

## INTERNAL AUDIT DEPARTMENT COUNTY OF ORANGE

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Integrity • Objectivity • Independence

# LIMITED REVIEW OF LEASE REVENUE THE HERTZ CORPORATION

For the Period October 1, 2005 through September 30, 2006

AUDIT NUMBER: 2643 REPORT DATE: August 20, 2007

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

Deputy Director: Eli Littner, CPA, CIA

Senior Audit Managers: Autumn McKinney, CPA, CIA

Alan Marcum, CPA, CIA

**Audit Manager:** Lily Chin, CPA

### LIMITED REVIEW OF LEASE REVENUE THE HERTZ CORPORATION

#### For the Period October 1, 2005 through September 30, 2006

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#### *Independence* **Objectivity** Integrity



Providing Facts and Perspectives Countywide

#### OFFICE OF THE DIRECTOR

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#### COUNTY OF ORANGE BOARD OF SUPERVISORS'

#### INTERNAL AUDIT DEPARTMENT

#### **Transmittal Letter**

Audit No. 2643

August 20, 2007

TO: Alan L. Murphy, Director

John Wayne Airport

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

Limited Review of Lease Revenue for The Hertz Corporation SUBJECT:

Parcel No. PM 1121-390-27

We have completed our limited review of lease revenue for The Hertz Corporation for the period October 1, 2005 through September 30, 2006. The final **Internal Auditor's Report** is attached along with your responses to our recommendations.

Please note, we have a 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). As a matter of policy, our first Follow-Up Audit will now begin at six months upon the official release of the report. A copy of all our Follow-Up Audit reports is provided to the BOS as well as to all those individuals indicated on our standard routing distribution listing.

The AOC and BOS expect the 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 and implemented.

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

We have attached a Follow-Up Audit Report Form. John Wayne Airport 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 need to obtain the completed document from you to facilitate our review.

Alan Murphy, Director John Wayne Airport August 20, 2007 Page ii

Each month I submit an **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 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.

As always, the Internal Audit Department is available to partner with John Wayne Airport so you can successfully implement or mitigate difficult audit recommendations. Please feel free to call me should you wish to discuss any aspect of our audit report or recommendations.

Additionally, we will request John Wayne Airport complete a <u>Customer Survey of Audit Services</u>. You will receive the survey shortly after the distribution of our final report.

#### Attachment

Other recipients of this report:
Members, Board of Supervisors
Members, Audit Oversight Committee
Thomas G. Mauk, County Executive Officer
Loan Leblow, Assistant Airport Director
Roy Freeman, Deputy Airport Director, JWA/Business Development
David De Leon, Manager, JWA/Parking, Ground Transportation and Special Projects
Barbara Swift, Real Property Agent, JWA/Business Development
Don Arthur, Deputy Airport Director, JWA/Finance and Administration
Cindy Wong, Accounting Manager, JWA/Accounting
Scott Suzuki, Manager, JWA/Quality Assurance and Compliance
Foreperson, Grand Jury
Darlene J. Bloom, Clerk of the Board of Supervisors

# Independence Objectivity Integrity



Providing Facts and Perspectives Countywide

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#### COUNTY OF ORANGE BOARD OF SUPERVISORS'

#### INTERNAL AUDIT DEPARTMENT

#### INTERNAL AUDITOR'S REPORT

Audit No. 2643

August 20, 2007

TO: Alan L. Murphy, Director

John Wayne Airport

SUBJECT: Limited Review of Lease Revenue for The Hertz

Corporation Parcel PM 1121-390-27

We have performed a limited review of certain records and documents for the period from October 1, 2005 through September 30, 2006, pertinent to the lease agreement (Agreement) between the County of Orange (County) and The Hertz Corporation (Hertz), dated December 15, 2000. The Agreement is limited to the operation of a rental car concession at John Wayne Airport.

The primary purpose of our review is to determine whether Hertz's records adequately supported their monthly gross receipts reported to the County. We also reviewed compliance with certain other provisions of the Agreement, such as accounting methods and payment procedures.

Based on our limited review, we find that Hertz has 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 eight control findings which 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 Hertz, JWA/Business Development, and JWA/Accounting Services. If you have any questions regarding our limited review of lease revenue, please call me, Eli Littner, Deputy Audit Director, at (714) 834-5899, or Autumn McKinney, Senior Audit Manager, at (714) 834-6106.

Peter Hughes, Pt.D., CPA Director, Internal Audit Alan Murphy, Director John Wayne Airport August 20, 2007 Page 2

Attachment A – Report Item Classifications Attachment B – JWA Management Responses

Distribution Pursuant to Audit Oversight Committee Procedure No. 1:

Members, Board of Supervisors

Members, Audit Oversight Committee

Thomas G. Mauk, County Executive Officer

Loan Leblow, Assistant Airport Director

Roy Freeman, Deputy Airport Director, JWA/Business Development

David De Leon, Manager, JWA/Parking, Ground Transportation and Special Projects

Barbara Swift, Real Property Agent, JWA/Business Development

Don Arthur, Deputy Airport Director, JWA/Finance and Administration

Cindy Wong, Accounting Manager, JWA/Accounting

Scott Suzuki, Manager, JWA/Quality Assurance and Compliance

Foreperson, Grand Jury

Darlene J. Bloom, Clerk of the Board of Supervisors

#### **EXECUTIVE SUMMARY**

#### **OBJECTIVES**

The Internal Audit Department conducted a limited review of lease revenue for The Hertz Corporation (Hertz) for the primary purpose of determining whether Hertz's records adequately supported their monthly gross receipts reported to the County.

#### **BACKGROUND**

The County of Orange entered into a lease agreement (Agreement) with Hertz dated December 15, 2000, for the operation of a rental car concession at John Wayne Airport. During the 12-month review period, Hertz generated approximately \$40.3 million in gross receipts and paid the County over \$4 million in rent.

#### **SCOPE**

Our review was limited to certain records and documents that support Hertz's gross receipts reported to the County for 12-month period of October 1, 2005 to September 30, 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.

#### **CONCLUSION**

Based on our limited review, we find that Hertz has retained sufficient documentation to adequately support monthly gross receipts reported to the County. **No material weaknesses or significant issues were identified.** However, we identified eight control findings which 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 14 of the Agreement defines the term "TENANT" to include tenant, its agents, sublessees, concessionaires, or licensees, or any person acting under contract with tenant. Clause 14.C defines gross receipts to include all rental, admission, and others fees of any nature or kind charged by tenant.

As allowed Clause 6 of the Agreement, Hertz entered into agreements with two of JWA's fixed base operators, Atlantic Aviation and Signature Flight Support, to provide car rental services. Hertz informed us that they began providing car rental service for Atlantic Aviation in February 2005.

**Findings Nos. 1, 2, and 3:** Hertz reported gross receipts generated at Signature Flight Support in the monthly gross receipts statement submitted to the County, but did not report gross receipts generated from Atlantic Aviation. During our review, we found that the underreported gross receipts for our sample months were \$7,128 for August 2006 and \$4,370 for December 2005, resulting in underpayment of rent (10% of gross receipts) by \$713 and \$437 respectively.

Hertz agreed that it should be reported and has begun including the gross receipts for Atlantic Aviation beginning with August 2006. Hertz will also make an adjustment to its audited Statement of Gross Receipts for the lease year ended November 2006 to include revenue from Atlantic Aviation.

**Recommendation No. 1:** We recommend that JWA require Hertz to calculate and pay rent owed for gross receipts generated at Atlantic Aviation for the audit period of October 1, 2005 through September 30, 2006.

**JWA Management Response:** Concur. This recommendation has been implemented. In a memo dated June 27, 2007, we required Hertz to calculate and pay all unpaid rent owed on gross receipts generated from Atlantic Aviation for the period stated in the recommendation. JWA Accounting will follow-up with Hertz at a later date to ensure the Airport receives back rent owed. Of additional note, Hertz's annual Statement of Gross Receipts and Concession Payments (audited by their independent auditors) for the year ended November 30, 2005, did not report any income from Atlantic Aviation.

**Recommendation No. 2:** We also recommend that JWA require Hertz to continue reporting revenue from Atlantic Aviation for periods subsequent to September 2006.

**JWA Management Response:** Concur. This recommendation has been implemented. In a memo dated June 27, 2007, we required Hertz to calculate and pay all unpaid rent owed on gross receipts generated from Atlantic Aviation for the period stated in the recommendation. Additionally, JWA Accounting has verified that recent Hertz monthly rent summaries have included revenue from Atlantic Aviation.

**Recommendation No. 3:** We also recommend that JWA determine if Hertz should calculate and pay rent owed for the period from February 2005 to September 2005.

**JWA Management Response:** Concur. This recommendation has been implemented. JWA has determined Hertz should calculate and pay back rent owed. In a memo dated June 27, 2007, we required Hertz to calculate and pay all unpaid rent owed on gross receipts generated from Atlantic Aviation for the period stated in the recommendation.

#### **Vehicle License Fee**

Hertz charges a vehicle license fee (VLF) to certain customers. Hertz informed us that it charges a VLF to its corporate customers to help recover the cost of the vehicle registration and licensing fee paid to the State of California (State), and it has charged the VLF since January 2005. Clause 14 of the Agreement states that gross receipts shall exclude all sales and excise tax payable by tenant to federal, state, county or municipal governments as a direct result of operations under the Agreement.

**Finding No. 4:** Hertz does not report the vehicle license fee charged as gross receipts to the County. Hertz stated that it considers the VLF as a tax imposed by the State. For our two sample months of December 2005 and August 2006, the total VLF charges were \$19,752 and \$23,051 respectively, resulting in potential rent owed (10%) of \$1,975 and \$2,305.

JWA is already aware of this issue and is currently researching whether the VLF charge should be reported. Based on our limited initial analysis, it appears that the VLF charge may not qualify as a tax under the Agreement. However, this issue will likely require further analysis by County Counsel.

**Recommendation No. 4:** We recommend that JWA evaluate whether the vehicle license fee charged by Hertz should be reported as gross receipts.

**JWA Management Response:** Concur. This recommendation has been implemented. JWA has evaluated this issue and concluded that the VLF fee charged should be included in gross receipts reported by Hertz. In a memo dated June 7, 2007, we asserted to Hertz that there is no statutory or contractual basis for Hertz to exclude VLF from concessionable revenue. Furthermore, in a memo dated June 27, 2007, we demanded that Hertz calculate and pay rent owed on the omitted VLF from January 2005 forward.

To assist our monitoring efforts of all rental car companies, we have modified the monthly gross receipts statement to explicitly itemize any deductions from gross receipts per contractual allowances. Additionally, we distributed a letter on July 19, 2007, to all on-Airport rental car companies reiterating our position on handling of the VLF.

#### **Fuel Purchase Option**

Clause 14 of the Agreement allows Hertz to exclude from gross receipts the reimbursements received from customers for fuel furnished at the inception of the car rental (i.e. fuel purchase option charges or prepaid gas charges) that is separately identifiable on the original rental agreement. Any fuel reimbursements by customers that are not made under this prepaid (fuel purchase option) exclusion are reportable to the County as gross receipts.

**Finding Nos. 5 and 6:** Hertz's car rental agreements separately identify prepaid and non-prepaid fuel. However, Hertz's car rental revenue reports and general ledger reports that are used to report

gross receipts to the County have one commingled account to record all fuel sales; e.g. prepaid fuel and non-prepaid fuel sales are not segregated or separately identified.

Each month, Hertz reports the total fuel sales as gross receipts to the County and does not make an allowed reduction for prepaid fuel. Instead, Hertz records an adjustment for prepaid fuel as part of its annual audited Statement of Gross Receipts. Additionally, since the fuel sales are commingled, Hertz utilizes an alternative method to calculate the annual adjustment for prepaid fuel.

As an alternative, Hertz uses a system extract to identify prepaid and total fuel sales. However, Hertz informed us that due to timing differences of when the reports are generated, the total amount of fuel per the system extract does not agree with the total amount of fuel reported to the County. Therefore, Hertz calculates the percentage of prepaid fuel sales based on the system extract and applies the percentage to the total fuel sales reported to the County in order to estimate the prepaid fuel adjustment. For the year ended November 30, 2005, Hertz's prepaid fuel adjustment was \$960,689 based on total fuel sales of about \$2.5 million and total gross receipts of about \$40 million. If applied consistently, Hertz alternative method appears reasonable based on the dollar amounts involved.

**Recommendation No. 5:** We recommend that JWA determine if the prepaid fuel (fuel purchase option) exclusion should be based on actual amounts or if estimated amounts can be used.

**JWA Management Response:** Concur. This recommendation has been implemented. JWA reviewed Hertz's methodology for calculating the prepaid fuel exclusion and concluded that their estimation procedures are acceptable.

**Recommendation No. 6:** We also recommend that JWA determine if the prepaid fuel (fuel purchase option) exclusion should be reported on a monthly basis, rather than annually.

**JWA Management Response:** Concur. This recommendation has been implemented. JWA reviewed reporting procedures by Hertz and has concluded the current annual reporting of prepaid fuel exclusion is appropriate.

#### **Validating Adjustment**

**Findings Nos. 7 and 8:** We found that on December 28, 2006, JWA issued a credit of \$36,757 to Hertz for rent overpaid as result of the annual fuel purchase option adjustment made on the audited Statement of Gross Receipts for the year ended November 30, 2005. Hertz did not provide detailed supporting documentation for the credit, other than the audited Statement of Gross Receipts. JWA prepared a reconciliation of Hertz's audited financial statements; however, JWA did not further validate the fuel purchase option adjustment prior to issuing the credit.

During our audit, we reviewed the supporting documents for the fuel purchase option adjustment used to calculate the credit and it appears that the adjustment amount of \$367,574 was incorrectly calculated. Based on a corrected adjustment amount of \$960,689 (as noted above in Findings No. 4 and 5), it appears the correct credit amount should be \$96,069 (10%).

**Recommendation No. 7:** We recommend that JWA require Hertz to provide detailed documentation to support adjustments before authorizing future credits against monthly rent.

**JWA Management Response:** Concur. This recommendation has been implemented. Procedures have been implemented wherein supporting documentation will be requested and analytical review will be performed by JWA Accounting before any credit against monthly rent is approved. In a memo dated June 27, 2007, we have required Hertz to provide their refueling analysis report to support future annual prepaid fuel adjustments. Additionally, JWA Accounting has obtained Hertz's 2006 refueling analysis and agreed it to the corresponding credit issued.

**Recommendation No. 8:** We also recommend that JWA evaluate if the credit amount for the year ended November 30, 2005 should be corrected.

**JWA Management Response:** Concur. The recommendation has been implemented. We have evaluated this issue and concluded the credit issued for the year ended November 30, 2005 was in fact understated. This finding was the result of a calculation error performed by Hertz that was subsequently overlooked by their independent auditors and carried forward by Hertz's annual Statement of Gross Receipts and Concession Payments. The credit owed to Hertz was resolved in March 2007's rent payment. Procedures identified in our response to Recommendation No. 7 above should ensure this event does not recur.

#### **ATTACHMENT A: Report Item Classifications**

For purposes of reporting our audit observations and recommendations, we have classified 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.



### **MEMO**



August 7, 2007

TO: Dr. Peter Hughes, Director

Internal Audit Department

FROM: Alan L. Murphy, Airport Director

John Wayne Airport

SUBJECT: Response to the Internal Audit Department's Report on Limited Review of Lease

Revenue, The Hertz Corporation, No. 2643

This memo is in response to the Internal Audit Department's review of lease revenue for the Hertz Corporation's operation of a rental car concession at John Wayne Airport. The review was comprised of an examination of certain records and documents for the period from October 1, 2005 through September 30, 2006.

The review found that Hertz has retained sufficient documentation to adequately support monthly gross receipts reported to the County of Orange. No material weaknesses or significant issues were identified.

Our response was reviewed and approved by the County Executive Office on August 6, 2007.

Attachment

Cc: Loan Leblow, Assistant Airport Director
Don Arthur, Deputy Airport Director, Finance & Administration
Roy Freeman, Deputy Airport Director, Business Development
David De Leon, Business Development Manager

Scott Suzuki, Quality Assurance & Compliance Manager Sharon Tabata, Accounting Manager

Sharon Tabata, Accounting Manage Barbara Swift, Real Property Agent

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# JOHN WAYNE AIRPORT Response to the Internal Audit Department's Report on Limited Review of Lease Revenue, The Hertz Corporation Audit No. 2643

**Recommendation No. 1:** We recommend that JWA require Hertz to calculate and pay rent owed for gross receipts generated at Atlantic Aviation for the audit period of October 1, 2005 through September 30, 2006.

JWA Management Response: Concur. This recommendation has been implemented. In a memo dated June 27, 2007, we required Hertz to calculate and pay all unpaid rent owed on gross receipts generated from Atlantic Aviation for the period stated in the recommendation. JWA Accounting will follow-up with Hertz at a later date to ensure the Airport receives back rent owed. Of additional note, Hertz's annual Statement of Gross Receipts and Concession Payments (audited by their independent auditors) for the year ended November 30, 2005, did not report any income from Atlantic Aviation.

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**JWA Management Response:** Concur. This recommendation has been implemented. JWA has evaluated this issue and concluded that the VLF fee charged should be included in gross receipts reported by Hertz. In a memo dated June 7, 2007, we asserted to Hertz that there is no statutory or contractual basis for Hertz to exclude VLF from concessionable revenue. Furthermore, in a memo dated June 27, 2007, we demanded that Hertz calculate and pay rent owed on the omitted VLF from January 2005 forward.

To assist our monitoring efforts of all rental car companies, we have modified the monthly gross receipts statement to explicitly itemize any deductions from gross receipts per contractual allowances. Additionally, we distributed a letter on July 19, 2007, to all on-Airport rental car companies reiterating our position on handling of the VLF.

#### **ATTACHMENT B: JWA Management Responses (continued)**

**Recommendation No. 5:** We recommend that JWA determine if the prepaid fuel (fuel purchase option) exclusion should be based on actual amounts or if estimated amounts can be used.

**JWA Management Response:** Concur. This recommendation has been implemented. JWA reviewed Hertz's methodology for calculating the prepaid fuel exclusion and concluded that their estimation procedures are acceptable.

**Recommendation No. 6:** We also recommend that JWA determine if the prepaid fuel (fuel purchase option) exclusion should be reported on a monthly basis, rather than annually.

**JWA Management Response:** Concur. This recommendation has been implemented. JWA reviewed reporting procedures by Hertz and has concluded the current annual reporting of prepaid fuel exclusion is appropriate.

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**Recommendation No. 8:** We also recommend that JWA evaluate if the credit amount for the year ended November 30, 2005 should be corrected.

**JWA Management Response:** Concur. The recommendation has been implemented. We have evaluated this issue and concluded the credit issued for the year ended November 30, 2005 was in fact understated. This finding was the result of a calculation error performed by Hertz that was subsequently overlooked by their independent auditors and carried forward to Hertz's annual Statement of Gross Receipts and Concession Payments. The credit owed to Hertz was resolved in March 2007's rent payment. Procedures identified in our response to Recommendation No. 7 above should ensure this event does not recur.