Internal Audit Report

Sky Chefs, Inc

Lease and Concession Compliance Audit

January 1, 2008 through December 31, 2009

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Table of Contents

Internal Auditor's Report

We have completed an audit of the Lease and Concession Agreement, as amended, between the Port of Seattle and Sky Chefs, Inc. The purpose of the audit was to determine the following:

1) Reported concession was complete, properly calculated and remitted timely to the Port.
2) Port and the lessee complied with provisions of the Lease and Concession Agreement.
3) Lease and Concession Agreement, as amended, complies with applicable state and Port requirements.

We examined information related to a two-year period from January 1, 2008, through December 31, 2009.

We conducted our audit using due professional care. We planned and performed the audit to obtain reasonable assurance as to compliance with significant provisions of the agreement, including complete and timely reporting of concessionable revenues.

Sky Chefs materially complied with the terms of the Lease and Concession agreement, with an exception of disallowed revenue deductions. The agreement itself complies with applicable state and Port requirements.

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

Kirangi

Joyce Kirangi, CPA
Director, Internal Audit

Executive Summary

Audit Scope and Objective The purpose of the audit was to determine the following:

1) Reported concession was complete, properly calculated and remitted timely to the Port.
2) Port and the lessee complied with provisions of the Lease and Concession Agreement.
3) Lease and Concession Agreement, as amended, complies with applicable state and Port requirements.

We examined the books and records of Sky Chefs, Inc., for a two-year period from January 1, 2008 through December 31, 2009. Aviation Business Development has the primary responsibility for administering and monitoring the agreement to ensure compliance with agreed-upon terms.

Agreement Terms Sky Chefs, Inc. provides in-flight catering service, including the preparation and distribution of in-flight foods, beverages, and related services to domestic and overseas airlines at Seattle Tacoma International Airport.

The terms of the agreement provide for a 7% concession fee on the gross sales for catering services to airlines, and a 3.5% concession fee on the gross sales to non-airline parties, with only the following acceptable offsets or deductions:

1) Returns and refunds
2) Taxes imposed and collected by Lessee as agent for its taxing body
3) Meals furnished to employees of Lessee

A monthly rent is payable in advance, on or before the first day of each month, without notice from the Port. The concession is due monthly within 15 days following the end of each calendar month. For untimely payments, the agreement provides interest to be accrued from the due date until paid.

Audit Result Summary Sky Chefs materially complied with the terms of the Lease and Concession agreement, with the exception of disallowed revenue deductions. The lessee offset its gross revenue with approximately $888,964 of disallowed discounts resulting in underpaid concessions of approximately $6,890. The agreement itself complies with applicable state and Port requirements.

Background

The agreement was originally signed with Marriott in November 1980, but later assigned to Caterair International Corporation in July 1995. Caterair subsequently subleased the agreement to Sky Chefs in September 2001.

Sky Chefs began its operations in the 1940s as a catering arm of American Airlines. Through acquisitions over time, the company became a wholly owned subsidiary of Lufthansa. The company is officially known as LSG Sky Chefs, and currently operates in 49 countries.

The concession fee per the agreement is defined as 7% and 3.5% of gross sales from airline and non-airline customers, respectively. Gross sales subject to the concession include all revenue streams from the lessee's operation at Seattle-Tacoma International Airport, with the exception of three expressly allowed sales deductions:

1) Returns and refunds
2) Taxes imposed and collected by Lessee as agent for its taxing body
3) Meals furnished to employees of Lessee

Financial Highlights

Year	Reported Gross Revenue	Paid Concession
2006	19,771,729	$1,032,199
2007	16,225,964	908,508
2008	20,480,996	1,351,834
2009	24,207,455	1,654,627
Total	**$80,686,144**	**$4,947,168**

Source: PROPworks and PeopleSoft

Audit Objectives

The objective of our audit was to determine the following:

1) Reported concession was complete, properly calculated and remitted timely to the Port.
2) Port and the lessee complied with provisions of the Lease and Concession Agreement.
3) Lease and Concession Agreement, as amended, complies with applicable state and Port requirements.

Audit Scope

The scope of the audit covered the period January 1, 2008 through December 31, 2009.

Audit Approach

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

- Read and analyzed the lease agreement, as amended.
- Reviewed applicable state and local rules and regulations.
- Identified significant provisions in the agreement.
- Obtained necessary financial and non-financial data from the lessee.
- Assessed relevant risks associate with the agreement.
- Designed and executed audit procedures based on risk.
- Analyzed data (internal & external) to determine completeness & compliance, including:
    - Reconciliation of the reported gross receipts to the lessee's accounting records to ensure completeness and consistency.
    - Reconciliation of the certified Audited Schedule of Gross Receipts to lessee's accounting records to ensure completeness.
    - Verification that concession fee were paid timely and intact.
    - Recalculation of concessions and related fees to ensure accuracy.

Conclusion

Sky Chefs materially complied with the terms of the Lease and Concession agreement, with the exception of disallowed revenue deductions. The lessee offset its gross revenue with approximately $888,964 of disallowed discounts resulting in underpaid concessions of approximately $6,890. The agreement itself complies with applicable state and Port requirements.

Schedule of Findings and Recommendations

1. Disallowed Revenue Deductions

This is a repeat finding. In 2007, we audited Sky Chefs records and suggested a recovery of approximately $30,000 because Sky Chefs was netting its gross revenue with disallowed discounts. Management disagreed with the finding and did not pursue collection.

Gross revenue is defined under Section 3.d iii as:

> "…the total selling price, fee or charge, whether for cash, credit or otherwise, of all prepared meals, food or other products, and of all related food catering services or other services, and all other receipts whatsoever, resulting from or attributable to Lessee's operations on the Premises, regardless of delivery point or place of payment, without offset or deduction of any kind except (i) returns and refunds; (ii) the amount of any sales tax or other excise tax imposed on the purchaser and collected by Lessee as agent for their taxing body item; and (iii) meals furnished to employees of Lessee..."

Except for the following three specific allowances to offset gross revenue, there are no other reductions allowed in the agreement:

- Returns and refunds
- The amount of tax collected on behalf of taxing body
- Meals furnished to employees of Lessee.

During this audit, we reviewed the lessee's general ledger in detail. We noted that the lessee continues to reduce its gross revenue with discounts such as Quick-Pay and Group Volume Discount. These discounts amounted to $518,094 and $370,870 in 2008 and in 2009, respectively. These discounts were inconsistently applied to gross revenue. Sometimes the discounts were offset against gross revenue, and in other months they were not.

Based on the audit finding from 2007, which resulted in a disagreement concerning the definition of gross revenue, we expected to see clarifying language in 2010, but we found none.

The effect of offsetting gross revenue with the disallowed discounts is documented below. The auditor's calculation shows Sky Chefs owes the Port an additional $6,890 in concession fees for this audit period. The relatively small additional concession amount is a result of Sky Chefs inconsistent treatment of the discounts.

Year	Type of Gross Revenue	Reported Gross	Actual Gross Revenue Per Audit	Rate	Total Concession Due Per Audit	Total Concession Paid	Additional Concession Due
2008	Airline	19,984,923	19,948,315	7.0%	1,396,382	1,416,307	2,436
	Non-Airline	496,074	638,877	3.5%	22,361		
2009	Airline	23,464,866	23,502,920	7.0%	1,645,204	1,668,531	4,454
	Non-Airline	742,589	793,748	3.5%	27,781		
							6,890

Recommendation

We recommend management collect approximately $6,890 in additional concession fees. Further for the upcoming lease agreement RFP, we recommend management clarify the definition of gross revenue.

Management Response

Aviation Business Development (AVBD) staff disagrees with this Internal Audit finding. In response to the 2007 audit of Sky Chefs where this same issue was identified, AVBD staff consulted Port Legal staff on the audit finding. Legal staff concluded that Internal Audit's interpretation of the lease was incorrect and that Sky Chef did not owe the Port this money. Since there have been no new developments to change this conclusion, AVBD staff see no reason to bill the tenant for this money.

Internal Audit did, however, note some irregularities in the reporting of the revenue deductions. Therefore AVBD staff will request corrected reports from Sky Chefs. In addition, since the current lease language relating to gross revenues is perceived by Internal Audit to be unclear, staff will work to clarify this language in terms of what is included and excluded from gross revenue in the up-coming lease negotiations. AVBD staff will also add a provision in the lease requiring an Annual Report and more specific language about late fees and interest charges.