INTERNAL AUDIT REPORT

CLUB INTERNATIONAL AND CLUB CASCADE THIRD-PARTY MANAGEMENT AGREEMENT

JANUARY 1, 2012 – DECEMBER 31, 2013

ISSUE DATE: JULY 29, 2014
REPORT NO. 2014-13

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TRANSMITTAL LETTER

Audit Committee
Port of Seattle
Seattle, Washington

We have completed an audit of the Third Party Management Agreement for Club International and Club Cascade at Seattle-Tacoma International Airport. The Port of Seattle owns these lounges, and VIP Hospitality LLC manages the day-to-day operations on behalf of the Port.

We reviewed information for the period January 1, 2012 - December 31, 2013.

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 management and staff of Aviation Business Development, Aviation Operations, and managers of VIP Hospitality for their assistance and cooperation during the audit.

Kirangi

Joyce Kirangi, CPA, CGMA
Internal Audit, Director

AUDIT TEAM	RESPONSIBLE MANAGEMENT TEAM
Roneel Prasad, Auditor-In-Charge	Jim Schone, Director – Aviation Business Development
Jack Hutchinson, Audit Manager	Nick Harrison, Senior Manager –Customer Service

EXECUTIVE SUMMARY

AUDIT OBJECTIVES AND SCOPE

The purpose of the audit was to determine whether:

1. Port management controls are adequate to ensure:
    a. Revenues are complete, timely recorded, and accurately reported.
    b. Expenses are appropriate and reasonable.

2. VIP Hospitality (VIP) complied with the agreement terms in the following areas:
    a. Budget
    b. Inventory
    c. Insurance requirements
    d. Customer billings and receipts
    e. Expenses

We reviewed information for the period January 1, 2012 - December 31, 2013. Details of our audit's scope and methodology are on page 6.

BACKGROUND

The Port owns and operates Club International (CI) and Club Cascade (CC) at Seattle-Tacoma International Airport. CI is located at the southeast end of the South Satellite, and CC is located at the southeast end of the A Concourse. In March 2010, the Port entered into a three-year management agreement with VIP to manage the day-to-day operations of CI. In 2013, the Port extended the agreement to include CC. These lounges provide a semi-private environment for premium-class airline customers who have purchased first-, business-, or other premium-class tickets.

The management agreement provides that VIP will operate the lounges for a fixed monthly Management Fee and a tiered Incentive Management Fee, based on Gross Operating Profit. The Port is responsible for the operating expenses at the lounges, including the payroll cost of the VIP employees at the lounges. The lounges served approximately 13,000 passengers (generating approximately $390,000 in revenue) and 34,000 passengers (generating approximately $1.1 million in revenue) in 2012 and 2013, respectively.

CONCLUSION

Port management controls are adequate to ensure revenues are complete, timely recorded, and accurately reported. Port management controls are inadequate to ensure expenses are reasonable. See Schedule of Findings, No. 1.

VIP complied with the agreement terms on budget, inventory, insurance requirements, and customer billings and receipts. VIP did not comply with the terms of the agreement related to payroll expenses. See Schedule of Findings, No. 2.

BACKGROUND

The Port owns and operates Club International (CI) and Club Cascade (CC) at Seattle-Tacoma International Airport. CI is located at the southeast end of the South Satellite, and CC is located at the southeast end of the A Concourse. In March 2010, the Port entered into a three-year management agreement with VIP Hospitality LLC to manage the day-to-day operations of CI. In 2013, the Port extended the agreement to include CC.

These lounges provide a semi-private environment for premium-class airline customers who have purchased first-, business-, or other premium-class tickets. The lounges have contracts with seven airlines. Access to the lounges is limited to departing passengers.

The management agreement provides that VIP will operate the lounges for a fixed monthly Management Fee and a tiered Incentive Management Fee based on Gross Operating Profit.

The Port is responsible for all operating expenses of the lounges, including the payroll cost of the VIP employees at the lounges.

The lounges served approximately 13,000 passengers (generating approximately $390,000 in revenue) and 34,000 passengers (generating approximately $1.1 million in revenue) in 2012 and 2013, respectively. Currently, the lounges have contracts with seven airlines, and access to the lounges is limited to departing passengers.

FINANCIAL HIGHLIGHTS

KEY FINANCIAL RESULTS OF CLUB INTERNATIONAL AND CLUB CASCADE

DESCRIPTION	CLUB INTERNATIONAL		CLUB CASCADE
	FISCAL YEAR 2012	FISCAL YEAR 2013	FISCAL YEAR 2013
PASSENGERS SERVED	13,000	33,500	550
AIRLINES SERVED	4	6	1
GROSS REVENUES	$ 390,000	$ 1,097,000	$ 18,000
EXPENSES			
MANAGEMENT FEE	$ 73,000	$ 85,900	$ 1,300
INCENTIVE MANAGEMENT FEE	10,600	8,100	-
LABOR COST	84,800	204,400	10,400
COST OF GOODS SOLD	61,200	148,400	2,700
OTHER	74,300	88,900	7,500
NET INCOME/(LOSS) TO PORT	**$ 86,100**	**$ 561,500**	**$ (3,900)**

Data Source: PeopleSoft Financials, VIP Hospitality Profit and Loss Financial Statements

HIGHLIGHTS AND ACCOMPLISHMENTS

- The Port established a lock box for remittance of customer receipts.
- The Port established a dedicated bank deposit account for the lounges, ensuring all deposits are "swept" to the Port's main bank account.
- The Port established a revolving checking account for the lounges, ensuring only valid payments are made from and reimbursed to this account.

AUDIT SCOPE AND METHODOLOGY

We reviewed information for the period January 1, 2012 - December 31, 2013. We utilized a risk-based audit approach from planning to testing. We gathered information through research, interviews, observations, and data analysis, in order to obtain a complete understanding of the operations of the lounges. We assessed significant risks and identified controls to mitigate those risks. We evaluated and tested controls to determine whether they were operating as intended.

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

1. To determine whether established Port management controls are adequate to ensure revenues are complete, timely recorded, and reported, we selected revenues for four months (two months from each year) and reviewed the following:

    a. Supporting documents to ensure accuracy.
    b. Deposit dates to determine timeliness.
    c. Deposit amounts and composition to ensure completeness.

2. To determine whether established Port management controls are adequate to ensure expenses are appropriate and reasonable.
3.
    a. We reviewed all monthly financial packages for the audit period to determine whether Port management performed its monthly monitoring activities.
    b. We selected 30 reimbursement payments from 6 months and reviewed expense items to determine whether the items were reasonable and appropriate.
    c. We recalculated the Incentive Management Fee (IMF) to ensure accuracy.

4. To determine whether the third-party management company complied with the terms of the agreement, we reviewed the following areas:

    a. Budget:
        - We analyzed the budget for the audit period to determine compliance with the budget submission and Port management review.
    b. Inventory
        - We analyzed cost-of-goods-sold for the audit period to determine reasonableness.
        - We selected 14 high-risk items from VIP payment records and traced the items to inventory records.
        - We reviewed inventory categories to determine appropriateness.
    c. Insurance requirements
        - We reviewed insurance certificates for the audit period and determine compliance with the insurance coverage requirements.
    d. Customer billings and receipts
        - We reviewed the current process of recording lounge customer counts, which is the base for monthly billings, to determine compliance with agreement provisions related to timeliness, complete invoicing to airlines (customers), and subsequent collection.

e. Expenses

- We selected three pay periods and examined employee timesheets to determine whether labor costs were accurate and completely supported.
- We examined employer payroll tax calculations (i.e., true-up process) for the audit period to determine accuracy.

CONCLUSION

Port management controls are adequate to ensure revenues are complete, timely recorded, and accurately reported. Port management controls are inadequate to ensure expenses are reasonable. See Schedule of Findings, No. I.

VIP complied with the agreement terms on budget, inventory, insurance requirements, and customer billings and receipts. VIP did not comply with the terms of the agreement related to payroll expenses. See Schedule of Findings, No. 2.

SCHEDULE OF FINDINGS AND RECOMMENDATIONS

1. VIP DID NOT MAINTAIN ADEQUATE ACCOUNTING RECORDS FOR LABOR COSTS

Accurate and verifiable records are a cornerstone of a reliable accounting system. Port management cannot establish the propriety of VIP expenses without reliable accounting information. The management agreement under Section 28 requires VIP to "keep all books of accounts and records with respect to the operation of the Designated Lounges…."

For the audit period, VIP did not maintain and was not able to provide adequate supporting records for its lounge labor costs. We could not determine whether Port reimbursements of the lounge labor expenses to VIP were accurate and adequately supported.

The majority of the lounge expenses were for labor costs. For example, in 2013, approximately 43% ($215,000) of lounge expenses were for labor costs.

We examined timesheets for three pay periods. We considered employee timesheets as the foundation to support Port reimbursements for VIP payroll expenses. We determined that VIP employee timesheets did not always support labor expenses reimbursed by the Port.

We noted significant variances as follows:

- Employee's timesheets were incomplete and possibly incorrect.

  We identified deficiencies in employee timesheets. Employee signatures, as an acknowledgment of their hours worked, were not consistently present. The Supervisors' signatures, as an indicator of having verified employee hours for correctness, were not consistently present. As a result, we could not determine whether timesheet information was correct.

- Employee timesheets were inconsistent.

  For the month of December 2013, VIP provided two sets of timesheets covering the same pay period. The two sets contained differences in the number of hours worked and the number of employees who worked.

Recommendations:

We recommend Port management:

Work closely with VIP to ensure that labor reimbursements are accurate and adequately supported. Controls should include review of the lowest source documents.

Management Response:

The payroll variances occurred during three months of the audit period (Dec 2012, Feb 2013 and Dec 2013). Some payroll journal entries overstated timesheet hours and some understated timesheet hours. Through research, VIP was able to reduce the total time unaccounted for down to 12.92 hours over those three months. VIP has issued a credit to the Port for $196.51, representing the labor cost for the unaccounted hours. The discrepancies were strictly human error by incomplete and inconsistent timesheet management, not a matter of misappropriation.

In January 2014, VIP installed finger print time clocks which eliminate the risk of inaccurate payroll time entries due to manual input. In addition, VIP created an internal 3rd party audit process as a double check for each payroll period. Port management believes that these processes will eliminate this problem.

2. PORT MANAGEMENT CONTROL OVER EMPLOYER PAYROLL TAX REIMBURSEMENTS IS INADQUATE

The Port owns and operates Club International and Cascade Lounge at Seattle-Tacoma International Airport. The Port reimburses VIP Hospitality for all lounge-related expenses, including the employer's payroll taxes. VIP compensates its employees bi-weekly, but seeks reimbursement from the Port monthly. Due to the timing differences, Port management agreed to pay VIP the employer payroll taxes based on an estimated rate of 20.99%.

Port management conducted a year-end reconciliation of the estimated payroll taxes reimbursed to the third-party company versus actual. However, certain employer taxes have tiered rates based on different levels of income. Other taxes have a maximum income level above which taxes do not apply. Because of unfamiliarity with the tax structure, Port management did not consider these variations during the true-up process.

Our audit of the expense reimbursements to VIP for employer payroll taxes identified an over reimbursement of approximately $27,000. Port management had not identified this overpayment during its year-end true-up process.

This finding is similar to a finding we issued in our prior audit in 2011. In that audit, we determined that Port management had reimbursed payroll benefits and payroll taxes to VIP based on budget estimates rather than on actual costs incurred. We recommended Port management implement a true-up process at the end of each year. Although Port management conducted the true-up process during this audit period, the process was inadequate to disclose the identified overpayment.

Recommendations

We recommend Port management:

1. Improve the true-up process to ensure that expenses reimbursed to VIP represent actual costs incurred.
2. Seek reimbursement of the overpayment (approximately $27,000) from VIP.

Management Response:

Following the recommendation stated in the Internal Audit Report dated September 7, 2011, Port staff implemented an annual true-up process to reconcile the estimated payroll benefit expenses with the actual expenses. At the time of the 2011 audit, the Club served one airline's passengers. Since that time, the lounge business has experienced remarkable growth. Port and VIP staff have worked closely to manage this growth with a focus on improving all lounge management systems.

With the improvements to VIP's payroll process as noted in the Management Response to Item I, actual payroll costs can be calculated and charged in lieu of the estimate and true up process currently in place. The new payroll system will assist with calculating the proper payroll taxes. These calculations will then be reviewed and approved by Port staff on the payroll invoices which are presented by VIP to the Port on a bi-monthly basis. Prior to the new system, these calculations were prepared manually. Additionally, Port staff have established a process for reviewing VIP's financial statements and payroll taxes during the regular monthly meeting involving staff of the two organizations rather than waiting until the end of the year as originally planned. Consequently, the true up process is no longer necessary.

VIP brought to the Port's attention the overpayment of payroll taxes on March 25, 2014, when it discovered the estimated payroll tax rate agreed to by Port staff and VIP resulted in an overpayment of $27,000. Repayment of the $27,000 by VIP is already in process.