City and County of San Francisco

Office of the Controller - City Services Auditor

AIRPORT COMMISSION:

Concession Audit of Host International, Inc. Food and Beverage Facilities

FINANCIAL AUDITS DIVISION

May 23, 2006
04002

CITY AND COUNTY OF SAN FRANCISCO
OFFICE OF THE CONTROLLER
FINANCIAL AUDITS DIVISION

Ed Harrington
Controller

Monique Zmuda
Deputy Controller

May 23, 2006 Audit Number 04002

San Francisco Airport Commission
P.O. Box 8097
San Francisco International Airport
San Francisco, CA 94128-8097

President and Members:

The Office of the Controller (Controller) presents its report concerning the audit of the food and beverage concessions of Host International, Inc. (Host) at the San Francisco International Airport. Host had a lease to operate the concessions, as well as the commissary and in-flight kitchen that provided in-flight meals to airlines. The lease required Host to pay as rent to the Airport Department (Airport) the greater of a minimum annual rent or a specified percentage of Host's gross revenues from these operations. Host's lease expired in August 2004.

Reporting Period:	June 1, 2003, through May 31, 2004
Rent Paid:	$4,829,096
Additional Rent Due:	$319,384

Results:

Because our audit tests revealed that Host significantly underreported some sales for the one-year period we audited, we expanded our tests to include periods outside our reporting period to identify any other revenues Host underreported. Our tests revealed that Host underpaid its rent by at least $319,384 mainly from not reporting:

- $2.5 million in sales and revenues from the operation of airline clubs.
- $1.3 million in sales earned by one of Host's sub-lessees.

Because Host significantly underpaid its rent, Host also owes the Airport:

- $193,511 in interest as of January 2006.
- $54,000 for the cost of this audit.

Host's response is attached to this report. The Controller's Financial Audits Division will be working with the Airport Department to follow up on the status of the recommendations made in this report.

Respectfully submitted,

Original signed by:
Noriaki Hirasuna
Director

INTRODUCTION

BACKGROUND

Host International, Inc. (Host) had a long-term lease with the Airport Commission (commission) to operate food and beverage facilities in San Francisco International Airport (SFO) terminals and to operate the in-flight kitchen from the commissary building, which Host used to provide in-flight meals for airlines departing from SFO. The lease also allowed Host to provide vending machines that sold food and beverages in the terminals. The commission entered the lease on June 17, 1975, and entered a lease modification on February 17,1992. The lease expired on August 31, 2004.

The lease modification required Host to submit to the Airport Department (Airport) monthly and annual reports showing Host's gross revenues derived from its own operations and from those of its sub-lessees. The lease modification also required Host to pay the Airport the greater of a minimum annual rent or a specified percentage of the gross revenues.

For its food and beverage facilities, Host was to pay rent equal to 15.24 percent of gross revenues from the sale of alcoholic beverages and 9.24 percent of gross revenues from the sale of food and non-alcoholic beverages, including those dispensed through vending machines. During our audit period, the annual minimum rent for the food and beverage facilities was $3,500,074.

For its commissary and in-flight sales, Host was to pay rent equal to 5 percent of gross revenues or the minimum rent. For the period we reviewed, the monthly minimum rent was $6,853.

SCOPE AND METHODOLOGY

The purpose of our audit was to determine whether Host complied with the reporting and payment provisions of its lease with the commission. Our audit period was June 1, 2003, through May 31, 2004. However, because we identified significant amounts of underreporting of some sales by Host, we extended some of our tests to cover the periods before and after these dates to identify amounts that Host owes the Airport for unreported revenues.

To conduct the audit, we reviewed the applicable terms of the lease and the adequacy of Host's procedures for recording, summarizing, and reporting its gross revenues to the Airport. To determine whether Host accurately reported its gross revenues, we tested a sample of Host's daily sales reports and monthly sales summaries. We also analyzed Host's previous years' sales to assess the reasonableness of Host's reported gross revenues for the period under review. Finally, we determined whether Host has any outstanding payments due to the Airport for the period we reviewed.

AUDIT RESULTS

HOST DID NOT REPORT ALL SALES AND UNDERPAID ITS RENT

From June 1, 2003, through May 31, 2004, Host International, Inc. (Host) reported $47,974,516 in revenues and paid $4,829,096 in rent to the Airport. Although Host correctly reported the sales of its main food and beverage concessions at SFO, we discovered that Host did not report any of the revenues it earned from operating airline clubs and the sales of one of its sub-lessees for the one-year period we reviewed. Because of this, we extended our tests to include the periods before and after the audit period to identify the extent to which Host underreported these revenues. As shown in the table below, our audit revealed that Host did not report $2,545,778 in revenues it earned from operating airlines clubs as well as $1,308,246 in sales of a sub-lessee. We also identified other errors Host made in paying its rent. After making the adjustments for these errors, we concluded that Host owes the Airport at least $319,384 in additional rent. The appendix at the end of the report provides the full details of underreported revenues and underpaid rent.

Further, because Host did not pay this rent when due, it also owes the Airport $193,511 in interest, calculated through January 2006. Moreover, because the underpayment was more than two percent of its annual rent, the lease requires Host to reimburse the Airport for the costs of this audit, which we estimate to be $54,000.

TABLE

Underreported Revenues and Underpaid Rent

	Underreported Sales	Percentage Rent	Under (Over) Paid Rent
Airline Clubs	$2,545,778	15.24%	$387,976 *
Sub-Lessee Sales	1,308,246	9.24%	120,882
Unapproved Rent Credits			53,002
In-flight and Commissary Minimum Rent			(10,750)
Excess Minimum Rent			(231,726)
Total	$3,854,024		$319,384

* This amount includes airline payments from September 2002, which is the earliest month that Host had records available. Host is still liable for airline payments it received prior to this month.

Host Did Not Report More Than $2.5 Million in Airline Club Revenues

Host did not report to the Airport revenues of at least $2,545,778 that Host earned from operating airline clubs, and underpaid the associated rent by at least $387,976. The airline club revenues consisted of the following:

- Patron sales, which are revenues from the sale of food and beverages to airline club patrons.
- Airline payments, which are revenues from airlines paying Host the amount it cost Host to operate the airline clubs in excess of the patron sales and liquor provided by the airlines. Host's operating costs included staff labor charges, goods and supplies, a management fee, and a concession fee that was the percentage rent for alcoholic beverages applied to patron sales.

Host Did Not Report Patron Sales

Although Host had previously reported patron sales from the airline clubs as revenues subject to rent, Host did not include these sales as part of the gross revenues it reported to the Airport starting in February 2002. In reviewing Host's records for the period from February 2002 through August 2004, we found that Host did not report $1,344,800 in patron sales and owes the Airport $204,947 in rent.

Host's manager stated that Host believed that airline club revenues were not subject to percentage rent because these receipts were reimbursements from airlines for Host's services. Although Host's original lease did not specifically identify airline club revenues as subject to percentage rent, the lease modification (Section 5.01.a.3.) defined gross revenues as the full amount of all orders for goods or services accepted by the lessee from the leased premises. Based on this definition, we concluded that airline club sales are subject to percentage rent. Further, Host's invoices to the airlines included a 15.24 percent fee on the amounts paid by airline club patrons, which is Host's percentage rent for alcoholic beverages. In charging this fee, Host appeared to be taking the position that it had to pay the percentage rent on patron sales.

Host provided us information on patron sales, but did not separate the food and non-alcoholic beverage sales from the alcoholic beverage sales. Host informed us that most of its patron sales were for alcoholic beverages. Because Host was not able to separate the patron sales and because Host charged the airlines the percentage rent for alcoholic beverages, we assessed Host the 15.24 percent rent specified for alcoholic beverages for all the patron sales. However, if Host is able to separately show the amount of total sales attributable to food and non-alcoholic beverage sales, Host should only pay the 9.24 percent rent that is applicable to those sales.

Host Did Not Report Airline Payments

Host also did not report airline payments of at least $1,200,978 that the airlines paid to Host for operating the airline clubs, and underpaid the associated rent by $183,029. The lease modification section cited above also applies to the airline payments, and we concluded that Host should also pay percentage rent on these revenues. According to a Host manager, Host had never reported the airline payments as part of the airline club sales. These sales came to our attention when Host provided us records of its unreported patron sales. The airlines payments are also subject to the 15.24 percent specified for alcoholic beverages because the patron sales at the airline clubs were mostly for sales of alcoholic beverages. Because Host informed us that it did not have available records for airline payments it received prior to September 2002, we only reviewed airline payments Host received from September 2002 through August 2004.

Host Did Not Report $1.3 Million in Sales of One of Its Sub-lessees

In addition to not reporting some of its own revenues, Host also failed to report $1,308,246 in sales of one its sub-lessees from March 2003 through August 2004. As a result, Host underpaid the associated rent by $120,882. Host is required to report the sales of its sub-lessees and pay the appropriate percentage rent on those sales. The sub-lessee, WSE Burger King, changed locations within SFO in March 2003. According to Host's manager for contractual requirements, Host did not receive required monthly sales reports from WSE Burger King since March 2003. Thus, Host did not report the sub-leasee's sales to the Airport or pay the rent on those sales.

Host Took Unapproved Rent Credits

Host underpaid its rent by $53,002 when it used rent credits in September 2003 that the Airport had not approved. Host claimed a credit of $21,333 for rent payments that Host believed it had erroneously made to the Airport for airline club sales from October 2001 through January 2002. Since our audit concludes that Host should pay percentage rent on airline club sales, Host is not due this credit. As of April 2006, Airport staff informed us that the Airport has not approved this rent credit.

Host also claimed a credit of $31,669 for rent payments made for a separate lease it had with the Airport for concessions in the north terminal of SFO. Host applied this rent credit to the food and beverage lease under review. Host claimed this credit when it submitted its annual CPA audit and calculated the rent due for the lease year. The Airport staff informed us that it had not received the annual CPA audit, and thus, had not taken action on this item. As of April 2006, Airport staff informed us that the Airport has not approved this rent credit.

Host Overpaid Some of Its Rents

For five months, Host overpaid the minimum rent for the commissary and in-flight kitchen by a total of $10,750. Because Host's revenues from the operations of the commissary and in-flight kitchen did not exceed the minimum sales amount under its lease, Host paid the monthly minimum rent. Beginning in April 2004, however, the Airport reduced Host's monthly minimum rent from $6,853 to $2,553 because the Airport required Host to surrender part of the commissary premises. When the Airport informed Host of this reduction, the Airport incorrectly indicated that the minimum rent was $4,703. As a result, Host overpaid its rent by $2,150 each month from April 2004 through August 2004 for a total of $10,750.

Host also paid excess minimum rent of $231,726 for September 2004. On October 15, 2004, Host paid $290,602 to the Airport for the minimum rent for the last month of operations. Because Host operated only six days in September, the Airport determined that Host owed the Airport only $58,406 as the minimum rent for the food and beverage facilities. The Airport correctly based its calculation on the applicable monthly minimum rent of $292,030. In addition, the Airport calculated that Host owed the Airport prorated minimum rent of $470 for the commissary and in-flight kitchen. As a result, Host paid $231,726 in excess rent to the Airport. The Airport issued credits to Host on October 20, 2004 for this excess rent it paid. [1]

Host Owes the Airport for Interest on the Unpaid Rent and the Costs of This Audit

Because Host did not pay all its rent when due, Host also owes the Airport $193,511 in interest. Host's lease modification (Section 5.02) required Host to pay monthly interest of 1.5 percent for any overdue rent. We identified the net amount of rent that Host had not paid each month, and calculated the interest that Host owes the Airport through January 31, 2006.

Host must also pay the Airport for the cost of this audit, which we estimate to be $54,000. Host's lease modification (Section 5.04) specifies that it reimburse the Airport for the cost of any audit that finds that Host underpaid the annual rent due by more than two percent. For the one-year period ending May 31, 2004, Host owed the Airport $5,112,152. Since Host only paid $4,829,096 for the year, it underpaid its rent by $283,056, which is more than five percent of the rent due. While our one-year audit period is not the same months as in the lease year, the lease does not define "annual rent due". We believe our one-year audit period is a reasonable interpretation of this requirement.

RECOMMENDATIONS

The Airport Department should take the following actions to ensure that Host International, Inc., correctly pays its rent:

- Collect from Host $319,384 in rent it did not pay.
- Because Host was not able to provide records of the airline payments it received prior to September 2002, and had never reported the airline payments as part of its airline club sales,

[1] The rent credits that the Airport issued to Host excluded additional rents due to the Airport. The Airport calculated that Host owed $70,658 in additional rent for the underreported gross revenues from airline club patron sales identified in the independent auditor's report that Host submitted to the Airport. Because we already identified these underreported gross revenues, we excluded this amount from the excess rent paid.

the Airport should determine if it wishes to further pursue identifying and collecting rent for the unreported revenues.

- Collect from Host interest on the rent it did not pay on a timely basis. As of January 31, 2006, we calculated that Host owes the Airport $193,511 in interest. The Airport should continue assessing additional interest until Host pays the outstanding rent due.

- Require Host to reimburse the Airport for the cost of this audit. We estimate the cost of the audit to be $54,000, and we will provide our final cost calculations at a later date.

We conducted this review according to the standards established by the Institute of Internal Auditors. We limited our review to those areas specified in the audit scope section of this report.

Staff: Ben Carlick, Audit Manager
Edwin De Jesus

Appendix

Underreported Revenues and Underpaid Rent

	Airline Club Patron Sales		Airline Club Airline Payments		WSE Burger King		Unapproved Rent Credits	In-flight and Commissary Minimum Rent	Excess Food & Beverage Minimum Rent	Total	
	Revenues Note a	Rent	Revenues Note b	Rent	Revenues Note c	Rent	Rent	Rent Note d	Rent Note e	Underreported Revenue	Underpaid Rent
Revenues Before Audit Period	$622,285		$602,712		$178,958					$1,403,955	
Rent Before Audit Period		$94,836		$91,853		$16,536	$13,857				$217,082
Revenues During Audit Period June 2003 through May 2004	592,652		515,635		858,315					1,966,602	
Rent During Audit Period June 2003 through May 2004		90,320		78,583		79,308	39,145	($4,300)			283,056
Revenues After Audit Period: June through August 2004	129,863		82,631		270,973					483,467	
Rent After Audit Period: June through August 2004		19,791		12,593		25,038		(6,450)	($231,726)		(180,754)
Total	$1,344,800	$204,947	$1,200,978	$183,029	$1,308,246	$120,882	$53,002	($10,750)	($231,726)	$3,854,024	$319,384

a Includes all unreported patron sales from February 2002 through August 2004.

b Includes airline payments from September 2002, which is the earliest month that Host had records available, through August 2004.

c Includes all unreported food and beverage revenues from March 2003 through August 2004.

d Excludes Host's $234 underpayment of the monthly minimum rent over seven months, which is an amount we considered immaterial.

e This column represents Host's monthly minimum rent for September 2004, when Host operated its food and beverage facilities for only six days of the month.

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HMS HOST

San Francisco Food and Beverage
HMS Host Audit Response

The following responses address those findings from the contract compliance audit of the Food and Beverage Master Concessionaire contracts at the San Francisco International Airport that relate directly to HMS Host.

Reporting Period – February 1, 2002 – September 6, 2004
Rent Paid -$ 14,620,835.30
Additional Amount Due $181,130.96
Enclosed check for the amount owed ($181,130.96)

I. Host did not report more than 1.3 Million Patron Sales

Host Response: Host is in partial agreement with the audit findings and agrees that Host inadvertently failed to report airline club sales from February 2002 to August 2003. ① However, the auditor claims Host underreported airline club patron sales from February 2002 through August 2004 in the amount of $1,344,800, when in fact Host reported sales of $463,634 for the periods September 2003 through September 2004 in there annual ② statement of sales and rent due (see exhibit B). Therefore, Host underreported patron sales of $881,166.

II. Host did not report Airline Payments

Host Response: Host disagrees with the auditor's interpretation of the contract as it relates to the operation of airline clubs. We provide this service as a benefit to the airport's tenants. The only monies we collect are a management fee of approximately 18% of labor. All costs are handled on a pass-through basis and sales from the clubs are included in Host's gross receipts which are reported to the airport. Each month, Hosts bills the airline clubs for the cost of operations (actual food and beverage costs) and a markup of approximately 18%. Host deducts these costs from the actual gross receipts collected and any shortage is paid by the airline. The auditor incorrectly claims that these shortages in some way represent reportable revenue. We believe that this position is not only incorrect but, runs counter to the spirit of the agreement. These payments generally represent reimbursement of our operating costs and should appropriately be excluded from gross sales as defined in Section 5, paragraph 5.01. 7. The contract specifically ③ states that the value of any merchandise, supplies or equipment exchanged or transferred from or to other locations of business of Lessee where such exchanges or transfers are not made for other than the purpose of avoiding sales shall be excluded from the definition of gross revenue. In case of airline club, Host is simply transferring the costs to the operations of the clubs and deducting those cost from the sales, which are reported to the airport. In our opinion, the Auditor has failed to point to any provision of the Lease to support the conclusion that the Management Fee and reimbursable expenses that Host received from the Airlines are subject to percentage rent. Moreover, it is Host's position that no such provision exists in the Lease and the "Airline Payments" are not gross revenues under the Lease, and are therefore are not subject to the reporting or percentage rent requirements contained in the Lease.

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III. **Host did not report 1.3 Million in Sales of one of its sub-Lessees:**

Host Response: We agree that from the period March 2002 through August 2004, Host inadvertently failed to report Burger King Subtenant sales on the monthly revenue statements. The auditor's finding indicated that Host did not report $1,308,246, however; $890, 279 of this amount was reported and is disclosed from September 2003 to August 2004 in our Annual Report (See attached Exhibit A). The net underreported subtenant sales total $417,967 resulting in rent due of $38,620.21. ④

IV. **Host took unapproved credits:**

Host Response: Host concurs with the auditors finding that Host should be paying rent on Airline club patron sales and agrees that the credit taken in the amount of $21,333 for lease year ended August 2002 should be returned to the Airport commission. This credit is reflected in our calculation of the total liability owed (See attached Exhibit D).

The audit findings also indicated that Host improperly claimed a credit in the amount of $31,699 for the North Terminal contract without the approval of the Airport Commission. According to section 4.5 of this contract there is no requirement that the credit be approved by the airport authority; "If such report (Annual report) shows that the Base rent actually paid by tenant with respect to such lease year exceeded the Base rent payable with respect to such year, then such excess shall be applied as a rent credit to amounts next coming due. Host has properly claimed the credit as allowed by the contract. ⑤

V. **Host overpaid its minimum Rent for Commissary and in-flight sales**

Host Response: Host agrees with the auditors findings and is entitled to a credit of $10,750. This credit will be netted against the rent that Host owes to the Airport. See attached Exhibit D.

VI. **Host paid Excess Minimum Rent in the Final Month for its F&B facilities**

Host Response: Host properly accounted for the overpayment of $231,726 in the audit for the lease year ended 09/06/2004. The balance on the annual report for lease year ended September 6, 2004 showed a credit balance of $62,888 due to Host (See attached Exhibit A). For that same period, we also calculated additional rent liability due to underreporting of Airline club patron sales in the amount of $26,754.08. The net result of the overpayment was $36,134.27 ($62,688 - $26,754). Please see attached Exhibit D that reflects the change. ⑥

VII. **Host must pay interest on the rent it owes to the airport:**

Host Response: Host agrees that it owes 1.5 percent interest for any overdue rent as stated in the contract, however; does not understand how the auditor calculated interest owed of $187,143. Based on our calculations, Host owes interest of $ 81,859.74 based our assessment of the amounts owed to the Airport commission through April 2006. Please find attached Exhibit E for details. ⑦

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VIII. **Host's lease requires it to pay for the cost of this audit:**

Host Response: Host has concluded the Company's total underpayment did not exceed 2% of our total liability to the airport and thus are not obligated to bear the cost of the audit (See attached Exhibit D).

Soghra Raza
Senior Manager, Contractual Requirements
HMSHost Corporation

Date:

04/24/2006

Note: All exhibits mentioned in Host's response are on file with the Controller's Financial Audits Division and the Airport.

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CONTROLLER'S FINANCIAL AUDITS DIVISION COMMENTS ON THE RESPONSE FROM HOST INTERNATIONAL, INC.

To provide clarity and perspective, we are commenting on the response to our audit report from Host International, Inc. (Host). The following numbered responses correspond to the numbers we have placed in Host's response.

① – Host did not report the airline club patron sales in its monthly statement of sales, which we brought to Host's attention in September 2004. Subsequently, Host reported airline club patron sales of $463,634 when it submitted the required annual statement of sales. Host submitted its annual statement of sales and its annual CPA audit report on March 29, 2005. Because Host did not remit an additional payment with its annual statement, the additional reported sales did not affect our calculations of the rent due.

② – While Host reported airline club patron sales of $463,634 in its annual statement of sales from September 2003 through September 2004, Host reported an incorrect amount. Host's CPA also included this incorrect amount in its audit report. Based on records Host submitted to us, the $463,634 was for airline payments, and not patron sales. Host's records show that the correct amount for patron sales was $639,185, excluding the minor amount of sales in the final few days of operations in September 2004.

③ – We disagree with Host's statement that it is not required by the lease to report the airline payments it received from operating the airline clubs as gross revenues. Host refers to lease modification Section 5.01. (a) (7) to support its contention. However, this section specifies that the transfer of merchandise between Host's business locations is not to be included in gross revenues subject to percentage rent. Clearly, the airline club operations were not simply a transfer of merchandise from one of Host's business locations to another. Rather, Host earned revenue from the airlines for operating the airline clubs. While paying the percentage rent on the airline club payments may cause operation of the airline clubs to be of no financial beneficial to Host, the lease did not provide for alternative treatment of these revenues. As such, these revenues are reportable as gross revenues according to lease modification Section 5.01 (a) (3), which defines gross revenues as the full amount of all orders for goods or services accepted by Lessee.

④ – As in the case of airline club patron sales, Host subsequently reported Burger King sales of $890,279 for the one-year period from September 2003 through September 2004 in its annual statement of sales. However, Host did not pay any rent for these sales, and still owes the entire amount of rent that we identified in our report totaling $120,882 from March 2003 through August 2004.

⑤ – In April 2006, the Airport received a copy of the audit report in support of the $31,699 credit and is evaluating whether the credit is appropriate.

⑥ – We concur with the Airport's calculation of overpaid rent of $231,726 for September 2004. Host's calculation includes other revenues that Host did not report monthly, such as airline club patron sales and sub-lessee sales. These are separately addressed in our calculation of underpaid rent as shown in the appendix of our report.

⑦ – We provided Host and the Airport support for our interest calculation, which we changed by a minor amount after providing Host a draft copy of this report. The interest calculation in the report is based on rent that Host did not pay when due. Host's interest calculations differed from our calculations in two important respects. First, Host did not calculate interest on the rent due from the airline payments because it disagreed that this revenue was reportable to the Airport. Second, Host did not calculate interest as of the month that rent was due for revenues it reported in its annual statement of sales but did not report in its monthly sales reports.

cc: Mayor
Board of Supervisors
Civil Grand Jury
Public Library