



INTERNAL AUDIT REPORT

LEASE AND CONCESSION AGREEMENT

CLIPPER NAVIGATION, INC.

May 1, 2014 – April 30, 2016

ISSUE DATE: October 10, 2016
REPORT NO. 2016-15

EXECUTIVE SUMMARY

AUDIT OBJECTIVES AND SCOPE

The purpose of the audit was to:

1. Evaluate the design and operating effectiveness of Port management monitoring controls.
2. Determine compliance with the significant terms and conditions within the Lease Agreement between Clipper Navigation, Inc. (Lessee) and the Port of Seattle.

Specifically, we evaluated:

- Accuracy and timeliness of the billings and payments
- Rent surety
- Insurance

We reviewed and analyzed records for the period May 1, 2014 through April 30, 2016.

Details of our audit's scope and methodology are on page six.

BACKGROUND

Clipper Navigation, Inc. (also known as Clipper Vacations) is a privately held company in Seattle, Washington and offers transportation services, tours, and accommodation packages. The company was established in 1986 and serves the Pacific Northwest and Western Canada.

The Port of Seattle and Clipper Navigation, Inc., entered into a lease agreement dated April 24th, 2014 whereby Clipper Navigation, Inc. agreed to pay Base Rent to lease certain property located at Pier 69. In addition to Base Rent, a per-passenger charge is paid to the Port of Seattle for every embarking or dis-embarking passenger.

AUDIT RESULT

Based on the audit procedures performed, Clipper Navigation, Inc. materially complied with most of the significant terms and conditions of the Lease Agreement.

We also concluded that internal controls are generally operating effectively. However, our testing identified an opportunity to further strengthen controls related to rent surety (see Finding #1).

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TRANSMITTAL LETTER

Audit Committee
Port of Seattle
Seattle, Washington

We completed an audit of Clipper Navigation, Inc. for the period May 1, 2014 - April 30, 2016.

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 management and staff for their assistance and cooperation during this audit.



On behalf of
Joyce Kirangi, CPA, CGMA
Internal Audit, Director

AUDIT TEAM	RESPONSIBLE MANAGEMENT TEAM
Ritika Marwaha, Auditor	Dave McFadden, Managing Director Economic Development
Jessica Martin-Carscadden, Audit Manager	Melinda Miller, Director Real Estate Asset Management
	Rudy Caluza, Director – Accounting and Financial Reporting

BACKGROUND

Clipper Navigation, Inc. (also known as Clipper Vacations) is a privately held company in Seattle, Washington and offers transportation services, tours, and accommodation packages. The company was established in 1986 and serves the Pacific Northwest and Western Canada.

Clipper Navigation, Inc. operates two high-speed catamarans used for passenger-only ferry service between Seattle and Victoria, BC and one catamaran used for passenger-only ferry service between Seattle and Friday Harbor, and whale-watching excursions. Departures are scheduled year round.

The Port of Seattle and Clipper Navigation, Inc., entered into a lease agreement dated April 24th, 2014 whereby Clipper Navigation, Inc. agreed to pay Base Rent to lease certain property located at Pier 69. Base Rent includes approximately 5,818 square feet of office, 6,174 square feet of working area, and almost 30,000 square feet of apron and berthing areas. In addition to Base Rent, a per-passenger charge is paid to the Port of Seattle for every embarking or dis-embarking passenger according to the following schedule:

SECTION 3.2 - PASSENGER FEE SCHEDULE

ANNUAL NUMBER OF PASSENGERS	PER PASSENGER CHARGE
Less than 275,000	\$ -
275,001 - 375,000	0.42
375,001 - 475,000	0.77
475,001 - 575,000	1.10
575,001 - 675,000	0.77
Greater than 675,000	0.42

Data Source: Clipper Navigation, Inc. Lease 002533 - Section 3.2 Passenger Fee

FINANCIAL HIGHLIGHTS

CLIPPER NAVIGATION RENT PAYMENTS

YEAR	AMOUNT
MAY 1, 2014 - APRIL 30, 2015	\$ 277,269.95
MAY 1, 2015 - APRIL 30, 2016	277,269.95

Data Source: PeopleSoft

AUDIT SCOPE AND METHODOLOGY

We reviewed information for the period May 1, 2014 through April 30, 2016. We used a risk-based audit approach from planning to testing transactions. In order to obtain a detailed understanding of the significant provisions of the agreement and the related internal control framework, we gathered information through review of documents, interviews, observation and data analysis.

Processes that we deemed highest risk, we applied the following detailed audit procedures:

- 1) Performed walkthroughs and tested controls to evaluate the design and operating effectiveness of monitoring controls to ensure:
 - Billings and payments were accurate, complete, and made timely
 - Rent surety was delivered to the port
 - Insurance complied with the Lease Agreement requirements
- 2) Agreed monthly base rent according to the lease agreement to billing schedule in PeopleSoft
- 3) Compared passenger count data provided to AFR to counts obtained directly from Clipper Navigation, Inc.
- 4) Compared invoice due dates to payment check data as reflected in the customer deposit download.
- 5) Reviewed insurance, rent surety, and line of credit evidence to evaluate compliance with lease terms.

CONCLUSION

Based on the audit procedures performed, Clipper Navigation, Inc. materially complied with most of the significant terms and conditions of the Lease Agreement.

We also concluded that internal controls are generally operating effectively. However, our testing identified an opportunity to further strengthen controls related to rent surety (see Finding #1).

SCHEDULE OF FINDINGS AND RECOMMENDATIONS

1. CONTROLS OVER RENT SURETY REQUIREMENTS ARE NOT ALWAYS OPERATING EFFECTIVELY

Clipper Navigation, Inc. leases property at Pier 69 to operate its business. To secure tenant's full performance of the agreement, the lease agreement, dated April 24, 2014, requires the Lessee to obtain and deliver to the Port, surety in the form of an irrevocable stand-by letter of credit of approximately four and one-half months' rent. The surety is to remain in place at all times throughout the full term of the lease.

When the new lease was signed, management evaluated the amount, but did not obtain a letter of credit for the new lease, which created a lapse in coverage of approximately 29 months. An amendment, dated September 2016, was obtained to reinstate the letter of credit after Internal Audit brought this issue to the attention of management during the audit.

Recommendation

We recommend developing a process to ensure controls are operating effectively so that a current letter of credit is obtained when new leases are implemented.

More broadly, we recommend performing an assessment to assess if surety, whether in the form of a corporate surety bond, cash deposit, or letter of credit is current for all leases.

Management Response

We acknowledge this oversight and appreciate the auditors' recommendations. Because of the long term relationship with Clipper (a tenant at Pier 69 since 1989) and their good standing with the Port, there was very little risk to the Port of any default event. Nevertheless, we recognize the importance of maintaining compliant surety for our tenants. When the missing amendment to the letter of credit was discovered, we began working to enhance our reporting and procedures for surety processing. We have implemented changes to ensure that tenant surety is received prior to new lease agreements being executed, and that renewal of expirations and required surety increases are done in a timely manner.