



The Port of Seattle

Internal Audit Report

**Lease Compliance Audit
Cruise Terminals of America
Lease No. EA000572 and No. EA000975**

Plus

**Limited Scope Review of the
Cruise Terminals of America Management Agreement
(Terminated April 30, 2003)**

January 1, 2004 through December 31, 2006

Issue Date: February 27, 2009
Report No. 09-02



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Cruise Terminal of America Management Agreement (Term.4/30/2003)
And Leases #572 & #975
Audit Period: January 1, 2004 – December 31, 2006

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Internal Auditor's Report

We have completed a compliance audit of Lease Agreement No. 572 and No. 975, as amended, between Cruise Terminals of America, LLC (CTA) and the Port of Seattle. In addition, we assessed the effectiveness and efficiency of the Port monitoring controls over the CTA lease agreements. We also conducted a limited scope review of the management services agreement that terminated on April 30, 2003.

We conducted the audit using due professional care. We planned and performed the audit to obtain reasonable assurance over completeness of concession fee reported, compliance with the lease provisions, and accountability of the Port cruise line-business equipment. We also evaluated the existing management monitoring controls over the CTA lease agreements to ensure that the controls are working efficiently and effectively as intended.

Based on our audit, CTA owes the Port \$8,578 in concession fees. We also identified other opportunities for improvement as discussed in the subsequent sections of this audit report.

We extend our appreciation to Port Management and staff, staff from Columbia Hospitality, Inc, and Cruise Terminals of America for their assistance and cooperation during the audit.

Sincerely,

A handwritten signature in black ink that reads "Joyce Kirangi".

Joyce Kirangi, CPA
Internal Audit Manager



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Executive Summary

Audit Scope and Objective

Our audit objectives were:

- To determine the level of compliance with the provisions of the CTA Lease Agreement No. 572, and No. 975, as amended, for the period 2004, 2005, and 2006.
- To determine that CTA timely closed the bank accounts that it managed for the Port under a management services agreement, and to establish that Port funds was promptly returned to the Port when the management services agreement ended in April 2003.
- To assess the effectiveness and efficiency of the Port management monitoring controls over the CTA lease agreements.

Agreement Terms The Port of Seattle is the owner of the cruise terminals at Pier 66 and Terminal 30. Lease agreements No. 572 and No. 975 are for the preferential use of those terminals by Cruise Terminal of America (CTA). CTA is an active cruise terminal operator in Seattle.

Lease agreement No. 572 between the Port and CTA became effective in May 2003. The lease required a base rent of \$10,000. The lease also provided additional concessions: 1) preferential use percentage fees (top line rent), ranging from 26.95% to 28.05% of all gross revenue that exceeded \$1.10 million, 2) 80% of net parking revenue, and 3) net Operating Income percentage lease fee (12.75%) and preferential use fee 12.25%-- bottom line rent.

Lease No. 975 superseded lease No. 572, and became effective in January 2006 and is in effect through December 2012. The lease has multiple concession parts with multi-tier calculations and a number of allowance accounts for different purposes.

Both agreements provide a basic set of exclusions from Gross Revenue including taxes, refund granted to the customers, and revenue derived from expenses passed directly through to third parties. However, any markup on such pass-through expenses is included in the Gross Revenue definition.



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Audit Result Summary Our review disclosed the following:

1. CTA owes the Port \$8,578 in concession fees. CTA underreported Gross Revenue with disallowed offsets, and included other unallowable expenses in the calculation of concession fee to the Port.

2. The Seaport Management has inadequate oversight and monitoring process over the CTA lease. We noted some areas for improvement as identified in the Schedule of Findings and Recommendations.



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Background

Prior to May 1, 2003, the Port of Seattle had a management services agreement with Cruise Terminals of America, LLC (CTA) for management of the Port cruise business line at Pier 66. CTA is an active cruise terminal operator in Seattle, and is a joint venture between three corporations consisting of General Steamship Agencies, SSA Marine (Stevedore), and Columbia Hospitality, Inc.

The CTA management services agreement with the Port ended at the end of April 2003, and the Port and CTA entered into a lease arrangement for the cruise business line at Pier 66 and Terminal 30.

Lease agreement No. 572 between the Port and CTA became effective in May 2003. The lease required a base rent of \$10,000. The lease also provided additional concession such as: 1) preferential use percentage fees (top line rent), ranging from 26.95% to 28.05% of all gross revenue that exceeded \$1.10 million, 2) 80% of net parking revenue, and 3) net Operating Income percentage lease fee (12.75%) and preferential use fee (12.25%)—bottom line rent.

Lease No. 975 superseded lease No. 572, and became effective in January 2006. The lease is in effect through December 2012. This lease include multiple concession parts with multi-tier calculations and a number of allowance accounts for different purposes.

Seaport Container and Cruise Services Department administers the CTA lease agreements.

Revenue

Terminal/Pier	Description	2004	2005	2006	Common Size Analysis		
					2004	2005	2006
Pier 66 Cruise	Sale of Utilities - Water			(108,231)	0%	0%	2%
Pier 66 Cruise	Sale of Utilities - Sewer			(24)	0%	0%	0%
Pier 66 Cruise	Revenues: Operating Costs	(112,067)	(115,716)	-	4%	3%	0%
Pier 66 Cruise	Space Rental General - L/H Tax	(524,297)	(745,401)	(863,965)	18%	19%	16%
Pier 66 Cruise	Preferential Use - Apron	(568,416)	(808,125)	(1,145,133)	20%	20%	21%
T-30 Cruise	Sale of Utilities - Water			(175)	0%	0%	0%
T-30 Cruise	Sale of Utilities-SurfaceWater		(34,932)	(8,495)	0%	1%	0%
T-30 Cruise	Revenues: Operating Costs	(30,564)	(31,559)	-	1%	1%	0%
T-30 Cruise	Security Services - Exempt	(2,674)	(3,854)	4,522	0%	0%	0%
T-30 Cruise	Space Rental General - L/H Tax	(856,255)	(1,219,113)	(1,404,383)	30%	30%	26%
T-30 Cruise	Preferential Use - Apron	(755,605)	(1,049,828)	(1,868,149)	27%	26%	35%
	Grand Total	(2,849,878)	(4,008,528)	(5,394,034)	100%	100%	100%

Source: **PeopleSoft**

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Audit Objectives

- To determine the level of compliance with the provisions of the CTA Lease Agreement No. 572, and No. 975, as amended, for the periods 2004, 2005, and 2006.
- To determine that CTA timely closed the bank accounts that it managed for the Port under a management services agreement, and to establish that Port funds was promptly returned to the Port when the management services agreement ended in April 2003.
- To assess and evaluate the effectiveness and efficiency of the Port management monitoring controls over the CTA lease agreements.

Audit Scope

The scope of the audit covered the CTA lease agreements from January 1, 2004 through December 31, 2006. We also reviewed the CTA management services agreement accounting closing entries and other arrangements made when the agreement ended in April 2003.

Audit Approach

We performed the following audit procedures:

- We obtained an understanding of the Cruise Terminals of America, LLC operations.
- We reviewed applicable state and local laws, rules and regulations, and Port policies related to leases.
- We analyzed CTA financial data (internal and external) and other relevant information and assessed risk.
- We analyzed financial data to determine completeness of the concession fee paid and compliance with the terms of the leases.

Conclusion

1. CTA owes the Port \$8,578 in concession fees. CTA underreported its Gross Revenue with disallowed offsets, and included unallowable expenses in calculating concession fee payable to the Port.



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2. The Seaport Management has inadequate oversight and monitoring process over the CTA lease. We noted some areas for improvement as identified in the Schedule of Findings and Recommendations.

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Audit Findings and Recommendations

Inadequate Management Monitoring System

The level of monitoring activity to administer an agreement must be proportional to the level and extent of compliance requirements. For the period under audit, Internal Audit reviewed three (3) separate CTA agreements, all having multiple concession parts with multi-tier calculations and several allowances. The terms of the agreements were not necessarily complex, but rather there were many parts with overlapping areas. Further, management agreed to certain terms and conditions without formally amending the agreements. While these conditions as a whole necessitated an increased level of monitoring to provide assurance over compliance, management's monitoring system was not adequately or sufficiently in place to mitigate the risk of noncompliance.

Less than optimal monitoring process resulted in numerous exceptions. Financial losses as well as accountability concerns over public assets are the direct results of lax management monitoring as noted below.

We have grouped the observed exceptions by the related agreement for convenience.

CTA Management Services Agreement--(terminated at the end of April 2003)

a. Untimely Closing of the Port Bank Accounts

The CTA management services agreement for the Port cruise business line at Pier 66 ended on April 30, 2003. When the management service agreement ended, CTA should have immediately closed the bank accounts that it managed for the Port and returned any remaining funds to the Port.

We observed the following:

- CTA did not close the Port capital reserve bank account until March 30, 2007-- 4 years after the management services agreement had ended.
- CTA did not immediately return to the Port the capital reserve bank balance (approximately \$110,000). Port management allowed CTA to keep the money left over from the management services agreement to purchase replacement equipment at Terminal 66. The auditor acknowledges that CTA eventually purchased the equipment as agreed-upon; however, *the verbal arrangement*

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that Port management made to leave Port funds under the control of a private company for an extended time was in violation of state statutes. Port funds (public funds) should be under the control of the Port Treasurer.

b. Retroactive Bonus –Lack of Evidence on How Bonus was Established

CTA paid a retroactive bonus of \$2,000 to an employee on April 30, 2003 for prior period services. Support for the bonus provided by CTA simply stated that it was for “excellent work.” The auditor found no evidence upon which the bonus was established or determined.

Further, the auditor could not ascertain whether:

- 1) CTA had commonly understood and shared company-wide policies or procedures regarding bonuses.
- 2) CTA and the employee had an understanding as to the bonus criteria for compensation.

During the period of the questioned bonus, CTA was managing the cruise line business at Pier 66 under a management services agreement, or as an extension of the Port. The funds used to pay for the bonus were public funds subject to all applicable rules and regulations, regardless of whether the Port paid the bonus directly or indirectly through a Port contractor. Washington State Constitution does not allow public entities to use public funds to make additional compensation for services already rendered and already compensated.

Recommendations

- Port management should ensure that Port funds are under the control of the Port Treasurer. Port funds or public funds should not be under the control of a private company. Finding No. a).
- Port management should ensure that its third-party service providers do not use public funds to pay bonuses in violation of the Washington State Constitution Article VIII, Section 7¹. Finding No. b).

Management Response--Finding No. a).

- *As noted in the audit findings in connection with the termination of the Management Agreement with CTA on April 30, 2003, Port cruise management verbally agreed that CTA would retain the Capital Reserve funds built up and not used over the duration of the Management Agreement. It was agreed that those funds would be used by CTA in the*

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2004-2005 timeframe to pay for replacements of Furniture, Fixture and Equipment or other capital items in or for the facility as had been anticipated in the Management Agreement.

In accordance with this agreement, these funds were used to purchase items such as mobile ticket counters, fences, radios, etc. (detailed list is available). As these items were purchased with Port funds, the items were either capitalized or expensed on Port of Seattle books, as they would have been under the Management Agreement. The Port has copies of the receipts for all items acquired. While 98% of the funds were expended in early 2005 and early 2006, the last items were purchased in October 2006. The account should have been closed no later than the end of 2006.

On November 14, 2006, the Port implemented new procedures whereby:

- 1. Revenue from all third-party managed facilities was deposited directly into the Port's bank account on a real time basis.*
- 2. Revolving funds were established with the Port's bank for purposes of paying expenses related to the operation of these facilities.*
- 3. Capital reserve funds as separate funds were eliminated and payment of these expenditures was consolidated in the revolving funds*

Management Response--Finding No. b)

- The Port's legal department is currently evaluating the opinion expressed in the audit findings that bonus payments paid by CTA to CTA employees during the term of the Management Agreement fall under Washington State Constitution, Article II, Section 25 Extra Compensation Prohibited. The Port's legal department is reviewing this issue, in relation to both the CTA lease audit and the CHI/BHICC management agreement audit.*
- It is not the understanding of Port cruise management that this law would be applicable to CTA employees paid by CTA during the term of the Management Agreement, or in this instance – immediately following the termination of the Management Agreement, but retroactive to the period before the Management Agreement was terminated and replaced by the CTA lease. Unless the legal department determines otherwise, it is our understanding that the language in the referenced Washington State Constitution Article applies to WA state employees, and not to those employed by a non-governmental third party under a valid Management Agreement*

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Lease No. 572 (the Covered Period was Between May 2003 through Dec. 2005)

The term of the lease was from May 1, 2003 through December 31, 2007. The auditor noted that in December of 2005, the Port and the lessee agreed to terminate the lease.

c. Disallowed Deductions from the Gross Revenue and Other Unallowable Expenses

The lease agreement has a limited number of authorized offsets to gross revenue. The agreement allows credits and taxes deductions collected from customers on behalf of the taxing jurisdiction. The agreement does not allow specific deductions from the gross revenue. The auditor noted the following deductions that the lease agreement does not allow to offset Gross Revenue: bad debts and expenses passed directly to third parties.

For the audit period, the lessee reduced gross revenue, reported to the Port, with disallowed offsets such as bad debts and net loss from expenses passed directly to third parties. The overall amount owed to the Port (Top Line) due to these disallowed reductions was approximately \$ 1,016.

The auditor also noted other unallowable expenses related to the lessee joint venture federal income tax preparation costs and other improper accrual expenses. The amount owed to the Port due to these unallowable expenses decreased the Bottom Line concession base and resulted in concession underpayments of \$1,250.

The table below summaries the concession underpayment as described above.

	2004	2005	Total
Top Line Rent – 28.05 % of Gross Revenue	\$181	\$307	\$488
Top Line Preferential Use Fee – 26.95% of Gross Revenue	\$196	\$332	\$528
Bottom Line Lease Fee - 12.75% of NOI	\$ 439	\$ 161	\$600
Bottom Line Preferential Use Fee – 12.25 of NOI	\$ 476	\$ 174	\$650
Total	\$1,292	\$974	\$2,266

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d. The Port Cruise line business Lease was not Publicly Advertised

The auditor found no evidence of publicly advertising of the cruise line-business lease. When the CTA management services agreement terminated in May 2003, Port management and CTA entered into a lease agreement and continued the cruise line-business operation as before.

Recommendations

- 1) Port management should closely monitor the lessee financial activities related to the lease, and should evaluate and collect the additional \$2,266 concession fees noted above. Finding No. c).
- 2) As a public agency, Port management should consider publicly advertising for its leases. Finding No. d).

Management Response — Finding No. c).

- *Management worked closely with CTA and POS Internal Audit to evaluate CTA's financial reporting and its compliance with the requirements of the CTA lease. Management agrees that the transactions identified in the final audit findings were not in compliance with the requirements of the CTA lease and additional rent of \$2,266 is owed to the Port. It is important to note that the magnitude of these compliance errors is very small and represents a less than 1% underpayment of rent due to the Port (underpayment equals 0.03%). Finding No. c).*

Management Response—Finding No. d).

- *There was no specific Port policy or common practice to advertise leases at the time the Commission authorized this lease in 2003. Currently the Commission has expressed interest in some leases being openly advertised and efforts are underway to establish guidelines as to when it is appropriate to advertise a lease and when direct negotiation would be more appropriate.*

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Lease #975 (Lease Period from Jan. 2006 to Present)

e. Disallowed Deductions from the Gross Revenue and Other Unallowable Expenses

The lease agreement has a limited number of authorized offsets to gross revenue. The auditor noted a number of disallowed items offset against the Gross Revenue, and other unallowable expenses. The disallowed items included third party expenses, equipment rentals, lessee joint venture tax preparation cost, and other expenses.

The disallowed items resulted in \$6,312 underpayment of concession fee to the Port as follows:

	2006
Lease Fee - underpayment	\$ 5,428
Preferential Use Fee – underpayment	\$ 7,195
Lease Fee Savings Fee – overpayment	(\$ 2,713)
Preferential Use Savings Fee – overpayment	(\$ 3,597)
Total - underpayment	\$ 6,312

f. Lack of Accountability of Port Equipment Used at the Cruise-line Business

From the Port disbursement records, the auditor sampled 42 equipment, worth \$189,594, and traced the equipment physically to the cruise business-line location at CTA. The auditor observed that although the Port purchased most of the equipment at the cruise line business, the equipment had CTA tags for identification. Port management does not maintain a comprehensive listing of its equipment used at the CTA cruise-line business.

Recommendations

- 1) Port management should closely monitor the lessee financial activities related to the lease, and should evaluate and collect the additional \$6,312 in concession fee as noted above. Finding No. e).
- 2) Port management should establish a tracking system that provides monitoring and accountability of Port equipment located at the CTA cruise line business. Finding No. f).

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Management Response—Finding No. e).

Management worked closely with CTA and POS Internal Audit to evaluate CTA's financial reporting and its compliance with the requirements of the CTA lease. Management agrees that the transactions identified in the final audit findings were not in compliance with the requirements of the CTA lease and additional rent of \$6,312 is owed to the Port. It is important to note that the magnitude of these compliance errors is very small and represents a less than 1% underpayment of rent due to the Port (underpayment equals 0.1%)

Management Response--Finding No. f).

We agree with the audit findings that internal controls and procedures for monitoring equipment at the Port cruise terminals could be improved. Port business operations staff is working with CTA staff to obtain an updated listing of non-capital equipment owned by the Port, to ensure that Port owned non-capital assets are accounted for and that notification procedures are in place to properly track the disposal or replacement of non-capital assets. This procedure is already in place for Port owned capital assets (cost of \$20,000 or more). Port business operations staff is also working with CTA staff to clearly mark Port owned equipment, both capital assets and non-capital equipment, with asset tags indicating they are the property of the Port of Seattle – Cruise.

Management Overall Response

There is continuous active monitoring by management of the CTA lease agreements. The CTA leases never contemplated that Port Staff would be monitoring procedures down to the accounting entry level as appears to be suggested by Internal Audit through their findings.

The CTA leases do provide for audits. It is the Port staff's position that the detailed financial review as suggested by Internal Audit was to be accomplished through the audit process. Until recently, it was thought that this function would be performed by the Port of Seattle's Internal Audit Department through a rotating audit schedule. With the recent change in roles for the Internal Audit Department, the Seaport Division may need to consider bringing in external independent auditors to perform periodic audits of the CTA lease.

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Auditor's Closing Comment

An audit is not entirely about numbers. It is a systematic examination of a process used in the achievement of an objective. As this relates to the audit at hand, what this means is that Internal Audit was looking for evidence of sufficient and adequate management monitoring to ensure full compliance with all agreed-upon terms of conditions. This was done without regard to how difficult it may be to adequately monitor the agreement.

Quantifying exceptions noted in an audit as percentage of the total population is not meaningful and often leads to an incorrect assessment of the audited areas. An audit does not review the entire population of transactions; if it did, that would be re-performance. Statements like "exceptions noted in the audit was XX% of the associated revenue" assumes that the base is without errors, which management cannot claim without sufficient and adequate controls. If management had sufficient controls, there would not be exceptions to the extent the auditor noted.

Exceptions noted in an audit are exactly that. They are what the auditor noted during the audit. It should not be interpreted as the full extent of the errors that could exist in the population. Because we cannot examine the entire population, the auditors are more interested in controls (which includes monitoring) that could provide reasonable assurance of compliance.

ⁱ **SECTION 7 CREDIT NOT TO BE LOANED.** *"No county, city, town or other municipal corporation shall hereafter give any money, or property, or loan its money, or credit to or in aid of any individual, association, company or corporation, except for the necessary support of the poor and infirm..."*