PORT OF SEATTLE
MEMORANDUM

DATE: December 4, 2012

TO: Audit Committee and CEO

FROM: Joyce Kirangi, Director, Internal Audit Department

SUBJECT: Risk-Based Audit Approach for Audit Report No. 2012-19

On November 13, 2012, the Internal Audit Department issued an audit report of the Real Estate Portfolio Department (Report No.2012-19). This was a comprehensive operational audit of the Department. After the audit presentation, the Audit Committee requested further explanation as to why the auditor had focused the audit on Real Estate Policies 1 and 2. This memo provides that explanation.

To gain efficiency and effectiveness in its audits, Internal Audit conducts its audits using a risk-based approach. The process involves, first, gaining a thorough understanding of the business unit objectives, environment, operations, activities, and assessing the risks that could significantly interfere with, or hinder, the business unit from meeting its objectives. Second, the audit is planned to focus on those high-risk areas of the operations, where Internal Audit believes it can add value.

For the Real Estate Portfolio Department, we specifically:

- Met with management and staff to gain an understanding of the Department operations and activities.
- Reviewed Port and Department policies and procedures that govern various activities.
- Conducted detailed financial and non-financial analytics of the Department activities including payroll, expenses, disbursements, etc.
- Evaluated prior external and internal audit reports and findings.
- Identified risks that could interfere with the Department's mission.
- Evaluated and assessed the established controls to mitigate or reduce perceived risks.

Based on our understanding and assessment of the Department operations, and working closely with Department management, we made a professional judgment to focus our audit (for further detailed testing) in the following two areas:

1. Development of real estate agreements for the Real Estate Division properties.
2. Management of the Real Estate and Seaport Division properties in the Port's PROPWorks system.

The first objective was developed in consideration of the Department's business objectives and the significant risks associated with real estate development activities, including potential non-compliance with the Port's Real Estate Policies. We evaluated all policies and sub-procedures to determine which individual elements were directly related to the significant risks identified in the first objective.

Below is a review of the Port's Real Estate Policies and sub-procedures that were evaluated as part of the audit planning and risk assessment. We have included a brief explanation as to why the policy or procedure was included as part of the audit plan.

Real Estate Policy 1 (RE-1) and Real Estate Procedure (REP-1)
The Port's RE-1 Policy covers all agreement types for Port properties, including the requirements for departmental review, identifying prevailing market conditions, and conducting a financial risk analysis for future and potential tenants seeking business agreements with the Port. REP-1 has specific requirements for month-to-month agreements, but the auditor's review concluded that they did not rise above the requirements of RE-1.

Real Estate Policy 2 (RE-2) and Real Estate Procedures (REP-2, REP-3, REP-4, REP-5, REP-6)
The Port's RE-2 Policy offers strategic requirements for the acquisition, use, and divesture of Port properties. The Real Estate Portfolio Department is only subject to the *use* clause, as it does not acquire or divest properties for the Real Estate Division. The auditor reviewed during planning the sub-procedures, as they pertain to existing Port properties actively managed by the Department:

- REP-2 provides additional detail for how Real Estate Division agreements should be developed in accordance with RCW 53.08. It primarily concerns Seaport properties and, as such, it is considered outside the scope.
- REP-3 is for aquatic leases, which are predominately outside the scope of the Portfolio Department. The auditors found good controls for ensuring environmental and legal review for aquatic leases and did not review further.
- REP-4 is for the sale and divesture of Port Real Estate properties. The Portfolio Department *only* manages properties. It does not buy or sell properties, so this procedure was excluded from the audit scope.
- REP-5 concerns broker commissions for the sale and leasing of properties. The auditors had conducted analytical reviews of commissions paid to brokers and deemed this an area of low risk.
- REP-6 concerns criteria for major real estate transactions, and largely falls outside of the scope of the Real Estate Department. Much of REP-6 is included in RE-1.