INTERNAL AUDIT DEPARTMENT

COUNTY OF ORANGE

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LIMITED REVIEW OF LEASE REVENUE FOR NEWPORT DUNES WATERFRONT RESORT

For the Period November 1, 2003 through October 31, 2004

AUDIT NUMBER: 2462 **REPORT DATE: APRIL 7, 2006**

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LIMITED REVIEW OF LEASE REVENUE FOR NEWPORT DUNES WATERFRONT RESORT

For the Period November 1, 2003 through October 31, 2004

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Transmittal Letter

Audit No. 2462

April 7, 2006

TO: Bryan G. Speegle, Director
Resources & Development Management Department

FROM: Peter Hughes, Ph.D., CPA, Director
Internal Audit Department

SUBJECT: Limited Review of Lease Revenue for Newport Dunes Waterfront Resort
Parcel HA55B-101.21, 101.4, 101.51

We have completed our limited review of lease revenue for Newport Dunes Waterfront Resort for the period November 1, 2003 through October 31, 2004. The final report is attached along with your responses to our recommendations.

Please note, beginning in January 2005, we implemented a more structured and rigorous follow-up audit process in response to recommendations and suggestions made by the Audit Oversight Committee (AOC) and the Board of Supervisors (BOS). **In the past, we followed-up on lease audit recommendations during a subsequent lease audit, which could be several years later.** As a matter of policy, our first Follow-Up Audit will now begin at six months upon the official release of the report. The AOC and BOS expect that audit recommendations will typically be implemented within six months and often sooner for significant and higher risk issues. Our second Follow-Up Audit will now begin at 12 months from the release of the original report by which time all audit recommendations are expected to be addressed or implemented.

At the request of the AOC, we are to bring to their attention any audit recommendations we find still not addressed, resolved or implemented after our second Follow-Up Audit. The AOC requests that such open issues appear on the agenda at their next scheduled meeting for their discussion.

As the Director of Internal Audit, I now submit a monthly audit status report to the Board of Supervisors (BOS) where I detail any material and significant audit findings released in reports during the prior month, the implementation status of audit recommendations as disclosed by our Follow-Up Audits, any pressing audit or resource issues; as well as, respond to inquiries from the BOS. Therefore, the results of this audit will be included in a future status report to the BOS.

The Internal Audit Department is an independent audit function reporting directly to the Orange County Board of Supervisors.

Because of these visible changes to our follow-up process, the Internal Audit Department is available to partner with all departments and agencies so that they can successfully implement or address difficult audit recommendations. Please feel free to call me should you wish to discuss any aspect of our audit report, recommendations or follow-up process.

We have attached a Follow-Up Audit Tracking Document template. Your department should complete this template as our audit recommendations are implemented. When we perform our follow-up audit approximately six months from the date of this report, we will request the completed document to facilitate our review.

Additionally, we will be submitting a Customer Survey of Audit Services. Please complete the survey and return it to Renee Aragon, Executive Secretary, Internal Audit Department. We appreciate the courtesy and cooperation of your staff during our review.

Attachment

Other recipients of this report:
Members, Board of Supervisors
Members, Audit Oversight Committee
Thomas G. Mauk, County Executive Officer
David L. Rudat, Interim Deputy CEO/Infrastructure & Environmental Services
Steve Danley, Director, RDMD/Administrative Services
Kevin Thomas, Director, RDMD/Harbors, Beaches & Parks
Bob Hamilton, Manager, RDMD/HB&P/Program Management
Rich Adler, Chief, RDMD/HB&P/Lease Management
Mike Hentzen, Leasing Coordinator, RDMD/HB&P/Lease Management
Stella Oviedo, Chief, RDMD/Real Estate Services
Josephine Alvarez, Real Property Agent, RDMD/Real Estate Services
Mary Fitzgerald, Manager, RDMD/Accounting Services
Pamela Middlebrook, Legislative Program Manager, RDMD/Central Quality Assurance
Foreperson, Grand Jury
Darlene J. Bloom, Clerk of the Board of Supervisors

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INTERNAL AUDITOR'S REPORT

Audit No. 2462

April 7, 2006

TO: Bryan G. Speegle, Director
Resources & Development Management Department

SUBJECT: Limited Review of Lease Revenue for Newport Dunes Waterfront Resort
Parcel HA55B-101.21, 101.4, 101.51

We have performed a limited review of certain records and documents for the year ended October 31, 2004, pertinent to the lease agreement (Agreement) between the County of Orange (County) and Resort Properties, LP and Newport Dunes Marina, LLC (referred to as Newport Dunes Waterfront Resort or NDWR), dated February 16, 1989, as amended and assigned. The Agreement is primarily to operate and maintain Newport Dunes Waterfront Resort, a public recreation facility located in Newport Beach. The facility includes a marina, RV park, dry boat storage, and recreational day use supported by food, beverage, and retail operations.

NDWR has also entered into the following sublease agreements:

- Water sport equipment rental operations subleased to Charles A. Berry, DBA Resort Watersports (Resort Watersports). Subsequent to our review period, effective May 2005, NDWR took over operations of Resort Watersports;
- Team and leadership development operation subleased to Aquarius Training & Development, LLC.

During the limited review period from November 1, 2003 to October 31, 2004, NDWR and its sublessees generated over $13.6 million in gross receipts and paid the County approximately $2.2 million in rent.

The primary purpose of our review is to determine whether NDWR and its sublessees' records adequately supported gross receipts submitted to the County. We also reviewed compliance with certain other provisions of the Agreement, such as accounting methods and payment procedures. It should also be noted that we conducted Audit No. 2237, dated October 7, 2002, to support the assignment of the Lease from Newport Dunes Partnership to NDWR.

Based on our limited review, we find that NDWR and its sublessees have retained sufficient documentation to adequately support monthly gross receipts reported to the County. **No material weaknesses or significant issues were identified.** However, we did identify **19** control findings related to compliance with the Agreement that are noted in the Detailed Observations,

The Internal Audit Department is an independent audit function reporting directly to the Orange County Board of Supervisors.

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 NDWR, RDMD/Harbors, Beaches, & Parks, RDMD/Real Estate Services, and RDMD/Accounting. If you have any questions regarding our limited review, please call me, Eli Littner, Deputy Director, at (714) 834-5899, or Autumn McKinney, Audit Manager, at (714) 834-6106.

Peter Hughes, Ph.D., CPA
Director, Internal Audit

Attachment A – Report Item Classifications
Attachment B – RDMD Management Response
Attachment B – Newport Dunes Waterfront Resort Response

Distribution Pursuant to Audit Oversight Committee Procedure No. 1:
- Members, Board of Supervisors
- Members, Audit Oversight Committee
- Thomas G. Mauk, County Executive Officer
- David L. Rudat, Interim Deputy CEO/Infrastructure & Environmental Services
- Steve Danley, Director, RDMD/Administrative Services
- Kevin Thomas, Director, RDMD/Harbors, Beaches & Parks
- Bob Hamilton, Manager, RDMD/HB&P/Program Management
- Rich Adler, Chief, RDMD/HB&P/Lease Management
- Mike Hentzen, Leasing Coordinator, RDMD/HB&P/Lease Management
- Stella Oviedo, Chief, RDMD/Real Estate Services
- Josephine Alvarez, Real Property Agent, RDMD/Real Estate Services
- Mary Fitzgerald, Manager, RDMD/Accounting Services
- Pamela Middlebrook, Legislative Program Manager, RDMD/Central Quality Assurance
- Foreperson, Grand Jury
- Darlene J. Bloom, Clerk of the Board of Supervisors

EXECUTIVE SUMMARY

OBJECTIVES

The Internal Audit Department conducted a limited review of the lease revenue for Waterfront Resort Properties, LP and Newport Dunes Marina, LLC (referred to as Newport Dunes Waterfront Resort or NDWR), for the primary purpose of determining whether NDWR and its sublessees' records adequately supported gross receipts submitted to the County.

BACKGROUND

The County of Orange entered into a lease agreement (Agreement) with Newport Dunes Partnership, a California General Partnership, dated February 16, 1989, which has been subsequently amended, assigned, and modified on various dates. The current tenants as of August 2002 are Waterfront Resort Properties, LP and Newport Dunes Marina, LLC (referred to as Newport Dunes Waterfront Resort or NDWR). The Agreement expires February 28, 2039.

The Agreement is primarily to operate and maintain Newport Dunes Waterfront Resort, a public recreation facility located in Newport Beach. The facility includes a marina, RV park, dry boat storage, and recreational day use supported by food, beverage, and retail operations.

NDWR has also entered into the following sublease agreements:

- Water sport equipment rental operations subleased to Charles A. Berry, DBA Resort Watersports (Resort Watersports). Subsequent to our review period, effective May 2005, NDWR took over operations of Resort Watersports;
- Team and leadership development operation subleased to Aquarius Training & Development, LLC, effective 8/18/04.

During the limited review period from November 1, 2003 to October 31, 2004, NDWR and its sublessees generated over $13.6 million in gross receipts and paid the County approximately $2.2 million in rent. Sublessee Resort Watersports generated over $220,000 in gross receipts and paid over $22,000 in rent; sublessee Aquarius Training & Development generated approximately $12,000 in gross receipts and paid $600 in rent.

SCOPE

Our review was limited to certain records and documents that support NDWR and its sublessees' gross receipts reported to the County for the period from November 1, 2003 to October 31, 2004. 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.

CONCLUSION

Based on our limited review, we find that NDWR and its sublessees have retained sufficient documentation to adequately support monthly gross receipts reported to the County. **No material weaknesses or significant issues were identified.** However, we did identify **19** control findings related to compliance with the Agreement 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

Rent Owed to the County

Clause 13 of the Agreement states that gross receipts shall include all charges made on or from the leased premises, whether payment is actually made or not, and whether services are actually performed. The Agreement further states that gross receipts shall include the fair market value (FMV) of facilities used by NDWR or its employees for purposes other than the business purposes for which the premises are leased. We noted the following instances where gross receipts were underreported:

Third Party Equipment Rentals

Finding Nos. 1 & 2: For banquets and other events, NDWR occasionally obtains equipment and/or services from outside third party vendors. NDWR sometimes charges an additional fee to the customer for arranging for these outside services and equipment. When utilizing an outside vendor, NDWR reports as gross receipts only the difference between the full amount charged to the customer and the amount paid by NDWR to the outside vendor. NDWR should report the full amount charged to the customer. We found that gross receipts for outside vendor charges were underreported by $129,453 in 2004, resulting in additional rent owed of $6,472 (5%).

Recommendation No. 1: We recommend that RDMD require NDWR to pay additional rent owed of $6,472 for banquet/event equipment rentals reported at net amounts during 2004.

RDMD Response: RDMD would like to clarify Findings 1 & 2 as follows: After discussing the findings with NDWR and reviewing the historical record, RDMD staff supports NDWR's position that the practice was an approved practice that had been in place for many years. Staff's review confirmed that, in 1990, the Director of Harbors, Beaches and Parks approved Newport Dunes' request regarding payment of percentage rent on third-party catering. Newport Dunes was permitted to pay percentage rent only on the commission paid by the caterer to Newport Dunes, not on the total charges to the customer. This was done at a time when Newport Dunes did not have on-site kitchen facilities, but wanted to offer competitive food and catering services for its special event customers. With the opening of the Back Bay Café, the third-party catering greatly diminished. However, the practice of paying percentage rent in this manner (only on the commission or surcharge paid to the Newport Dunes) has continued until the present based on the 1990 approval and is used for catering and similar third-party services not offered by Newport Dunes, such as entertainers or unique place-settings for banquets. No issues regarding this practice were identified in comprehensive County audits completed as recently as 2000 and 2002. RDMD, therefore, supports NDWR's position and will not be requiring NDWR to pay the additional rent identified in Recommendation No. 1. Additionally, RDMD will be reconfirming and clarifying the approval of the practice in writing to NDWR, as we have done recently with Sand Canyon LLC (Strawberry Farm Golf Club lessee).

Recommendation No. 2: We also recommend that RDMD require NDWR to calculate and pay rent owed for the periods 8/01/02 through 12/31/03 and 1/1/05 through month of correction.

RDMD Response: As noted in Response number one, RDMD respectfully disagrees with the recommendation. See response to Recommendation No. 1.

"Trade-Out" Credits

Finding Nos. 3 & 4: As part of doing business, NDWR occasionally provides services free of charge or at reduced rates in exchange for goods/services. NDWR refers to these types of services as "trade-out credits." NDWR does not report trade-out credits given for marina services (reduced slip rent). We

found that gross receipts for marina trade-out credits were underreported by $3,173 in June and July 2004, resulting in additional rent owed of $793 (25%).

Recommendation No. 3: We recommend that RDMD require NDWR to pay rent owed of $793 for the unreported marina trade-out credits.

RDMD Response: RDMD agrees with the recommendation and has discussed the finding with NDWR. By letter dated February 16, 2006, NDWR has agreed to pay the additional rent owed of $793 for the period of June and July 2004.

Recommendation No. 4: We also recommend that RDMD require NDWR to calculate and pay rent owed for the periods 8/01/02 through 5/31/04 and 8/01/04 through month of correction.

RDMD Response: RDMD agrees with the recommendation and has discussed the finding with NDWR. By letter dated February 16, 2006, NDWR has agreed to pay rent owed for the periods 8/01/02 through 5/31/04 and 8/01/04 through the current month.

Incorrect Credit

Finding Nos. 5 & 6: In 2004, NDWR noticed that 2003 boat slip rental revenue reported to the County was $15,514 higher than reported in its audited financial statements. As this discrepancy existed, NDWR took a credit against monthly rent without providing supporting documentation to the County to explain the credit. It was later determined that the discrepancy was appropriate. Therefore, the credit should not have been taken, resulting in rent of $3,173 (25%) owed to the County.

Recommendation No. 5: We recommend that RDMD require NDWR to pay rent owed of $3,723 for the incorrect credit taken in 2004.

RDMD Response: RDMD agrees with the recommendation and has discussed this finding with NDWR. By letter dated February 16, 2006, NDWR has agreed to pay additional rent of $3,723 for the incorrect credit taken in 2004.

Recommendation No. 6: We recommend that RDMD require NDWR to provide documentation to support adjustments before authorizing future credits against monthly rent.

RDMD Response: RDMD agrees with the recommendation and has discussed this finding with NDWR. By letter dated February 16, 2006, NDWR agrees to provide the County documentation to support credits taken for Prior Year activity or that are unusual in nature. NDWR also notes that this documentation requirement would not apply to minor correction or adjustments of a prior month's rent (e.g. due to misclassification of any activity); these would be handled by NDWR's normal accounting procedures. RDMD concurs with this procedure.

Financial Statements

Clause 16.C of the Agreement requires NDWR to submit the following financial statements within 90 days after the end of each accounting year:

- A statement of gross receipts audited by a CPA wherein 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 demised premises.

- A balance sheet and income statement prepared or audited by a CPA. The CPA must attest that the balance sheet and income statement submitted are an accurate representation of tenant's records as reported to the USA for income tax purposes.

Finding No. 7: NDWR submitted financial statements that were very close to complying with the Agreement for the YE 12/31/04, the YE 12/31/03, and the 5 Months Ended 12/31/02. However, we suggest that the following changes be made to future financial statements to be in full compliance with the Agreement:

- Audit procedures were applied to the Schedule of Gross Receipts when the audit of the basic financial statements was performed. The CPA issued an audit opinion that the Schedule of Gross Receipts was fairly stated in all material respects <u>in relation to the basic financial statements as a whole</u>. However, the Agreement requires a separate opinion specific to the statement of gross receipts. Also the opinion should state that gross receipts <u>as defined by the lease agreement</u> are fairly stated or that gross receipts are fairly stated <u>in conformity with the lease agreement</u>.
- The balance sheet and income statement did not contain the required additional CPA attestation regarding the balance sheet and income statement representing what was also reported for income tax purposes. The CPA may provide the attestation in the transmittal letter if desired.

Recommendation 7: We recommend that RDMD require NDWR to submit future financial statements with the above changes included.

RDMD Response: RDMD agrees with the recommendation and has discussed this finding with NDWR. By letter dated February 16, 2006, NDWR has agreed that all future financial statements will be submitted in accordance with the terms of the lease.

<u>Mobile Cash Registers</u>

Clause 16.A of the Agreement requires all retail sales to be recorded by means of cash registers or other comparable devices. The registers shall be equipped with devices that lock in sales totals and other transactions with counters which are not resettable and which record transaction numbers and sales details. Totals registered shall be read and recorded by NDWR at the beginning and end of each business day.

Finding No. 8: NDWR utilizes auxiliary cash registers to record food/beverage sales at certain special events and seasonal snack bars. These cash registers are mobile and can be set-up at the event or snack bar location. NDWR maintains several registers for these purposes. NDWR does not account for the sequence of the control totals/counter numbers (z-out numbers) recorded on the cash register's end of day close-out tape to ensure that all cash register activity is accounted for.

Recommendation No. 8: We recommend that RDMD require NDWR to monitor the completeness of sales activity recorded on those mobile cash registers as evidenced by the sequential z-out numbers.

RDMD Response: RDMD agrees with the recommendation and has discussed the finding with NDWR. By letter dated February 16, 2006, NDWR has notified the County that it has modified its procedures to ensure that control totals/counter numbers (z-out numbers) for mobile cash registers are properly accounted for and documentation is retained.

Finding No. 9: Snack bar sales initially recorded on mobile cash registers are manually transferred to the Marketplace point-of-sale cash register system and commingled with Marketplace sales. The snack

bar register tapes are not retained as evidence that snack bar sales are recorded completely and accurately.

Recommendation 9: We recommend that RDMD require NDWR to retain the mobile register tapes.

RDMD Response: RDMD agrees with the recommendation and has discussed the finding with NDWR. By letter dated February 16, 2006, NDWR has notified the County that it has modified its procedures from leaving the daily activity on one tape, to tearing off each tape after each day's sales and retaining that tape with the daily sales' envelope.

Adequacy of Supporting Records – Serially Numbered Forms

Clause 16.A of the Agreement requires NDWR to keep true and complete records and accounts of all financial transactions in the operation of all business activities. In the event of rental charges, NDWR shall issue serially numbered tickets for each rental and shall keep an adequate record of said tickets, both issued and unissued.

Finding No. 10: Resort Watersports issues pre-numbered wrist bands for entrance into their seasonal AquaPark, a water activity park. Resort Watersports did not adequately control or account for the wristbands (bands were issued out of sequence, band numbers not documented, some band numbers were missing and not accounted for, and entrance fees waived and the reasons were not documented).

Recommendation No. 10: We recommend that RDMD require NDWR to ensure adequate control is maintained over future AquaPark wristbands. Wristbands should be issued in sequential order and all wristbands should be accounted for, including issued and unissued.

RDMD Response: RDMD agrees with this recommendation and discussed the finding with NDWR. In April 2005, NDWR terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. By letter dated February 16, 2006, NDWR has agreed to conduct all operations in accordance with the terms of the lease, including issuing wristbands in sequential order and accounting for issued and unissued wristbands.

Finding No. 11: Equipment rental agreements for Resort Watersports' special and group events were not pre-numbered or accounted for.

Recommendation No. 11: We recommend that RDMD require NDWR to ensure adequate control is maintained over future watersports special and group event equipment rental agreements. The agreements should be pre-numbered, issued in sequential order, and accounted for (issued and unissued).

RDMD Response: RDMD agrees with this recommendation and discussed the finding with NDWR. In April 2005, NDWR terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. By letter dated February 16, 2006, NDWR has agreed to conduct all operations in accordance with the terms of the lease, including having special and group events equipment rental agreements pre-numbered and issued in sequential order and accounting for issued and unissued agreements.

Finding No. 12: At the end of our review period, NDWR entered into a sublease agreement with Aquarius Ropes to provide corporate team building through facilitation of a ropes course. For each event, Aquarius Ropes requires the customer to sign a Letter of Agreement, which stipulates the details of the contract. We noted the Letter of Agreement forms are not pre-numbered or controlled.

Recommendation No. 12: We recommend that RDMD require NDWR to ensure Aquarius Ropes' Letter of Agreement forms are pre-numbered, issued in sequential order, and accounted for (issued and unissued).

RDMD Response: RDMD agrees with the recommendation and has discussed this finding with NDWR. By letter dated February 16, 2006, NDWR has notified the County that the sublease with Aquarius Training and Development has been terminated and the ropes course has been removed.

Finding No. 13: NDWR offers various activities and events to guests. A nominal fee is charged to the guest, typically $1-$5, depending on the activity. The fee is generally paid in cash and is collected by NDWR staff at the activity site. NDWR collected approximately $17,000 in activity/event fees in 2004. NDWR does not issue pre-numbered receipts to account for activity fees collected. Alternatively, NDWR could consider utilizing an activity sign-in sheet that documents the amount paid by each guest and includes each guest's signature.

Recommendation 13: We recommend that RDMD require NDWR to issue pre-numbered receipts to guests upon payment of activity fees or alternatively, utilize guest sign-in sheets that include the amount paid and each guests' signature. A separate person should account for the receipts or sign-in sheets and reconcile to the cash collected.

RDMD Response: RDMD respectively disagrees with the recommendation. According to NDWR, activities for which NDWR charges a nominal activity fee (typically a dollar or so) include ice cream socials for RV guests and popcorn sales by roving vendors during "Movies on the Beach" nights and are solely intended to cover the cost of providing the activity to the guests. NDWR contends it is impractical to use mobile registers or sign-in sheets for these events especially when large numbers of guests or children are involved in the activity and RDMD concurs with the impracticality and lack of necessity to use registers in this regard. NDWR also considers these nominal charges promotional or marketing in nature and not "sales" in the typical sense. However, in accordance with the terms of the lease NDWR does include the amounts collected in their gross receipts and pay the appropriate percentage rent. Additionally, NDWR relies on vigilant management oversight to ensure all funds are properly accounted for. By letter dated February 16, 2006, NDWR has requested approval to continue to report these charges in this manner due to the relatively minor dollar amounts involved and the impracticality of using mobile registers or sign-in sheets. RDMD concurs with this approach and will notify NDWR of its approval in writing after IA review of this response.

Adequacy of Supporting Records – Incomplete or Missing Documents

Clause 16.A of the Agreement requires NDWR to keep true and complete records and accounts of all financial transactions in the operation of all business activities. The records must be supported by source documents such as sales slips, cash register tapes, purchase invoices, or other pertinent documents.

Finding No. 14: During testing of Resort Watersports' records, we noted two equipment rental agreements were missing and not accounted for in total sales reported to the County. On those dates, we noted cash overages of $47 and $82, which may be attributed to the missing rental agreements.

Recommendation No. 14: We recommend that RDMD require NDWR to ensure future watersport rental agreements are retained and all rental charges are reported to the County.

RDMD Response: RDMD agrees with this recommendation and discussed the finding with NDWR. In April 2005, NDWR terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. By letter dated February 16, 2006, NDWR has agreed to conduct all operations in accordance with the terms of the lease, including retaining all rental agreements.

Finding No. 15: We noted the following instances where Resort Watersports' equipment rental agreements were not documented or calculated accurately:

- Time-in was not documented on one rental agreement (out of seven tested).
- Rental charge was not calculated correctly on one rental agreement resulting in an immaterial variance (out of seven tested).
- Time out/in was documented manually for four rental agreements (out of seven tested); documentation should be done with a time-clock or similar device.

Recommendation No. 15: We recommend that RDMD require NDWR to ensure future watersport rental agreements are documented completely and calculated accurately.

RDMD Response: RDMD agrees with this recommendation and discussed the finding with NDWR. In April 2005, NDWR terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. By letter dated February 16, 2006, NDWR has agreed to conduct all operations in accordance with the terms of the lease, including ensuring that all rental agreements are documented completely and calculated accurately.

Finding Nos. 16 & 17: For special events and banquets, NDWR requires the customer to sign several forms: an initial contract, the Banquet Event Order (an estimate of costs prepared upon receipt of customer deposit), and the Banquet Check (total cost upon completion of event). Customer signature provides assurance that the charges are accurate and provide evidence that charges are properly reported to the County. For the four events tested during our review, we noted the following instances where special events/banquet documentation was not complete:

- One initial contract was not in the customer file and could not be located.
- One Banquet Event Order was not signed by the customer.
- One Banquet Event Order was not in the customer file and could not be located.
- Four Banquet Checks were not signed by the customer.

Recommendation No. 16: We recommend that RDMD require NDWR to establish procedures to ensure the customer's signature is obtained on pertinent special event/banquet documents.

RDMD Response: RDMD agrees with the recommendation and has discussed the finding with NDWR. By letter dated February 16, 2006, NDWR has notified the County that NDWR has reviewed these findings as they pertain to documentation for special events and banquets held at Newport Dunes and will conduct additional training for banquet staff to ensure all documentation for special events and banquets is properly signed and retained in the file. However, NDWR does wish to clarify its procedures on the last bullet point in the Finding, "Four Banquet Checks were not signed by the customer". NDWR considers Banquet Checks to be an internal document. Due to the nature of many corporate events, the person making the arrangements on behalf of the corporation is not always present at the end of the event and available to sign the Banquet Check. Therefore, NDWR does not require all Banquet Checks to be signed by the customer, but instead considers payment of the Banquet Check as constituting approval by the customer. RDMD concurs with this procedure.

Recommendation No. 17: We further recommend that RDMD require NDWR to ensure documentation is retained to support banquet/special event activity.

RDMD Response: RDMD agrees with the recommendation and has discussed the finding with NDWR. By letter dated February 16, 2006, NDWR has notified the County that NDWR has reviewed these findings as they pertain to documentation for special events and banquets held at Newport Dunes and will conduct additional training for banquet staff to ensure all documentation for special events and banquets is properly signed and retained in the file.

Past-Due Balances and Advance Deposits

Clause 13.B of the Agreement states that gross receipts shall include the charges made for the sale or rendition of services of any nature or kind whatsoever, whether for cash or credit, whether payment is actually made or not, and whether the services are actually performed or not. Clause 13 also states that bad debt losses shall not be deducted from gross receipts.

Finding No. 18: NDWR reduces gross receipts for past due balances from customers, including bad checks. If the customer does not pay, NDWR will eventually write-off the debt and increase gross receipts reported to the County. This practice results in a timing difference in reporting gross receipts and does not result in additional rent due. Instead, no reduction to gross receipts should be made for past due activity. Past-due balances for RV and banquet/special event charges were approximately $86,000 at 7/31/04.

Recommendation No. 18: We recommend that RDMD require NDWR to report charges as gross receipts when the charges are made, whether or not payment has been received. As part of this recommendation, NDWR will have to make a one-time correcting adjustment to gross receipts for the current balance in the past due account.

RDMD Response: RDMD agrees with this recommendation and has discussed this finding with NDWR. By letter dated February 16, 2006, NDWR has notified the County that in the future, past due balances will not be deducted from income and a one-time adjustment to the gross receipts for past due balances as of December 31, 2005 was made on December 31, 2005, except for the Marina. That adjustment will be made as part of NDWR's gross receipts audit for the year ending December 31, 2005.

Finding No. 19: Resort Watersports requires customers to place a deposit for group and special events. The deposit amounts were reported as gross receipts at the time of the event, not when received. This practice results in a timing difference in reporting gross receipts and does not result in additional rent due to the County.

Recommendation No. 19: We recommend that RDMD require NDWR to report advance deposits when received.

RDMD Response: RDMD agrees with this recommendation and discussed the finding with NDWR. In April 2005, NDWR terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. By letter dated February 16, 2006, NDWR has agreed to conduct all operations with the terms of the lease, including reporting advance deposits when received.

Employee Discounts and Complimentary Services

Clause 13.F states that gross receipts should include the fair market value (FMV) of facilities used by NDWR or its employees for purposes other than the business purposes for which the premises are leased.

NDWR provides occasional discounts and comps to employees for RV site and cottage rentals, Resort Watersports equipment rentals, and Market purchases. Only the discounted amount is reported in gross receipts. During July 2004, employee discounts for RV site and cottage rent were approximately $470. Employee Market and Resort Watersports discounts appeared to be small amounts on our test dates. RDMD has informed us that, in general, employee discounts are allowed for employees to inspect/experience the facilities during non-peak times. Therefore, no specific recommendation appears necessary.

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 immediately address "Material Weaknesses" brought to their attention.

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

COUNTY OF ORANGE

RESOURCES & DEVELOPMENT MANAGEMENT DEPARTMENT

Bryan Speegle, Director
300 N. Flower Street
Santa Ana, CA

P.O. Box 4048
Santa Ana, CA 92702-4048

Telephone: (714) 834-2300
Fax: (714) 834-5188

RECEIVED
INTERNAL AUDIT DEPARTMENT
2006 APR -5 AM 10:

DATE: March 17, 2006

TO: Peter Hughes, Director, Internal Audit Department

FROM: Bryan Speegle, Director
Resources and Development Management Department

SUBJECT: Response to Limited Review Audit No. 2462 – Newport Dunes Waterfront Resort – Upper Newport Bay (HA55B-101.21)

The Resources and Development Management Department (RDMD) has reviewed the draft letter of the Internal Audit Department's Limited Review of the lease agreement (Agreement) between the County of Orange (County) and Waterfront Resort Properties, LP, and Newport Dunes Marina, LLC, (referred to as Newport Dunes Waterfront Resort or NDWR), dated February 16, 1989, as amended and assigned. The Agreement is primarily to operate and maintain Newport Dunes Waterfront Resort, a public recreation facility located in the City of Newport Beach. Situated on approximately 204 acres, the facility includes a marina, RV park, dry boat storage, boat launch and recreational day use supported by food, beverage, and retail operations. The review also included two sublease agreements, Charles A. Berry dba Resort Watersports, a watersport equipment rental operation, and Aquarius Training and Development, a team and leadership development "ropes course" operation. Under the terms of the Agreement, NDWR pays the County either a minimum rent ($1,500,000) or a percentage of the gross receipts, whichever is higher. **During the review period, NDWR and its sublessees generated over $13.6 million in gross receipts and paid the County approximately $2.2 million in rent.**

We understand the primary purpose of Internal Audit's review was to determine whether NDWR's records adequately supported their computation of percentage rent payments made to the County. We also understand that Internal Audit reviewed compliance with certain other provisions of the Agreement, such as accounting methods and payment procedures.

The audit concluded that NDWR retained sufficient documentation to adequately support monthly gross receipts reported to the County; however, the audit identified additional rent owed, areas of non-compliance with the Agreement and areas of improvements. The audit made a total of 19 recommendations.

RDMD staff provided NDWR with a copy of Audit No. 2462 and discussed with NDWR the findings, RDMD's responses to the findings and any required actions.

RDMD hereby provides the following "Responses" to the Internal Audit Department's "Findings" and "Recommendations":

RENT OWED TO THE COUNTY

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Clause 13 of the Agreement states that gross receipts shall include all charges made on or from the leased premises, whether payment is actually made or not, and whether services are actually performed. The Agreement further states that gross receipts shall include the fair market value (FMV) of facilities used by NDWR or its employees for purposes other than the business purposes for which the premises are leased. We noted the following instances where gross receipts were underreported:

Third Party Equipment Rentals

Findings Nos. 1 & 2: For banquets and other events, NDWR occasionally obtains equipment and/or services from outside third party vendors. NDWR sometimes charges an additional fee to the customer for arranging for these outside services and equipment. When utilizing an outside vendor, NDWR reports as gross receipts only the difference between the full amount charged to the customer and the amount paid by NDWR to the outside vendor. NDWR should report the full amount charged to the customer. We found that gross receipts for outside vendor charges were underreported by $129,453 in 2004, resulting in additional rent owed of $6,472 (5%).

Recommendation No. 1: We recommend that RDMD require NDWR to pay additional rent owed of $6,472 for banquet/event equipment rentals reported at net amounts during 2004.

RDMD Response: *RDMD would like to clarify Findings 1 & 2 as follows: After discussing the findings with NDWR and reviewing the historical record, RDMD staff supports NDWR's position that the practice was an approved practice that had been in place for many years. Staff's review confirmed that, in 1990, the Director of Harbors, Beaches and Parks approved Newport Dunes' request regarding payment of percentage rent on third-party catering. Newport Dunes was permitted to pay percentage rent only on the commission paid by the caterer to Newport Dunes, not on the total charges to the customer. This was done at a time when Newport Dunes did not have on-site kitchen facilities, but wanted to offer competitive food and catering services for its special event customers. With the opening of the Bay Bay Café, the third-party catering greatly diminished. However, the practice of paying percentage rent in this manner (only on the commission or surcharge paid to the Newport Dunes) has continued until the present based upon the 1990 approval and is used for catering and similar third-party services not offered by Newport Dunes, such as entertainers or unique place-settings for banquets. No issues regarding this practice were identified in comprehensive County audits completed as recently as 2000 and 2002. RDMD, therefore, supports NDWR's position and will not be requiring NDWR to pay the additional rent identified in Recommendation No. 1. Additionally, RDMD will be reconfirming and clarifying the approval of the practice in writing to NDWR, as we have done recently with Sand Canyon LLC (Strawberry Farm Gold Club lessee).*

Recommendation No. 2: We also recommend that RDMD require NDWR to calculate and pay rent owed for the periods 8/01/02 through 12/31/03 and 1/1/05 through month of correction.

RDMD Response: *As noted in Response number one, RDMD respectfully disagrees with the recommendation. See response to Recommendation No. 1.*

"Trade-Out" Credits

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Findings Nos. 3 & 4: As part of doing business, NDWR occasionally provides services free of charge or at reduced rates in exchange for goods/services. NDWR refers to these types of services as "trade-out credits." NDWR does not report trade-out credits given for marina services (reduced slip rent). We found that gross receipts for marina trade-out credits were underreported by $3,173 in June and July 2004, resulting in additional rent owed of $793 (25%).

Recommendation No. 3: We recommend that RDMD require NDWR to pay rent owed of $793 for the unreported marina trade-out credits.

RDMD Response: *RDMD agrees with the recommendation and has discussed the finding with NDWR. By letter dated February 16, 2006, NDWR has agreed to pay the additional rent owed of $793 for the period of June and July 2004.*

Recommendation No. 4: We also recommend that RDMD require NDWR to calculate and pay rent owed for the periods 8/01/02 through 5/31/04 and 8/01/04 through the month of correction.

RDMD Response: *RDMD agrees with the recommendation and has discussed the finding with NDWR. By letter dated February 16, 2006, NDWR has agreed to pay rent owed for the periods 8/01/02 through 5/31/04 and 8/01/04 through the current month.*

Incorrect Credit

Findings Nos. 5 & 6: In 2004, NDWR noticed that 2003 boat slip rental revenue reported to the County was $15,514 higher than reported in its audited financial statements. As this discrepancy existed, NDWR took a credit against monthly rent without providing supporting documentation to the County to explain the credit. It was later determined that the discrepancy was appropriate. Therefore, the credit should not have been taken, resulting in rent of $3,173 (25%) owed to the County.

Recommendation No. 5: We recommend that RDMD require NDWR to pay rent owed of $3,723 for the incorrect credit taken in 2004.

RDMD Response: *RDMD agrees with the recommendation and has discussed this finding with NDWR. By letter dated February 16, 2006, NDWR has agreed to pay additional rent of $3,723 for the incorrect credit taken in 2004.*

Recommendation No. 6: We recommend that RDMD require NDWR to provide documentation to support adjustments before authorizing future credits against monthly rent.

RDMD Response: *RDMD agrees with the recommendation and has discussed this finding with NDWR. By letter dated February 16, 2006, NDWR agrees to provide the County documentation to support credits taken for Prior Year activity or that are unusual in nature. NDWR also notes that this documentation requirement would not apply to minor correction or adjustments of a prior month's rent (e.g., due to misclassification of any activity); these would be handled by NDWR's normal accounting procedures. RDMD concurs with this procedure.*

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FINANCIAL STATEMENTS

Clause 16.C of the Agreement requires NDWR to submit the following financial statements within 90 days after the end of each accounting year:

- A statement of gross receipts audited by a CPA wherein 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 demised premises.
- A balance sheet and income statement prepared or audited by a CPA. The CPA must attest that the balance sheet and income statement submitted are an accurate representation of tenant's records as reported to the USA for income tax purposes.

Finding No. 7: NDWR submitted financial statements that were very close to complying with the Agreement for the YE 12/31/04, the YE 12/31/03, and the 5 Months Ended 12/31/02. However, we suggest that the following changes be made to future financial statements to be in full compliance with the Agreement:

- Audit procedures were applied to the Schedule of Gross Receipts when the audit of the basic financial statements was performed. The CPA issued an audit opinion that the Schedule of Gross Receipts was fairly stated in all material respects in relation to the basic financial statements as a whole. However, the Agreement requires a separate opinion specific to the statement of gross receipts. Also the opinion should state that gross receipts as defined by the lease agreement are fairly stated or that gross receipts are fairly stated in conformity with the lease agreement.

- The balance sheet and income statement did not contain the required additional CPA attestation regarding the balance sheet and income statement representing what was also reported for income tax purposes. The CPA may provide the attestation in the transmittal letter if desired.

Recommendation 7: We recommend that RDMD require NDWR to submit future financial statements with the above changes included.

RDMD Response: *RDMD agrees with the recommendation and has discussed this finding with NDWR. By letter dated February 16, 2006, NDWR has agreed that all future financial statements will be submitted in accordance with the terms of the lease.*

MOBILE CASH REGISTERS

Clause 16.A of the Agreement requires all retail sales to be recorded by means of cash registers or other comparable devices. The registers shall be equipped with devices that lock in sales totals and other transactions with counters which are not resettable and which record transaction numbers and sales details. Totals registered shall be read and recorded by NDWR at the beginning and end of each business day.

Finding No. 8: NDWR utilizes auxiliary cash registers to record food/beverage sales at certain special events and seasonal snack bars. These cash registers are mobile and can be set-up at the event or snack bar location. NDWR maintains several registers for these purposes. NDWR does not account for the sequence of the control totals/counter numbers (z-out numbers) recorded on the cash register's end of day close-out tape to ensure that all cash register activity is accounted for.

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Recommendation No. 8: We recommend that RDMD require NDWR to monitor the completeness of sales activity recorded on those mobile cash registers as evidenced by the sequential z-out numbers.

RDMD Response: *RDMD agrees with the recommendation and has discussed the finding with NDWR. By letter dated February 16, 2006, NDWR has notified the County that it has modified its procedures to ensure that control totals/counter numbers (z-out numbers) for mobile cash registers are properly accounted for and documentation is retained.*

Finding No. 9: Snack bar sales initially recorded on mobile cash registers are manually transferred to the Marketplace point-of-sale cash register system and commingled with Marketplace sales. The snack bar register tapes are not retained as evidence that snack bar sales are recorded completely and accurately.

Recommendation 9: We recommend that RDMD require NDWR to retain the mobile register tapes.

RDMD Response: *RDMD agrees with the recommendation and has discussed the finding with NDWR. By letter dated February 16, 2006, NDWR has notified the County that it has modified its procedures from leaving the daily activity on one tape, to tearing off each tape after each day's sales and retaining that tape with the daily sales' envelope.*

ADEQUACY OF SUPPORTING RECORDS – SERIALLY NUMBERED FORMS INTERNAL

Clause 16.A of the Agreement requires NDWR to keep true and complete records and accounts of all financial transactions in the operation of all business activities. In the event of rental charges, NDWR shall issue serially numbered tickets for each rental and shall keep an adequate record of said tickets, both issued and unissued.

Finding No. 10: Resort Watersports issues pre-numbered wrist bands for entrance into their seasonal AquaPark, a water activity park. Resort Watersports did not adequately control or account for the wristbands (bands were issued out of sequence, band numbers not documented, some band numbers were missing and not accounted for, and entrance fees waived and the reasons were not documented).

Recommendation No. 10: We recommend that RDMD require NDWR to ensure adequate control is maintained over future AquaPark wristbands. Wristbands should be issued in sequential order and all wristbands should be accounted for, including issued and unissued.

RDMD Response: *RDMD agrees with this recommendation and discussed the finding with NDWR. In April 2005, NDWR terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. By letter dated February 16, 2006, NDWR has agreed to conduct all operations in accordance with the terms of the lease, including issuing wristbands in sequential order and accounting for issued and un-issued wristbands.*

Finding No. 11: Equipment rental agreements for Resort Watersports' special and group events were not pre-numbered or accounted for.

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Recommendation No. 11: We recommend that RDMD require NDWR to ensure adequate control is maintained over future watersports special and group event equipment rental agreements. The agreements should be pre-numbered, issued in sequential order, and accounted for (issued and unissued).

RDMD Response: *RDMD agrees with this recommendation and discussed the finding with NDWR. In April 2005, NDWR terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. By letter dated February 16, 2006, NDWR has agreed to conduct all operations in accordance with the terms of the lease, including having special and group events equipment rental agreements pre-numbered and issued in sequential order and accounting for issued and un-issued agreements.*

Finding No. 12: At the end of our review period, NDWR entered into a sublease agreement with Aquarius Ropes to provide corporate team building through facilitation of a ropes course. For each event, Aquarius Ropes requires the customer to sign a Letter of Agreement, which stipulates the details of the contract. We noted the Letter of Agreement forms are not pre-numbered or controlled.

Recommendation No. 12: We recommend that RDMD require NDWR to ensure Aquarius Ropes' Letter of Agreement forms are pre-numbered, issued in sequential order, and accounted for (issued and unissued).

RDMD Response: *RDMD agrees with the recommendation and has discussed this finding with NDWR. By letter dated February 16, 2006, NDWR has notified the County that the sublease with Aquarius Training and Development has been terminated and the ropes course has been removed.*

Finding No. 13: NDWR offers various activities and events to guests. A nominal fee is charged to the guest, typically $1-$5, depending on the activity. The fee is generally paid in cash and is collected by NDWR staff at the activity site. NDWR collected approximately $17,000 in activity/event fees in 2004. NDWR does not issue pre-numbered receipts to account for activity fees collected. Alternatively, NDWR could consider utilizing an activity sign-in sheet that documents the amount paid by each guest and includes each guest's signature.

Recommendation 13: We recommend that RDMD require NDWR to issue pre-numbered receipts to guests upon payment of activity fees or alternatively, utilize guest sign-in sheets that include the amount paid and each guests' signature. A separate person should account for the receipts or sign-in sheets and reconcile to the cash collected.

RDMD Response: *RDMD respectively disagrees with the recommendation. According to NDWR, activities for which NDWR charges a nominal activity fee (typically a dollar or so) include ice cream socials for RV guests and popcorn sales by roving vendors during "Movies on the Beach" nights and are solely intended to cover the cost of providing the activity to the guests. NDWR contends it is impractical to use mobile registers or sign-in sheets for these events especially when large numbers of guests or children are involved in the activity and RDMD concurs with the impracticality and lack of necessity to use registers in this regard. NDWR also considers these nominal charges promotional or marketing in nature and not "sales" in the typical sense. However, in accordance with the terms of the lease NDWR does include the amounts collected in their gross receipts and pay the appropriate percentage rent. Additionally, NDWR relies on vigilant management oversight to ensure all*

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funds are properly accounted for. By letter dated February 16, 2006, NDWR has requested approval to continue to report these charges in this manner due to the relatively minor dollar amounts involved and the impracticality of using mobile registers or sign-in sheets. RDMD concurs with this approach and will notify NDWR of its approval in writing after IA review of this response.

ADEQUACY OF SUPPORTING RECORDS – INCOMPLETE OR MISSING DOCUMENTS

Clause 16.A of the Agreement requires NDWR to keep true and complete records and accounts of all financial transactions in the operation of all business activities. The records must be supported by source documents such as sales slips, cash register tapes, purchase invoices, or other pertinent documents.

Finding No. 14: During testing of Resort Watersports' records, we noted two equipment rental agreements were missing and not accounted for in total sales reported to the County. On those dates, we noted cash overages of $47 and $82, which may be attributed to the missing rental agreements.

Recommendation No. 14: We recommend that RDMD require NDWR to ensure future watersport rental agreements are retained and all rental charges are reported to the County.

RDMD Response: *RDMD agrees with this recommendation and discussed the finding with NDWR. In April 2005, NDWR terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. By letter dated February 16, 2006, NDWR has agreed to conduct all operations in accordance with the terms of the lease, including retaining all rental agreements.*

Finding No. 15: We noted the following instances where Resort Watersports' equipment rental agreements were not documented or calculated accurately:

- Time-in was not documented on one rental agreement (out of seven tested).
- Rental charge was not calculated correctly on one rental agreement resulting in an immaterial variance (out of seven tested).
- Time out/in was documented manually for four rental agreements (out of seven tested); documentation should be done with a time-clock or similar device.

Recommendation No. 15: We recommend that RDMD require NDWR to ensure future watersport rental agreements are documented completely and calculated accurately.

RDMD Response: *RDMD agrees with this recommendation and discussed the finding with NDWR. In April 2005, NDWR terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. By letter dated February 16, 2006, NDWR has agreed to conduct all operations in accordance with the terms of the lease, including ensuring that all rental agreements are documented completely and calculated accurately.*

Finding Nos. 16 & 17: For special events and banquets, NDWR requires the customer to sign several forms: an initial contract, the Banquet Event Order (an estimate of costs prepared upon receipt of customer deposit), and the Banquet Check (total cost upon completion of event). Customer signature provides assurance that the charges are accurate and provide evidence that charges are properly reported to the County. For the four events

tested during our review, we noted the following instances where special events/banquet documentation was not complete:

- One initial contract was not in the customer file and could not be located.
- One Banquet Event Order was not signed by the customer.
- One Banquet Event Order was not in the customer file and could not be located.
- Four Banquet Checks were not signed by the customer.

Recommendation No. 16: We recommend that RDMD require NDWR to establish procedures to ensure the customer's signature is obtained on pertinent special event/banquet documents.

RDMD Response: *RDMD agrees with the recommendation and has discussed the finding with NDWR. By letter dated February 16, 2006, NDWR has notified the County that NDWR has reviewed these findings as they pertain to documentation for special events and banquets held at Newport Dunes and will conduct additional training for banquet staff to ensure all documentation for special events and banquets is properly signed and retained in the file. However, NDWR does wish to clarify its procedures on the last bullet point in the Finding, "Four Banquet Checks were not signed by the customer". NDWR considers Banquet Checks to be an internal document. Due to the nature of many corporate events, the person making the arrangements on behalf of the corporation is not always present at the end of the event and available to sign the Banquet Check. Therefore, NDWR does not require all Banquet Checks to be signed by the customer, but instead considers payment of the Banquet Check as constituting approval by the customer. RDMD concurs with this procedure.*

Recommendation No. 17: We further recommend that RDMD require NDWR to ensure documentation is retained to support banquet/special event activity.

RDMD Response: *RDMD agrees with the recommendation and has discussed the finding with NDWR. By letter dated February 16, 2006, NDWR has notified the County that NDWR has reviewed these findings as they pertain to documentation for special events and banquets held at Newport Dunes and will conduct additional training for banquet staff to ensure all documentation for special events and banquets is properly signed and retained in the file.*

PAST-DUE BALANCES AND ADVANCE DEPOSITS

Clause 13.B of the Agreement states that gross receipts shall include the charges made for the sale or rendition of services of any nature or kind whatsoever, whether for cash or credit, whether payment is actually made or not, and whether the services are actually performed or not. Clause 13 also states that bad debt losses shall not be deducted from gross receipts.

Finding No. 18: NDWR reduces gross receipts for past due balances from customers, including bad checks. If the customer does not pay, NDWR will eventually write-off the debt and increase gross receipts reported to the County. This practice results in a timing difference in reporting gross receipts and does not result in additional rent due. Instead, no reduction to gross receipts should be made for past due activity. Past-due balances for RV and banquet/special event charges were approximately $86,000 at 7/31/04.

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Recommendation No. 18: We recommend that RDMD require NDWR to report charges as gross receipts when the charges are made, whether or not payment has been received. As part of this recommendation, NDWR will have to make a one-time correcting adjustment to gross receipts for the current balance in the past due account.

RDMD Response: *RDMD agrees with this recommendation and has discussed this finding with NDWR. By letter dated February 16, 2006, NDWR has notified the County that in the future, past due balances will not be deducted from income and a one-time adjustment to the gross receipts for past due balances as of December 31, 2005 was made on December 31, 2005, except for the Marina. That adjustment will be made as part of NDWR's gross receipts audit for the year ending December 31, 2005.*

Finding No. 19: Resort Watersports requires customers to place a deposit for group and special events. The deposit amounts were reported as gross receipts at the time of the event, not when received. This practice results in a timing difference in reporting gross receipts and does not result in additional rent due to the County.

Recommendation No. 19: We recommend that RDMD require NDWR to report advance deposits when received.

RDMD Response: *RDMD agrees with this recommendation and discussed the finding with NDWR. In April 2005, NDWR terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. By letter dated February 16, 2006, NDWR has agreed to conduct all operations in accordance with the terms of the lease, including reporting advance deposits when received.*

Thank you for allowing us the opportunity to respond to your draft letter. If you have any questions or need additional information, please feel free to contact Mike Hentzen of my staff at (714) 834-6286.

Sincerely,

Bryan Speegle, Director

Attachment – NDWR letter dated February 16, 2006

cc: Thomas Mauk, County Executive Officer
Dave Rudat, Interim Deputy County Executive Officer
Kevin Thomas, Director, RDMD/Harbors, Beaches & Parks
Bob Hamilton, Manager, RDMD/HBP/Program Management
Rich Adler, Chief, RDMD/HBP/Lease Management
Mike Hentzen, Leasing Coordinator, RDMD/HBP/Lease Management
Steve Danley, Director, RDMD/Management Services
Mary Fitzgerald, Manager, RDMD/Accounting Services
Pamela Middlebrook, Interim Chief, RDMD/Central Quality Assurance
Diane Villanueva, CEO

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NEWPORT DUNES
WATERFRONT RESORT

February 16, 2006

Mr. Kevin Thomas
Harbors, Beaches and Parks
P.O. Box 4048
Santa Ana, CA 92702

Re: Audit No. 2462 – Newport Dunes Waterfront Resort

Dear Mr. Thomas:

We have discussed the findings of the abovementioned audit with Mssrs. Mike Hentzen and Rich Adler of your staff and respond as follows:

Findings No. 1 & 2. In 1990, the Director of Harbors, Beaches and Parks approved Newport Dunes' request regarding payment of percentage rent on third-party catering. Newport Dunes was permitted to pay percentage rent only on the commission paid by the caterer to Newport Dunes, not on the total charges to the customer. This was done at a time when Newport Dunes did not have on-site kitchen facilities, but wanted to offer competitive food and catering services for its special event customers. With the opening of the Back Bay Café, the third-party catering greatly diminished. However, the practice of paying percentage rent in this manner (only on the commission or surcharge paid to the Newport Dunes) has continued until the present and is used for catering and similar third-party services not offered by Newport Dunes, such as entertainers or unique place-settings for banquets. This has enabled Newport Dunes to offer a broader range of services in the highly competitive special event business. Additionally, no issues regarding this practice were identified in County audits completed in 1991, 2000 and 2002. Consequently, we disagree with the findings and respectfully request that they be eliminated from the audit.

Findings No. 3 & 4. Newport Dunes will include "trade-out credits" in gross receipts and pay the additional rent owed of $793 for the period of June and July 2004. We will also calculate and pay any amounts due for the period 8/1/02 through 5/31/04 and for periods subsequent to 8/1/04 through the current month.

Findings No. 5 & 6. Newport Dunes will pay additional rent of $3,723 for an incorrect credit taken in 2004. In the future, Newport Dunes also agrees that it will provide the County documentation to support credits taken for Prior Year activity or that are unusual in nature. However, this documentation requirement would not apply to minor corrections or adjustments of a prior month's rent (e.g., due to misclassification of an activity); these will be handled by our normal accounting procedures.

Finding No. 7. All future financial statements will be submitted in accordance with the terms of the lease.

1131 Back Bay Drive • Newport Beach, California 92660 • 949.729.3863 • Fax 949.729.1133

Finding No. 8. Newport Dunes has modified its procedures to ensure that control totals/counter numbers (z-out numbers) for mobile cash registers are properly accounted for and documentation is retained.

Finding No. 9. Newport Dunes has modified its procedures from leaving the daily activity on one tape to tearing off each tape after each day's sales and retaining that tape with the daily sales' envelope.

Finding No. 10. In April 2005, Newport Dunes terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. Newport Dunes will conduct all operations in accordance with the terms of the lease including issuing wristbands in sequential order and accounting for all issued and unissued wristbands.

Finding No. 11. In April 2005, Newport Dunes terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. Newport Dunes will conduct all operations in accordance with the terms of the lease including having special and group events equipment rental agreements pre-numbered and issued in sequential order and accounting for all issued and un-issued agreements.

Finding No. 12. In 2005, Newport Dunes terminated its sublease with Aquarius Ropes and the ropes course has been removed.

Finding No. 13. Activities for which Newport Dunes charges a nominal activity fee (typically a dollar or so) include ice cream socials for RV guests and popcorn sales by roving vendors during "Movies on the Beach" nights and are solely intended to cover the cost of providing the activity to the guests. It is impractical to use mobile registers or sign-in sheets for these events especially when large numbers of guests or children are involved in the activity. Also, we consider these nominal charges promotional or marketing in nature and not "sales" in the typical sense. However, in accordance with the terms of the lease we include the amounts collected in our gross receipts and pay the appropriate percentage rent. Additionally, Newport Dunes relies on vigilant management oversight to ensure all funds are properly accounted for. Newport Dunes respectively requests approval to continue to report these charges in this manner due to the relatively minor dollar amounts involved and the impracticality of using mobile registers or sign-in sheets.

Finding No. 14. In April 2005, Newport Dunes terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. Newport Dunes will conduct all operations in accordance with the terms of the lease including retaining all rental agreements.

Finding No. 15. In April 2005, Newport Dunes terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. Newport Dunes will conduct all operations in accordance with the terms of the lease including ensuring that all rental agreements are documented completely and calculated accurately.

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Findings No. 16 & 17. Newport Dunes has reviewed these findings as they pertain to documentation for special events and banquets held at Newport Dunes and will conduct additional training for banquet staff to ensure all documentation for special events and banquets is properly signed and retained in the file. However, Newport Dunes does wish to clarify our procedures on the last bullet point in the Finding – Four Banquet Checks were not signed by the customer. We consider Banquet Checks to be an internal document. Due to the nature of many corporate events, the person making the arrangements on behalf of the corporation is not always present at the end of the event and available to sign the Banquet Check. Therefore, we do not require all Banquet Checks to be signed by the customer and consider payment of the Banquet Check to constitute approval by the customer.

Finding No. 18. The one-time adjustment to the gross receipts for past due balances as of December 31, 2005 was made on December 31, 2005, except for the Marina That adjustment will be made as part of our gross receipts audit as of December 31, 2005. In the future, past due balances will not be deducted from income.

Finding No. 19. In April 2005, Newport Dunes terminated its sublease with Resort Watersports for beach concessions and assumed full responsibility for the operations. Newport Dunes will conduct all operations in accordance with the terms of the lease including reporting advance deposits when received.

Should you have further questions please do not hesitate to contact us.

Sincerely,

Andrew Theodorou
General Manager

Michael Gelfand
President, Terra Vista Management

Cc: Mike Hentzen, County of Orange
Rich Adler, County of Orange

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