INTERNAL AUDIT REPORT

LIMITED CONTRACT COMPLIANCE

HOST INTERNATIONAL, INC.

JANUARY 2015 – DECEMBER 2016

ISSUE DATE: MARCH 9, 2018

REPORT NO. 2017-26

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Internal Audit (IA) completed an audit of the Lease and Concession Agreement (Agreement) between Host International, Inc. (Host or Lessee) and the Port of Seattle (Port) for the period January 1, 2015 – December 31, 2016. The audit was performed to verify compliance with key terms in the Agreement, including the completeness and accuracy of concession fees paid to the Port.

The original Agreement (000439) between Host and the Port was executed June 6, 2003, for the right to operate certain food and beverage concessions at the Airport. The Agreement required the Lessee to pay the Port a Minimum Annual Guarantee (MAG) equal to ninety percent (90%) of the total amount paid by the Lessee for the previous year.

An amendment to the original lease, allowed for a reduced concession rate applied to Branded Food and Beverages, if a franchise fee was paid by the franchisee or licensee, to the franchisor or licensor. The fee was established at a minimum of three percent (3%) of gross sales per year and gives the franchisee or licensee the right to use the licensor's and franchisor's trademark and/or trade name.

We concluded that concession fees paid to the Port, by Host and its subtenants, were complete and accurate (see page five for testing procedures performed). However, we determined that Disadvantaged Business Enterprise (DBE) participation goals were not achieved. This issue is discussed in more detail on page six.

1) For the period, October 2015 to November 2016, Host reported a DBE participation of 24.29%. Host also reported a DBE participation of 17.15% under the Lease and Concession Agreement with Seattle Restaurant Associates, a partnership of Host and Uwajimaya. The targeted DBE participation goal in both Agreements was 25%.

We extend our appreciation to Port management and staff of the Aviation Commercial Management Department for their assistance and cooperation during the audit.

Glenn C Fernandes

Glenn Fernandes, CPA
Director, Internal Audit

RESPONSIBLE MANAGEMENT TEAM
Lance Lyttle, Managing Director Aviation
Jim Schone, Director, Aviation Commercial Management
Dawn Hunter, Senior Manager, Airport Dining and Retail
Scott Van Horn, Senior Business Manager, Airport Dining and Retail
Khalia Moore, Senior Business Manager, Airport Dining and Retail

BACKGROUND

The original Agreement between Host and the Port was executed June 6, 2003, for the right to operate certain food and beverage concessions at the Airport. The Agreement required the Lessee to pay the Port a MAG equal to ninety percent (90%) of the total amount paid by the Lessee for the previous year. In March 2016, the MAG was adjusted downward to approximately $5.2 million, because seven stores/units were deleted from the Agreement; nonetheless, the concession revenues from Host have consistently exceeded the MAG.

The table below reflects the total concession revenue earned by the Port through the Host agreement.

HOST CONCESSION REVENUE BY CATEGORY*		
Category	**2015**	**2016**
Food and Beverage (Includes branded and non-branded)	$5,563,032	$5,129,985
Alcohol, Beer, Wine	1,835,889	1,803,435
Retail	280,397	244,252
TOTAL	**$7,679,318**	**$7,177,672**

* Data Source: PeopleSoft for Agreement 000435

In addition to the original Agreement, the Port and Host executed four amendments dated December 22, 2005, July 29, 2009, January 21, 2010, and March 30, 2016. Most notably, the first amendment lowered the concession fee for Branded Food and Beverage, if a franchise fee of at least 3% of gross sales per year was paid by the franchisee or licensee to the franchisor or licensor. Payment of the fee gives the franchisee the right to use the franchisor's trademark and/or trade name.

Rates paid to the Port by subtenant operated units are slightly lower than rates paid by Host operated units. Seventeen Host and seven subtenant stores/locations are operated under this Agreement. The table below reflects the aggregate percentage of gross receipts, paid to the Port, from these locations:

PERCENTAGE OF GROSS RECEIPTS PAID TO THE PORT*				
	Host Operated	**Subtenant Operated**		
Concession Category	**2006 - 2016**	**2006 - 2007**	**2008 - 2010**	**2011 - 2016**
Non-Branded Food and Beverage	14%	12%	13%	13.5%
Branded Food and Beverage	12	10	11	11.5
Alcohol, Beer, Wine	18	16	17	17.5
Souvenir Merchandise	27	25	26	26.5
Advertising and All Others	15	13	14	14.5
Duty Free and Tax Paid	16	n/a	n/a	n/a

* Data Source: Lease and Concession Agreement 000435 and first amendment

AUDIT SCOPE AND METHODOLOGY

We conducted this audit in accordance with Generally Accepted Government Auditing Standards and the International Standards for the Professional Practice of Internal Auditing. 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.

The period audited was January 2015 – December 2016. After identifying significant provisions in the Agreement, we performed the following audit procedures:

<u>Disadvantaged Business Enterprises</u>

- Compared the DBE participation goal in each contract (000435) and (000439) to the participation calculation prepared by Host.

<u>Revenue Completeness and Accuracy</u>

- Agreed daily sales detail (z-tapes) to monthly sales and profit and loss reports and to the general ledger.
- Agreed calculated concession fees by category, to amounts reported to the Port.
- Verified the accuracy of the concession fee by agreeing the percentage rate applied to the revenue category and agreeing to the fees invoiced.

<u>Franchise Fees</u>

- Obtained certification from the Chief Financial Officer of Host for the following:
  - ➢ Royalty payments paid as a percentage of 2015 and 2016 gross revenue.
  - ➢ Royalty percentages as reflected in the Franchise Agreements.
- Recalculated franchise fees to verify mathematical accuracy.
- Reviewed a sample of invoices and check details from Host to validate franchise fees that were paid.
- Validated that at least three percent (3%) of gross receipts was paid in franchise or license fees for Host and a sample of Host subtenants, per the agreement.

SCHEDULE OF FINDINGS AND RECOMMENDATIONS

1) RATING: MEDIUM

The Port established a Disadvantaged Business Enterprises (DBE) participation goal of 25% for the Lease and Concession Agreements with Host International, Inc. (Agreement 000435) and Seattle Restaurant Associates (Agreement 000439).

Both Agreements state that the Lessee shall make every reasonable effort to meet the Port DBE goal of at least twenty-five percent (25%) participation, measured in gross receipts. The Agreements also state that failure to meet the participation levels shall be deemed a material default and 90 days will be provided to satisfy the participation levels or the Port may issue a notice of default.

For the period October 2015 – November 2016, Host reported the following DBE participation:

- 24.29% - Host International, Inc. (Agreement 000435)
- 17.15% - Seattle Restaurant Associates, a partnership of Host International, Inc. and Uwajimaya, Inc. (Agreement 000439)*

*This agreement was not included in the original audit scope.

Recommendation:

Internal Audit recognizes that under agreement 000435, Host materially complied with the requirement. However, under agreement 000439, the DBE percentage achieved was significantly under the participation goal. We recommend, Port management inquire with Host as to what steps they have taken or plan to take to meet participation goals.

We also recommend assessing alternative penalties, if permitted by FAA regulation, into future Lease and Concession Agreements, as opposed to issuing a notice of default. With over 15 stores operating under Agreement 000435 and 9 stores operating under Agreement 000439[1], terminating the contract is not realistic or beneficial to the Port, Host, or DBE subtenants.

Management Response/Action:

Host contractually agreed to 25% ACDBE participation. The federal regulation requires Host to make good faith efforts to maintain the 25%. Port staff has asked Host to present documentation on their good faith efforts to achieve the ACDBE participation goal for the period of the audit as well as for the time subsequent to that covered by the audit by the end of March 2018. Also, Port staff recognizes the need for additional mechanisms in the lease, short of default, for holding tenants accountable for non-compliance with lease provisions including ACDBE good faith efforts. Port staff will develop recommendations towards this goal for incorporation into future leases by the end of September 2018.

[1] As of 2016

APPENDIX A: RISK RATINGS

Findings identified during the course of the audit are assigned a risk rating, as outlined in the table below. The risk rating is based on the financial, operational, compliance or reputational impact the issue identified has on the Port. Items deemed "Low Risk" will be considered "Exit Items" and will not be brought to the final report.

Rating	Financial	Internal Controls	Compliance	Public	Port Commission/ Management
HIGH	Large financial impact Remiss in responsibilities of being a custodian of public trust	Missing, or inadequate key internal controls	Noncompliance with applicable Federal, State, and Local Laws, or Port Policies	High probability for external audit issues and/or negative public perception	Important Requires immediate attention
MEDIUM	Moderate financial impact	Partial controls Not adequate to identify noncompliance or misappropriation timely	Inconsistent compliance with Federal, State, and Local Laws, or Port Policies	Potential for external audit issues and/or negative public perception	Relatively important May or may not require immediate attention
LOW/ Exit Items	Low financial impact	Internal controls in place but not consistently efficient or effective Implementing/enhancing controls could prevent future problems	Generally complies with Federal, State and Local Laws or Port Policies, but some minor discrepancies exist	Low probability for external audit issues and/or negative public perception	Lower significance May not require immediate attention
Efficiency Opportunity	An efficiency opportunity is where controls are functioning as intended; however, a modification would make the process more efficient				