Port of Seattle

Internal Audit Report

Third-Party Arrangements Operational Audit
Club International Lounge

March 5, 2010 to present

Issue Date: September 7, 2011
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Transmittal Letter

We have completed an audit of a third-party management agreement of Club International Lounge at the airport. The purpose of the audit was to determine whether Port management has established adequate controls to ensure that operating expenses are effectively managed and the contractor has complied with the third-party agreement.

Management has the primary responsibility to establish and implement effective controls. Our role was to assess and test those controls in order to establish whether the controls were adequate and operating effectively.

We conducted the audit using due professional care. The audit was planned and performed to obtain reasonable assurance that department controls are adequate and operating effectively as intended.

Port management has adequate and effective controls to ensure compliance with the third-party agreement. Operating expenses were effectively managed with the exception of payroll.

We extend our appreciation to management and staff of VIP Hospitality, Aviation Customer Services, and Aviation Business Development for their assistance and cooperation during the audit.

Kirangi

Joyce Kirangi, CPA
Internal Audit, Director

Executive Summary

Audit Scope and Objective Our audit objective was to determine if management implemented adequate controls to assure:

1.) Compliance with the management agreement
2.) Monitoring of the operating expenses was adequate

We reviewed information from the date of the start of the agreement March 5, 2010 to July 2011.

Background The Port owns Club International Lounge at Sea-Tac Airport. The Port pays for all the Lounge operating expenses, including costs related to compensation, benefits, and payroll taxes for the contractor's employees working at the Lounge. All revenue generated by the Lounge is remitted to the Port.

In March of 2010, a three-year management agreement was entered into with VIP Hospitality LLC to manage the day-to-day services of the Lounge. The management agreement provides that at a fee the contractor will operate, manage, and maintain lounge services on a per-flight basis for designated airline passengers.

The Lounge currently services two airlines - Asiana and Condor Airlines - with plans to expand the number of airlines serviced. Operating revenues were approximately $92,000, and operating expenses were approximately $46,000 for the first seven months of 2011.

Audit Result Summary Management has adequate controls to ensure that Club International Lounge operations are effectively managed and in compliance with the third-party agreement. We; however, noted a control exception over payroll reimbursements in that payroll benefits and taxes were reimbursed based on budget estimates rather than actual expenses incurred.
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Background

The Port owns Club International Lounge at Sea-Tac Airport. The Port pays for all the Lounge operating expenses, including costs related to compensation, benefits, and payroll taxes for the contractor's employees working at the Lounge. All revenue generated by the Lounge is remitted to the Port.

In March of 2010, a three-year management agreement was entered into with VIP Hospitality LLC, through a request for proposal (RFP) process, to manage the day-to-day services of the Lounge. The management agreement provides that the contractor will operate, manage, and maintain lounge services on a per-flight basis for designated airline passengers in consideration of a management fee.

The Lounge currently services two airlines - Asiana and Condor Airlines - with plans to expand the number of airlines serviced. The Port bills monthly the airlines for the number of passengers that patronize the lounge. All the assets of the operation including inventory are owned by the Port. Operating revenues were approximately $92,000, and operating expenses were approximately $46,000 for the first seven months of 2011.

The lounge is located in the South Satellite and consists of a serving area and office area with internet hook-up and printer access for passengers. Currently a variety of food and other than alcohol beverage are available to patrons. In an effort to promote sales growth, a liquor license application has been submitted to the Washington Liquor Control Board.

As part of the 2011 Work Plan, management requested an audit of this third-party management agreement. Although the operation is still small, Port management plans to expand the airport lounge services and patrons. Based on the risks we have encountered with the other Port management agreements, Internal Audit concurred to include this audit in the 2011 Work Plan.

Highlights of Revenues and Expenses for the Last Two Calendar Years:

	2010	2011 thru July
Revenue	105,500	92,320
Operating Expenses	114,188	46,108
Management Fee	42,672	36,847
Net Income	(51,360)	9,365

Audit Objective

The purpose of the audit was to determine if management has implemented adequate controls to assure:

1.) Compliance with the management agreement

2.) Monitoring of the operating expenses was adequate

The scope of the audit covered the period from of March 2010 to present.

Department Highlights and Accomplishments

The Club International Lounge started off with one airline and has grown to serve two airlines. Passenger counts and revenue have increased by 30 percent since its inception. The lounge is a profitable model in 2011. There are plans to add liquor service and additional airlines.

Audit Scope and Methodology

We conducted the audit to determine whether the contractor was in compliance with the terms of the management agreement. We utilized a risk-based audit approach from planning to test sampling. We performed a multitude of information gathering methods including research, interviews, observations, and analytical reviews in order to obtain a complete understanding of the Club International Lounge operations. We conducted an assessment of significant risks associated with the Port's management of the third-party agreement, and identified controls to mitigate those risks. We evaluated whether the implemented controls were functioning as intended. Based on the risk assessment, we established the area of audit focus.

We applied additional detailed audit procedures to areas with the highest likelihood of significant negative impact as follows:

1. Compliance with the management agreement

    - To determine compliance with contract procurement requirements, we reviewed documentation related to the advertisement for request for proposal (RFP), submitted proposals, and the selection process including a scoring summary.

    - To determine compliance with the spending limitations set by the agreement, we compared budgeted to actual expenditures for the first six months of 2011.

    - We selected and reviewed a risk-based sample of 28 checks to determine if expenses were valid, legitimate and related to lounge operations.

    - To determine the propriety of payroll expense reimbursements, including benefits, we reviewed January and April of 2011 reimbursements. Each transaction was analyzed, recalculated, and agreed to the reimbursements.

    - To determine compliance with insurance requirements, we reconciled insurance requirements to the coverage reflected in the certificate of insurance in force for a 12-month period ending 3/15/2012.

2. Management Monitoring

- To assess the effectiveness of inventory controls, we reviewed management monitoring processes and June 2011 inventory reconciliation. In addition, we performed an inventory count and reviewed the result for reasonableness.

- To determine the effectiveness of management controls to ensure continuing adequate/sufficient insurance coverage over Port's assets, we reviewed the insurance policies for adequacy and sufficiency in insurance coverage, as defined in the agreement.

- To determine the effectiveness of management controls over revenue, we reviewed the invoicing and receipt of funds for the first six months of 2011.

- To determine whether the monitoring of operating expenses was adequate, we reviewed 28 checks and related invoices for the evidence and extent of management review.

Conclusion

Management has adequate controls to ensure that Club International Lounge operations are effectively managed and in compliance with the third-party agreement. We; however, noted a control exception over payroll reimbursements in that payroll benefits and taxes were reimbursed based on budget estimates rather than actual expenses incurred.

Schedule of Findings and Recommendations

1. Payroll Reimbursements Based on Estimates

Under Section 24 a.2.(ii) of the agreement, the Port agreed to reimburse all operating expenses including compensation costs (e.g., benefits and taxes) for all employees working full or part-time at the lounge. We noted that the contractor, VIP Hospitality, included a flat percentage of payroll expenses for taxes and benefits, as opposed to actual costs incurred. Specifically, the Port reimbursed VIP Hospitality for payroll expenses based on a budget estimate of 33% and 28% for administrative and lounge staff, respectively.

Employing estimates in operating expenses could result in over/under reimbursements. If reimbursements to the contractor are based on estimates during the year, a true-up reconciliation need to be performed at the yearend. Close review and monitoring by Port management should ensure that yearend reconciliations are performed.

Recommendation

We recommend the management:

- Review and recalculate prior months' payroll expenses based on actual expenses incurred by VIP Hospitality.
- Consider implementing a true-up process whereby estimated charges are compared and trued up with actual expenses over a reasonable time period (e.g., annually).

Management Response

Management agrees that employing estimates for payroll expenses could result in either an underpayment or overpayment. In order to remove the risk of either occurrence, management will implement a true-up process to reconcile the estimated payroll benefit expenses with the actual expenses. The true-up process shall occur annually prior to January 31. The difference of the amounts shall be paid by either the Port of Seattle to VIP in cases of underpayment and conversely by VIP to the Port of Seattle in cases of overpayment. This year's true-up process shall include a reconciliation of all payroll expenses, dating back to the agreement commencement date, March 5, 2010.