Internal Audit Department

ORANGE COUNTY

REVIEW OF LEASE REVENUE FOR OCEAN INSTITUTE

AUDIT NO: 2577
REPORT DATE: NOVEMBER 6, 2007

For the Period
February 1, 2005 through January 1, 2006

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Letter from Director Peter Hughes

Transmittal Letter

AUDIT NO. 2577 **DATE NOVEMBER 6, 2007**

TO: Brad Gross, Director
Dana Point Harbor Department

FROM: Dr. Peter Hughes, CPA, Director
Internal Audit Department

SUBJECT: Final Report of Lease Revenue for Ocean Institute

We have completed our review of lease revenue for Ocean Institute for the period year ended January 31, 2006. The final **Internal Auditor's Report** is attached along with your responses to our recommendations.

Each month I submit an **Audit Status Report** to the BOS where I detail any material and significant audit findings released in reports during the prior month and the implementation status of audit recommendations as disclosed by our **Follow-Up Audits**. Accordingly, the results of this audit will be included in a future status report to the BOS.

We appreciate the cooperation and assistance extended to us by your staff during our revenue lease review.

Other recipients of this report are listed on the Internal Auditor's Report on page 1.

Table of Contents

Review of Lease Revenue for Ocean Institute
Audit No. 2577

For the Period
February 1, 2005 through January 1, 2006

INTERNAL AUDITOR'S REPORT

AUDIT NO. 2577 **DATE NOVEMBER 6, 2007**

TO: Brad Gross, Director
Dana Point Harbor Department

SUBJECT: Review of Lease Revenue for Ocean Institute, Parcel HA78H-24-133, 134

Audit Highlight
Ocean Institute has retained sufficient documentation to adequately support its monthly rent payments to the County.

However, we did identify additional potential rent owed of $66,895 related to facility rental revenue.

We have performed a review of certain records and documents for the year ended January 31, 2006, pertinent to the lease agreement (Agreement) between the County of Orange (County) and Ocean Institute, a California non-profit corporation, dated June 29, 1999. The Agreement is primarily to develop and operate County approved facilities and programs specifically related to marine science research, marine-related cultural activities/events, protection and conservation of the marine environment, and maritime and marine science education.

The primary purpose of our review is to determine whether Ocean Institute's records adequately supported its monthly rent payments to the County. We also reviewed compliance with certain other provisions of the Lease Agreement, such as accounting methods and payment procedures.

Based on our review, we find that Ocean Institute has retained sufficient documentation to adequately support its monthly rent payments to the County. **No material weaknesses or significant issues were identified.** However, we did identify additional potential rent owed of **$66,895** related to facility rental revenue. We also identified **sixteen (16)** control findings related to compliance with the Agreement or improving controls that are noted in the Detailed Observations, Recommendations and Management Responses section of this report. See Attachment A for a description of report item classifications.

We appreciate the courtesy and cooperation extended to us by the personnel at Ocean Institute, DPHD, and RDMD/Accounting Services. If you have any questions regarding our review of lease revenue, please contact Eli Littner, Deputy Director at (714) 834-5899 or Autumn McKinney, Senior Audit Manager at (714) 834-6106.

Respectfully Submitted,

Peter Hughes

Dr. Peter Hughes, CPA
Director, Internal Audit Department

ATTACHMENTS

Distribution Pursuant to Audit Oversight Committee Procedure No. 1:

Members, Board of Supervisors
Members, Audit Oversight Committee
Thomas G. Mauk, County Executive Officer
Paul Lawrence, Operations Manager, DPHD
Gregory Dean, Lease Compliance Specialist, DPHD
Louis McClure, Budget Officer, DPHD
Mary Fitzgerald, Manager, RDMD/Accounting Services
Betsy Estrada, Chief, RDMD/Accounting Services/External Claims/HB&P Programs
Anne Tran, Senior Accountant, RDMD/Accounting Services/Dana Point Operating Leases
Foreperson, Grand Jury
Darlene J. Bloom, Clerk of the Board of Supervisors

EXECUTIVE SUMMARY

AUDIT NO. 2577 **DATE NOVEMBER 6, 2007**

OBJECTIVES

The Internal Audit Department conducted a review of lease revenue pertinent to the lease agreement with Ocean Institute, a California non-profit organization, for the primary purpose of determining whether the records of Ocean Institute adequately supported monthly rent payments to the County.

BACKGROUND

The County of Orange entered into a 36-year lease agreement (Agreement) with Friends of the Marine Institute in Orange County, a California non-profit corporation, dated June 29, 1999. In January 2000, the organization was renamed Ocean Institute. The purpose of the Agreement is for Ocean Institute to develop and operate County approved facilities and programs specifically related to marine science research, marine-related cultural activities/events, protection and conservation of the marine environment, and maritime and marine science education. For the year ended January 31, 2006, Ocean Institute reported gross receipts (not subject to percentage rent) of $3.9 million to the County and paid $12,000 in rent to the County.

SCOPE

Our review was limited to certain records and documents that support Ocean Institute's monthly rent payments to the County for the year ended January 31, 2006. We also reviewed compliance with certain other provisions of the Agreement, such as accounting methods and payment procedures. Our review included inquiry, auditor observation, and limited testing for assessing the adequacy of documentation and ensuring completeness of reported gross receipts.

RESULTS

Based on our limited review, we find that Ocean Institute has retained sufficient documentation to adequately support monthly rent payments to the County.

No material weaknesses or significant issues were identified. However, we did identify potential additional rent owed of $66,895 related to facility rental revenue. We also identified sixteen (16) control findings related to compliance with the Agreement or improving controls that are noted in the Detailed Observations, Recommendations and Management Responses section of this report. See Attachment A for a description of report item classifications.

DETAILED OBSERVATIONS, RECOMMENDATIONS AND MANAGEMENT RESPONSES

Percentage Rent Not Paid on Facility Rental Revenue

According to its website, Ocean Institute rents portions of its facility to the public for special events such as corporate functions, seminars, conferences, meetings, product launches, team-building seminars, business receptions, and luncheons.

Clause 5.B of the Agreement (Optional Rent Free Uses) specifies the following uses are excluded from percentage rent payments to the County:

- Clauses 5.B.6: Meeting rooms to the extent they are used by Ocean Institute in accordance with the **Purpose** as defined in the Agreement.
- Clause 5.B.7: Theater/Auditorium to the extent that performances are produced solely by Ocean Institute and that such performances substantially related to the **Purpose** as defined in the Agreement.

Clause 5.C of the Agreement (Optional Uses Subject to Rent) specifies the following uses are subject to percentage rent payments to the County:

- Clause 5.C.4: Meeting and banquet room uses other than the uses permitted pursuant to Clause B.6 above.
- Clause 5.C.5: Theater/Auditorium uses other than the uses permitted pursuant to Clause 5.B.7 above.

The Definitions section of the Agreement states the “**Purpose**” means Ocean Institute’s “requirement to develop and operate Lessor-approved facilities and programs specifically related to marine science research, marine-related cultural activities/events, protection and conservation of the marine environment, and maritime and marine science education. Said programs and activities shall be operated such that substantial public benefit in the form of advancement of enhanced knowledge, awareness, and understanding of the marine environment is derived. Said facilities and programs shall be readily available to school groups (kindergarten through college) and other groups, and to individuals and families within the general public and related professional groups such as teachers and research scientists all on a non-discriminatory basis. The guiding principle shall be to provide for the delivery of the highest quality marine educational experience, available to the greatest number of people, consistent with the **Purpose** herein, and Tenant’s status as a non-profit organization.”

To summarize the above, it appears that facility rentals are excluded from percentage rent if the facility rental is for marine related research and educational programs. However, if the facility rental is for commercial purposes, the facility rental is subject to percentage rent.

In addition, Clause 5.A of the Agreement states that in the event of a dispute between the County and Ocean Institute as to whether a particular use shall be considered a “rent free use,” a use “subject to rent,” or a “restricted use,” pursuant to Clause 5 (USE), then the decision of the Director of DPHD, in his/her sole and absolute discretion, shall be final and binding.

Finding Nos. 1 and 2: Ocean Institute reports facility rental revenue in the Theater/Auditorium (educational activities only) category excluded from percentage rent.

During our detailed testing of the sample month of January 2006, we reviewed the supporting documentation (contracts) for the facility rentals to determine the research or educational nature of the rental. We found that the Ocean Institute's conference center was rented on 3 days and total revenue of $7,500 was received as follows:

- 1/7/06 - The facility was rented for a homecoming event ($7,000)
- 1/22/06 - The facility was rented for a wine auction/dinner (no charge).
- 1/30/06 - The facility was rented to a high school for a staff meeting ($500).

Based on our review of Ocean Institute's website description for facility rentals and our limited testing above, it appear that the facility rentals are more commercial in nature rather than marine related research and education. It appears the gross receipts from facility rentals should be subject to percentage rent of 10%.

For the 12 month period of February 2005 through January 2006, Ocean Institute reported facility rental revenue of $252,944 and we calculated additional rent of **$25,294** (10% x $252,944) that would be owed. For the 16 month period of February 2006 through May 2007, Ocean Institute reported facility rental revenue of $416,010 and we calculated additional rent of **$41,601** (10% x $416,010) that would be owed. A net credit for minimum monthly rent of $1,000 less flat rent ($50 per cruise) paid for commercial cruises could potentially reduce these amounts owed. See details below in Finding No. 7.

During our review of relevant correspondence, we identified a letter dated March 13, 2003, from the Ocean Institute to the County. In that letter, Ocean Institute requested a modification to the Agreement and made a case that the facility rental revenue should be excluded from gross receipts subject to percentage rent. DHPD or Ocean Institute could not provide evidence of the County responding to the letter or approving the exclusion of facility rental revenue.

DPHD should determine whether Ocean Institute should be required to report facility rental revenue as gross receipts subject to percentage rent. DPHD should document its conclusion and provide it in writing to Ocean Institute.

Recommendation No. 1: We recommend that DPHD determine and clarify in writing whether Ocean Institute should report facility rental revenue as gross receipts subject to percentage rent.

DPHD Response: Ocean Institute must report facility rental revenue as gross receipts subject to percentage rent. Regarding the letter dated March 13, 2003, a subsequent meeting with Ocean Institute, DPHD denied Mr. Gee's request to eliminate facility rental revenue from percentage rent. DPHD met with Ocean Institute officials on October 15 & 16, 2007 and informed Ocean Institute of their lease obligation to report not only facility revenues subject to percentage rent, but all Ocean Institute revenues. Ocean Institute was also instructed in a letter dated October 19, 2007 that the monthly sales report needs to be received no later then 20 days after the close of the reporting month, and that the sales report must be signed by Tenant or by Tenant's responsible Agent under the penalty of perjury. Commencement of this reporting is required no later than November 20, 2007.

Recommendation No. 2: We also recommend that if DPHD determines the facility rental revenue is subject to percentage rent, that DPHD require Ocean Institute to pay percentage rent owed of $66,895 for the 28 month period of February 2005 through May 2007. DPHD should also require Ocean Institute to calculate and pay percentage rent owed for the period of June 2007 through the month of correction. A net credit for minimum monthly rent of $1,000 less flat rent ($50 per cruise) for commercial cruises could potentially reduce these amounts owed. See details below in Finding No.7.

DPHD Response: Ocean Institute has been directed to pay percentage rent owed of $66,895 for the 28 month period of February, 2005 through May, 2007. Ocean Institute has been directed to calculate and pay percentage rent for the period of June, 2007 through the month of correction. DPHD met with Ocean Institute officials on October 15 & 16, 2007 and instructed Ocean Institute to pay the amounts described above. Ocean Institute was also instructed to pay the above amounts by November 19, 2007 in a letter dated October 19, 2007.

Facility Rental Security Deposits

Clause 9.C of the Agreement states that the term "gross receipts" upon which percentage rents are to be based includes all "Admission, entry, rental, and other fees of any nature or kind received by Tenant (including, but not limited to, deposits accepted by Tenant)." Ocean Institute typically requires facility renters to pay an advance security deposit. The security deposits are recorded as deferred revenue and revenue is realized when the rental takes place.

Finding Nos. 3 and 4: Ocean Institute excludes the security deposits for facility rentals from gross receipts "subject to percentage rent." However, if the facility rental revenue is determined to be "subject to percentage rent" as discussed above in Finding No. 1, the related security deposits should also be reported as gross receipts "subject to percentage rent" when the security deposit is received by Ocean Institute. As of January 31, 2006, Ocean Institute had $51,888 in security deposits for facility rentals recorded in its accounting records.

Recommendation No. 3: If the facility rental revenue is determined to be gross receipts "subject to rent," we recommend that DPHD require Ocean Institute to report security deposits for facility rentals as gross receipts "subject to rent" and pay the percentage rent owed (10%) when the security deposit is collected.

DPHD Response: DPHD has directed Ocean Institute to report security deposits for facility rentals as gross receipts that are "subject to rent" and pay the percentage rent owed (10%) when the security deposit is collected. DPHD met with Ocean Institute officials on October 15 & 16, 2007 and instructed Ocean Institute to pay percentage rent on the deposit amounts described above. Ocean Institute was also instructed to report security deposits for facility rentals as gross receipts that are "subject to rent" and to pay the percentage rent owed (10%) when the security deposit is collected (in a letter dated October 19, 2007). Completion of this is required no later than November 19, 2007.

Recommendation No. 4: If the facility rental revenue is determined to be gross receipts "subject to rent," we also recommend that DPHD require Ocean Institute to make a one-time adjustment to report the balance of security deposits as of the date of correction as gross receipts "subject to rent" and pay the percentage rent owed (10%).

DPHD Response: DPHD has instructed Ocean Institute to make a one-time adjustment to report the balance of security deposits as of the date of correction as gross receipts "subject to rent" and pay the percentage rent owed (10%) on the balance held. DPHD met with Ocean Institute officials on October 15 & 16, 2007 and instructed Ocean Institute to pay percentage rent on the deposit amounts described above. Ocean Institute was instructed to pay the percentage rent in a letter dated October 19, 2007, which required completion of this no later than November 19, 2007.

Percentage Not Paid on Museum Style Retail Store Sales

Ocean Institute has a museum style retail store, Chambers Gallery Book and Gift Store, on its premises.

Clause 5.B.5 of the Agreement states that revenue derived from the museum style retail store is not subject to percentage rent "… so long as one hundred percent (100%) of the store's gross sales are derived from the sale of items that are substantially marine/ocean related and that are customarily sold in museum style retail sales stores, the sale of books, learning kits, and materials that support Tenant's educational exhibits and programs."

Clause 5.C.3 of the Agreement states that "retail sales other than those permitted pursuant to Clause B.7 above" are subject to percentage rent.

Clause 5.A of the Agreement states that "Tenant shall operate its programs and all other activities in a manner such that Tenant does not unfairly commercially compete with Harbor merchants or other Lessor approved entities offering similar goods and/or services."

Finding No. 5: For the period February 2005 through January 2006, Ocean Institute reported retail sales of $378,885 as gross receipts excluded from percentage rent.

Certain items sold in the Chambers Gallery Book and Gift Store may not qualify as items that are substantially marine/ocean related and that are customarily sold in museum style retail stores.

We observed that the store sells a variety of merchandise, such as educational books and videos, maps and guides, clothing, jewelry, decorative items (statues, wind chimes, clocks, throws, etc.), greeting cards and stationary, games, sunglasses, key chains, magnets, film, and bottled water.

For the sample month of January 2006, the following is a summary of retail sales as recorded in the store's cash register:

Category	Amount
Apparel	$ 3,981
Books	$ 3,202
Children	$ 4,678
Food	$ 99
Gifts	$ 3,539
Jewelry	$ 2,389
Multi-media	$ 116
Novelties	$ 3,400
Paper	$ 1,014
Science	$ 637
Service Items	$ 443
Softgoods	$ 40
Xmas/Sp Focus	$ 392
Total	**$23,856**

Based on our review of some of the items for sale, it appears that they are not marine/ocean related but may be items customarily sold in museum style retail stores. DPHD stated that it was informed by Ocean Institute that it hired a consultant who had experience in merchandising for museum style retail stores and this consultant helped Ocean Institute develop it product mix and merchandising strategy.

DPHD should evaluate whether the merchandise sold at Ocean Institute's store is substantially marine/ocean related **and** customarily sold in museum style retail stores and therefore, should be excluded from percentage rent. DPHD should document its conclusion and provide it in writing to Ocean Institute.

Recommendation No. 5: We recommend that DPHD determine and clarify in writing whether the merchandise sold at Ocean Institute's store complies with the Agreement and should be excluded from percentage rent.

DPHD Response: DPHD has determined that the merchandise sold at Ocean Institute's store complies with the Agreement and should be excluded from percentage rent. The merchandise mix at the Ocean Institute's store has been determined by a consultant, Shelley L. Stephens of Manask & Associates to be in compliance with the Agreement requirements and Museum Store Association standards. Manask & Associates provides advisement for museum and similar stores' merchandise at many categorically similar facilities. DPHD met with Ocean Institute officials on October 15 & 16, 2007 and instructed Ocean Institute must remain consistent with the guidelines provided by Manask & Associates, and consistent with Museum Store association standards.

DPHD will be conducting visits to the store at least once each three months to check the merchandise mix. Ocean Institute was also notified of this in a letter dated October 19, 2007.

Commercial Cruises

Clause 5.C.1 of the Agreement states that commercial cruises including, but not limited to, Catalina cruises, cocktail/dinner cruises, wedding ceremonies/cruises, recreational cruises, burials at sea, loading and unloading of passengers for hire, parking of vessels that are not owned or otherwise an asset of Ocean Institute and "open party/open boat" or other such cruises available to the general public shall be subject to rent pursuant to Clause 8.C. Clause 8.C of the Agreement states Ocean Institute shall pay a flat rent of $50 per cruise to the County.

Finding Nos. 6 and 7: During two sample months tested, we identified errors made by Ocean Institute when reporting commercial cruises subject to flat ($50 per cruise) rent as follows:

- August 2005: Ocean Institute reported nine (9) commercial private party and open party cruises. However, we identified eleven (11) commercial private party and "open party" (open to general public) cruises that should have been reported. Therefore rent of $100 (2 x $50) is due to the County.

- January 2006: Ocean Institute reported zero (0) commercial private party and "open party" cruises. However, we identified two (2) commercial private party cruises (1/14/06 and 1/24/06) and five (5) "open party" cruises (open to the general public) that should have been reported. Therefore rent of $350 (5 + 2 = 7 x $50) is due to the County.

To help ensure completes of commercial cruise reported to the County, Ocean Institute should consider performing a comparison of commercial cruises recorded in its reservation system and those recorded in its accounting system.

Recommendation No. 6: We recommend that DPHD require Ocean Institute pay additional rent owed of $450 for commercial cruises for the months of August 2005 and January 2006.

DPHD Response: DPHD has directed Ocean Institute in writing (in a letter dated October 19, 2007) to pay additional rent owed of **$**450 for commercial cruises for the months of August 2005 and January 2006. Completion of this is required no later than November 19, 2007.

Recommendation No. 7: We also recommend that DPHD remind Ocean Institute of the need for accurate reporting of commercial cruises to the County.

DPHD Response: Ocean Institute officials have been strongly advised in two recent meetings (October 15 & 16, 2007) of the need for accurate reporting of commercial cruise revenues to the County, and DPHD has notified Ocean Institute of this in writing (in a letter dated October 19, 2007).

Commercial Cruise Flat Rent Should Be Separate From Minimum Annual Rent

Clause 8.C of the Agreement states that flat rent of $50 per commercial cruise shall be separate from the minimum annual rent. Clause 10.A.6 also states that for any month in which Ocean Institute reports that no percentage rent is due, Ocean Institute shall not have to pay minimum annual rent for such month.

However, Clause 8 of the Agreement states that if percentage rent is due in a subsequent month, then the minimal annual rent requirement is triggered and minimum annual rent for prior months is required to be retroactively paid in lump sum for that accounting year.

Finding Nos. 8 and 9: Beginning July 2004, Ocean Institute pays the greater of flat rent ($50 per commercial cruise) or minimum annual rent. However, Ocean Institute should potentially be paying **both** flat rent and minimum annual rent. Clause 10.A.6 of the Agreement states that the comparison that should be performed is the greater of minimum annual rent and percentage of gross receipts rent, if there are gross receipts subject to percentage rent.

Recommendation No. 8: We recommend that DPHD require Ocean Institute to properly segregate and pay the flat rent for commercial cruises.

DPHD Response: DPHD met with Ocean Institute officials on October 15 & 16, 2007 and explained Ocean Institute's lease obligation to properly segregate and to pay the flat rent for commercial cruises, **in addition** to the minimum rent. Ocean Institute was also instructed to pay the flat rent described above in a letter dated October 19, 2007, which required completion of this no later than November 20, 2007.

Recommendation No. 9: We also recommend that DPHD and Ocean Institute evaluate the proper reporting of minimum annual rent in relation to percentage rent.

DPHD Response: DPHD and Ocean Institute met October 16, 2007 to evaluate the proper reporting of minimum annual rent in relation to percentage rent. DPHD met with Dan Stetson & Robert Poteraj (Director of Finance) of Ocean Institute and explained DPHD's lease interpretation that Ocean Institute is obligated to pay the percentage rent, **in addition** to the minimum rent. Ocean Institute was also told to pay the flat rent for commercial cruises described above in a letter dated October 19, 2007, which required commencement of this no later than November 20, 2007.

Periodic Increases to Minimum Annual Rent

Clause 13.A of the Agreement states that on the fifth anniversary date of the Agreement and on the anniversary date every five years thereafter, the minimum annual rent shall be automatically adjusted to the greater of seventy five percent (75%) of the average (mean) annual rent paid by Ocean Institute to the County for the preceding three (3) years, or the base minimum annual rent of $12,000 adjusted in proportion to the changes in the Consumer Price Index for Los Angeles-Anaheim-Riverside (All Urban Consumers - All Items) promulgated by the Bureau of Labor Statistics of the U.S. Department of Labor or any widely recognized replacement index.

Finding No. 10: On the fifth anniversary date of the Agreement (June 30, 2004), the minimum annual rent of $12,000 was not increased.

Recommendation No. 10: We recommend that DPHD adjust Ocean Institute's minimum annual rent as allowed by the Agreement.

DPHD Response: Ocean Institute has been notified in writing that their minimum annual rent has been adjusted. Payment of the retroactive minimum rent amount that should have been paid (increased minimum rent from when it should have been adjusted) has been required by November 1, 2007 (required in a letter to Ocean Institute dated October 1, 2007).

Periodic Increases to Security Deposit

Clause 12 of the Agreement states that on the fifth anniversary date of the Agreement and on the anniversary date every five years thereafter, the amount of the security deposit shall be adjusted by the change in the Consumer Price Index, or any replacement index thereto.

Finding No. 11: On the fifth anniversary date of the Agreement (June 30, 2004), the security deposit amount of $10,000 was not increased.

Recommendation No. 11: We recommend that DPHD adjust Ocean Institute's security deposit amount as allowed by the Agreement.

DPHD Response: Ocean Institute has been notified in a letter dated October 1, 2007 that their security deposit amount has been adjusted, consistent with Clause 12 and submission of documentation has been requested to verify that the additional deposit funds have been added to their CD. Submission of documentation has been required by November 1, 2007 in a letter to Ocean Institute dated October 1, 2007.

Required Financial Statements Not Submitted

Clause 14.C of the Agreement requires Ocean Institute to submit, within ninety (90) days after the end of each accounting year, a balance sheet and income statement prepared or audited by a CPA, reflecting business transaction on or from the leased premises.
The CPA must attest the balance sheet and income statement are an accurate representation of Ocean Institute's records as reported to the United States of America for income tax purposes.

Clause 14.C also requires Ocean Institute to submit a statement of gross receipts audited by a CPA wherein the total gross receipts for the accounting year are classified according to the categories of business established for percentage rent and for any other business conducted on or from the premises.

At the same time, as an attachment the audited statement of gross receipts, Ocean Institute is required to submit a schedule listing both business activities receipts subject to percentage rent and rent free business activities receipts. Said schedule shall list and detail receipts under the same categories of percentage rent (as provided in Clause 8 of the Agreement). Additionally, said schedule shall itemize and separate program participant receipts from other visitor receipts. Said schedule shall be audited by a CPA.

Finding Nos. 12 and 13: For calendar years ending December 31, 2004, 2005, and 2006, a balance sheet and income statement was not submitted by Ocean Institute. The last audited financial statements provided by Ocean Institute were for the year ended June 30, 2003. As Ocean Institute is a non-profit organization, the financial statements included a Statement of Financial Position and a Statement of Activities. If provided for 2004, 2005, and 2006, these financial statements would satisfy the balance sheet and income statement requirement of the Agreement.

In addition, we could not find evidence that an audited statement of gross receipts and related schedule (as described above) have been provided by Ocean Institute since inception of the Agreement in 1999.

Recommendation No. 12: We recommend that DPHD require Ocean Institute to submit annual balance sheets and income statements (or comparable statements for a non-profit organization) prepared or audited by a CPA that comply with the Agreement.

DPHD Response: Ocean Institute states that they have previously submitted the required financial information to RDMD Accounting Services; copies of the financial statements for 2000, 2004, 2005 and 2006 are separately attached.

Recommendation No. 13: We also recommend that DPHD require Ocean Institute to submit annual statements of gross receipts and related schedule (as defined in the Agreement) audited by a CPA that comply with the Agreement. DPHD should evaluate whether to require Ocean Institute to submit the audited statement of gross receipts and related schedule for previous years.

DPHD Response: Ocean Institute is required to submit annual statements of gross receipts and related schedule audited by a CPA that comply with the Agreement. Ocean Institute is to submit the audited statement of gross receipts and related schedule on a go-forward basis only. The above requirement was communicated to Ocean Institute in meetings with them on October 15 & 16, 2007; and in a DPHD letter dated 10-19-07.

Other Required Annual Reports

Clause 14.C of the Agreement requires Ocean Institute to prepare and submit to the County "an annual activities and operating/capital program report which describes proposed budgets, programs, attendance, fees, hours, financial status, and future operating and site and facility capital program plans as to the Premises." Such report shall be submitted to the County each year prior to September 1, or as agreed in advance by the County and Ocean Institute.

Clause 14.C also requires Ocean Institute to prepare and submit to the County annually "a report describing the status of the Capital Replacement Fund (CRF), required in Clause 25 (Maintenance Obligations of Tenant) including the amount accumulated and identification of the account where funds are deposited." Such report shall be submitted to the County within six months of the close of each accounting year.

Finding No. 14: We did not observe evidence that Ocean Institute has submitted the above required reports to DPHD.

Recommendation No. 14: We recommend that DPHD require Ocean Institute to submit the other annual reports required by Clause 14.C (as described above) on a go forward basis.

DPHD Response: Ocean Institute has been instructed in a letter dated October 19, 2007 to provide DPHD within 30 days three prior years of the reports required and then on a continuing basis to provide reports annually. DPHD met with Ocean Institute officials on October 16, 2007 and reviewed lease requirements and instructed Ocean Institute to provide the required information within 30 days.

Monthly Gross Receipts Statement

Clause 10.A of the Agreement requires that each month Ocean Institute shall submit to the County a statement of all gross receipts for the preceding calendar month. The statement shall be signed under penalty of perjury by Ocean Institute's responsible agent.

Clause 10.A.6 of the Agreement states that the statement of gross receipts shall include a detailed breakdown of gross receipts of the operations that are not subject to percentage rent.

Finding No. 15: Ocean Institute's responsible agent does not sign under penalty of perjury the monthly gross receipts statements submitted to the County.

Recommendation No. 15: We recommend that DPHD require Ocean to sign and certify the monthly gross receipts statement submitted to the County.

DPHD Response: DPHD met with Dan Stetson & Robert Poteraj (Director of Finance) of Ocean Institute on October 16, 2007. Ocean Institute was instructed in the meeting to sign and certify the monthly gross receipts statement submitted to the County. Ocean Institute was required to do this in a letter dated October 19, 2007, which required completion of this no later than November 20, 2007.

Finding No. 16: For the sample month of January 2006, Ocean Institute did not report all gross receipts generated from the premises to the County. For example, Ocean Institute did not report $65,046 for a time capsule program and $1,826 for license revenue related to an educational program used by the San Diego Maritime Museum.

These gross receipts do not appear to be subject to percentage rent; however, Ocean Institute is required by the Agreement to report all gross receipts not subject to percentage rent for informational purposes.

Recommendation No. 16: We recommend DPHD to require Ocean Institute to completely report all gross receipts generated from the premises, regardless if subject to percentage rent.

DPHD Response: DPHD met with Dan Stetson on October 15, 2007 and with Dan Stetson & Robert Poteraj (Director of Finance) of Ocean Institute on October 16, 2007 and instructed Ocean Institute to completely report all gross receipts generated from the premises, regardless if subject to percentage rent. Ocean Institute was directed to do this in a letter dated October 19, 2007, which required completion of this no later than November 20, 2007.

Audit Cost Provision

Clause 14.C of the Agreement states that Ocean Institute shall bear the full cost of the audit if the audit reveals an underpayment of more than two percent (2%) between the rent due as reported and paid and the rent due as determined by the audit.

Finding No. 17: If Ocean Institute is required to pay percentage rent for facility rentals as discussed above in Finding No. 1, the additional rent owed will exceed the 2% threshold and is sufficient to active the audit costs clause of the Agreement. Depending on the resolution of

Finding No. 1, DPHD may be allowed to assess the audit costs of $5,760 to Ocean Institute.

Recommendation No. 17: Depending on the outcome of Finding No. 1 above, we recommend that DPHD evaluate whether to assess Ocean Institute for audit costs.

DPHD Response: DPHD has determined that Ocean Institute is to pay audit costs of $5,760 to DPHD. This was addressed in the meeting with Dan Stetson on 10-15-07. Ocean Institute was notified they will pay the audit cost in a letter dated October 19, 2007, which required payment no later than November 19, 2007.

ATTACHMENT A: Report Item Classifications

For purposes of reporting our audit observations and recommendations, we will classify audit report items into three distinct categories:

- **Material Weaknesses:**
  Audit findings or a combination of Significant Issues that can result in financial liability and exposure to a department/agency and to the County as a whole. Management is expected to address "Material Weaknesses" brought to their attention immediately.

- **Significant Issues:**
  Audit findings or a combination of Control Findings that represent a significant deficiency in the design or operation of processes or internal controls. Significant Issues do not present a material exposure throughout the County. They generally will require prompt corrective actions.

- **Control Findings and/or Efficiency/Effectiveness Issues:**
  Audit findings that require management's corrective action to implement or enhance processes and internal controls. Control Findings and Efficiency/Effectiveness issues are expected to be addressed within our follow-up process of six months, but no later than twelve months.

ATTACHMENT B: DPHD Management Responses

COUNTY OF ORANGE

DANA POINT HARBOR DEPARTMENT

Brad Gross, Director
24650 Dana Point Harbor Drive
Dana Point, CA 92629

Telephone: (949) 923-2236
Fax: (949) 923-3792

DATE: November 1, 2007

TO: Peter Hughes, Director Internal Audit Department

FROM: Brad Gross, Director Dana Point Harbor Department

SUBJECT: Draft Report, Limited Review of Lease Revenue, Ocean Institute

Attached are responses to the findings and recommendations of your audit: Draft Report, Limited Review of Lease Revenue, Ocean Institute. We concur with your recommendations.

I would like to express my gratitude for your department's work regarding the audit of the Ocean Institute.

ATTACHMENT B: DPHD Management Responses (continued)

Percentage Rent Not Paid on Facility Rental Revenue

According to its website, Ocean Institute rents portions of its facility to the public for special events such as corporate functions, seminars, conferences, meetings, product launches, team-building seminars, business receptions, and luncheons.

Clause 5.B of the Agreement (Optional Rent Free Uses) specifies the following uses are excluded from percentage rent payments to the County:

- Clauses 5.B.6: Meeting rooms to the extent they are used by Ocean Institute in accordance with the **Purpose** as defined in the Agreement.
- Clause 5.B.7: Theater/Auditorium to the extent that performances are produced solely by Ocean Institute and that such performances substantially related to the **Purpose** as defined in the Agreement.

Clause 5.C of the Agreement (Optional Uses Subject to Rent) specifies the following uses are subject to percentage rent payments to the County:

- Clause 5.C.4: Meeting and banquet room uses other than the uses permitted pursuant to Clause B.6 above.
- Clause 5.C.5: Theater/Auditorium uses other than the uses permitted pursuant to Clause 5.B.7 above.

The Definitions section of the Agreement states the "**Purpose"** means Ocean Institute's "requirement to develop and operate Lessor-approved facilities and programs specifically related to marine science research, marine-related cultural activities/events, protection and conservation of the marine environment, and maritime and marine science education. Said programs and activities shall be operated such that substantial public benefit in the form of advancement of enhanced knowledge, awareness, and understanding of the marine environment is derived. Said facilities and programs shall be readily available to school groups (kindergarten through college) and other groups, and to individuals and families within the general public and related professional groups such as teachers and research scientists all on a non-discriminatory basis. The guiding principle shall be to provide for the delivery of the highest quality marine educational experience, available to the greatest number of people, consistent with the **Purpose** herein, and Tenant's status as a non-profit organization."

To summarize the above, it appears that facility rentals are excluded from percentage rent if the facility rental is for marine related research and educational programs. However, if the facility rental is for commercial purposes, the facility rental is subject to percentage rent.

In addition, Clause 5.A of the Agreement states that in the event of a dispute between the County and Ocean Institute as to whether a particular use shall be considered a "rent free use," a use "subject to rent," or a "restricted use," pursuant to Clause 5 (USE), then the decision of the Director of DPHD, in his/her sole and absolute discretion, shall be final and binding.

ATTACHMENT B: DPHD Management Responses (continued)

Finding Nos. 1 and 2: Ocean Institute reports facility rental revenue in the Theater/Auditorium (educational activities only) category excluded from percentage rent.

During our detailed testing of the sample month of January 2006, we reviewed the supporting documentation (contracts) for the facility rentals to determine the research or educational nature of the rental. We found that the Ocean Institute's conference center was rented on 3 days and total revenue of $7,500 was received as follows:

- 1/7/06 - The facility was rented for a homecoming event ($7,000)
- 1/22/06 - The facility was rented for a wine auction/dinner (no charge).
- 1/30/06 - The facility was rented to a high school for a staff meeting ($500).

Based on our review of Ocean Institute's website description for facility rentals and our limited testing above, it appear that the facility rentals are more commercial in nature rather than marine related research and education. It appears the gross receipts from facility rentals should be subject to percentage rent of 10%.

For the 12 month period of February 2005 through January 2006, Ocean Institute reported facility rental revenue of $252,944 and we calculated additional rent of **$25,294** (10% x $252,944) that would be owed. For the 16 month period of February 2006 through May 2007, Ocean Institute reported facility rental revenue of $416,010 and we calculated additional rent of **$41,601** (10% x $416,010) that would be owed. A net credit for minimum monthly rent of $1,000 less flat rent ($50 per cruise) paid for commercial cruises could potentially reduce these amounts owed. See details below in Finding No. 7.

During our review of relevant correspondence, we identified a letter dated March 13, 2003, from the Ocean Institute to the County. In that letter, Ocean Institute requested a modification to the Agreement and made a case that the facility rental revenue should be excluded from gross receipts subject to percentage rent. DHPD or Ocean Institute could not provide evidence of the County responding to the letter or approving the exclusion of facility rental revenue.

DPHD should determine whether Ocean Institute should be required to report facility rental revenue as gross receipts subject to percentage rent. DPHD should document its conclusion and provide it in writing to Ocean Institute.

Recommendation No. 1: We recommend that DPHD determine and clarify in writing whether Ocean Institute should report facility rental revenue as gross receipts subject to percentage rent.

DPHD Response: Ocean Institute must report facility rental revenue as gross receipts subject to percentage rent. Regarding the letter dated March 13, 2003, a subsequent meeting with Ocean Institute, DPHD denied Mr. Gee's request to eliminate facility rental revenue from percentage rent. DPHD met with Ocean Institute officials on October 15 & 16, 2007 and informed Ocean Institute of their lease obligation to

ATTACHMENT B: DPHD Management Responses (continued)

report not only facility revenues subject to percentage rent, but all Ocean Institute revenues. Ocean Institute was also instructed in a letter dated October 19, 2007 that the monthly sales report needs to be received no later then 20 days after the close of the reporting month, and that the sales report must be signed by Tenant or by Tenant's responsible Agent under the penalty of perjury. Commencement of this reporting is required no later than November 20, 2007.

Recommendation No. 2: We also recommend that if DPHD determines the facility rental revenue is subject to percentage rent, that DPHD require Ocean Institute to pay percentage rent owed of $66,895 for the 28 month period of February 2005 through May 2007. DPHD should also require Ocean Institute to calculate and pay percentage rent owed for the period of June 2007 through the month of correction. A net credit for minimum monthly rent of $1,000 less flat rent ($50 per cruise) for commercial cruises could potentially reduce these amounts owed. See details below in Finding No.7.

DPHD Response: Ocean Institute has been directed to pay percentage rent owed of $66,895 for the 28 month period of February, 2005 through May, 2007. Ocean Institute has been directed to calculate and pay percentage rent for the period of June, 2007 through the month of correction. DPHD met with Ocean Institute officials on October 15 & 16, 2007 and instructed Ocean Institute to pay the amounts described above. Ocean Institute was also instructed to pay the above amounts by November 19, 2007 in a letter dated October 19, 2007.

Facility Rental Security Deposits

Clause 9.C of the Agreement states that the term "gross receipts" upon which percentage rents are to be based includes all "Admission, entry, rental, and other fees of any nature or kind received by Tenant (including, but not limited to, deposits accepted by Tenant)." Ocean Institute typically requires facility renters to pay an advance security deposit. The security deposits are recorded as deferred revenue and revenue is realized when the rental takes place.

Finding Nos. 3 and 4: Ocean Institute excludes the security deposits for facility rentals from gross receipts "subject to percentage rent." However, if the facility rental revenue is determined to be "subject to percentage rent" as discussed above in Finding No. 1, the related security deposits should also be reported as gross receipts "subject to percentage rent" when the security deposit is received by Ocean Institute. As of January 31, 2006, Ocean Institute had $51,888 in security deposits for facility rentals recorded in its accounting records.

Recommendation No. 3: If the facility rental revenue is determined to be gross receipts "subject to rent," we recommend that DPHD require Ocean Institute to report security deposits for facility rentals as gross receipts "subject to rent" and pay the percentage rent owed (10%) when the security deposit is collected.

DPHD Response: DPHD has directed Ocean Institute to report security deposits for facility rentals as gross receipts that are "subject to rent" and pay the percentage rent

ATTACHMENT B: DPHD Management Responses (continued)

owed (10%) when the security deposit is collected. DPHD met with Ocean Institute officials on October 15 & 16, 2007 and instructed Ocean Institute to pay percentage rent on the deposit amounts described above. Ocean Institute was also instructed to report security deposits for facility rentals as gross receipts that are "subject to rent" and to pay the percentage rent owed (10%) when the security deposit is collected (in a letter dated October 19, 2007). Completion of this is required no later than November 19, 2007.

Recommendation No. 4: If the facility rental revenue is determined to be gross receipts "subject to rent," we also recommend that DPHD require Ocean Institute to make a one-time adjustment to report the balance of security deposits as of the date of correction as gross receipts "subject to rent" and pay the percentage rent owed (10%).

DPHD Response: DPHD has instructed Ocean Institute to make a one-time adjustment to report the balance of security deposits as of the date of correction as gross receipts "subject to rent" and pay the percentage rent owed (10%) on the balance held. DPHD met with Ocean Institute officials on October 15 & 16, 2007 and instructed Ocean Institute to pay percentage rent on the deposit amounts described above. Ocean Institute was instructed to pay the percentage rent in a letter dated October 19, 2007, which required completion of this no later than November 19, 2007.

Percentage Rent Not Paid on Museum Style Retail Store Sales

Ocean Institute has a museum style retail store, Chambers Gallery Book and Gift Store, on its premises.

Clause 5.B.5 of the Agreement states that revenue derived from the museum style retail store is not subject to percentage rent "… so long as one hundred percent (100%) of the store's gross sales are derived from the sale of items that are substantially marine/ocean related and that are customarily sold in museum style retail sales stores, the sale of books, learning kits, and materials that support Tenant's educational exhibits and programs." Clause 5.C.3 of the Agreement states that "retail sales other than those permitted pursuant to Clause B.7 above" are subject to percentage rent.

Clause 5.A of the Agreement states that "Tenant shall operate its programs and all other activities in a manner such that Tenant does not unfairly commercially compete with Harbor merchants or other Lessor approved entities offering similar goods and/or services."

Finding No. 5: For the period February 2005 through January 2006, Ocean Institute reported retail sales of $378,885 as gross receipts excluded from percentage rent.

Certain items sold in the Chambers Gallery Book and Gift Store may not qualify as items that are substantially marine/ocean related **and** that are customarily sold in museum style

ATTACHMENT B: DPHD Management Responses (continued)

retail stores. We observed that the store sells a variety of merchandise, such as educational books and videos, maps and guides, clothing, jewelry, decorative items (statues, wind chimes, clocks, throws, etc.), greeting cards and stationary, games, sunglasses, key chains, magnets, film, and bottled water.

For the sample month of January 2006, the following is a summary of retail sales as recorded in the store's cash register:

CATEGORY	AMOUNT
Apparel	$ 3,981
Books	$ 3,202
Children	$ 4,678
Food	$ 99
Gifts	$ 3,539
Jewelry	$ 2,389
Multi-media	$ 116
Novelties	$ 3,400
Paper	$ 1,014
Science	$ 637
Service Items	$ 443
Softgoods	$ 40
Xmas/Sp Focus	$ 392
Total	$23,856

Based on our review of some of the items for sale, it appears that they are not marine/ocean related but may be items customarily sold in museum style retail stores. DPHD stated that it was informed by Ocean Institute that it hired a consultant who had experience in merchandising for museum style retail stores and this consultant helped Ocean Institute develop it product mix and merchandising strategy.

DPHD should evaluate whether the merchandise sold at Ocean Institute's store is substantially marine/ocean related **and** customarily sold in museum style retail stores and therefore, should be excluded from percentage rent. DPHD should document its conclusion and provide it in writing to Ocean Institute.

Recommendation No. 5: We recommend that DPHD determine and clarify in writing whether the merchandise sold at Ocean Institute's store complies with the Agreement and should be excluded from percentage rent.

DPHD Response: DPHD has determined that the merchandise sold at Ocean Institute's store complies with the Agreement and should be excluded from percentage rent. The merchandise mix at the Ocean Institute's store has been determined by a consultant, Shelley L. Stephens of Manask & Associates to be in compliance with the Agreement requirements and Museum Store Association standards. Manask & Associates provides advisement for museum and similar stores' merchandise at many categorically similar facilities. DPHD met with Ocean Institute

ATTACHMENT B: DPHD Management Responses (continued)

officials on October 15 & 16, 2007 and instructed Ocean Institute must remain consistent with the guidelines provided by Manask & Associates, and consistent with Museum Store association standards. DPHD will be conducting visits to the store at least once each three months to check the merchandise mix. Ocean Institute was also notified of this in a letter dated October 19, 2007.

Commercial Cruises

Clause 5.C.1 of the Agreement states that commercial cruises including, but not limited to, Catalina cruises, cocktail/dinner cruises, wedding ceremonies/cruises, recreational cruises, burials at sea, loading and unloading of passengers for hire, parking of vessels that are not owned or otherwise an asset of Ocean Institute and "open party/open boat" or other such cruises available to the general public shall be subject to rent pursuant to Clause 8.C. Clause 8.C of the Agreement states Ocean Institute shall pay a flat rent of $50 per cruise to the County

Finding Nos. 6 and 7: During two sample months tested, we identified errors made by Ocean Institute when reporting commercial cruises subject to flat ($50 per cruise) rent as follows:

- August 2005: Ocean Institute reported nine (9) commercial private party and open party cruises. However, we identified eleven (11) commercial private party and "open party" (open to general public) cruises that should have been reported. Therefore rent of $100 (2 x $50) is due to the County.

- January 2006: Ocean Institute reported zero (0) commercial private party and "open party" cruises. However, we identified two (2) commercial private party cruises (1/14/06 and 1/24/06) and five (5) "open party" cruises (open to the general public) that should have been reported. Therefore rent of $350 (5 + 2 = 7 x $50) is due to the County.

To help ensure completes of commercial cruise reported to the County, Ocean Institute should consider performing a comparison of commercial cruises recorded in its reservation system and those recorded in its accounting system.

Recommendation No. 6: We recommend that DPHD require Ocean Institute pay additional rent owed of $450 for commercial cruises for the months of August 2005 and January 2006.

DPHD Response: DPHD has directed Ocean Institute in writing (in a letter dated October 19, 2007) to pay additional rent owed of $450 for commercial cruises for the months of August 2005 and January 2006. Completion of this is required no later than November 19, 2007.

ATTACHMENT B: DPHD Management Responses (continued)

Recommendation No. 7: We also recommend that DPHD remind Ocean Institute of the need for accurate reporting of commercial cruises to the County.

DPHD Response: Ocean Institute officials have been strongly advised in two recent meetings (October 15 & 16, 2007) of the need for accurate reporting of commercial cruise revenues to the County, and DPHD has notified Ocean Institute of this in writing (in a letter dated October 19, 2007).

Commercial Cruise Flat Rent Should Be Separate from Minimum Annual Rent

Clause 8.C of the Agreement states that flat rent of $50 per commercial cruise shall be separate from the minimum annual rent. Clause 10.A.6 also states that for any month in which Ocean Institute reports that no percentage rent is due, Ocean Institute shall not have to pay minimum annual rent for such month. However, Clause 8 of the Agreement states that if percentage rent is due in a subsequent month, then the minimal annual rent requirement is triggered and minimum annual rent for prior months is required to be retroactively paid in lump sum for that accounting year.

Finding Nos. 8 and 9: Beginning July 2004, Ocean Institute pays the greater of flat rent ($50 per commercial cruise) or minimum annual rent. However, Ocean Institute should potentially be paying **both** flat rent and minimum annual rent. Clause 10.A.6 of the Agreement states that the comparison that should be performed is the greater of minimum annual rent and percentage of gross receipts rent, if there are gross receipts subject to percentage rent.

Recommendation No. 8: We recommend that DPHD require Ocean Institute to properly segregate and pay the flat rent for commercial cruises.

DPHD Response: DPHD met with Ocean Institute officials on October 15 & 16, 2007 and explained Ocean Institute's lease obligation to properly segregate and to pay the flat rent for commercial cruises, **in addition** to the minimum rent. Ocean Institute was also instructed to pay the flat rent described above in a letter dated October 19, 2007, which required completion of this no later than November 20, 2007.

Recommendation No. 9: We also recommend that DPHD and Ocean Institute evaluate the proper reporting of minimum annual rent in relation to percentage rent.

DPHD Response: DPHD and Ocean Institute met October 16, 2007 to evaluate the proper reporting of minimum annual rent in relation to percentage rent. DPHD met with Dan Stetson & Robert Poteraj (Director of Finance) of Ocean Institute and explained DPHD's lease interpretation that Ocean Institute is obligated to pay the percentage rent, **in addition** to the minimum rent. Ocean Institute was also told to pay the flat rent for commercial cruises described above in a letter dated October 19, 2007, which required commencement of this no later than November 20, 2007.

ATTACHMENT B: DPHD Management Responses (continued)

Periodic Increases to Minimum Annual Rent

Clause 13.A of the Agreement states that on the fifth anniversary date of the Agreement and on the anniversary date every five years thereafter, the minimum annual rent shall be automatically adjusted to the greater of seventy five percent (75%) of the average (mean) annual rent paid by Ocean Institute to the County for the preceding three (3) years, or the base minimum annual rent of $12,000 adjusted in proportion to the changes in the Consumer Price Index for Los Angeles-Anaheim-Riverside (All Urban Consumers - All Items) promulgated by the Bureau of Labor Statistics of the U.S. Department of Labor or any widely recognized replacement index.

Finding No. 10: On the fifth anniversary date of the Agreement (June 30, 2004), the minimum annual rent of $12,000 was not increased.

Recommendation No. 10: We recommend that DPHD adjust Ocean Institute's minimum annual rent as allowed by the Agreement.

DPHD Response: Ocean Institute has been notified in writing that their minimum annual rent has been adjusted. Payment of the retroactive minimum rent amount that should have been paid (increased minimum rent from when it should have been adjusted) has been required by November 1, 2007 (required in a letter to Ocean Institute dated October 1, 2007).

Periodic Increases to Security Deposit

Clause 12 of the Agreement states that on the fifth anniversary date of the Agreement and on the anniversary date every five years thereafter, the amount of the security deposit shall be adjusted by the change in the Consumer Price Index, or any replacement index thereto.

Finding No. 11: On the fifth anniversary date of the Agreement (June 30, 2004), the security deposit amount of $10,000 was not increased.

Recommendation No. 11: We recommend that DPHD adjust Ocean Institute's security deposit amount as allowed by the Agreement.

DPHD Response: Ocean Institute has been notified in a letter dated October 1, 2007 that their security deposit amount has been adjusted, consistent with Clause 12 and submission of documentation has been requested to verify that the additional deposit funds have been added to their CD. Submission of documentation has been required by November 1, 2007 in a letter to Ocean Institute dated October 1, 2007.

Required Financial Statements Not Submitted

Clause 14.C of the Agreement requires Ocean Institute to submit, within ninety (90) days after the end of each accounting year, a balance sheet and income statement prepared or

ATTACHMENT B: DPHD Management Responses (continued)

audited by a CPA, reflecting business transaction on or from the leased premises. The CPA must attest the balance sheet and income statement are an accurate representation of Ocean Institute's records as reported to the United States of America for income tax purposes.

Clause 14.C also requires Ocean Institute to submit a statement of gross receipts audited by a CPA wherein the total gross receipts for the accounting year are classified according to the categories of business established for percentage rent and for any other business conducted on or from the premises. At the same time, as an attachment the audited statement of gross receipts, Ocean Institute is required to submit a schedule listing both business activities receipts subject to percentage rent and rent free business activities receipts. Said schedule shall list and detail receipts under the same categories of percentage rent (as provided in Clause 8 of the Agreement). Additionally, said schedule shall itemize and separate program participant receipts from other visitor receipts. Said schedule shall be audited by a CPA.

Finding Nos. 12 and 13: For calendar years ending December 31, 2004, 2005, and 2006, a balance sheet and income statement was not submitted by Ocean Institute. The last audited financial statements provided by Ocean Institute were for the year ended June 30, 2003. As Ocean Institute is a non-profit organization, the financial statements included a Statement of Financial Position and a Statement of Activities. If provided for 2004, 2005, and 2006, these financial statements would satisfy the balance sheet and income statement requirement of the Agreement.

In addition, we could not find evidence that an audited statement of gross receipts and related schedule (as described above) have been provided by Ocean Institute since inception of the Agreement in 1999.

Recommendation No. 12: We recommend that DPHD require Ocean Institute to submit annual balance sheets and income statements (or comparable statements for a non-profit organization) prepared or audited by a CPA that comply with the Agreement.

DPHD Response: Ocean Institute states that they have previously submitted the required financial information to RDMD Accounting Services; copies of the financial statements for 2000, 2004, 2005 and 2006 are separately attached.

Recommendation No. 13: We also recommend that DPHD require Ocean Institute to submit annual statements of gross receipts and related schedule (as defined in the Agreement) audited by a CPA that comply with the Agreement. DPHD should evaluate whether to require Ocean Institute to submit the audited statement of gross receipts and related schedule for previous years.

DPHD Response: Ocean Institute is required to submit annual statements of gross receipts and related schedule audited by a CPA that comply with the Agreement. Ocean Institute is to submit the audited statement of gross receipts and related schedule on a go-forward basis only. The above requirement was communicated to

ATTACHMENT B: DPHD Management Responses (continued)

Ocean Institute in meetings with them on October 15 & 16, 2007; and in a DPHD letter dated 10-19-07.

Other Required Annual Reports

Clause 14.C of the Agreement requires Ocean Institute to prepare and submit to the County "an annual activities and operating/capital program report which describes proposed budgets, programs, attendance, fees, hours, financial status, and future operating and site and facility capital program plans as to the Premises." Such report shall be submitted to the County each year prior to September 1, or as agreed in advance by the County and Ocean Institute.

Clause 14.C also requires Ocean Institute to prepare and submit to the County annually "a report describing the status of the Capital Replacement Fund (CRF), required in Clause 25 (Maintenance Obligations of Tenant) including the amount accumulated and identification of the account where funds are deposited." Such report shall be submitted to the County within six months of the close of each accounting year.

Finding No. 14: We did not observe evidence that Ocean Institute has submitted the above required reports to DPHD.

Recommendation No. 14: We recommend that DPHD require Ocean Institute to submit the other annual reports required by Clause 14.C (as described above) on a go forward basis.

DPHD Response: Ocean Institute has been instructed in a letter dated October 19, 2007 to provide DPHD within 30 days three prior years of the reports required and then on a continuing basis to provide reports annually. DPHD met with Ocean Institute officials on October 16, 2007 and reviewed lease requirements and instructed Ocean Institute to provide the required information within 30 days.

Monthly Gross Receipts Statement

Clause 10.A of the Agreement requires that each month Ocean Institute shall submit to the County a statement of all gross receipts for the preceding calendar month. The statement shall be signed under penalty of perjury by Ocean Institute's responsible agent.

Clause 10.A.6 of the Agreement states that the statement of gross receipts shall include a detailed breakdown of gross receipts of the operations that are not subject to percentage rent.

Finding No. 15: Ocean Institute's responsible agent does not sign under penalty of perjury the monthly gross receipts statements submitted to the County.

Recommendation No. 15: We recommend that DPHD require Ocean to sign and certify the monthly gross receipts statement submitted to the County.

ATTACHMENT B: DPHD Management Responses (continued)

> **DPHD Response:** DPHD met with Dan Stetson & Robert Poteraj (Director of Finance) of Ocean Institute on October 16, 2007. Ocean Institute was instructed in the meeting to sign and certify the monthly gross receipts statement submitted to the County. Ocean Institute was required to do this in a letter dated October 19, 2007, which required completion of this no later than November 20, 2007.

Finding No. 16: For the sample month of January 2006, Ocean Institute did not report all gross receipts generated from the premises to the County. For example, Ocean Institute did not report $65,046 for a time capsule program and $1,826 for license revenue related to an educational program used by the San Diego Maritime Museum. These gross receipts do not appear to be subject to percentage rent; however, Ocean Institute is required by the Agreement to report all gross receipts not subject to percentage rent for informational purposes.

Recommendation No. 16: We recommend DPHD to require Ocean Institute to completely report all gross receipts generated from the premises, regardless if subject to percentage rent.

> **DPHD Response:** DPHD met with Dan Stetson on October 15, 2007 and with Dan Stetson & Robert Poteraj (Director of Finance) of Ocean Institute on October 16, 2007 and instructed Ocean Institute to completely report all gross receipts generated from the premises, regardless if subject to percentage rent. Ocean Institute was directed to do this in a letter dated October 19, 2007, which required completion of this no later than November 20, 2007.

<u>Audit Cost Provision</u>

Clause 14.C of the Agreement states that Ocean Institute shall bear the full cost of the audit if the audit reveals an underpayment of more than two percent (2%) between the rent due as reported and paid and the rent due as determined by the audit.

Finding No. 16: If Ocean Institute is required to pay percentage rent for facility rentals as discussed above in Finding No. 1, the additional rent owed will exceed the 2% threshold and is sufficient to active the audit costs clause of the Agreement. Depending on the resolution of Finding No. 1, DPHD may be allowed to assess the audit costs of $5,760 to Ocean Institute.

Recommendation No. 17: Depending on the outcome of Finding No. 1 above, we recommend that DPHD evaluate whether to assess Ocean Institute for audit costs.

> **DPHD Response:** DPHD has determined that Ocean Institute is to pay audit costs of $5,760 to DPHD. This was addressed in the meeting with Dan Stetson on 10-15-07. Ocean Institute was notified they will pay the audit cost in a letter dated October 19, 2007, which required payment no later than November 19, 2007.