Port of Seattle

Internal Audit Report

Borders, Inc.
Lease and Concession Compliance Audit

June 1, 2006 through May 30, 2009

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Internal Auditor's Report

We audited the Lease and Concession Agreement between the Port of Seattle (Port) and Borders, Inc., for the period June 1, 2006 through May 2009. The purpose of the audit was to determine whether the lessee properly reported gross revenue and that the provisions of the lease and the concession agreement were adequately monitored by Port management.

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

The lessee materially complied with the terms and conditions of the agreement but did not fully comply with the proper reporting of all gross receipts. We also noted that Borders was not timely in remitting monthly concession fees which Port management could have monitored more effectively to ensure compliance.

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

Kirangi

Joyce Kirangi, CPA
Director, Internal Audit

Executive Summary

Audit Scope and Objective The purpose of our audit was to determine the level of compliance with the provisions of Borders, Inc (Lessee) Lease and Concession Agreement No. 622. We examined the books and records of the Lessee in order to verify the accuracy and completeness of reported gross receipts and concession fees paid from June 1, 2006 through May 30, 2009. We also evaluated Port controls in order to determine whether lease and concession contract provisions were adequately monitored. The Aviation Business Development Department has the primary responsibility for monitoring and implementing effective controls for the Borders lease agreement.

Agreement Terms Lease and Concession Agreement No. 622 authorizes Borders, Inc. to operate a retail book store at the Airport. In accordance with the terms of the lease, the Lessee pays the Port a rental fee of 7% on its gross receipts and a 5% concession fee.

Audit Result Summary The lessee materially complied with the terms and conditions of the agreement but did not fully comply with the proper reporting of all gross receipts. We also noted that Borders was not timely in remitting monthly concession fees which Port management could have monitored more effectively to ensure compliance.

Background

The Port's lease and concession agreement with Borders, Inc. authorizes the Lessee to operate a branded retail book store at Sea-Tac airport.

Borders Group, Inc. is a publicly held company with 2008 consolidated sales of $3.2 billion and operates over 515 superstores in the U.S. Borders Group owns London-based Paperchase Products Limited, a retailer of stationery, cards and gifts with 124 locations outside the U.S., including stand-alone stores and concessions. Borders operating goal is to engage customers with a rich shopping experience and provide them with books, music, movies, and other entertainment items.

Borders occupancy date at Sea-Tac occurred on January 21, 2005. That was the effective date of the agreement which has an expiration date of 5/31/2015.

The agreement requires twelve monthly payments of a Minimum Annual Guarantee (MAG) due in advance by the first of each month. There has been routine annual maintenance activities pertaining to insurance and surety bond requirements and annual adjustments to the MAG based on prior year's sales activity.

The total lease concession fee revenue generated for the Port is as follows:

FY Ended May 30	Amount
2007	576,422
2008	592,139
2009	562,101
Total	$1,730,662

Source: PeopleSoft and Borders, Inc. reporting

Audit Objectives

The purpose of the audit was to determine whether:

1. The lessee complied with the terms and conditions of the concession lease agreement in terms of completeness, accuracy and timeliness including:

   - The accurate and complete reporting of gross receipts and payment of concession fees.

   - Monthly gross receipts statement and computation of required rent, concession and related leasehold taxes were reported accurately.

- Monthly payments of Minimum Annual Guarantee and Payments of Percentage Fees were made timely.

2. Lease and concession agreement provisions were adequately enforced by Port management including:

    - Required insurance coverage and surety.
    - Timely submittal of annual attested reports.
    - Any unique provisions in the Agreement, such as Quality Assurance Audits.

Audit Scope

The scope of the audit covered the period of June 1, 2006 through May 30, 2009.

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 the Lessee, including Bank and Profit and Loss Statements, z-tapes, and sales reports to the Washington State Department of Revenue
- Analyzed data (internal & external) to determine completeness & compliance.

Conclusion

The lessee materially complied with the terms and conditions of the agreement but did not fully comply with the proper reporting of all gross receipts. We also noted that Borders was not timely in remitting monthly concession fees which Port management could have monitored more effectively to ensure compliance.

Schedule of Findings and Recommendations

1) Noncompliance with Lease Terms

The lease agreement in *Section 1.8* stipulates all the provisions for reporting gross receipts. The agreement makes the following allowances for not including in gross receipts:

Section 1.8.1 Refunds because of unacceptable or unsatisfactory goods.
Section 1.8.2 Discounts actually granted.
Section 1.8.3 Sales taxes imposed and collected as agent for the taxing body.

We reviewed Borders Profit and Loss statements for the audit period and noted that credit card fees were recognized as reduction to concessionable gross receipts. Such fees are not included in the allowed deductions, and thus the reduction resulted in underreporting of concession fees as follows:

	Disallowed Credit Card Fees	Additional Concession (12 %) owed to the Port
2007	$ 83,673	$ 10,041
2008	$ 72,716	$ 8,726
2009	$ 70,307	$ 8,437
Total	$ 226,696	$27,204

Source: Borders, Inc. Profit and Loss Statements

Per *Section 7* of the lease agreement, audit costs are borne by the Port of Seattle unless the results reveal a discrepancy of more than two percent reported in accordance with *Section 4* for any twelve month period. In the event of such discrepancy, the full cost of the audit shall be borne by the Lessee. For each of the three years audited, the two percent threshold was exceeded as follows:

Fiscal Year Ended May 30	Gross Receipts Reported	Rent and Concession Reported	2% of Rent and Concession Reported	Discrepancy due to Credit Card Fees	Discrepancy Exceeds the 2%?
2007	$ 4.5 M	$ 576,422	$ 11,528	$ 83,673	Yes
2008	$ 4.9 M	$ 592,139	$ 11,842	$ 72,716	Yes
2009	$ 4.8 M	$ 562,101	$ 11,242	$ 70,307	Yes

Source: Borders, Inc. Profit and Loss Statements

As a result, Borders is responsible for the audit cost of $9,287.

In addition, the lease agreement defines in *Section 1.8* gross receipts to include any "retail display allowances" or other promotional or advertising income received. Borders entered into agreements with magazine cooperatives beginning in February 2007 for the placement of their magazines in more prime locations in all Borders stores. However, income received (approximately $225,000 during the audit period for all Border's stores) was not allocated from these agreements to individual stores. Consequently, none of the display allowances were reported as part of concessionable receipts in the audit period. Due to lack of an allocation base, the display allowances attributable to the location at the airport cannot be estimated.

Recommendations

We recommend management:

1. Bill Borders, Inc. for $27,204 in lost concession.
2. Bill Borders $9,287 for audit cost.
3. Review periods prior to the audit period for potential underreporting of concessionable gross receipts due to credit card fees.
4. Work with Borders to establish an equitable formula to be allocated for all retail display allowances. Further, seek reimbursement, of any concession fee owed to the Port as a result of this display allowance or gross receipts that were not reported to the Port.

Management Response:

The Concessions group was pleased to hear about the great degree of cooperation by the Borders accounting staff with the Port's internal audit staff. We understand that they complied with all requests on a timely basis and were readily forthcoming with information.

Underreporting of concessions sales

The audit revealed that Borders had deducted credit card fees from gross reported sales. The Concessions group commends the efforts of Internal Audit in discovering this non-compliance with the provisions of the Borders lease agreement. We agree (along with the management of Borders Books) that they must pay the Port for the lost concession revenue.

Audit Costs

The recoverable from this audit exceeded the allowable for the Port to incur the cost of the audit. Therefore, we agree that the Port should bill Borders the costs for this audit, in accordance with the lease agreement.

Review Prior Periods for Lost Revenue

The Borders lease agreement states that the lessee "shall not be required to maintain such enumerated records for more than three years." For this reason, concessions does not believe that it is possible to audit records prior to those already subject to audit. However, Borders did begin reporting credit card fees in reported sales, when this non-compliant practice was first brought to Borders attention (some agreements may allow this practice, but the Port lease agreement does not). Borders also has agreed to submit revised sales reporting for the lease year beginning June 2009.

Retail Display Allowance

As is common with magazine and booksellers, publishers pay a retail display allowance for more prominent display in stores. Such allowances should be reported as gross sales. Borders did receive such allowance during the audit period, but it was not allocated to specific stores. Concessions commits to working with Borders staff and Port Legal to determine a method of allocating future allowances as gross sales.

2) Late Payments

The lease agreement requires concession/rent fees be paid within fifteen (15) days following the end of each calendar month. For late payments, the agreement provides under *Section 8* a penalty of 5% and interest to be accrued at 18% per annum or the maximum allowed by the law, whichever is less.

We reviewed Borders, Inc. payment history for the audit period and noted the following:

- We noted 22 instances of late concession/rent fees exceeding the 10 day grace period.
- We applied 5% to overdue amounts and an annual interest of 18% to the balance until paid for our calculation.
- Our calculation resulted in penalty/interest of $11,113 for the period June 1, 2006 through May 30, 2009.

Recommendation

We recommend the management bill Border's, Inc. $11,113 in late fees and interest charges.

Management Response:

The audit documented instances when Borders submitted payment and/or reporting more than 10 days (grace period) after the 15th of the month following the sales month. The lease agreement stipulates a 5% penalty and interest accrued at 18% per annum until payment of sales and penalty is made. Different from lease/rental payments which facilitate predetermined amounts to bill regularly, the amount to bill on concession agreements is variable and not known until the concessionaires submit reporting (and payment) to the Port. The Port's central financial system does not provide an automated mechanism to support after-the-fact variable computation and billing of late fees. In 2009, the Port implemented a manual solution using a desktop application to compute and bill late fees. With this solution in place, all tenants were notified in 2009 that moving forward they could expect to be billed penalty and/or interest accrued. All tenants are now being billed for any applicable late fees according to the terms of their lease. As for the retroactive considerations, management will work toward resolution with guidance from the Port Legal department.