

Metropolitan Nashville Airport Authority

MEMORANDUM

TO: Raul Regalado, President and CEO

CC: Monty Burgess, Executive Vice President and COO
Stan Van Ostran, Vice President and CFO
John Howard, Assistant Vice President of Properties and Business Development
Tom Bibb, Director of Properties
Rebecca Ramsey, Assistant Director of Properties
Amber Gooding, Director of Business Diversity Development

FROM: Basil A. Dosunmu, Internal Auditor

DATE: May 6, 2011

SUBJ: Host International, Inc. Audit Report

Background

On September 29, 2006, Host International, Inc. (“HMSHost”), a Delaware Corporation entered into two Master Lease and Concession Agreements for Package No. 2 (A06-243) and No. 3 (A-06-244) with the Metropolitan Nashville Airport Authority (“Authority”). The Agreements granted HMSHost the rights to operate food and beverage concession businesses at the Nashville International Airport for a period of eight (8) years, which commenced on January 31, 2009, the beginning of the Operational Phase and would continue until June 30, 2017, with two (2) one year renewal options.

Commencing after January 31, 2009, HMSHost would pay to the Authority the greater of a minimum annual guarantee (“MAG”) One Million Two Hundred Thirty Three Thousand and 00/100 Dollars (\$1,233,000.00) and One Hundred Fifty Thousand and 00/00 Dollars (\$150,000.00) for Package No. 2 and No. 3, respectively, which is subject to an annual adjustment based on prior year rentals, or annual calculated percentage of payment of gross revenue derived from the sale of food and beverage concession businesses at the Airport. The following are the food and beverage services and percentage of gross revenue derived from HMSHost.

<u>Concession Package No. 2</u>	<u>Concession Operations</u>	<u>% of Gross Revenue</u>
Alcoholic Beverages at Casual Dining Restaurant/Lounge	Noshville Deli	15%
Alcoholic Beverages at Fast Food & Locally Themed Café/Lounge	Gibson Café, Neely's Bar-B-Que, Tennessee Tavern	15%
Food & Non-Alcoholic Beverages at Casual Dining Restaurant/Lounge	Noshville Deli	10%
Food & Non-Alcoholic Beverages at Fast Food & Locally Themed Café/Lounge	Burger King, Provence Bread, Baja Burrito, Famous Famiglia, Quiznos Sub, Starbucks Coffee	12%
Related Merchandise	All Locations	15%
<u>Concession Package No. 3</u>	<u>Concession Operations</u>	<u>% of Gross Revenue</u>
Food & Non-Alcoholic Beverages/Specialty Gourmet Coffee	Starbucks Coffee	11%
Related Merchandise	Starbucks Coffee	15%

In addition to the MAG and/or percentage of gross revenue payments required, HMSHost agreed to contribute to the Joint Marketing Fund, on a monthly basis, an amount not to exceed three quarters of one percent (0.75%) of all gross receipts derived from concession operations. The types of expenses that Authority may pay out of the joint marketing fund shall include, without limitation, the following:

- a) Direct costs associated with marketing and promotional activities (including, without limitation, costs incurred for the purchase of marketing program creative materials, costs for special events and/or paid media);
- b) Costs associated with marketing program development and the day-to-day coordination of the marketing program;
- c) Costs for development and provision of shopping bags to promote Concession Operations;
- d) Secret shopping and other inspection programs with respect to Concession Operations;
- e) Directory signage within the Terminal relating to the Concession Locations;
- f) The preparation of a full-color catalog featuring the Concession Operations, the Concession Locations and the products and services offered by Concession Operators, which may include coupons; and
- g) Other programs, such as brochures, common shopping bags, graphics, media promotions, pamphlets and public events, to promote sales through the Concession Program.

HMSHost would also pay to the Authority common area maintenance (“CAM”) charges monthly in an amount equal to one and twenty-five one-hundredths (1.25%) of all gross revenues from concession operations.

Likewise, HMSHost is required to provide for a level of Authority-certified Disadvantage Business Enterprise (“DBE”) participation of fifteen and seven tenths percent (15.7%) or more of total gross receipts from Concession Operations. HMSHost engaged the service of Transfare, Inc. for DBE purposes.

Furthermore, On January 1, 2008, HMSHost entered into a Space Lease Agreement (A-08-291) with the Authority. This Agreement granted HMSHost the right to use certain improved real property, commonly known as Support Space on the first floor level of the Passenger Terminal Building (632 square feet) as well as Ramp Storage space in the C triangle storage area (3,996 square feet) and in the A/B Apex Storage area (754 square feet) located on the Nashville International Airport, for the operation of a office space and storage facility associated with Lessee's on-airport food and beverage concession. The term of the Agreement shall automatically renew on a month-to-month basis.

The First Amendment to the Space Lease Agreement, effective July 1, 2009, provided for change in cost per square foot of support space for the first 4,500 square feet at the rate of Ten and 00/100 Dollars (\$10.00) per square foot per annum and addition of support space room (T0051), consisting of 426 square feet.

HMSHost would also pay the amount of Ten and 00/100 Dollars (\$10.00) per square foot per annum for the first 4,500 square feet and Thirty Six and 00/100 Dollars (\$36.00) per square foot per annum for each additional square foot.

On August 23, 2009, through a Letter of Notification, Blue Coast Burrito, Inc. informed the Authority that BCB Franchising, LLC will no longer be operating restaurants under the name of Baja Burrito; the new name of the restaurants will be Blue Coast Burrito.

The Second Amendment to the Space Lease Agreement, effective January 25, 2010, provided for the deletion of support space room (T0051), consisting of 426 square feet and addition of support space rooms (T0010) and (T0022D), consisting of 127 square feet and 184 square feet, respectively.

The First Amendment to the Master Lease and Concession Agreement for package No. 3, effective January 25, 2010, provided for addition of a new specialty coffee location (T2058) within the A/B rotunda, consisting of 747 square feet operated as Starbucks. HMSHost agreed to pay the Authority a revised MAG of Two Hundred Thirty Thousand and 00/100 Dollars (\$230,000.00), payable in equal monthly installments.

The Concession Agreement stated that HMSHost would furnish audited statements to the Authority, prepared in accordance with generally accepted accounting principles that the minimum annual guarantee and the percentage payment paid by the Concessionaire to the Authority during the preceding contract year were made in accordance with the terms of the Agreement. The statement would contain gross revenues as shown on the books and records of HMSHost that were used to compute the percentage payment made to the Authority.

In addition, within sixty (60) days after the end of each year, HMSHost shall provide its annual report along with a reconciliation and payment to Authority, if any, due to the Authority for the preceding lease year on account of the percentage payment provisions. If any refund is due to HMSHost, such refund would be applied to future rental payments due to the Authority.

The following are the gross revenues and percentage payment provisions for HMSHost per the Statement of Monthly Gross Revenues and Concession Payments, Joint Marketing Fees, and CAM Charges for the Year Ended June 30, 2010, provided by KPMG:

FY2010 Statement of Monthly Gross Revenues and Concession Payments:

Period	Food & Non-Alcoholic Beverages at Fast Food & Locally Themed Cafe/Lounge No. 2	Alcoholic Beverages at Fast Food & Locally Themed Cafe/Lounge No. 2	Food & Non-Alcoholic Beverages at Casual Dining Restaurant/Lounge No. 2	Alcoholic Beverages at Casual Dining Restaurant/Lounge No. 2	Related Merchandise (All Locations) No. 2	Total No. 2	Food & Non-Alcoholic Beverages No. 3	Specialty Gourmet Coffee No. 3	Related Merchandise (All Locations) No. 3	Total No. 3	Total No. 2 & No. 3
July 2009	\$691,693	\$94,703	\$114,342	\$16,060	\$587	\$917,386	\$50,752	\$171,822	\$4,218	\$226,791	\$1,144,177
August	603,177	95,778	110,634	18,555	530	828,674	44,177	151,501	4,138	199,816	1,028,490
September	539,556	97,365	110,412	20,371	555	768,258	41,994	145,262	4,763	192,019	960,277
October	621,255	107,332	128,363	20,189	698	877,836	50,764	167,830	5,536	224,131	1,101,967
November	522,170	88,876	116,066	17,083	831	745,026	41,509	153,951	5,711	201,171	946,196
December	578,385	99,752	107,144	15,596	1,221	802,099	43,632	163,841	5,911	213,384	1,015,483
January 2010	508,100	82,820	109,048	17,965	887	718,821	36,806	136,449	5,587	178,842	897,662
February	497,816	91,112	94,322	15,842	598	699,690	39,207	141,031	6,258	186,495	886,185
March	599,856	105,684	121,336	20,025	718	847,619	51,425	172,505	7,124	231,054	1,078,673
April	564,870	94,559	112,500	17,679	748	790,357	52,394	171,144	6,515	230,053	1,020,410
May	607,002	112,252	121,495	18,371	630	859,750	53,162	180,870	7,309	241,341	1,101,091
June	697,313	126,166	122,372	19,002	955	965,809	55,575	194,370	8,802	258,748	1,224,556
Total Gross Revenue	\$7,031,195	\$1,196,400	\$1,368,034	\$216,738	\$8,959	\$9,821,325	\$561,398	\$1,950,574	\$71,872	\$2,583,844	\$12,405,169
Contractual Percentage Rate	12%	15%	10%	15%	15%		11%	11%	15%		
Calculated Percentage Payment Due	\$843,743	\$179,460	\$136,803	\$32,511	\$1,344	\$1,193,861	\$61,754	\$214,563	\$10,781	\$287,098	\$1,480,959
Minimum Annual Guarantee						\$1,233,000				\$230,000	\$1,416,333
Rent paid by HMSHost						\$1,262,601				\$287,098	\$1,549,699
(Under)/Over payment						\$29,601				\$0	\$29,601

FY2010 Joint Marketing Fund Contributions:

Period	Gross Revenue No. 2	Gross Revenue No. 3	Gross Revenue A/B	Total Gross Revenue
	July 2009	\$917,387	\$153,117	\$73,675
August	828,674	133,789	66,027	1,028,490
September	768,258	128,181	63,837	960,277
October	877,836	151,545	72,586	1,101,967
November	745,026	136,226	64,945	946,196
December	802,099	146,917	66,467	1,015,483
January 2010	718,821	143,795	35,046	897,662
February	699,690	186,495	-	886,185
March	847,619	231,054	-	1,078,673
April	790,357	230,053	-	1,020,410
May	859,750	241,341	-	1,101,091
June	965,809	258,748	-	1,224,556
Total Gross Revenue	\$9,821,326	\$2,141,261	\$442,583	\$12,405,170
Rate	0.75%	0.75%		
Calculated Percentage Payment Due	\$73,660	\$16,059		\$89,719
Marketing Fees paid by HMSHost	\$73,660	\$16,059		\$89,719
(Under)/Over payment	\$0	\$0		\$0

FY2010 CAM Charges:

<u>Period</u>	<u>Gross Revenue</u> <u>No. 2</u>	<u>Gross Revenue</u> <u>No. 3</u>	<u>Gross</u> <u>Revenue A/B</u>	<u>Total Gross</u> <u>Revenue</u>
July 2009	\$917,387	\$153,117	\$73,675	\$1,144,178
August	828,674	133,789	66,027	1,028,490
September	768,258	128,181	63,837	960,277
October	877,836	151,545	72,586	1,101,967
November	745,026	136,226	64,945	946,196
December	802,099	146,917	66,467	1,015,483
January 2010	718,821	143,795	35,046	897,662
February	699,690	186,495	-	886,185
March	847,619	231,054	-	1,078,673
April	790,357	230,053	-	1,020,410
May	859,750	241,341	-	1,101,091
June	965,809	258,748	-	1,224,556
Total Gross Revenue	\$9,821,326	\$2,141,261	\$442,583	\$12,405,170
CAM Rate	1.25%	1.25%		
Calculated Percentage Payment Due	\$122,767	\$26,766		\$149,532
CAM paid by HMSHost	\$122,767	\$26,766		\$149,533
(Under)/Over payment	\$0	(\$0)		\$0

HMSHost’s percentage payments from the gross revenues for package No. 2 were \$1,193,861. Thus, the minimum annual guarantee paid to the Authority was greater than the percentage payment calculation. The total rent paid by HMSHost to the Authority for the Year Ended June 30, 2010, was \$1,262,601; therefore HMSHost had an overpayment of rent to the Authority in the amount of \$29,601. Accordingly, HMSHost was due a refund for the overpayment of rent to the Authority in the amount of \$29,601, which should be credited to the Concessionaire’s account and applied against one or more of the next succeeding monthly payments during the next ensuring contract year.

HMSHost’s percentage payments from the gross revenues for package No. 3 were \$287,098. Thus, the percentage payment paid to the Authority was greater than the minimum annual guarantee. The total rent paid by HMSHost to the Authority for the Year Ended June 30, 2010, was \$287,098; therefore there is no amount due either the Authority or HMSHost.

The Authority’s Finance Department (“Finance”) determined on November 23, 2010, that HMSHost had an overpayment of rent to the Authority in the amount of \$29,601 and issued HMSHost a credit memo (CRM#0001869) for the overpayment amount. Finance based the determination upon the minimum annual guarantee, percentage payment provisions, and the total rent paid by HMSHost to the Authority for the Year Ended June 30, 2010.

Objectives

The objectives of the audit were as follows:

1. Determine the validity of gross revenue amounts reported and fees paid to the Authority.
2. Determine compliance with contract terms and operational requirements.
3. Document and evaluate existing internal controls.

Testing

In order to satisfy the audit objectives, the following tests were performed:

1. Selected 3 months for detail testing (January, March, and June 2010). For each month selected, performed the following:
 - a. Obtained the monthly fixed rent invoices from Authority's Accounts Receivable and verified that the invoiced amount agreed to the schedule of rental fees and charges in the Master Lease and Concession Agreements.
 - b. Obtained monthly revenue report and performed the following:
 - i. Reviewed report for mathematical accuracy.
 - ii. Tied amounts per report to amounts reported to the Authority.
 - iii. Verified HMSHost had properly calculated the percentage of gross revenue requirements.
 - iv. Verified monthly CAM charges were equal to 1.25% of the gross receipts from concession operations.
 - v. Determined HMSHost was contributing 0.75% of monthly gross receipts to the Joint Marketing Fund.
 1. Verified the Authority was maintaining the Joint Marketing Fund in a separate account and not commingled with other funds.
 - c. Obtained a copy of the Tennessee Sales and Use Tax and Alcoholic Beverage and Beer Tax forms.
 - i. Reviewed revenue amounts per sales tax and alcoholic beverage tax forms for reasonableness.
2. Selected 3 months for detail testing (January, March, and June 2010) of a specific concession location (package No. 3 Starbucks). For each month selected, performed the following:
 - a. Obtained a copy of Starbucks general ledger and performed the following:
 - i. Reviewed report for mathematical accuracy.
 - ii. Verified that the revenue amounts reported per the general ledger were consistent with the revenue amounts reported to the Authority.
 - iii. Verified Starbucks had properly calculated the percentage of gross revenue requirements.
 - iv. Sub selected a week each month and performed the following:
 1. Obtained the Daily Revenue Reports for the week selected.

2. Verified the daily revenue amount agreed to the monthly general ledger report.
 3. Determined that the revenue was properly stated by noting sales receipts per the Daily Revenue Reports contained appropriate information (e.g., sales date, total, method of payment, etc.).
 4. Reviewed the Daily Revenue Reports and noted any unusual activity. Performed testing of areas identified.
3. Determined HMSHost had satisfied their obligations for not meeting the initial capital improvement costs requirement.
 4. Determined HMSHost met operational requirements.
 - a. Determined through observations that Concessionaire's premises was maintained in a First Class Manner.
 - b. Verified Concessionaire was meeting operational hours and staffing requirements.
 - c. Determined Concessionaire was submitting quarterly update regarding recent trends or developments in food and beverage concession operations.
 - d. Verified Concessionaire was conducting formal performance audits on a bi-monthly basis.
 - e. Determined HMSHost was meeting annual reporting requirements.
 - i. Determined Concessionaire was submitting an annual pricing report to ensure reasonable pricing was being maintained.
 5. Determined Concessionaire's has in place a customer service training program.
 6. Verified Authority personnel were conducting monthly meetings with Concessionaire to discuss operational issues.
 7. Verified Concessionaire has met the Disadvantaged Business Enterprise ("DBE") Program requirements established in the contract.
 8. Determined HMSHost maintains adequate insurance coverage.
 - a. Obtained a copy of the current certificate of insurance on file.
 - b. Verified that the commercial general liability, property, automobile, and worker's compensation insurance coverage met or exceeded the amounts specified in the contract.
 - c. Verified that the certificate of insurance was current and adhered to all other contract terms.
 9. Determined HMSHost maintained an Irrevocable Letter of Credit ("LOC").
 - a. Obtained a copy of the current LOC.
 - b. Verified that the LOC coverage met or exceeded the amount specified in the contract.
 - c. Verified that the LOC was current and adhered to all other contract terms.
 10. Determined Concessionaire's Sublease tenant was meeting contract requirements.
 11. Through inquiry and observation, reviewed the existing internal controls in place.

Conclusion

Based upon the audit, the following was determined with respect to the stated objectives:

1. The LOC coverage for package No. 3 should be increased to \$115,000 as noted in finding #1.

2. The cancellation clause on the Certificate of Insurance needs to be revised to the Authority's required clause as noted in finding #2.
3. The operating hours for Burger King are not posted as noted in finding #3.

Finding #1

Observation

The LOC coverage for package No. 3 should be increased to \$115,000.

Background

An objective of this audit is to verify that the LOC coverage meets or exceeds the amount specified in the Agreement.

Article XIX, Financial Guarantee, Section 19.1 of the Master Lease and Concession Agreement, Letter of Credit, states that as security for Concessionaire's full, faithful and prompt performance of and compliance with all covenants, terms and conditions of this Agreement on the part of Concessionaire, Concessionaire hereby agrees to deposit with Authority, at all times from and after the Effective Date, a stand-by, irrevocable letter of credit (the "Letter of Credit") for the benefit of Authority, in the form of Exhibit I hereto, in a stated principal amount that is not less than fifty percent (50%) of the MAG hereunder for the then current Lease Year (or, for the period prior to the Commencement Date, in an amount that is not less than the minimum MAG for the initial full Lease Year), and issued by a national banking association or state chartered bank subject to examination by federal authority of the United States of America, of good standing and having a combined capital and surplus aggregating not less than Five Hundred Million and No/100 Dollars (\$500,000,000.00).

The current LOC on file for package No. 3 is in the amount of Seventy Five Thousand and 00/100 Dollars (\$75,000.00) which is less than fifty percent (50%) of the current minimum annual guarantee ("MAG") on the package No. 3. The current MAG on package No. 3 is in the amount of Two Hundred and Thirty Thousand and 00/100 Dollars (\$230,000.00) as a result, the LOC should for the amount of One Hundred Fifteen Thousand and 00/100 (\$115,000.00).

Recommendation

The Authority's Properties Department ("Properties") should require HMSHost to submit to the Authority an LOC in the amount of One Hundred Fifteen Thousand and 00/100 (\$115,000.00), as required by the Agreement.

Management Response

Properties will request in writing that HMSHost submit to the Authority an LOC in the amount of One Hundred Fifteen Thousand and 00/100 (\$115,000.00), as required by the Agreement.

Finding #2

Observation

The cancellation clause on the Certificate of Insurance needs to be revised to the Authority's required clause.

Background

An objective of this audit was to verify that the certificate of insurance adhered to the Agreement terms.

Article XV, Insurance, Section 15.5 of the Master Lease and Concession Agreement, General Requirements, states that each such certificate of insurance shall provide that the insurance company issuing the insurance policy or policies referenced or described therein shall give to Authority notice of the cancellation or non-renewal of each such insurance policy not less than thirty (30) days prior to the effective date of such cancellation or the expiration date of such insurance policy, as applicable.

It was determined through audit testing that the commercial general liability, automobile, and worker's compensation certificate of liability insurance for package No. 2 and No. 3 does not include the requirement cancellation clause.

Recommendation

Properties should require HMSHost to re-submit certificate of liability insurance with the requirement cancellation clause.

Management Response

Properties will request in writing requiring HMSHost re-submit a certificate of liability insurance with a cancellation clause that is in accordance with their Agreement.

Finding #3

Observation

The operating hours for Burger King are not posted.

Background

An objective of this audit is to verify Concessionaire is meeting operational hours and staffing requirements.

Article IV, Concessionaire's Obligations, Section 4.5 of the Master Lease and Concession Agreement, Hours of Operation, states that the Airport is open every day of the year and often busy during hours before and after normal meal hours. In addition, travelers using the Airport

have often just traveled from different time zones and are not yet acclimated to the time zone in which the Airport is located. For these reasons, all Concession Locations shall be operated seven (7) days a week, 365 days a year, unless otherwise approved by Authority, and in a manner otherwise consistent with the requirements prescribed by Authority in accordance with the actual aviation operations at the Airport.

Furthermore, in March 2010, the Authority required the Concessionaire to post each Concession Location hour of operations to assist passenger with each location's operating hours. During Internal Audit's tour of HMSHost Concession Location, it was noted that the hours of operations for the Burger King Concession Location was not posted as required by the Authority.

Recommendation

Properties should notify HMSHost to post the hours of operation for the Burger King location within a reasonable period of time.

Management Response

Properties notified HMSHost to post the hours of operation for the Burger King location and they have complied.