



INTERNAL AUDIT REPORT

THIRD-PARTY MANAGEMENT AGREEMENT

BELL HARBOR INTERNATIONAL CONFERENCE CENTER
(BHICC) / WORLD TRADE CENTER (WTC)

JANUARY 1, 2015 – DECEMBER 31, 2016

ISSUE DATE: JUNE 27, 2017

REPORT NO. 2017-07

EXECUTIVE SUMMARY

AUDIT OBJECTIVES AND SCOPE

The purpose of the audit was:

1. To determine whether Port management internal controls were effective to ensure:
 - a. Reported revenues and operating expenses were complete and accurate.
 - b. Expenses were appropriate and in accordance with the Agreement terms and conditions.
 - c. Related party events were held in accordance with the Agreement terms and conditions.
2. To ensure Columbia Hospitality, Inc. complied with significant terms of the Agreement.

We reviewed and analyzed records for the Audit period. For purposes of rendering our opinion, we focused on the period January 1, 2015 through December 31, 2016.

Details of our audit's scope and methodology are on page six.

BACKGROUND

On June 1, 2012, the Port of Seattle (Port) entered into a Third Party Management Agreement with Columbia Hospitality, Inc. (CHI) to manage operations for Bell Harbor International Conference Center (BHICC) and the World Trade Center (WTC). The initial term of the agreement is 10 years, expiring on May 31, 2022.

CHI receives a base management fee equal to 3.5% of gross revenues. If net operating profit is greater than or equal to 15% of the gross revenue, CHI receives an incentive management fee equal to 15% of the net operating profit.

AUDIT RESULT

CHI generally complied with key terms of the Agreement.

However, we identified opportunities for management to strengthen its monitoring controls as to ensure compliance with the agreement terms and conditions. For instance, internal controls could be improved to ensure proper allocation of CHI's labor costs for employees in accordance with the percentage agreed between the two parties.

We also noted an opportunity for the Agreement to be clarified relating to affiliated party events and CHI's use of Port facilities and the allowability of discounted rates.

Please refer to the Schedule of Findings and Recommendations for further detail.

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TRANSMITTAL LETTER

Audit Committee
Port of Seattle
Seattle, Washington

We have completed an audit of the Third Party Management Agreement for the Bell Harbor International Conference Center and World Trade Center. We reviewed information for the period January 1, 2015 - December 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 Columbia Hospitality Inc., Central Harbor Management, Seaport Finance and Budget and Accounting and Financial Reporting for their assistance and cooperation during the audit.



Joyce Kirangi, CPA, CGMA
Internal Audit, Director

AUDIT TEAM	RESPONSIBLE MANAGEMENT TEAM
Ritika Marwaha, Auditor	Dave McFadden, Managing Director - Economic Development
Spencer Bright, CIA, CFE, CGAP Senior Auditor	Melinda Miller, Director – Real Estate Management
Dan Chase, CPA, Audit Manager - Acting	Susie Archuleta, Real Estate Manager

BACKGROUND

On June 1, 2012, the Port of Seattle (Port) entered into a Third Party Management Agreement with Columbia Hospitality, Inc. (CHI) to manage operations for Bell Harbor International Conference Center (BHICC) and the World Trade Center (WTC). The initial term of the agreement is 10 years, expiring on May 31, 2022.

CHI receives a base management fee equal to 3.5% of gross revenues. If net operating profit is greater than or equal to 15% of the gross revenue, CHI receives an incentive management fee equal to 15% of the net operating profit. The Port pays all costs of the facility including, repair and maintenance, utilities and labor and compensation of CHI employees.

The WTC is located on Seattle’s downtown waterfront and includes conference rooms and executive and private dining rooms. The BHICC features 18 meeting rooms totaling 100,000 square feet. CHI oversees the day-to-day operations and provides a full range of services including meeting room rentals and food and beverage catering.

CHI’s mission is to maintain the highest quality international conference center and world trade center and provide superior customer service that consistently exceeds its customers’ expectations.

FINANCIAL HIGHLIGHTS

BELL HARBOR INTERNATIONAL CONFERENCE CENTER		
REVENUE AND EXPENSE DESCRIPTION	2015	2016
REVENUES	\$8,844,226	\$6,669,867
EXPENSES (EXCLUDING BASE AND INCENTIVE MANAGEMENT FEES)	(6,568,645)	(5,535,645)
BASE MANAGEMENT FEE	(309,576)	(233,417)
INCENTIVE MANAGEMENT FEE	221,268	31,538
NET OPERATING PROFIT	\$1,966,005*	\$900,805*

Data Source: PeopleSoft Financials (*Includes Smith Cove Conference Center Data)

WORLD TRADE CENTER		
REVENUE AND EXPENSE DESCRIPTION	2015	2016
REVENUES	\$1,245,568	\$1,297,661
EXPENSES (EXCLUDING BASE AND INCENTIVE MANAGEMENT FEES)	(873,483)	(976,478)
BASE MANAGEMENT FEE	(43,595)	(45,418)
INCENTIVE MANAGEMENT FEE	(43,204)	(34,915)
NET OPERATING PROFIT	\$328,490	\$275,765

Data Source: PeopleSoft Financials

* Does not include depreciation expense of the buildings or maintenance costs.

HIGHLIGHTS AND ACCOMPLISHMENTS

We observed the following highlights and best practices:

- CHI staff members were professional and provided all documentation as requested.
- Through its hospitality business, CHI is helping create jobs and assisting in economic development in the region. This is in line with the Port's mission of creating jobs by stimulating economic development.

AUDIT SCOPE AND METHODOLOGY

We utilized a risk-based audit approach from planning through testing for the period January 1, 2015 through December 31, 2016. We obtained a complete understanding of the financial requirements of the Agreement through document requests, interviews, observation and data analysis.

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

1. To determine whether Port Management internal controls were effective, we
 - i. Evaluated the design and operating effectiveness of internal controls that were designed and/or operated by the Property Manager and Financial Analyst:
 - By reviewing evidence to ensure the Annual Plan was being timely approved by Port Management
 - Reviewing samples of the Monthly Operations Reports provided to the Port by CHI
 - Reviewing the Cash Disbursement worksheets, submitted to the Port by CHI
 - Reviewing the Incentive Management Fee worksheet and a selection of Base Management Fee invoices
 - ii. Selected a total of thirty four checks from the Check Registers for 2015 and 2016 utilizing a risk based approach, for both BHICC (total of ten samples) and WTC (total of twenty four samples), and reviewed the supporting documentation to determine whether the expenses incurred by BHICC/WTC and reimbursed by the Port were accurate, reasonable, valid and were being properly allocated to BHICC and WTC.
 - iii. Reviewed the GL Expense Summary by Location Reports and Reimbursement Request Summary Invoices for the eight samples (four months from each year) selected for testing the Payroll expenses. The total of the filtered Payroll Expense codes were then compared to the reimbursement request invoices.
 - iv. Performed testing around the payroll expense allocation, by reviewing the Personnel Action Form for the one Shared Employee for both years; 2015 and 2016. Utilizing the GL Detail Reports from the selected pay periods, we determined the amount charged to BHICC. This amount was compared to the amount that was recalculated by IA.

- v. Analyzed the Banquet Event Order Forms/Event Checks for completeness and appropriateness. We tested a risk-based selection of twenty four Booking ID confirmations for events (six from each year for both BHICC and WTC), which included a total of eighty one BEOs for BHICC and sixteen BEO's for WTC related to Columbia Hospitality and its affiliates. Banquet Event Order/Event Check is a document that itemizes the room rental, equipment, food & beverage, and labor.
2. To determine whether CHI complied with the significant terms of the Agreement, we:
 - i. Analyzed the financial statements by line-item for significant outliers.
 - ii. Recalculated the Incentive Management Fees and the Base Management Fees, to determine whether these fees were being accurately calculated.
 - iii. Picked a selection of three Affiliated Party Events from each year under Audit, and reviewed the Banquet Event Checks, to determine if any discounts were applied on these transactions, and whether they were allowed by the Agreement.
 - iv. Reviewed the listing of all the Affiliated Party Events reported to the Port for the period under Audit. This helped us gain an understanding of the type of related party events held and the location of the respective events, to determine, whether the events were allowed a reduced rate according to the Third Party Management Agreement.

CONCLUSION

We identified opportunities for management to strengthen some of its monitoring controls as well as some areas where new monitoring controls could be designed and implemented to ensure compliance with the Agreement terms and conditions. For example:

- We identified opportunities for management to strengthen its monitoring controls to ensure proper allocation of CHI's labor costs for employees in accordance with the percentage agreed between the two parties.
- We also identified opportunities for the Agreement to be clarified relating to affiliated party events and CHI's use of Port facilities and the eligibility of discounted rates, if any.

Please refer to the Schedule of Findings and Recommendations for further detail.

With regards to compliance with the Agreement, we determined CHI complied with the significant terms of the Agreement.

SCHEDULE OF FINDINGS AND RECOMMENDATIONS

1. INTERNAL CONTROLS COULD BE IMPROVED TO ENSURE COMPLIANCE WITH THE TERMS OF THE AGREEMENT

We observed that internal controls could be designed more effectively to validate gross revenues and ensure only allowable operating expenses are paid. For example:

a. Revenues

In 2016, CHI reported combined BHICC and WTC revenues of \$7.5 million. Our testing of the base and incentive management fees paid to CHI did not identify any exceptions. However, the Port’s reliance on reports submitted by CHI without an adequate review of supporting documentation increased the risk of inaccurate payments to CHI.

b. Operating Expenses

During 2016, the Port paid operating expenses totaling \$6.8 million. Port management relied on reports submitted by CHI and performed random reviews of supporting documentation. In general, the Port paid allowable expenses. However, we identified a discrepancy between the agreed upon percentage of the allocated salary between CHI and BHICC.

Section 7.2 of the amended Management Agreement states in part:

“The Port and Manager may agree that the expense associated with shared employees may be allocated between the Port (as an operating expense) and Manager on other more easily administered metrics... The particular, agreed methodology shall be documented between the parties in writing from time to time and shall not include any markup or other multiplier beyond the employee costs allocated between the parties.”

The Port did not perform any review to ensure the salary allocation was accurate which resulted in the following overpayments in 2015 and 2016:

Shared Employee	2015	2016	Total overpayment
Salary:	\$170,000	\$176,800	
Agreed Percent Allocation:	80%	70%	
Expected Salary Allocation:	\$136,000	\$123,760	
Actual Allocated to BHICC:	\$161,974.81	\$124,172.57	
Difference: over/(under):	\$25,974.81	\$412.57	\$26,387.38

Data source: Columbia Hospitality personnel action forms & detail account analysis reports

We reviewed the salary allocation with CHI management for 2017 and determined the allocation was correct.

Recommendation

We recommend:

- Port management establish adequate internal controls to ensure reported revenues and expenses are accurate and allowable.
- Port management seek recovery of the overpayment of salary costs.

Management Response

Port management thanks our Internal Audit colleagues for the professional manner in which they conducted this audit. They took the time to understand the Conference and Event business and to review and acknowledge the multiple internal controls that exist today, including monthly reviews of:

Owner's reports

Documentation supporting operating expense reimbursement requests

Management fee expenses

Documentation supporting randomly selected checks in the check registers

Banquet Event Orders (invoices) for randomly selected Affiliated Party events

Now IA recommends expanding these Internal Controls, and we are supportive of this concept.

1. We have begun conversations with CHI to understand what revenue testing processes we might add to our monthly reviews.
2. We have also begun conversations with CHI to review shared employee salary allocation documentation on a regular basis.
3. Lastly, we have requested reimbursement from CHI for the \$26,387.38 which is the total salary allocation overpayment. CHI has acknowledged the error and has already delivered a check to us for the amount recommended.

2. RELATED AND AFFILIATED PARTY TRANSACTIONS

Section 15.2 of the Agreement between the Port and CHI., states that the *"Manager shall not grant discounts for use of the Facility on the basis of any contractual or business affiliation that Manager (or any Affiliate or Qualified Person) may have with the user"*.

The agreement however, is silent regarding the use of Port owned facilities by CHI. We identified more than 100 events, including team member orientations, employee parties, and trainings, in which CHI held these events at a discount (68% discount). Some of these events were held at affiliate locations. This resulted in a discount of approximately \$250,000 over the period June 1, 2012 through December 31, 2016.

Of the \$250,000 discount, approximately \$110,000 appeared ineligible and therefore, a discount shouldn't have been granted to CHI.

Without clear guidance in the Agreement, there is an increased risk that CHI may use Port owned facilities at a discounted rate and the Port may not receive all revenues it is entitled. Further,

there is an increased risk of the appearance of a gift of public funds by a private company using Port owned facilities at a discounted rate.

Recommendation

In order to decrease the risk of an appearance of gifting of public funds and to ensure the Port receives all revenue it is entitled, we recommend:

- Amending the agreement to define the type of events and discounted rate for related party and affiliate events held at Port facilities.
- Port management approves all CHI related and affiliate party events prior to being held.
- Port Management review the list of events identified by Internal Audit and determine whether the event should have been held at a discount (i.e. at cost). If it is determined that the event should not have been held at a discount then Management should seek the respective compensation from CHI.

Management Response

Port management agrees that the current Affiliated Party language could be expanded to provide helpful clarifications for all.

- 1. We will amend the Agreement to provide the additional clarifying language to ensure compliance.*
- 2. We currently require that CHI provide a list of Affiliated Party events in the monthly Owners Report. Going forward, we will also require advance approval of these events.*
- 3. While our initial review of the list of affiliated events provided by IA appears to us to be in compliance, we agree to review this list in detail to confirm that they qualify as compliant Affiliated Events and whether reimbursement should be sought. This review will also help us develop the clarification language needed to avoid confusion in the future.*

Thank you for providing opportunities for us to continue improving our oversight and management of the Conference and Event Center Management Agreement.

SCHEDULE OF PRIOR AUDIT FINDINGS

**Port of Seattle
 Bell Harbor International Conference Center/ World Trade Center
 January 1, 2015 through December 31, 2016**

This schedule presents the status of findings reported in prior audit periods. Internal Audit has reviewed the status as presented.

Audit Period: 01/01/2010 - 12/31/2011		Report Ref. No: 2013-03	Finding Ref. No: 1
Finding Caption: Port management monitoring could be strengthened			
Background: We identified the following deficiencies in internal controls: <ul style="list-style-type: none"> • Management monitoring over areas of high risk (e.g., payroll cost allocation and expense payments) were not effectively focused to ensure compliance. 			
Status of Corrective Action: (check one)			
<input type="checkbox"/> Fully Corrected	<input checked="" type="checkbox"/> Partially Corrected	<input type="checkbox"/> Not Corrected	<input type="checkbox"/> Finding is considered no longer valid
Corrective Action Taken:			
<p><u>Dedicated Employees:</u> CHI dedicated employees to the Port Facilities. There was one remaining employee whose salary was allocated between BHICC and CHI. This employee's allocated salary percentage was approved by the Port. The percentage charged to BHICC was not in accordance with the Agreement in 2015 or 2016 which resulted in the Port paying more than agreed. We noted in 2017, the salary allocation between BHICC and CHI was accurate.</p> <p><u>Related And Affiliated Party Activities:</u> CHI met with Port management to obtain a compliant approach on related party events. The current audit identified opportunity to ensure compliance with the Agreement and decrease the risk of an appearance of gifting of public funds.</p>			