, HMS Host uses seven subtenants (including Airport Concessionaire Disadvantaged Business Enterprises (ACDBE)) to carry out the service of this concession agreement. While the concession agreement allows subleasing with Port's consent, the Port is not a party to such sublease agreements.

Until August 2011, Host also operated a duty-free concession for the Port. Both the food and beverage concession and the duty-free concession agreements require a specific percentage of gross receipts be paid to the Port. The concession fee depends on the category of the gross receipts, including: non-branded food and beverage, branded food and beverage, alcohol, advertising, and merchandise.

HMS Host and its subtenants operate the following locations at Sea-Tac International Airport:

Current HMS Host Food & Beverage Locations

Seattle-Tacoma International Airport



HMS Host Locations			
1*	Africa Lounge	10	Great American Bagel Bakery
2	Alaska Lodge	11*	La Pisa
3	Burger King	12*	Manchu Wok
4	Casa del Agave	13*	Quiznos
5	Dungeness Bay Seafood House	14	Sbarro
6*	Diva Espresso	15	Sports Page Pub
7	Seahawks 12 Club	16	Starbucks (7 locations)
8	Freshens	17*	Coffee Bean & Tea Leaf
9*	Great American Bagel Bakery (2 locations)		
** Subtenant Operated*			

Both lease and concession agreements state that minimum rent payments are due on the 1st of each month. The concession fee is due on the 15th of the following month, along with a statement of gross receipts for the previous month. There are provisions for late fees and interest, if the payment is not received within a 10-day grace period.

The figures below summarize the concession revenue received from HMS Host related to the food and beverage and duty-free lease agreements.

Concession Revenue Received (in thousands)
January 1, 2009 – December 31, 2011

	2009	2010	2011
Food & Beverage Agreement (#435)			
Branded Food	$2,466	$2,591	$3,050
Non-Branded Food	$930	$976	$805
Alcohol	$1,020	$1,097	$1,093
Merchandise	$97	$121	$147
Total Food and Beverage Agreement	**$4,513**	**$4,785**	**$5,095**
Duty Free Agreement (#436)			
Advertising	$7	$17	$11
Duty Free and Tax Paid	$1,479	$1,909	$1,199
Total Duty Free Agreement	**$1,486**	**$1,926**	**$1,210**
Grand Total for Both Agreements	**$5,999**	**$6,711**	**$6,305**

Source: PROPWorks

Audit Scope and Methodology

We reviewed information for the period from January 1, 2009 – December 31, 2011. We utilized a risk-based audit approach from planning to the testing phase. We gathered information through research, interviews, observations, and analytical reviews, in order to obtain a complete understanding of the HMS Host lease and concession agreements.

We applied additional detailed audit procedures to areas with the highest likelihood of significant negative impact as follows:

1. Completeness of Reported Revenue

   We reviewed the lessee's financial records including point-of-sale data, general ledger, bank/deposit records, and gross receipts reported to the Port. We selected one week of sales from August 2009, August 2010, and August 2011 for a total of three weeks. The testing period involved four HMS Host-operated food and beverage locations, two subtenant-operated food and beverage locations, and one HMS Host-operated duty-free location. We traced the revenue from the point-of-sale to the general ledger to the deposit records to the revenues reported to the Port.

2. Timely Submission of Rent and Concession Payments

   We reviewed the Port's records to determine whether the rent and concession payments were received on time. In the event that payments were received later than the ten-day grace period identified in the lease and concession agreements, we calculated the expected interest and finance charge, if it had not been assessed.

3. Compliance with Branded Food & Beverage (Branded Food) Reporting Requirements

   We identified the requirements for reporting concession revenue at the lower Branded Food concession rate. We reviewed franchise agreements and lessee documentation of royalty payments, to determine whether the locations reporting Branded Food during the audit period met the criteria for the Branded Food rate.

4. Compliance with Insurance Requirements

   We identified the insurance coverage required by the food and beverage agreement for the audit period and determined whether the lessee had maintained sufficient coverage and submitted evidence to the Port in accordance with the agreement.

5. Compliance with Letter-of-Credit Requirements

   We identified the letter-of-credit amounts required by the food and beverage agreement for the audit period and determined whether the lessee had obtained the appropriate letter-of-credit and submitted evidence to the Port in accordance with the agreement.

6. Compliance with Annual Reporting Requirements

   We identified the annual reports required by the food and beverage agreement for the audit period and determined whether the lessee had submitted the reports to the Port in accordance with the agreement.

7. Compliance with Disadvantaged Business Enterprise Requirements

   We identified the disadvantaged business enterprise requirements for the food and beverage agreement for the audit period and determined whether the lessee had submitted the required information to the Port in accordance with the agreement.

Conclusion

HMS Host did not properly report the concession owed to the Port. Specifically, certain concession amounts were reported at the lower branded food and beverage concession rate when the gross receipts did not meet the criteria defined by the agreement. In addition, HMS Host did not provide the auditor with the requested accounting records and did not provide documents in a reasonable timeframe.

Schedule of Findings and Recommendations

1. HMS HOST DID NOT USE THE CORRECT CONCESSION RATE, RESULTING IN AN ADDITIONAL $635,704 OWED TO THE PORT

The lease and concession agreement allows a lower concession fee for Branded Food and Beverage (Branded Food) locations, provided that certain requirements are met. Port management is responsible for reviewing and approving eligibility for the Branded Food concession rate.

The first amendment to the lease agreement was executed December 22, 2005. It states:

> *…"Branded Food and Beverage" shall mean a food and beverage facility operated by a franchisee or licensee that pays an initial fee for the right to use the franchisor's or licensor's trademark and/or trade name and <u>pays the franchisor or licensor not less than (3%) of gross sales per year.</u> The franchisee or licensee must provide the Port and Lessee a copy of the franchise or license agreement to substantiate that the franchisee or licensee is operating as a bona fide franchisee or licensee. The Port shall review and determine, in its sole discretion, if the gross receipts from a branded food and beverage outlet shall qualify for payment of the branded food and beverage percentage rental…*

We determined that the lessee incorrectly reported sales as "Branded Food and Beverage" for the three Great American Bagel Bakery and Diva Espresso locations. To qualify as Branded Food, the lessee must pay a royalty payment of at least 3% of its gross sales to the franchisor. We determined that the royalty payment to the franchisor was below the 3% minimum required by the Port lease agreement. As a result, sales for the above locations did not meet the definition of Branded Food as defined by the Port lease agreement. The effect of this noncompliance with the Branded Food and beverage definition is that the concession fee paid to the Port was two percent lower than required by the agreement.

We observed a copy of the franchise agreement for the Great American Bagel Bakery on file with Port management. The agreement included an addendum reducing the royalty rate below the required 3% threshold. Although the addendum was in Port files, the auditor could not determine whether Port management had reviewed the agreement or determined whether those concession locations were eligible for the Branded Food concession rate.

In our prior audit of the lease and concession agreement with HMS Host for the lease year 2006-2007, we observed ineffective Port management monitoring controls over the Branded Food concession rate. We previously recommended management improve its monitoring to ensure compliance with the lease agreements.

The table below summarizes the additional concession owed for the period January 1, 2009 – December 31, 2011:

Total Underreported Concession	
2009	$121,514
2010	132,546
2011	141,040
Total Additional Concession Due	395,100
Late Charge (5% Per Agreement Terms)	19,755
Interest Accrued Through 9/30/2013	220,849
Total Amount Due to Port	**$635,704**

In addition, Section 8 of the Lease Agreement requires "the full cost of the audit" be borne by the lessee in the event an audit reveals a discrepancy of more than 2% of rent and concession for any 12-month period. As indicated below, the discrepancy was greater than 2% for all three agreement years in the audit period. The cost of the audit was $34,029 as of September 9, 2013.

The underreported concession exceeds the 2% threshold as follows:

	Underreported Concession	Total Concession Paid to the Port	Discrepancy Rate
2009	$121,514	$4,512,064	2.69%
2010	132,546	4,785,728	2.77%
2011	141,040	5,095,242	2.77%

Recommendation

We recommend Port management:

- Seek recovery of $635,704 in underpaid concession fees, late charges, and interest.
- Review agreement years prior to the audit period, to determine compliance with the Branded Food definition, and seek recovery, as appropriate.
- Seek recovery of $34,029 in audit costs, in accordance the lease agreement.
- Strengthen internal controls over the determination of Branded Food eligibility.
- Work with HMS Host to ensure that all receipts subject to the concession fee are accurately reported.

Management Response

In order to encourage branded operations, which typically generate significantly higher revenues due to customer familiarity, branded operations pay 2% lower percentage rent. An amendment to the HMSHost agreement in December 2005 defined what constitutes branded food for the purposes of rent reporting and payment.

In an audit of the HMSHost agreement in 2008 for the agreement years 2006-2007, Internal Audit concluded that this management review had not taken place. Noting management's failure to obtain the agreement, the report explained that Internal Audit "had to request the franchise and license agreements from Host." While the audit report clearly recommended that staff review and approve all franchise and license agreements, it did not note any rent reporting or payment issues associated with the existing franchise and license agreements.

Thereafter, management implemented this recommendation. Since 2008, three new branded concepts have opened under the HMSHost or affiliated SRA agreements (Seahawks 12 Club, Quiznos, Coffee Bean & Tea Leaf), and in each instance staff received, reviewed and approved each license/franchise agreement. However, management mistakenly believed that the existing franchise and license agreements that were reviewed by Internal Audit in 2008 complied with definition of branded food. As a result, staff did not require further verification, except when a location's concept changed. The current audit has made clear this misunderstanding, and management now further acknowledges its need for regular review of all license and franchise agreements to verify previous interpretations and ensure no amendments have been made. And management agrees that regular review of license agreements is important to assuring proper reporting of branded vs. non-branded food consistent with this definition.

Therefore, with respect to the findings of the current audit report:

- *Management will review the circumstances surrounding the identified underreporting and underpayment, and work with the HMSHost regarding appropriate recovery.*
- *Management also will require HMSHost (and its subtenants) to begin reporting their sales from branded operations (GABB, Diva Espresso) that fail to meet the definition for branded food as non-branded food and make payment at the non-branded rent rate.*
- *Management will work with HMSHost to improve protocols for review of license agreements, including pre-negotiated confidentiality agreements where necessary.*
- *Management will work with HMSHost to recover the costs of the audit.*

2. HMS HOST DID NOT PROVIDE ADEQUATE DOCUMENTATION TO SUPPORT GROSS SALES, AS REQUIRED BY THE AGREEMENT

Section 1.11 of the food and beverage lease agreement states:

> "*Gross Receipts" shall mean the aggregate gross amount of revenue derived from all sales of food, beverage and all other merchandise of any type or kind transacted…*

The agreement excludes certain items from gross receipts, such as tips paid to employees, refunds, complimentary meals, taxes, etc.

Our initial analysis of the lessee's financial records determined that the gross receipts for SeaTac Bar Group were underreported to the Port. SeaTac Bar Group is one of seven subtenants operating under the agreement. The lessee-provided sales reports for the three weeks selected for detailed testing did not agree with the daily bank deposits. At first, the lessee-provided reports, data, and explanations could not account for the variance. Upon repeated requests for further information, the lessee provided additional documentation of the difference for the entire audit period and asserted that incorrectly recorded upcharges for alcoholic beverages caused the difference. This assertion could not be substantiated because of a lack of detailed sales data.

Point-of-sale data (such as cash register tapes) or similar transaction level information would have explained the variance. However, the lessee could not provide such information because the subtenant did not maintain the information.

Section 7 of the lease agreement states:

> *Lessee shall retain all accounting records, including cash register tapes and guest checks, for not less than three (3) years after the close of the applicable Agreement Year or until the close of any ongoing audit.*

The difference between the reported and collected amounts was $21,962 for the audit period, resulting in an additional concession of $3,773. After applicable late charges and interest are applied, a total of $5,788 is owed to the Port.

We realize that the amount questioned above is small relative to the total concession paid to the Port. However, the initial lack of cooperation from the subtenant, continuing challenges with data requests, and the lack of detailed accounting records to support the sales, raises questions as to the validity and/or accuracy of the financial data provided and the concession paid to the Port. This lack of cooperation required HMS Host to issue a notice of default before the subtenant responded to the auditor's request.

Recommendation

We recommend Port management:

- Seek recovery of $5,788 in underpaid concession fees, late charges, and interest.
- Work with the lessee to ensure compliance with record keeping requirements.

Management Response

Management acknowledges that one Airport Concessions Disadvantaged Business Enterprise (ACDBE) subtenant, SeaTac Bar Group, was uncooperative with Internal Audit's requests for data and could not substantiate its reported revenue. Management further agrees with Internal Audit's assessment that the subtenant's records do not meet the requirements of the HMSHost agreement and, based on the records available, revenues were underreported and rent underpaid. Therefore, with respect to the findings of the current audit report:

- *Management will work with HMSHost to better understand the cause of their subtenant's underpaid concession fees, and recover those amounts together with late charges and interest.*

- *Management will work with HMSHost to bring the subtenant's accounting records into full compliance with the lease agreement.*

3. HMS HOST DID NOT TRANSMIT ACCOUNTING RECORDS AND OTHER REQUESTED DOCUMENTS IN A TIMELY MANNER

Section 7 of the lease and concession agreement requires timely availability of accounting documents for auditing purposes and states:

> *It is further agreed that a representative designated by the Port shall be allowed to inspect and audit Lessee's books and records with reference to the determination of any such matters at all reasonable times.*

We transmitted the audit notification letter, dated August 24, 2012, to HMS Host International, Inc., requesting certain data be available *"…in an electronic format within two weeks following the receipt of this letter."*

During the engagement, the auditors experienced multiple delays in securing financial information necessary to conduct the audit. Since the accounting records were not maintained locally, the auditors requested HMS Host electronically transmit the records. The auditors accepted records in raw form and piecemeal to expedite the process. The following schedule clearly shows that the timeline between written request and receipt of financial records was unreasonable, making the audit process inefficient:

Subtenant Records Requested	Requested Date	Received Date	Elapsed Time (In Days)
Cash Register Receipt Data (aka Point-of-Sale)	2-13-13	3-8-13 (partial)	23
Cash Register Receipt Data (aka Point-of-Sale)	2-13-13	4-19-13 (remainder)	65
Franchise Agreements	3-4-13	6-20-13	108
Schedule of Royalty Payments	3-5-13	7-11-13	128

The elapsed times exceed the "reasonable times" required under the agreement. These unreasonable time frames delayed the completion of the audit. The audit was originally scheduled to be exited with the Audit Committee in April 2013, but was delayed until October 2013.

Recommendation

We recommend Port management continue to work with the Lessee to ensure compliance with the transmittal of accounting records for audit purposes.

Management Response

Management acknowledges the audit of the HMSHost agreement took too long to complete. However, management believes it is important to acknowledge the collaborative effort that took place between Airport and Internal Audit staff in order to achieve compliance when HMSHost failed to provide timely responses. Audit staff encountered many delays due to Host's concern about company-competitive information contained in the license agreements that the Port requested to review. For some agreements, Host was particularly reluctant to allow review without a Non-Disclosure Agreement in place.

Therefore, with respect to the findings of the current audit report:

- *Management will work with HMSHost to address the issues with providing requested materials, including a commitment to voice confidentiality concerns immediately as they arise.*
- *As stated above, management will work with HMSHost to establish new protocols for review of license agreements in order to expedite this work, including pre-negotiated confidentiality agreements.*
- *Management will consider the options afforded by the lease agreement if timely transmittal is not demonstrated for future requests for records.*
- *As stated above, management will work to recover the costs of the audit.*