Port of Seattle

Internal Audit Report

Lease and Concession Audit

Airport Management Services, LLC

May 1, 2008– April 30, 2010

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Transmittal Letter

Audit Committee
Port of Seattle
Seattle, Washington

We have completed an audit of the Lease and Concession Agreement, as amended, between the Port of Seattle and Airport Management Services, LLC.

We examined information related to a two-year period from May, 1 2008 to April 30, 2010.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We extend our appreciation to the Aviation Business Development staff for their assistance and cooperation during the audit.

Kirangi

Joyce Kirangi, CPA
Director, Internal Audit

Executive Summary

Audit Scope and Objective The audit objective was to determine whether Airport Management Services complied with the following gross receipts reporting requirements of the Lease and Concession Agreement:

1. Complete reporting of sales subject to gross receipts
2. Complete reporting of "Retail Display Allowances" in the report of gross receipts
3. Compliance with significant provisions of the agreement including the certified CPA reports

We examined the books and records of Airport Management Services, LLC for a two-year period from May 1, 2008 through April 30, 2010. Aviation Business Development in conjunction with Accounting and Financial Reporting (AFR) has the primary responsibility for administering and monitoring the agreement to ensure compliance with agreed-upon terms.

Background The Port of Seattle entered into a lease and concession agreement with Hudson News Company, d/b/a Hudson News Group, for operation of Retail Concessions at Seattle-Tacoma International Airport. In July of 2004, with consent from the Port of Seattle, Hudson News Group assigned all its lease rights to Airport Management Services, LLC.

Hudson operates 20+ different concession locations under the lease, including 4 specialty locations. The lease provides four different categories of retail merchandise with a different concession rate ranging from 11.5% to 26.5%. The agreement generates annually approximately $7 million in non-utility revenues to the Port:

	2009	2010	2011
Revenue	$7,054,411	$6,973,595	$7,559,343

Source: PeopleSoft

The concession fee is payable to the Port to the extent that the concession fee is greater than the monthly Minimum Annual Guarantee. Concession fee, if applicable, is due by the 15th of the following month and is paid in accordance to an established schedule.

For untimely payments, the agreement provides for a one-time late fee of 5% of the overdue amount and interest to be accrued at the rate of 18% per annum from the due date until paid.

Audit Result Summary We concluded that Airport Management Services did not properly report concession related to Retail Display Allowances (RDAs) and promotional & marketing efforts in the amount of $297,679 and $74,916, respectively. Additionally, we noted that certain merchandise types were misclassified for the purpose of concession calculations which resulted in a concession overpayment of $116,336 to the Port. See Schedule of Findings and Recommendations on Page 7.

We noted no other instances of noncompliance with significant provisions of the agreement.

Background

On January 28, 2003, the Port of Seattle entered into a lease and concession agreement with Hudson News Company, d/b/a Hudson News Group, for operation of Retail Concessions at Seattle-Tacoma International Airport. In July of 2004, with consent from the Port of Seattle, Hudson News Group assigned all its lease rights to Airport Management Services, LLC.

There are 20+ different concession locations under this lease. This includes 4 specialty locations: Discover Puget Sound, Made in Washington, Life is Good, and Kid's Works. There are 2 bookstores, and 2 "stores within a store" at the north and south satellite locations. The lessee is allowed to sell specialty items at these stores within a store location. The rest of the concession locations are basic newsstands.

The lease provides the following four different categories of retail merchandise; each category has a different concession rate:

Category A	14.5% Concession	Newspapers, magazines, books, retail display allowance (RDAs), promotional income, HBA, sundries, candy, snacks, beverage, travel accessories, tobacco products, and other news related products
Category B	26.5% Concession	Souvenirs, gifts, and apparel, with the exception of items which are offered for sale in distinct “boutiqued” areas of News/Gift stores and approved by the Port as Category C items
Category C	11.5% Concession	Specialty Retail merchandise that is sold in distinct “boutiqued” areas of News/Gift stores and approved by the Port as Category C item
Category D	11.5% Concession	Souvenirs, books, gifts crafts and apparel sold from Specialty Retail and Book Stores

The concession fee is payable to the Port to the extent that the concession fee is greater than the monthly Minimum Annual Guarantee. Concession fee, if applicable, is due to the Port by the 15th of the following month and is paid in accordance to an established schedule.

For untimely payments, the agreement provides for a one-time late fee of 5% of the overdue amount and interest to be accrued at the rate of 18% per annum from the due date until paid.

Below is the highlight of revenues (non-utility) to the Port from Airport Management Services, LLC:

	2009	2010	2011
Space Rental General	$106,900	$105,819	$155,108
License to Use	3,360	3,360	3,360
Tenant Marketing Assessment	206,292	207,880	218,356
Retail Display Allowance	3,433	1,980	54,790
Retail - L/H Taxable	2,908,491	3,050,164	3,213,556
Retail	3,569,791	3,695,904	3,822,364
Retail MAG	256,145	(91,513)	91,809
	$7,054,411	**$6,973,595**	**$7,559,343**

Source: PeopleSoft

Audit Scope and Methodology

We reviewed information for a two-year period from May 1, 2008 to April 30, 2010. We utilized a risk-based audit approach from the planning phase to testing. We gathered information through observations and detailed analytical reviews in order to obtain a complete understanding of the lessee operations and financial records.

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

a. Concession Revenue

- Obtained and analyzed detailed accounting information including sales reports by category and store location to ensure that the recorded sales were reasonable and complete.
- Agreed a profit and loss statement to the receipts reported and concession paid to the Port.
- Verified that the reported receipts were consistent with the lessee's sales records.
- Verified the reported sales to an independent sales data source.
- Reviewed and verified that deductions to gross receipts were proper and reasonable.
- Recalculated the reported concession to ensure accuracy.

b. Retail Display Allowance

- Conducted a survey among the members of Association of Airport Internal Auditors (AAIA) to establish a RDA baseline expected of similarly sized retail operations at an airport.
- Analyzed accounting information including billings and cost of goods records to determine that all so-called RDA accounts were reported in accordance with the agreement.
- Conducted on-site visits at the airport to ensure consistency and reasonable completeness.
- Judgmentally tested a sampled of ten RDA billings and reviewed associated agreements to verify that they were proper, complete, and accurate.

c. Certified Annual Report

- Reviewed the annual certifications for the audit period to determine timely submission and the accuracy of information in the certification.

Conclusion

We concluded that Airport Management Services did not properly report concession related to Retail Display Allowances (RDAs) and promotional & marketing efforts in the amount of $297,679 and $74,916, respectively. Additionally, we noted that certain merchandise types were misclassified for the purpose of concession calculations which resulted in a concession overpayment of $116,336 to the Port.

We noted no other instances of noncompliance with significant provisions of the agreement.

Schedule of Findings and Recommendations

1. Unreported Gross Receipts from the Retail Display Allowances (RDAs)

The agreement under Section 1.11 defines concession gross receipts as:

> *"… aggregate gross amount of revenue derived from all sales of goods and merchandise of any type or kind transacted or made and all charges for services performed by Lessee or any persons, firms or corporations …in or upon the concession premises…*
>
> *...including the amount of all consideration other than money received for any of the foregoing…*
>
> Gross Receipts shall also include
> *…any so-called "retail display allowances" or other promotional or advertising income received by or credited to Lessee on account of displays, promotions, advertising or other activities at the Premises…"*

The above programs (retail display allowances, promotions, advertising, and other agreed-upon retail activities) generate revenue to Airport Management Services. The receipts and consideration received from vendors, publishers, and or suppliers are directly attributable to the concession arrangement with the Port on airport premises and therefore subject to concession.

For the audit period, we noted that Airport Management Services did not report approximately $2 million in RDA receipts related to product promotion and displays. After reviewing its accounting records, Airport Management Services acknowledged the underreporting. The effect of the underreporting is additional concession owed to the Port as calculated below:

	Concessionaire Reported RDA Receipts			**Audited RDA Receipts**			**Unreported RDA Receipts**	**RDA Concession Rate**	**Total Under Reported to the Port**
Agreement Year	Point of Sales	Product Awareness (a)	Additional Promotion	Point of Sales (b)	Product Awareness (c)	Additional Promotion (d)	(e)=(b+c+d)-(a)	(f)	(e x f)
2009	0	$70,747	0	$960,953	$70,747	$114,962	$1,075,915	14.50%	$156,007
2010	0	58,184	0	860,715	58,184	116,332	977,047		141,672
Underpaid Concession to the Port									**$297,679**

Recommendation

We recommend Port management:

1. Seek and recover approximately $297,679 from Airport Management Services.
2. Ensure that Airport Management Services complies with the lease agreement definition of gross receipts.

3. Review prior agreement years including 2011 and 2012 for the correct reporting of gross receipts and recover underpaid fees, if applicable.

Management Response

Aviation Business Development agrees with the recommendations of the audit. Airport Management Services has agreed with the auditors regarding the payment on Retail Display Allowances (RDA) and immediately changed its reporting procedure for correct reporting during all of 2011 and moving forward. It is worth noting that within the airport concessions industry, the subject of accurate reporting of percentage rent on RDAs is seen as very difficult to calculate for each individual airport due to the complexity of the national promotional agreements. At the outset of the audit, approximately three and one half years ago, staff specifically called attention to the RDA as being an item requiring a complete audit review of amounts and means of calculating.

2. Concession Overpayment Due to Specialty Merchandise Misclassification

Airport Management Services operates 20+ concession locations including four specialty merchandise locations at Sea-Tac Airport. At non-specialty locations, the agreement allows the sale of specialty items in "stores within a store" areas which is commonly referred to as boutiqued areas.

The agreement provides the following four concession categories of retail merchandise, and each of the four categories has a different concession rate:

a. Category A (concession rate 14.5%) – Newspapers, magazines, books, retail display allowance (RDAs), promotional income
b. Category B (concession rate 26.5%) – Souvenirs, gifts, and apparel
c. Category C (concession rate 11.5%) – Specialty Retail merchandise that is sold in distinct "boutiqued" areas
d. Category D (concession rate 11.5%) – Souvenirs, books, gifts crafts and apparel at Specialty Retail and Book Stores

We noted Airport Management Services reported to the Port certain specialty goods under Category C and reported them as Category A and B. Category A, and B, have a higher concession rate than Category C and therefore this action resulted in concession fee overpayment to the Port. The overpayment is calculated as follows:

			Concessionaire Reported		Audited		Over Reported Concession on Specialty Goods
Agreement Year	Merchandise Type	Receipts (a)	Rates (b)	Concession (c) = a x b	Rates (d)	Concession (e) = a x d	(c – e)
2009	Food	$786,213	14.50%	$ 114,001	11.50%	$90,415	$ 23,586
	Gift	109,755	26.50%	29,085		12,622	16,463
	Candy	446,111	14.50%	64,686		51,303	13,383
	Electronics	78,027	14.50%	11,314		8,973	2,341
2010	Food	814,683	14.50%	118,129		93,689	24,441
	Gift	119,258	26.50%	31,603		13,715	17,889
	Candy	488,874	14.50%	70,887		56,221	14,666
	Electronics	118,888	14.50%	17,239		13,672	3,567
						Overpaid Concession to the Port	**$116,336**

Recommendation

We recommend Port management:

1. Reimburse approximately $116,336 to Airport Management Services.
2. Ensure that Airport Management Services reports specialty goods in accordance with the terms of the lease agreement.
3. Review prior agreement years including 2011 and 2012 for the correct reporting of gross receipts and reimburse overpaid fees, if applicable.

Management Response

Aviation Business Development agrees with the recommendations of the audit. The North and South Satellite Hudson stores include what is referred to as "a store within a store." This concept works well for the satellites due to limited space for specialty retail. During the earlier years of the lease agreement, Hudson's point of sale system was not capable of tracking the different merchandise sales that were listed as specialty items in the lease agreement and as a result paid at a higher percentage rent than required by the lease agreement. Their systems have been updated and are now capable of pulling these sales as specialty retail and paying the appropriate percentage as per the lease agreement. They were aware of the overpayment but were unable to make the adjustment until the new system was administered.

3. Exclusion of Certain Promotional and Advertising Income from Reported Concession Gross Receipts

The agreement under Section 1.11 defines concession gross receipts as:

"… *the aggregate gross amount of revenue derived from all sales of goods and merchandise of any type or kind transacted or made and* <u>*all charges for services*</u> *performed by Lessee or any persons, firms or corporations …in or upon the concession premises…*

...including the amount of all consideration other than money received for any of the foregoing…

Gross Receipts shall also include any so-called "retail display allowances" or other promotional or advertising income received by or credited to Lessee on account of displays, promotions, advertising or other activities at the Premises…"

We reviewed the monthly profit and loss (P&L) statements for the two-year audit period. We noted a number of accounts recorded as a reduction to the cost of goods (COG) for a cumulative total of approximately $3.8 million. We evaluated the nature of the transactions and noted that some of the transactions represented income from vendors for Retail Display Allowance (RDA) at Sea-Tac Airport. Airport Management Services did not recognize the receipts as part of concession, but recorded the receipts as reductions to the cost of goods. Following the discovery, Airport Management Services acknowledged that approximately $2 million in such receipts (Finding #1) had not been properly reported to the Port.

At the same time, Airport Management Services maintained that the remaining reduction of $1.6 million ($3.8 million less $2.2 million) to the cost of goods would not be subject to concession. We were, pursuant to the terms of a confidentiality agreement, able to further test Lessee's practices related to promotional and advertising income and have concluded that Lessee failed to properly account for certain items in its calculation of Gross Receipts. In addition to the amounts acknowledged as owing in Finding #1 ($297,679), we specifically conclude that Lessee owes the Port approximately an additional $74,916 related to these items.

Recommendation

We recommend Port management:

1. Seek and recover approximately $74,916.
2. Revise the Gross Receipts definition to clarify its applicability to the lessee operations.
3. Ensure that Airport Management Services complies with the lease agreement definition of gross receipts.
4. Review prior agreement years including 2011 and 2012 for the correct reporting of gross receipts and recover underpaid fees, if applicable.

Management Response

In general, Aviation Business Development agrees with the recommendations of the audit. However, recommendation #2 is difficult to implement immediately, and would require an amendment to the Lease and Concession Agreement. The definition of gross receipts is identical in all concession lease agreements, which makes revision of such a definition in one tenant agreement very problematic. Instead, concessions management would recommend working with Legal counsel and an outside concessions consultant with development of a revised definition of gross receipts for the next generation of concessions leases. Hudson has demonstrated a willingness to evaluate its payment practices despite the uncertainty of the gross receipts definition for determining concessionable amounts. Management supports the audit recommendation to conduct a review of 2011 and 2012 gross receipts to evaluate correct reporting.