

INTERNAL AUDIT REPORT

THIRD-PARTY MANAGEMENT SERVICES AGREEMENT
THE AIRPORT CLUB AT SEA LOUNGES

APRIL 1, 2015 – MARCH 31, 2016

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TABLE OF CONTENTS

TRANSMITTAL LETTER.....	3
EXECUTIVE SUMMARY.....	4
FINANCIAL HIGHLIGHTS.....	5
HIGHLIGHTS AND ACCOMPLISHMENTS.....	5
AUDIT SCOPE AND METHODOLOGY.....	6
CONCLUSION.....	7
SCHEDULE OF FINDINGS AND RECOMMENDATIONS.....	8
1. MANAGEMENT CONTROLS NEED IMPROVEMENT.....	8

TRANSMITTAL LETTER

Audit Committee
Port of Seattle
Seattle, Washington

We have completed an audit of the Airport Club at SEA Lounges managed by Airport Lounge Development Corporation (ALD). We reviewed information for the period April 1, 2015 - March 31, 2016.

We conducted this performance 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.

We extend our appreciation to the management and staff of the Aviation Commercial Management Department, AV Finance & Budget Department, and Accounting & Financial Reporting Department for their assistance and cooperation during the audit.



Joyce Kirangi, CPA, CGMA
Director, Internal Audit

AUDIT TEAM	RESPONSIBLE MANAGEMENT TEAM
Margaret Songtantaruk, CFE, CB, Senior Auditor	Lance Lyttle, Managing Director - Aviation
Dandan Wang, CPA, Senior Auditor	James Schone, Director AV Commercial Management
	James Jennings, Manager Aviation Property

EXECUTIVE SUMMARY

AUDIT OBJECTIVES AND SCOPE

The purpose of the audit was:

1. To determine whether management controls were effective to ensure:
 - a. airlines usage billings/invoices (revenue) were complete and accurate.
 - b. lounge expenses were proper and in accordance with the terms of the agreement.
2. To determine whether Airport Lounge Development Corporation (ALD) complied with significant terms of the agreement.

We reviewed information for the period April 1, 2015 - March 31, 2016. Details of our audit's scope and methodology are on page 6.

BACKGROUND

The Port of Seattle owns the Club at SEA lounges at the Sea-Tac airport (formerly known as the International and Cascade Clubs).

The Port has outsourced the day-to-day management of the Club at SEA lounges to ALD. The services include sales and marketing, airlines services, solicitation of new clients, and overall accounting services for both lounges. Revenue generated from the lounges is remitted to the Port daily.

ALD receives a base management fee of \$15,208 per month, and an Incentive Management Fee up to 6% of the Net Operating Profit.

AUDIT RESULT

Airport Development Lounge Corporation materially complied with the significant terms of the management agreement. However, we determined that Port management monitoring controls could be improved. The Port overpaid compensation costs, benefits, and payroll taxes by a net amount of \$54,139. The Port also overpaid insurance by approximately \$4,222. In addition, we noted some instances where time card reports were not available to support hours worked. See the Schedule of Findings and Recommendations.

BACKGROUND

The Port of Seattle owns the Club at SEA lounges (formerly known as the International and Cascade Clubs). The primary objective of the Club at SEA is to provide a wide range of services for the benefit of the domestic and international airlines including first and business class, and priority membership, etc.

The Port has outsourced the day-to-day management of the Club at SEA to Airport Lounge Development (ALD) management firm, who has partnered with Gideon Toal Management Services (GTMS) to provide the management agreement services. The services include sales and marketing, airlines services, solicitation of new clients, and overall accounting services for both lounges. Revenue generated from the lounges is remitted to the Port daily.

The Port of Seattle is responsible for the costs of operating the lounges. The Port pays for all costs including repair and maintenance, utilities, insurance, legal and accounting services, and labor compensation, including benefits and payroll taxes related to GTMS employees who work at the Club at SEA lounges.

ALD receives a base management fee of \$15,208 per month, and an Incentive Management Fee up to 6% of the Net Operating Profit.

FINANCIAL HIGHLIGHTS

	Gate – A Lounge	Gate – S Lounge	Total
Revenue			
Airlines	\$597,008	\$1,645,127	\$2,242,135
Day Passes	16,435	17,476	33,911
Priority Pass – Third Party	223,025	278,804	501,829
Gross Revenue	\$836,468	\$1,941,407	\$2,777,875
Expense			
Cost of Sales	99,324	215,961	315,285
Direct Operating Expenses	160,994	469,159	630,153
Management Fee	63,875	119,125	183,000
Incentive Management Fee	25,614	56,858	82,472
Operating Expenses	349,807	861,103	1,210,910
Net Income/(Loss)	486,661	1,080,304	1,566,965

Source: The Club at SEA Financial Statement

HIGHLIGHTS AND ACCOMPLISHMENTS

During the course of the audit, we observed that AV Commercial Management achieved the following significant accomplishments:

- **Revenue increase:** ALD's marketing strategy increased revenue to \$2.8 million for the fiscal year 2015-2016 when compared to \$1 million in our prior audit ending December 2013 (134% increased) by creating a new business revenue stream.
- **Effective communication with its third-party management company:** Port management regularly holds bi-weekly and monthly operations meetings to go over the financial activities with its third-party management company.

AUDIT SCOPE AND METHODOLOGY

We reviewed information for the fiscal period April 01, 2015 - March 31, 2016. We utilized a risk-based audit approach from planning to testing. We gathered information through document reviews, staff interviews, observations, and data analyses, and obtained a complete understanding of the ALD management agreement. We assessed significant risks and identified controls to mitigate those risks.

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

- 1) To determine whether management controls were effective, we:
 - a. Evaluated the design and effectiveness of the monitoring controls performed by AV Commercial Management:
 - Validated ALD invoices airlines and other membership's usages of the airport lounges were complete and accurately calculated.
 - Verified that outstanding Accounts Receivables were consistent with the management agreement.
 - Conducted a variety of analyses, to selected risk-based of four months payroll claimed for reimbursement:
 - Determined if paid payroll costs, benefits, and payroll taxes were valid.
 - Cross-referenced all GTMS employee history listing on Credential Center ID badging report to employee listed on payroll register.
 - Validated completeness of all checks paid to third-party.
 - Examined evidence of time card reports, verified the accuracy, and reviewed available documents to support the number of hours worked for each payroll check in our sample.
 - Corroborated working hours with third-party management to ensure propriety of worked hours.
 - Validated if pay was in compliance with the City of SeaTac Proposition-1 for minimum wage rates.
 - Reviewed the lounges financial information in order to verify the accuracy of the base management fees.
 - Re-performed management control over vendor disbursements. We traced and agreed checks issued to vendors and agreed to supporting documents.
 - Traced and agreed ALD calculated Incentive Management Fees (IMF) to Port management approval.

- 2) To determine whether ALD Development Corp. complied with significant terms of the agreement, we:
- Conducted a risk-based analysis of 42 checks and verified proper support and approval.
 - Analyzed the insurance policy coverage to ensure the coverage met the requirements.
 - Analyzed the financial statements by line-item for significant outliers.
 - Recalculated Incentive Management Fee.
 - Verified 12 transactions of the agreement year-end expenses to ensure they were properly accounted and were legitimate.
 - Identified missing check number and verified completeness.

CONCLUSION

Airport Development Lounge Corporation materially complied with the significant terms of the management agreement. However, we determined that Port management monitoring controls could be improved. The Port overpaid compensation costs, benefits, and payroll taxes by a net amount of \$54,139. The Port also overpaid insurance by approximately \$4,222. In addition, we noted some instances where time card reports were not available to support hours worked. See the Schedule of Findings and Recommendations.

SCHEDULE OF FINDINGS AND RECOMMENDATIONS

1. MANAGEMENT CONTROLS NEED IMPROVEMENT

Although the day-to-day operations of the Club at SEA are managed by a third-party, Port management is accountable and has the primary responsibility to ensure that costs paid are reasonable and appropriate.

The Port monitoring processes of its third-party agreement could be improved. Internal Audit does acknowledge the presence and performance of certain monitoring controls by management. However, the monitoring system could be improved.

A well-designed and well-placed system of monitoring is necessary to provide management with reasonable assurance of compliance with agree-upon terms and conditions. Such a system should be based on an analysis of risks related to the agreement and an identification of key controls that may mitigate identified risks. Management then determines what controls to monitor and how the controls will be monitored.

Based on the management agreement, the Port pays for all the Club at SEA costs. Costs include repair and maintenance, utilities, insurance, legal and accounting services, and compensation (including benefits and payroll taxes related to Gideon Toal Management (GTMS) employees who worked at the Port lounges).

We observed the following:

1. Payroll - \$54,139 net amount overpayment

- a) Per the Management Agreement Section 1.16.1 ... compensation costs, benefits, and payroll taxes for the On-site Manager and Executive Personnel of ALD/GTMS are excluded and not allowable operating expenses.

We observed the Port paid compensation including benefits, and payroll taxes for GTMS On-site Manager totaling approximately \$ 63,982.

- b) Port paid GTMS compensation cost twice for the payroll period 3/16/15 - 3/31/15. Total duplicate paid was \$3,539.
- c) GTMS failed to claim for compensation costs of its employees for the payroll period 4/16/15 - 4/30/15. Total payroll cost not claimed was \$13,383.

2. Lack of Support for Some Hours Worked and Charged to the Port

GTMS uses a biometric system to track employee's worked hours. There were some glitches in the time card system set up, and GTMS could not generate time card reports to support some hours worked and charged to the Port. Without the support, we could not ascertain to the reasonableness of those hours.

A table illustrating auditor’s testing with instances of missing time-card reports:

Description	March 2015	April 2015	July 2015	December 2015
Number of Employees Selected for Testing	10	13	20	18
Number of Time card reports to support hours worked	0	4	5	8
% of Time Card Reports Missing	100%	69%	75%	56%

3. Insurance Expenses

Insurance coverage did not comply with the agreement requirements.

Management Agreement - *Exhibit B requires Commercial General Liability, Automobile Liability, Professional Liability- Errors and Omissions, Specialized Insurance coverage to cover employee dishonesty... and liquor liability...*

We observed the Port was charged and paid for non-required insurance. ALD allocated \$4,222 from its umbrella commercial property insurance to the Port. The Port is self-insured for its properties and does not require commercial property insurance. Therefore, this was unnecessary cost.

Recommendations

We recommend Port management:

1. Improved its third-party management monitoring processes.
2. Seek and recover the net effect of \$54,139 that the Port overpaid in compensation costs, benefits, and payroll taxes.
3. Seek and recover the \$4,222 of the umbrella Commercial Property insurance that was allocated and paid for by the Port.
4. Work with ALD/GTMS to ensure that all employees costs charged to the Port are properly supported by time card reports. Further, as part of management monthly review, sample payroll charges for proper support.

Management Response:

Port staff discussed the findings and recommendations contained in this audit report with ALD and ALD concurs with the audit findings and has agreed to reimburse the Port the \$54,139 associated with the overpayment of compensation costs, benefits and payroll taxes, as well as reimburse the \$4,222 cost for Commercial Property insurance. Further, the

following represents the Port's analysis and actions to mitigate these findings in the future:

1. The procedures used to monitor third-party management of the lounge management contract are:
 - a) Port staff (Commercial Management/Operations/Finance & Budget) conducts bi-weekly telephone conferences with ALD and GTMS management staff to review the monthly budget, passenger volumes, new initiatives, operational issues, staffing issues/changes, marketing efforts, and facility changes;
 - b) Port staff reviews the check register on a monthly basis against supporting invoices for compliance with expense reimbursements allowed per the contract, and make a request to replenish the lounge operating account;
 - c) Port staff maintains a binder containing monthly income statements, and all supporting memoranda related to operating account replenishment, with supporting checks and invoices that are identified as approved expenses falling within the approved budget related to lounge operations.

Based on the findings contained in this audit, Port staff will improve its monitoring of this third-party management agreement by employing the following:

- d) Confirm the amount of monthly management fee paid to the third-party manager on a quarterly basis against the contract terms;
- e) Request that the third-party manager provide a current list of employees and then check the active employee roll against payroll on a monthly basis;
- f) Ensure that manager payroll is not included in payroll distribution as this expense is included in the monthly management fee; and
- g) Confirm the insurance certificate is current and tracks the coverage requirements noted in the contract.

In addition, Port staff are continuing efforts to strengthen and enhance the overall contract compliance process, and especially so for the most complex agreements such as this. The most significant effort is the development of the Agreement Compliance and Administration Plan (ACAP). The ACAP combines a new process and technology that provides additional focus on contract obligations and a clear understanding of roles and responsibilities across multiple business units, departments and divisions. The increased clarity that the ACAP provides will assist Port staff in their efforts to effectively and efficiently manage and administer agreements and licenses.

2. The salary for the on-site manager was mistakenly charged to the Port, despite language prohibiting such payment in the contract. Staff will insure reimbursement of \$54,139 from ALD for this expense.
3. ALD will reimburse \$4,222 that was incorrectly paid by the Port for commercial property insurance.
4. GTMS uses a biometric payroll system (using fingerprints) for all employee timecards. Any alterations to the payroll requires local management authorization. Going forward, Port staff will ensure that all employee costs charged to the Port are properly supported by the biometric payroll

log, as well as review the monthly sample payroll charges for proper support.

Aviation Division staff appreciate the close working relationship with Internal Audit staff as part of our collective efforts to continuously improve agreement monitoring processes across the Port.