AUDIT REPORT

CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
BUREAU OF FINANCIAL AUDIT
WILLIAM C. THOMPSON, JR., COMPTROLLER

Audit Report on the Compliance of Hyatt Equities, LLC, With Its Lease Agreement

FM04-118A

April 21, 2005

THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
1 CENTRE STREET
NEW YORK, N.Y. 10007-2341

WILLIAM C. THOMPSON, JR.
COMPTROLLER

To the Citizens of the City of New York

Ladies and Gentlemen:

In accordance with the responsibilities of the Comptroller contained in Chapter 5, § 93, of the New York City Charter, my office has examined the compliance of Hyatt Equities, LLC (Equities) with the terms of its agreement with the Department of Citywide Administrative Services. Under the provisions of the agreement, Equities operates and maintains the Grand Hyatt Hotel, which is located at Lexington Avenue and 42nd Street in Manhattan.

The results of our audit, which are presented in this report, have been discussed with Hyatt Equities officials, and their comments have been considered in preparing this report.

Audits such as this provide a means of ensuring that private concerns under contract with the City comply with the terms of their agreements, properly report revenues and expenditures, and pay all fees due the City.

I trust that this report contains information that is of interest to you. If you have any questions concerning this report, please contact my audit bureau at 212-669-3747 or e-mail us at audit@Comptroller.nyc.gov.

Very truly yours,

William C. Thompson, Jr.

WCT/gr

Report: **FM04-118A**
Filed: **April 21, 2005**

Table of Contents

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AUDIT REPORT IN BRIEF

This audit determined whether Hyatt Equities, LLC (Equities) accurately reported the net profits from Grand Hyatt operations, paid all fees due under the lease, maintained proper insurance, and paid all water and sewer charges.

The Empire State Development Corporation (Empire) and the City of New York—represented by the Department of Citywide Administrative Services (DCAS)—jointly own the land and building at Lexington Avenue and 42nd Street in Manhattan on which the Grand Hyatt Hotel was built.

In May 1978, a 99-year lease agreement commenced whereby the hotel would be developed, maintained, and operated by Regency-Lexington Partners until Hyatt Equities, LLC, (Equities) assumed the lease in 1996. Under the lease agreement, Equities is required to make three types of rent payments—Net Rent, Tax Equivalency Fee, and Percentage Rental—to Empire, which acts as a pass-through agent by remitting the payments to DCAS. During calendar year 2002, Equities reported $113 million in revenues and $13.2 million in net profits, and paid rent totaling $6.5 million.

Audit Findings and Conclusions

Except for the issues noted below, Equities accurately reported net profits from Grand Hyatt operations and paid the fees due under the lease. In addition, Equities maintained proper insurance coverage and paid the required water and sewer charges.

However, Equities understated its net profits by $445,743. This resulted in additional Percentage Rental fees due of $222,871. Specifically, Equities:

- misclassified certain tangible assets as repair and maintenance expenses. Those expenses were overstated by $200,455.

- did not provide supporting documentation for one repair and maintenance transaction totaling $12,448.

- understated net profits by $317,813 because it incorrectly calculated cash sales, and it deducted an expense for which it was not entitled.

Audit Recommendations

To address these issues, we recommended that Equities should:

- Remit $222,871 in additional Percentage Rental fees to Empire and the City.

- Ensure that capital expenditures are properly recorded and expended over the useful lives of the assets.

- Maintain appropriate records to support reported revenue and expenses, as required by the lease agreement

- Cease deducting the allowance for doubtful accounts when calculating the Percentage Rental.

Additionally, we recommended that DCAS should:

- Ensure that Equities pays $222,871 for additional Percentage Rental and comply with the audit's other recommendations.

INTRODUCTION

Background

The Empire State Development Corporation (Empire), (previously known as the New York State Urban Development Corporation) and the City of New York—represented by the Department of Citywide Administrative Services (DCAS)—jointly own the land and building at Lexington Avenue and 42nd Street in Manhattan on which the Grand Hyatt Hotel was built.[1]

In May 1978, a 99-year lease commenced whereby the hotel would be developed, maintained, and operated by Regency-Lexington Partners (consisting of two partners: Refco Properties, Inc., a subsidiary of Grand Hyatt, Inc., and Wembley Realty, Inc., a subsidiary of the Trump Organization) until Hyatt Equities, LLC, (Equities) assumed the lease in 1996.

Under the lease agreement, Equities is required to make three types of rent payments to Empire, which acts as a pass-through agent by remitting the payments to DCAS. The first type

[1]The Grand Hyatt was formerly the Commodore Hotel.

of payment, Net Rent, which is an annual payment of $100. The second type of payment is the Tax Equivalency Fee, which is an annual payment in lieu of real property tax, payable in 12 monthly installments. The annual amount of the Tax Equivalency Fee is specified in the lease agreement. For calendar year 2002, the period covered by this audit, the fee was $1,475,000. The third type of payment, the Percentage Rental payment, which is due within 90 days after the end of each calendar year, is the percentage of various profits as defined in the lease agreement, as follows:

a) 10 percent of the first $500,000 of profits;
b) 12 1/2 percent of the next $1,000,000 of profits;
c) 15 percent of the next $1,000,000 of profits;
d) 20 percent of the next $1,000,000 of profits;
e) 30 percent of the next $1,000,000 of profits;
f) 40 percent of the next $1,000,000 of profits; and
g) 50 percent of any additional profits.

Equities operates and maintains the Grand Hyatt Hotel, which consists of more than 1,300 guest rooms and suites, banquet and conference facilities, restaurants, and retail space. During calendar year 2002, Equities reported $113 million in revenues and $13.2 million in net profits, and paid rent totaling $6.5 million.

Objectives

The audit's objectives were to determine whether Equities:

- accurately reported the net profits from Grand Hyatt operations and paid all fees due under the lease; and

- maintained proper insurance and paid all water and sewer charges.

Scope and Methodology

The scope of this audit was calendar year 2002. To obtain an understanding of the relationships among Equities, Empire, and the City, we reviewed and abstracted the 1978 lease agreement and the 1985 amendment. We interviewed Empire and DCAS officials to understand their roles in monitoring compliance with lease terms and collecting the fees due. In addition, we reviewed Empire's books and records to determine whether Equities paid the amounts due on time.

To obtain an understanding of Equities' operations and internal controls over its operations, we interviewed the Grand Hyatt's controller and MIS manager, conducted a walk-through of the operations, and familiarized ourselves with Equities accounting and record-keeping procedures. We also observed the processing of simulated transactions through

Equities' computerized point-of-sales system. We documented our understanding of the operations through written narratives.

To ensure that Equities properly recorded Grand Hyatt restaurant, banquet, and room rental revenue, we judgmentally chose May 2, 2002, the day with the highest recorded revenue amounts, for our audit testing. To determine the reliability of Equities' computerized sales report generated from its point-of-sales system, we reviewed the 1,562 guest checks issued for May 2, 2002, and traced them to the computerized sales report. In addition, we examined all guest checks to ensure that each check was consecutively numbered and accounted for, and to ensure that the amounts were accurately recorded on the computerized sales reports.

For our tests of restaurant revenue, we compared the sales for May 2, 2002, recorded on the computerized sales report to the daily income journal, and then to the general ledger. We traced revenue generated from room service from Grand Hyatt's Property Management System Control Report to the individual guest checks to ensure that all revenue was properly accounted for.

For our tests of banquet revenue, we obtained the eight banquet contracts for May 2, 2002, and compared them to the computerized sales report, the daily income journal, and the general ledger. In addition, we traced all banquet checks received in December 2002 to the corresponding banquet contract and to the computerized sales reports, to determine whether all banquet revenue was accurately recorded. We judgmentally selected December 2002 because that month included payments for banquets that occurred during the three-month period September through November 2002—Grand Hyatt's peak season.

For our tests of revenue from room rentals, we obtained the May 2, 2002, daily room revenue control report and traced revenue from all 1,260 room rentals on that day to the daily income journal. We then traced the revenue from the daily income journal to the general ledger.

To ensure that Equities properly recorded its "Miscellaneous Revenues" (i.e., rental income, parking, telephone, and movie rentals), we obtained and reviewed all retail space leases and traced the revenue (based on the amounts specified in the lease agreements) to the general ledger. In addition, we judgmentally selected 15 transactions in other miscellaneous revenue accounts for calendar year 2002, and traced the amounts recorded in the general ledger to the underlying source documents (i.e., copies of the checks, deposit slips, and accounts receivable records).

To determine whether Equities properly recorded expenditures in the general ledger, we conducted tests of 100 transactions that were randomly selected from the Accounts Payable account for the last quarter of the year (October 1, 2002, through December 31, 2002). We traced the recorded expenditures to the source documents (i.e., invoices and canceled checks), and to the corresponding expenditure accounts in the general ledger. To determine whether Equities properly capitalized its fixed asset expenditures, we judgmentally selected 48 payments in excess of $5,000 in the Repairs and Maintenance accounts and reviewed the source documentation (i.e., invoices and purchase orders) to confirm that the costs should not have been capitalized.

To determine the accuracy and reliability of the amounts reported on Equities' financial statements, we traced revenue and expenses from the general ledger to the trial balance, and then to the financial statements. In addition, we analyzed Equities' methodology for calculating Percentage Rental. In that regard, we analyzed the deductions taken by Equities (i.e., depreciation, accounts receivable, and allowance for doubtful accounts) against gross income.

To determine whether Equities maintained appropriate insurance coverage, we checked whether the policies were active and the coverage amounts complied with the terms of the lease agreement. We also determined whether that Equities paid all water and sewer charges on the facility by reviewing billing records maintained by the Department of Environmental Protection.

The results of our tests, while not projectable to all of Grand Hyatt's revenue and expenses, provided us with a reasonable basis to assess the appropriateness of the amounts reported and the fees paid to the City.

This audit was conducted in accordance with generally accepted government auditing standards (GAGAS) and included tests of books and records and other audit procedures considered necessary. This audit was performed in accordance with the audit responsibilities of the City Comptroller as set forth in Chapter 5, §93, of the New York City Charter.

Discussion of Audit Results

The matters covered in this report were discussed with Equities, Empire, and DCAS officials during and at the conclusion of this audit. A preliminary draft report was sent to Equities, Empire, and DCAS officials and discussed at an exit conference held on January 18, 2005. On January 27, 2005, we submitted a draft report to Equities, Empire, and DCAS officials with a request for comments. We received written responses from Equities and DCAS officials on February 10, 2005; and a revised response from Equities on April 11, 2005. Empire officials did not provide a written response.

In their response, Equities officials did not dispute our finding concerning repair and maintenance costs; however, they did not agree with our calculation of the amount due. Equities officials stated that they will make an adjustment to capitalize the costs of capital improvements and expense them over their useful lives. In addition, Equities officials contend that they are correctly calculating profit and that the provision for doubtful accounts is an includable operating expense.

In contrast, DCAS officials agreed with the audit's findings and recommendations and stated that they would enforce the recommendations in the audit report. The specific issues raised by Equities officials and our rebuttals are included in the body of the report.

The full texts of Equities and DCAS comments are included as addenda to this report.

FINDINGS

Except for the issues noted below, Equities accurately reported net profits from Grand Hyatt operations and paid the fees due under the lease. In addition, Equities maintained proper insurance coverage and paid the required water and sewer charges. However, Equities understated its net profits by $445,743. This resulted in additional Percentage Rental fees due of $222,871. (See Appendices I, II, and III for our detailed calculations of understated profits and additional fees due.)

These issues are discussed in more detail in the following sections of this report.

Understated Net Profits and Fees Due

Repair and Maintenance Costs

Equities understated its profits because it misclassified certain tangible assets as repair and maintenance expenses. Those expenses were overstated by $200,455. According to Generally Accepted Accounting Principles (GAAP), tangible assets with relatively long life must be capitalized and expended (i.e., depreciated) over the useful life of the asset. The tangible assets that were misclassified included furniture, fixtures, and capital improvements.

For example, Grand Hyatt officials purchased $73,962 in furniture and fixtures for a suite undergoing renovation. According to Grand Hyatt's general ledger, the entire cost of those items was expensed during the year. However, the items purchased, which included $14,000 for a living room cabinet and $8,500 for a television cabinet, should have been capitalized and the amounts paid should have been expensed over their useful life. Similarly, on August 16, 2002, Hyatt paid $11,960 for the installation of eight electrical circuits in a ballroom—another improvement that should have been capitalized.

Moreover, Grand Hyatt officials did not provide supporting documentation for one repair and maintenance transaction totaling $12,448. According to the lease agreement, Hyatt should maintain "full and accurate books of account and records from which Profits for each lease year during the term can be determined. Such records shall be so kept and maintained for at least two (2) years after the end of the period in question." Accordingly, we deducted $12,448 from the repairs and maintenance account.

After reclassifying tangible assets as capital improvements and deducting unsupported transaction, we calculated that Grand Hyatt reported profits were understated by $127,930 resulting in additional Percentage Rental fees of $63,965 due for Calendar Year 2002. (See Appendix I.)

> ***Equities Response:*** "Equities has chosen not to dispute the City's finding; however, Equities does not agree with the calculation. Please see attached Schedule A. An adjustment will be made to capitalize the expenses over their useful lives"

Auditor Comment: Based on our review of the documentation provided by Equities, we revised our calculation of understated profits and additional percentage rent due. Understated profits were reduced to $127,930 from the $132,858 stated in the draft version of this report. As a result, additional rent due was reduced to $63,965 from $66,429. In addition, Equities adjusted the amount due by $10,143, which represents calendar year 2003 depreciation expense on the assets that were originally expensed. As result, Equities has agreed to pay $53,822 in additional Percentage Rental fees. We agree that an adjustment is necessary; however, since Equities did not provide documentation to support the $10,143 claimed, we cannot accept such an adjustment. Therefore, Equities should pay the $10,143—the difference between the $63,965 due according to the audit and the $53,822 it agreed to pay—pending a review by DCAS of Equities' claim for additional depreciation expenses.

Calculation Errors

As of December 31, 2002, Equities understated net profits by $317,813. As a result Equities owes the City $158,906 in additional percentage rent. (See Appendix I.) Equities understated net profits because it incorrectly calculated cash sales, and it deducted an expense for which it was not entitled. According to the lease, net profits are defined as cash sales less certain operating expenses—cash sales are the "aggregate amount of monies actually received by [Equities] in any Lease Year for goods, services rendered or merchandise sold at the [Grand Hyatt]." Equities inappropriately increases cash sales by each year's actual uncollectible accounts receivable write-off. Equities also estimates an amount of uncollectible accounts receivable and incorrectly deducts it as an operating expense—Equities is allowed to deduct only "actual expenses incurred" in its calculation of net profits.

Equities Response: "Since the inception of the lease, Equities has included a deduction for the provision for doubtful accounts within the lease calculation. According to Exhibit F (6) of the Lease,

"In determining Gross Income, Expenses, Excluded Receipts and Excluded Expenses, Landlord and Tenant agree that the Uniform System of Accounts for Hotels dated 1971, adopted by the American Hotel and Motel Association, as such system may be subsequently revised, shall be utilized. . . .

"According to the Ninth Edition of the Uniform System of Accounts for the Lodging Industry (edition in effect in 2002), the provision for doubtful accounts which includes, 'a charge adequate to provide for the probable loss in collection of accounts and notes receivable' should be included within administrative and general expenses. Exhibit F (2) (e) of the Lease lists administrative and general services as an includable expense. Accrual basis accounting includes the use of estimates. The provision for doubtful accounts represents an estimate of expenses incurred.

"Because the hotel records revenue on the accrual basis, a calculation is necessary to reflect cash basis revenue. This calculation adjusts accrual basis revenue by the change in the accounts receivable account. Despite prior audits and reviews, this practice has not been challenged."

Auditor Comment: Equities is being somewhat disingenuous in its citation of Exhibit F (6) of the lease in that it left out the end of the quoted sentence. The entire sentence is: "In determining Gross Income, Expenses, Excluded Receipts and Excluded Expenses, Landlord and Tenant agree that the Uniform System of Accounts for Hotels dated 1971, adopted by the American Hotel and Motel Association, as such system may be subsequently revised, shall be utilized **to the extent such system is not inconsistent with the provisions hereof**." [Emphasis added.] According to Exhibit F (2) of the lease, Equities is entitled to deduct only "the **actual** expenses incurred." [Emphasis added.] Since the provision for doubtful accounts is an estimated expense, it should not have been deducted by Equities when calculating net profit.

While we agree that an adjustment is required to reflect Equities' cash basis revenue from that recorded on its books and records, the method used by Equities is incorrect. The change in accounts receivable that Equities uses includes accounts receivable write-offs, which distorts the actual amount of cash sales for the year. To bring Equities into compliance with the agreement, it should cease increasing cash sales by actual accounts-receivable write-offs and stop deducting the estimated uncollectible accounts receivable as operating expenses in its calculation of percentage rent due. This approach is in line with the provisions of the lease.

RECOMMENDATIONS

We recommend that Equities should:

1. Remit $222,871 in additional Percentage Rental fees to Empire and the City.

   Equities Response: Equities did not directly respond to the part of the recommendation arising from calculation errors, which makes up $158,906 of the amount that should be paid. With regard to the $63,965 arising from our finding on repair and maintenance costs, it stated: "Equities will remit $53,822 in additional Percentage Rental fees which includes a credit for the depreciation allowance that should have been taken in the 2003 calculation for the newly capitalized items to Empire and the City."

   Auditor Comment: As stated previously, Equities is entitled to deduct only actual expenses incurred when calculating net profits. Since the provision for doubtful accounts is an estimated expense, it should not be deducted. Therefore, Equities should also pay the $158,906 in addition to the $53,822 that it has agreed to pay. Furthermore, Equities should pay the remaining $10,143 (pertaining to overstated repair and maintenance expenses) pending review by DCAS of Equities' claim for additional depreciation expenses.

2. Ensure that capital expenditures are properly recorded and expended over the useful lives of the assets.

   ***Equities Response:* "**Equities agrees that it is its responsibility to properly account for capitalized expenditures and ensure they are expended over the useful lives of the assets."

3. Maintain appropriate records to support reported revenue and expenses, as required by the lease agreement.

   ***Equities Response:* "**Equities agrees that it is its responsibility to maintain appropriate records to support reported revenue and expenses, as required by the lease agreement."

4. Cease increasing cash sales by actual accounts-receivable write-offs and stop deducting the estimated uncollectible accounts receivable as operating expenses in its calculation of percentage rent due.

   ***Equities Response:* "**Equities believes it is correctly calculating profit and will not change the methodology. In addition, Equities believes the provision for doubtful accounts in an includable operating expense and will not adjust the calculation."

   Auditor Comment: Equities' belief that it is correctly calculating profit is misguided. As previously stated, the change in accounts receivable that Equities uses includes accounts-receivable write-offs, which distorts the actual amount of cash sales for the year. In addition, as previously stated, Equities should cease taking a deduction for estimated expenses, which are not allowed under the agreement. Therefore, Equities should reconsider its position on this matter.

We recommend that DCAS should:

5. Ensure that Equities pays $222,871 for additional Percentage Rental and comply with the audit's other three recommendations.

   DCAS Response: "The Department of Citywide Administrative Services will enforce the recommendations in the report by taking the following actions:

   1) Notify the Empire State Development Corporation to bill Hyatt Equities L.L.C. in the amount of $225,335[1] for percentage rent as identified in the audit report and pursue collection of that amount as necessary;

   2) Continue to periodically audit Hyatt Equities L.L.C. account to ensure ongoing compliance with the other recommendations of the audit report."

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[1] The Draft report stated that the amount due from Hyatt was $225,335. This amount was revised as a result of our review and acceptance of additional information provided by Hyatt.

Appendix I

Schedule of Percentage Rental Fee

	Per Hyatt Calculations	Auditor Adjustments	Adjusted Total
Gross Income	$113,168,464	$ -	$113,168,464
Expenses			
Departmental	50,671,622	-	50,671,622
Administrative (Unallocated operating)	22,141,674	(212,903)	21,928,771
Management Fee	10,905,612	74,516[3]	10,980,128
Tax Equivalency Fees and Taxes	1,814,547	-	1,814,547
Depreciation	6,055,336	10,457[4]	6,065,793
Debt Service on 1st Leasehold Mortgage	8,354,000	-	8,354,000
Profits	$ 13,225,673	$ 127,930	$ 13,353,603
Auditor Adjustment - Allowance for Doubtful Accounts	-	317,813	317,813
Adjusted Profits	$ 13,225,673	$ 445,743	$ 13,671,416
Percentage Rental			
10% of first $500,000 of profits	50,000		50,000
12.5% of next $1,000,000 of profits	125,000		125,000
15% of next $1,000,000 of profits	150,000		150,000
20% of next $1,000,000 of profits	200,000		200,000
30% of next $1,000,000 of profits	300,000		300,000
40% of next $1,000,000 of profits	400,000		400,000
50% of any additional profits	3,862,837		4,085,708
Percentage Rental	$ 5,087,837	$ 222,871	$ 5,310,708

Understated Profits	Amount	Percentage Applied to Additional Profits	Additional Percentage Rent
Overstatement of Operating Expenses	$127,930	50%	$ 63,965
Unallowable Deduction for Doubtful Accounts	317,813	50%	158,906
Total	**$445,743**		**$222,871**

[3] The Incentive Management fee, which is a fixed percentage of Grand Hyatt's net operating income, increased due to the decrease of Grand Hyatt's operating expenditures. (See Appendix III.)

[4] We calculated the additional amount of depreciation expenses because of the additional depreciable fixed assets cited in this report. (See Appendix II.)

Appendix II

Schedule of Deductible Depreciation Expenses

	Per Hyatt Calculations	Auditor Adjustments	Adjusted Total
Buildings & Improvements	$136,288,211	$ 94,725	$136,382,936
Leasehold Interest	13,188,653	-	13,188,653
Total Capital Expenditures	149,476,864	94,725	149,571,589
Less: First Mortgage Principal	(70,000,000)	-	(70,000,000)
Excess over First Mortgage	79,476,864	94,725	79,571,589
Allowable Depreciation %	53.17%	-	53.20%
2002 Depreciation Expense			
Buildings & Improvements	1,825,444	2,000	1,827,444
Leasehold Interest	135,849	-	135,849
Total	1,961,293	2,000	1,963,293
Allowable Depreciation %	53.17%	-	53.20%
Allowable Depreciation	1,042,820	1,646	1,044,465
Furniture, Fixtures and Equipment Depreciation	5,012,516	8,811	5,021,327
Total Depreciation	**$ 6,055,336**	**$ 10,457**	**$ 6,065,792**

Appendix III

Schedule of Management Fee

	Per Hyatt Calculations	Auditor Adjustments	Adjusted Total
Basic Management Fee			
Total Revenue	$112,963,869	$ -	$112,963,869
Less: Rental Income	2,220,154	-	2,220,154
Gross Receipts	110,743,715	-	110,743,715
Basic Fee Percentage	4%	-	4%
Total Basic Fee	$ 4,429,749	$ -	$ 4,429,749
Incentive Management Fee:			
Operating Net Income	$ 40,161,964	$ 212,903	$ 40,374,867
Less:			
Provision for Replacement of and additions to furnishings and equipment	(4,429,749)	-	(4,429,749)
Real Estate taxes, per agreement	(2,000,000)	-	(2,000,000)
Basic Fee	(4,429,749)	-	(4,429,749)
Debt Service on 1st Mortgage, per agreement	(10,800,000)	-	(10,800,000)
Profit	18,502,466	212,903	18,715,369
Incentive Fee Percentage	35%	35%	35%
Total Incentive Fee	$ 6,475,863	$ 74,516	$ 6,550,379
Management Fees:			
Basic	$ 4,429,749	$ -	$ 4,429,749
Incentive	6,475,863	74,516	6,550,379
Total Management Fee	**$ 10,905,612**	**$ 74,516**	**$ 10,980,128**

April 11, 2005

Mr. Greg Brooks
Deputy Comptroller
The City of New York
Office of the Comptroller
Executive Offices
1 Centre Street
New York, NY 10007-2341

Re: **Hyatt Equities Response to Audit Report on the Compliance of Hyatt Equities, LLC With its Lease Agreement FM04-118A**

Dear Mr. Brooks:

Enclosed is Hyatt Equities' revised response to the above-referenced draft report. After your review, please let us know if you are in agreement with our responses. If you have any questions regarding this response, please contact me at 312-780-5430.

Sincerely,

Kathleen Sullivan

Enclosure

Written Response to Draft Audit Report on the Compliance of Hyatt Equities, LLC, With its Lease Agreement

Written Response to Draft Audit Report on the Compliance of Hyatt Equities, LLC, With its Lease Agreement dated January 27, 2005 on financial operations and percentage rent paid to the City of New York by the Grand Hyatt New York for 2002.

The City of New York, Office of the Comptroller (City) audited the financial operations of the Grand Hyatt New York (GHNY) for the year ended December 31, 2002, in order to verify the accuracy of the percentage rental payments made to the City of New York for this year. The City concluded per the draft response dated January 27, 2005 that the GHNY in its statements submitted to the City, understated its 2002 net profits and consequently understated the percentage rental due to the City by $225,335 for that year. Hyatt Equities, L.L.C. (Equities), the owner of the hotel property, disputes the findings as noted below

Repair and Maintenance Costs

City Finding: In 2002, GHNY misclassified certain tangible assets as repair and maintenance expenses. In addition, Equities was unable to provide supporting documentation for one repair and maintenance expense totaling $12,448. After reclassifying tangible assets as capital improvements and deducting applicable depreciation expense and management fees, the City calculated that GHNY understated 2002 net profits by $132,858, resulting in additional Percentage Rental fees of $66,429.

Equities Response: Equities has chosen not to dispute the City's finding; however, Equities does not agree with the calculation. Please see attached Schedule A. An adjustment will be made to capitalize the expenses over their useful lives.

Calculation Errors

City Finding: Cumulatively, as of December 31, 2002, Equities understated net profits by $317,813 due to the net amount of the allowance for uncollectible accounts and bad debt expense taken as a deduction. The City calculated that Equities owes $158,906 in additional Percentage Rental fees.

Equities Response: Since the inception of the lease, Equities has included a deduction for the provision for doubtful accounts within the lease calculation. According to Exhibit F (6) of the Lease,

"In determining Gross Income, Expenses, Excluded Receipts and Excluded Expenses, Landlord and Tenant agree that the Uniform System of Accounts for Hotels dated 1971, adopted by the American Hotel and Motel Association, as such system may be subsequently revised, shall be utilized…"

Written Response to Draft Audit Report on the Compliance of Hyatt Equities, LLC, With its Lease Agreement

According to the Ninth Edition of the Uniform System of Accounts for the Lodging Industry (edition in effect in 2002), the provision for doubtful accounts which includes, "a charge adequate to provide for the probable loss in collection of accounts and notes receivable" should be included within administrative and general expenses. Exhibit F (2) (e) of the Lease lists administrative and general services as an includable expense. Accrual basis accounting includes the use of estimates. The provision for doubtful accounts represents an estimate of expenses incurred.

Because the hotel records revenue on the accrual basis, a calculation is necessary to reflect cash basis revenue. This calculation adjusts accrual basis revenue by the change in the accounts receivable account. Despite prior audits and reviews, this practice has not been challenged.

RESPONSE TO RECOMMENDATIONS

1. Equities will remit $53,822 in additional Percentage Rental fees which includes a credit for the depreciation allowance that should have been taken in the 2003 calculation for the newly capitalized items to Empire and the City (see attached schedules).

2. Equities agrees that it is its responsibility to properly account for capitalized expenditures and ensure they are expended over the useful lives of the assets.

3. Equities agrees that it is its responsibility to maintain appropriate records to support reported revenue and expenses, as required by the lease agreement.

4. As stated in the response above, Equities believes it is correctly calculating profit and will not change the methodology. In addition, Equities believes the provision for doubtful accounts is an includable operating expense and will not adjust the calculation.

SCHEDULE A

Schedule of Percentage Rental Fee

	Per Hyatt Calculations	Auditor Adjustments	Adjusted Total
Gross Income	113,168,464		113,168,464
Less Expenses:			
Departmental expenses	50,671,622		50,671,622
Unallocated expenses	22,141,674	(212,903)	21,928,771
Management fees	10,905,612	74,516	10,980,128
Tax equivalency fees & taxes & rent	1,814,547		1,814,547
Depreciation allowance, as defined	6,055,336	10,457	6,065,793
Debt service-First Mortgage (fixed)	8,354,000		8,354,000
Total Expenses	99,942,791	(127,930)	99,814,861
Profit	13,225,673	127,930	13,353,603
10% of first $500,000	50,000		50,000
12.5% of next $1,000,000	125,000	-	125,000
15% of next $1,000,000	150,000	-	150,000
20% of next $1,000,000	200,000	-	200,000
30% of next $1,000,000	300,000	-	300,000
40% of next $1,000,000	400,000	-	400,000
50% of any additional	3,862,837	0	3,926,802
Percentage Rental	5,087,837	63,965	5,151,802
Understated Profits			
Overstatement of operating expenses	127,930	50%	63,965
2003 Adjustment for Depreciation	(20,287)	50%	(10,143)
			$ 53,822

SCHEDULE B

Schedule of Management Fee

Basic Management Fee	Per Hyatt Calculations	Auditor Adjustments	Adjusted Total
Total Revenue	112,963,869	-	112,963,869
Less: Rental Income	2,220,154	-	2,220,154
Gross Receipts	110,743,715	-	110,743,715
Basic Fee Percentage	4%	-	4%
Total Basic Fee	4,429,749	-	4,429,749
Incentive Management Fee			
Operating Net Income	40,161,964	212,903	40,374,867
Less:			
Provision for Replacement of and additions to furnishings and equipment	(4,429,749)	-	(4,429,749)
Real Estate taxes, per agreement	(2,000,000)	-	(2,000,000)
Basic Fee	(4,429,749)	-	(4,429,749)
Debt Service on 1st Mortgage, per agreement	(10,800,000)	-	(10,800,000)
Profit	18,502,466	212,903	18,715,369
Incentive Fee Percentage	35%	35%	35%
Total Incentive Fee	6,475,863	74,516	6,550,379
Management Fees:			
Basic	4,429,749	-	4,429,749
Incentive	6,475,863	74,516	6,550,379
Total Management Fee	10,905,612	74,516	10,980,128

SCHEDULE C

Schedule of Deductible Depreciation Expenses - 2002

	Per Hyatt Calculations	Auditor Adjustments	Adjusted Total
Buildings & Improvements	136,288,211	94,725	136,382,936
Leasehold Interest	13,183,653	-	13,183,653
Total Capital Expenditures	149,476,864	94,725	149,571,589
Less: First Mortgage Principal	(70,000,000)	-	(70,000,000)
Excess over First Mortgage	79,476,864		79,571,589
Allowable Depreciation %	53.17%		53.20%
2002 Depreciation Expense			
Buildings & Improvements	1,825,444	2,000	1,827,444
Leasehold Interest	135,849	-	135,849
Total	1,961,293	2,000	1,963,293
Allowable Depreciation %	53.17%		53.20%
Allowable Depreciation	1,042,820		1,044,465
FF&E Depreciation	5,012,516	8,811	5,021,327
Total Depreciation	6,055,336	8,811	6,065,792
			10,457

Schedule of Deductible Depreciation Expenses - 2003

Buildings & Improvements	143,046,912	94,725	143,141,637
Leasehold Interest	13,188,653		13,188,653
Total Capital Expenditures	156,235,565	94,725	156,330,290
Less: First Mortgage Principal	(70,000,000)	-	(70,000,000)
Excess over First Mortgage	86,235,565	94,725	86,330,290
Allowable Depreciation %	55.20%		55.22%
2003 Depreciation Expense			
Buildings & Improvements	1,972,689	3,789	1,976,478
Leasehold Interest	135,849		135,849
Total	2,108,538	3,789	2,112,327
Allowable Depreciation %	55.20%		55.22%
Allowable Depreciation	1,163,826	-	1,166,491
FF&E Depreciation	3,197,485	17,622	3,215,107
Total Depreciation	4,361,311		4,381,597
			20,287

SCHEDULE D

Building Depreciation
Straight line method, 25 year life

Date in Service	Amount	Depreciation Expense
3/9/2002	26,458	862
5/3/2002	6,467	172
6/28/2002	5,508	129
7/31/2002	16,789	336
8/16/2002	11,960	199
9/20/2002	14,746	197
11/5/2002	6,292	42
11/15/2002	6,505	43
	94,725	2,000

FF&E Depreciation
Straight line method, 6 year life, half year convention

Various 2002	105,730	8,811

2003 Depreciation Expense

Building	94,725	3,789
FFE	105,730	17,622
		21,411

DEPARTMENT OF CITYWIDE ADMINISTRATIVE SERVICES
DIVISION OF REAL ESTATE SERVICES

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Martha K. Hirst
Commissioner

Lori Fierstein
Deputy Commissioner

Citywide Personnel Services

Facilities Management & Construction

Municipal Supply Services

Real Estate Services

Citywide Equal Employment Opportunity

Citywide Occupational Safety & Health

Transportation Services

The City Record

CityStore

February 10, 2005

Greg Brooks
Deputy Comptroller for Audits,
Accountancy & Contracts
Office of the City Comptroller
1 Centre Street
New York, NY 10007-2341

RE: Draft Audit Report on the Compliance of
Hyatt Equities, L.L.C.
With Lease Agreement (FM04-118A)
Account #386
Block 1280, Lot 30
Borough of Manhattan

Dear Mr. Brooks:

Thank you for the opportunity to respond to the above captioned draft report dated January 27, 2005.

Please be advised that the Department of Citywide Administrative Services will enforce the recommendations in the report by taking the following actions:

1) Notify the Empire State Development Corporation to bill Hyatt Equities L.L.C in the amount of $225,335 for percentage rent as identified in the audit report and pursue collection of that amount as necessary;

2) Continue to periodically audit the Hyatt Equities L.L.C. account to ensure ongoing compliance with the other recommendations of the audit report.

If this matter requires further discussion please contact Shelley Goldman, Deputy Assistant Commissioner for Property Management and Leasing at (212) 669-4019.

Sincerely,

Barry Gendelman
Assistant Commissioner
Bureau of Property Management & Leasing

C: Martha K. Hirst
Lewis Finkelman
Lori Fierstein
Richard Friedman
Shelley Goldman
Chris Lane