Port of Seattle

The Port of Seattle

Internal Audit Report

Host International, Inc and Seattle Restaurant Associates
Lease and Concession Compliance Audits

January 1, 2006 through December 31, 2007

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Internal Auditor's Report

We audited Lease and Concession Agreement number 435, as amended, between the Port of Seattle (Port) and Host International, Inc., and Lease and Concession Agreement number 439, as amended, between the Port and Seattle Restaurant Associates (a partnership between Host International, Inc. and Uwajimaya, Inc.) for the period January 1, 2006 through December 31, 2007. The purpose of the audits was to determine whether the lessees properly reported gross revenue and that the provisions of the lease and concession agreements were adequately monitored by Port management.

We conducted our audits using due professional care, and we planned and performed the audits to obtain reasonable assurance as to whether the Port and the lessees had complied with the provisions of the agreement.

The audits identified opportunities for improvement, which are detailed in subsequent sections of this report.

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

Kirangi

Joyce Kirangi, CPA
Internal Audit Manger

Executive Summary

Audit Scope and Objective

The purpose of our audit was to determine the level of compliance with the provisions of the Host International Inc. and the Seattle Restaurant Associates Food and Beverage Lease and Concession Agreements No. 435, as amended, and No. 439, as amended respectively. We examined the books and records of Host International Inc., who maintained the accounting records for both leases, to verify reported gross receipts and concession fees paid from January 1, 2006 through December 31, 2007. We also evaluated Port internal controls (Accounting and Aviation Business Development Department) in order to determine whether lease and concession contract provisions were adequately monitored.

Agreement Terms

Lease and Concession Agreements No. 435 and No. 439 authorize Host International, Inc. and Seattle Restaurant Associates to operate certain food and beverage concessions in the Airport. In accordance with the terms of the leases, Host International, Inc. and Seattle Restaurant Associates pay the Port percentage fees based on gross receipts. The percentage fees are based on concession categories, with a lower percentage fee base for the lessees' subtenants. The agreements also contain specific lease provisions that the lessees must comply with.

Audit Result Summary

Host International Inc., and Seattle Restaurant Associates complied with the terms and conditions of the lease agreements, and Port management effectively monitored the agreements, with the exception of the following:

- Franchise and license agreements were not obtained, reviewed, or approved Port by management.
- Revenue reconciliations between the lessee's and Port's records was not completed in a timely manner.
- Promotional and advertising income was not reported by the lessee.

Background

Host International, Inc., and Seattle Restaurant Associates operate food and beverage concessions at the Sea-Tac International. Seattle Restaurant Associates is a partnership between Host International, Inc. and Uwajimaya, Inc., and all accounting functions for both leases are performed by HMS Host in Bethesda, Maryland. The food and beverage concession agreements state that a specific percentage of gross receipts are to be paid to the Port for categories such as non-branded food and beverage; branded food and beverage; alcohol, beer, and wine; advertising; and souvenir merchandise. The percentages for these same categories are slightly lower for space that Host International, Inc., and Seattle Restaurant Associates sublease.

The Lease and Concession Agreements state that minimum rent payments are due on the first of each month. The concession fee is required to be paid monthly within fifteen (15) days following the end each calendar month as well as a statement of gross receipts generated from concessions in the prior month.

Gross Receipts and Concession fees generated by Host International, Inc. are as follows:

	2006			2007		
	Gross Receipts	Concession Fees	% Fee	Gross Receipts	Concession Fees	% Fees
Branded Food	14,507,410	1,668,352	11.5%	15,916,705	1,830,421	11.5%
Branded Food Subtenants	5,879,709	587,971	10.0%	6,427,624	642,762	10.0%
Food	2,818,342	380,476	13.5%	3,998,390	539,783	13.5%
Food Subtenants	2,854,752	342,570	12.0%	3,384,317	406,118	12.0%
Gifts	333,858	88,472	26.5%	405,943	107,575	26.5%
Gifts Subtenants	969	242	25.0%	24,088	6,022	25.0%
Liquor	5,091,479	891,009	17.5%	5,897,619	1,032,083	17.5%
Liquor Subtenants	925,347	148,056	16.0%	1,054,790	168,766	16.0%
TOTAL	32,411,866	4,107,148	12.7%	37,109,476	4,733,530	12.7%

Source: PeopleSoft and HMS Host reporting

Gross Receipts and Concession fees generated by Seattle Restaurant Associates are as follows:

	2006			2007		
	Gross Receipts	Concession Fees	% Fee	Gross Receipts	Concession Fees	% Fees
Branded Food	4,166,293	479,124	11.5%	6,536,915	751,745	11.5%
Branded Food Subtenants	0	0	10.0%	0	0	10.0%
Food	2,108,620	284,664	13.5%	2,064,096	278,653	13.5%
Food Subtenants	1,829,000	219,480	12.0%	2,282,246	273,870	12.0%
Gifts	517	137	26.5%	0	0	26.5%
Gifts Subtenants	0	0	25.0%	0	0	25.0%
Liquor	3,313,908	579,934	17.5%	3,982,931	697,013	17.5%
Liquor Subtenants	391,487	62,638	16.0%	482,278	77,164	16.0%
TOTAL	11,809,825	1,625,977	13.7%	15,348,466	2,078,445	13.5%

Source: PeopleSoft and HMS Host reporting

Audit Objectives

We reviewed Host and Seattle Restaurant Associates accounting records in order to verify that the company had:

- Properly reported its gross sales to the Port in accordance with the terms of the lease and concession agreement.
- Properly calculated and paid the appropriate concession fee due to the Port.
- Paid its concession fee on time and in accordance with the terms of the agreement.

We also reviewed Port management's monitoring processes over compliance of lease agreement provisions.

Audit Scope

The scope of the audit covered the period January 1, 2006 through December 31, 2007.

Audit Approach

To achieve our audit objectives, we performed the following procedures:

- Obtained an understanding of the lease agreement and the significant compliance requirements
- Reviewed Port internal controls and monitoring activities over lease requirements
- Obtained relevant financial data from HMS Host and it's subtenants
- Analyzed data (internal & external) to determine completeness & compliance

Conclusion

Host International Inc., and Seattle Restaurant Associates complied with the terms and conditions of the lease agreements and Port management effectively monitored the agreements, with the exception of the findings and recommendations discussed in this report.

Schedule of Findings and Recommendations

1) Approval of Franchisees and Licensees

The monitoring system was ineffective with regards to reviewing and approving the franchise and license branded food and beverage concession rate. The Port was charging Host and Seattle Restaurant Associates the branded food rate in the instances where Host and Seattle Restaurant Associates had identified establishments as franchisees or licensees. According to the lease agreement, the branded food concession rate is lower than the non-branded food concession rate. Host did not provide the license and franchise agreements to the Port.

According to the First Amendment to the Lease and Concession Agreement dated December 22, 2005 for Host International, Inc. Food and Beverage Lease and Concession Agreement paragraph five and the First Amendment to the Lease and Concession Agreement dated December 22, 2005 for Seattle Restaurant Associates paragraph four:

Definition of Branded Food & Beverage

"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 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 found no evidence that management had obtained, reviewed or approved the franchise and license agreements. Since management had not obtained these agreements, we had to request the franchise and license agreements from Host.

Effective monitoring and administration of lease agreements assures that the lessee is properly adhering to the terms and conditions of the lease agreement and properly reporting revenue. Management review of the franchise and licensee agreements is a control to assure that the Port is receiving the proper amount of concession fees from the lessee for branded and non-branded food. If the franchise and license agreements are not reviewed, management would not know if the lessee was under reporting non-branded and over reporting branded categories that would result in lost revenue to the Port.

Recommendation

We recommend that Aviation Business Development department review and approve all franchise and license agreements to assure that the proper concession categories are reported by Host and Seattle Restaurant Associates in accordance with the lease agreements.

Department Response:

Concessions management concurs that the franchise agreements should be reviewed and placed in the lease file for each concessionaire. We believe, however, that the absence of most franchise agreements from the lease files should not be seen as evidence that concessions staff has not actively monitored the accurate reporting of category sales for branded or non-branded food. The audit team has made no recoveries as the result of errors in the reporting of branded and non-branded food.

Two examples also demonstrate the effective staff monitoring of branded vs. non-branding reporting:

In 2005, a Host DBE subtenant (Backdraft LLC) opened a Diva Espresso coffee shop. The subtenant began reporting sales as 'branded' while Host made payments to the Port as 'non-branded.' Concessions staff immediately directed Host's attention to this inconsistency. The subtenant subsequently provided concessions staff with its franchise agreement, which demonstrated that Host was over-paying by reporting non-branded sales.

In 2006, Host opened a new restaurant under the name "Jose Cuervo Taquileria." The first reporting from Host was submitted as 'branded' at the branded rent percentage. Concessions staff immediately questioned this operation's franchise status and requested that Host provide the franchise agreement. When Host could not provide such an agreement, staff directed Host to report sales as 'non-branded' and retroactively pay percentage rent in accordance with the required percentage for non-branded food.

The vast majority of branded food establishments in the Airport, which pay a lower percentage rent than non-branded operations, are nationwide franchise chains such as Burger King, Starbucks, Manchu Wok, Sbarro and Tully's Coffee. In the experience of concessions staff, there are no known instances of these types of restaurants being operated as any other type of operation than as a franchise, when not operated by the corporate entity.

With the review and placement of the franchise agreements in the lease files, this issue should be satisfactorily resolved for Host International.

2) Yearly Revenue Reconciliation

The management monitoring system was ineffective to ensure that Host and Seattle Restaurant Associates revenue reconciliations were completed timely. We noted that the independent Certified Public Accountant's reports of the audited gross receipts for both Host and Seattle Restaurant Associates were issued on April 27, 2007 and April 23, 2008 for the years ending on 2006 and 2007 respectively. However, management reconciliations of the 2006 and 2007 reported revenue, with the independent Certified Public Accountant's report were not completed until in January of 2009. Sound business practices dictate timely reconciliation of accounting records in order to assure timely credit or billing of balances.

Recommendation

We recommend that both Aviation Business Development department and Accounting and Financial Reporting (AFR) departments ensure that reported concession revenue is reconciled with the independent Certified Public Accountant's report on a timely basis.

Department Response

AFR takes responsibility to support the Aviation Business Development department by reviewing the annual audited financial statements of the concession tenants and comparing the revenues contained in those reports with that reported by the concession tenants. AFR has protocols and procedures in place to accomplish this. The area for improvement identified in the audit was caused by an interim staffing difficulty experienced by AFR. A key senior team member unexpectedly left for an extended period of time under the Family Medical Leave Act (FMLA). With already a conservative staffing level and now facing a notable staff resource challenge, AFR ensured coverage of the highest priority items with a conscious decision to defer less critical tasks until the AFR Billing team resumed with full staff resources. Upon subsequent return of the senior team member, immediate attention was given to areas such as these that had to be deferred. AFR is now fully staffed again and review of audited financial statements against revenues reported by the concession lease tenants are being timely accomplished. It remains a key priority for the AFR Billing team to ensure timely & accurate monthly billings, timely revenue collection, and subsequent reported revenue accuracy verification.