

AUDIT REPORT

Division of Real Estate

Revenue Leases

July 2017

**Office of the Auditor
Audit Services Division
City and County of Denver**



**Timothy M. O'Brien, CPA
Denver Auditor**



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Report Year: **2017**



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July 20, 2017

AUDITOR'S REPORT

We have completed an audit of Real Estate Revenue Leases. These leases are for City-owned property leased to third parties that are managed or co-managed by the Division of Real Estate (Real Estate). The purpose of the audit was to evaluate whether Real Estate effectively monitors leases to ensure that payments on rental revenue leases are properly received, whether lessees comply with all other lease terms, and whether justification is documented when leases are granted at below-market or nominal rates.

Our audit revealed that lessees generally comply with lease terms; however, key internal controls were lacking in several areas resulting in undetected lessee payment and reporting deficiencies. Specifically, the lack of reconciliation of payments received resulted in missing and late payments as well as payments remitted in incorrect amounts. Furthermore, the lack of monitoring other lease terms for compliance resulted in several types of reporting and insurance deficiencies. Finally, the criteria and business case for renting at below-market rates, or at nominal rates to business organizations, was not consistently documented.

The audit identified many areas for improvement in internal controls that would ensure accurate and more timely collection of rental revenue owed to the City. Through development of stronger policies and procedures, Real Estate will be better positioned to ensure effective oversight, holding lessees accountable for compliance with all lease terms. Our report provides six related recommendations.

This performance audit is authorized pursuant to the City and County of Denver Charter, Article V, Part 2, Section 1, *General Powers and Duties of Auditor*, and was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We extend appreciation to Real Estate, Denver Arts and Venues, and accounting personnel who assisted and cooperated with us during the audit.

Denver Auditor's Office

A handwritten signature in black ink, appearing to read "Timothy M. O'Brien", is written over a horizontal line.

Timothy M. O'Brien, CPA
Auditor



Real Estate Revenue Leases July 2017

Background

The Division of Real Estate manages the City's real estate portfolio. Responsibilities include conducting administrative tasks, providing oversight, and monitoring compliance with lease terms, as well as managing the amendment and termination processes.

Objective

The objective of the audit was to examine Real Estate's monitoring of City-owned property leases. The audit evaluated the monitoring of lease agreements to ensure that revenue was received and lessees were held accountable for compliance with lease terms. We also evaluated whether there was proper justification and documentation for below-market and nominal leases granted to business organizations.

REPORT HIGHLIGHTS

Highlights

Although lessees generally comply with lease terms, we found that key internal controls were lacking in several areas, resulting in lessee payment and reporting deficiencies going undetected. Specifically, we identified issues in the following areas:

- Lack of lease payment reconciliations
- Missing payments, late payments, and payments remitted in incorrect amounts
- Checks mailed to wrong addresses
- Accounting entries lacked basic information on payee

We also found that lease reporting requirements are not tracked or monitored. Further, certificates of insurance are not properly tracked or monitored. Finally, the criteria and business case for renting at nominal rates to certain business organizations was not properly documented.

Through development of stronger policies and procedures, the Division of Real Estate would be better positioned to ensure effective oversight, holding lessees accountable for compliance with all lease terms. Our report provides six related recommendations.

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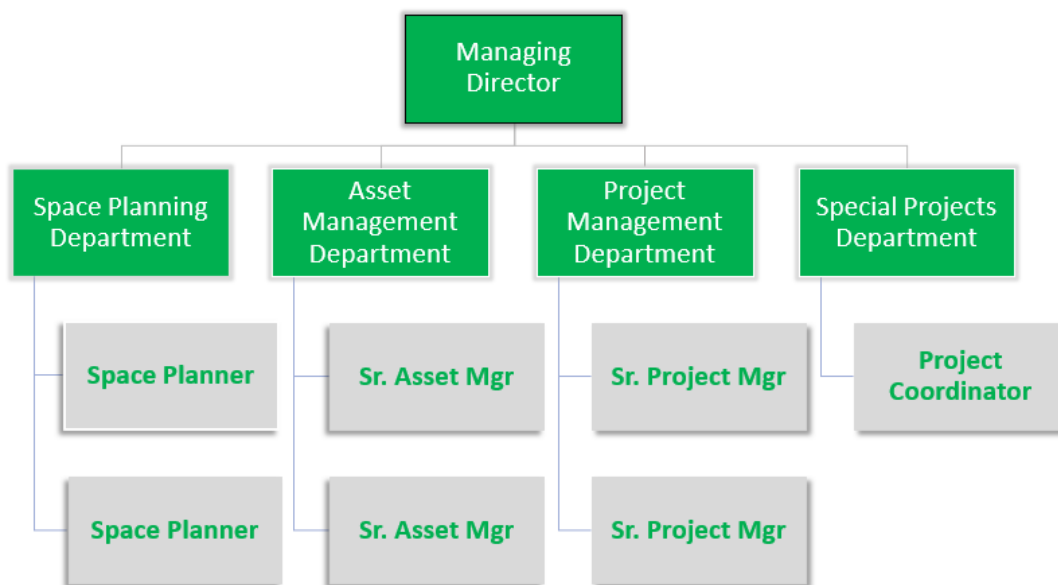
BACKGROUND

The Division of Real Estate

The mission of the City and County of Denver's (City's) Division of Real Estate (Real Estate) is to provide cost-effective management of the City's real estate portfolio, perform real estate services for all City agencies, create ideal working environments for City employees, and proactively meet the City's short- and long-term real estate needs.¹ Real Estate is responsible for real property transactions for all City agencies, except for the Denver Water Board, Denver International Airport, the Denver Art Museum, the Denver Museum of Nature and Science, the Denver Botanic Gardens, and the Denver Zoo. Real Estate also serves in an advisory capacity where real estate powers are vested in other agencies by City Charter, ordinance, or other directive.

The duties and functions of Real Estate include, but are not limited to, acquisition, disposition, exchanging, leasing, space programming and space planning, and uses of real property.² As shown in Figure 1, Real Estate is a relatively small organization with just eight employees. The group seeks to maximize value for the City's real estate portfolio through strategic inventory management and leasing unused City-owned property to business organizations. At the time of the audit, Real Estate was managing 38 revenue leases for various City properties.

FIGURE 1. Division of Real Estate Organizational Chart



Source: City and County of Denver Division of Real Estate.

¹ "Denver Department of Finance / Real Estate," accessed March 10, 2017

<https://www.denvergov.org/content/denvergov/en/denver-department-of-finance/real-estate.html>

² Executive Order No. 100 dated October 5, 2016.

The Division of Real Estate Acts as the Asset Manager for the City's Real Estate Portfolio

Denver Revised Municipal Code §3.2.6, Leases and Contracts, specifies that a lease includes all agreements, permits, contracts, licenses, easements, or other instruments whereby the City grants the exclusive use of all or a portion of real property owned by the City for an indefinite or specific period of time in excess of 30 days.³ All leases of City-owned real property must serve a public purpose, be authorized by the Denver City Council acting by ordinance or resolution, and be signed by the Mayor.⁴

Real Estate carries out responsibilities such as the acquisition, management, and disposition of City-owned real estate and partners with other City agencies, such as Arts and Venues and the Department of Parks and Recreation, to increase the efficiency with which the City uses its land and buildings. For example, finding uses for vacant City-owned property provides opportunities to collect rental revenue by leasing space to businesses that serve the needs of employees and citizens and providing needed space for City agency employees.⁵ Real Estate also leases land and buildings to business organizations that benefit citizens. Some uses include leasing space for cultural events, community and education centers, food banks, and urban gardens. Some of these alternative uses may benefit the City more broadly from an economic perspective, such as providing office space for entrepreneurs to grow startup technology businesses.

Lease Administration Activities

Management of a lease begins when it is fully executed. This includes conducting administrative tasks, providing oversight, and monitoring compliance with lease terms, as well as managing the amendment and termination processes for all City property that is being leased to a third-party. Real Estate works with the Controller's office, and other departments if applicable, to reconcile lease payments on a quarterly basis. From an asset management perspective, Real Estate negotiates lease rates and business terms and in some cases, assists other agencies in the management of their leases.

Administration of Below-Market and Nominal Leases

Under certain circumstances, the City grants leases at below-market value or at nominal lease rates. This requires City Council approval. Agencies requesting to lease to business organizations must submit information addressing specific criteria demonstrating the benefits that the organization provides to the community when leasing City property. Real Estate decides whether or not to proceed with the agreement. If Real Estate moves forward the request, they manage the contract process and submission of the ordinance request to City Council for approval of below-market and nominal lease rates. A below-market rate may be granted on properties that are less than desirable. For example, some City-owned properties have restricted access, reducing potential customer traffic thereby reducing the lessee's ability to maximize revenue. A nominal lease rate may be granted to an organization that does not have the ability to pay market rates. For example, the City leases property to an organization for \$1 per year because the organization provides benefits to the citizens of Denver, and not having to direct financial

³ D.R.M.C § 3.2.6, (A)(ii)

⁴ *Ibid*, (A)(i) and (B).

⁵ City and County of Denver Mayor's 2017 Budget, Division of Real Estate, page 168. The real estate portfolio excludes DIA and certain park land.

resources towards rent allows the organization to provide greater services to the community. In some cases, the lessee has agreed to make property improvements over time in order to provide an additional benefit to the City.

OBJECTIVE

The objective of the audit was to examine Real Estate's monitoring of City-owned property leases. The audit evaluated the monitoring of lease agreements to ensure that revenue was received and lessees were held accountable for compliance with lease terms. We also evaluated whether there was proper justification and documentation for below-market and nominal leases.

SCOPE

Our examination of property leases and related financial transactions covered fiscal years 2015 and 2016. During our examination of these leases, we assessed whether Real Estate adequately monitored lessees' compliance with lease terms. Specifically, we sought to determine whether the City received timely and accurate rental payments, and other lease requirements, reconciled rental payments, and properly documented justification for below-market and nominal leases.

METHODOLOGY

We utilized several methodologies to gather and analyze information related to the audit objectives. The methodologies include the following:

- Interviewing key personnel in Real Estate, the Controller's office, Denver Parks and Recreation, and Denver Arts and Venues to gain an understanding of their roles in monitoring and reconciling rental revenue
- Obtaining and comparing active revenue lease lists from Real Estate and from the City Attorney's Office to identify all active leases
- Reviewing Real Estate's policies and procedures to gain an understanding of monitoring procedures
- Reviewing City Fiscal Accountability Rules for applicable guidance for receiving and reconciling rent payments
- Reviewing City Executive Orders for applicable guidance in contract and lease administration and management
- Reviewing additional best practice guidance regarding monitoring lease agreements for financial and performance compliance
- Selecting a judgmental sample of 29 leases from a population of 38, achieving 77-percent coverage of the population
- Reviewing lease agreements and amendments and documenting key lease terms in preparation to test compliance with lease terms
- Reviewing and testing key lease terms for proper documentation such as completeness of payments received, accuracy of payment calculations, reporting requirements, and existence of certificates of insurance
- Obtaining and analyzing fiscal year 2015 and 2016 accounting system records for rent payments received and comparing them to lease terms
- Evaluating proper recording of rent payments into the accounting system of record for consistent use of rent payment descriptions

- Reviewing below-market and nominal lease agreements to assess the lessees' financial ability to pay a higher rental rate, including reviewing Form 990s
- Reviewing City Council Bill Requests and Ordinance Requests to gain an understanding of the rationale for awarding the 14 below-market leases included in the sample

FINDING

The Division of Real Estate's Limited Controls over Lease Management Has Resulted in Uncollected Payments and Non-Compliance

The Division of Real Estate (Real Estate) is responsible for managing the City's real estate portfolio, which includes inventory management and leasing unused City-owned property to business organizations. Our audit evaluated how Real Estate monitors real estate lease agreements for compliance with agreement terms. We also reviewed below-market and nominal- leases for adequate documentation when granting a discounted rate.

We found that improvement is needed in three areas to strengthen internal control and compliance of real estate lease agreements. First, insufficient internal controls surrounding lease payments has resulted in some uncollected payments and instances of non-compliance. Second, lessees do not consistently provide Real Estate with the monitoring reports that are required by lease agreements, including financial statements, gross sales reports, and number of people served. The information from these reports is necessary for Real Estate to perform proper oversight of lease terms. Third, with regard to below-market or nominal lease rates, we found that the criteria and business cases were not well defined or documented by Real Estate. We make six recommendations to mitigate the risk associated with these findings.

Controls Surrounding Lease Payments and Agreement Terms Should Be Strengthened to Ensure Accurate and Timely Revenue Collection

Evaluating a sample of 29 real estate lease agreements, we sought to determine whether the City is receiving lease payments that are accurate and timely. We found that payment reconciliations are not performed quarterly in accordance with Real Estate's policies and procedures; some lease payments are unaccounted for, incorrect, and delayed; and lessee descriptions within accounting entries for lease payments are inconsistent.

Real Estate Does Not Consistently Perform Lease Payment Reconciliations

According to the City's Fiscal Accountability Rules, reconciliation is the process of comparing information that exists in two systems or locations, analyzing differences, and making corrections so that the information is accurate, complete, and consistent.⁶ Our audit work found that Real Estate personnel could not demonstrate that they are consistently performing reconciliations or retaining documentation of those reconciliations. Specifically, we requested documentation of payment reconciliations to determine whether they are completed quarterly. Real Estate personnel provided documentation of only one reconciliation, which was completed for a lease in which payment terms were being negotiated. Real Estate personnel informed us that they do not retain reconciliations on file after completing them.

We also learned that Accounting Services, in accordance with the Fiscal Accountability Rules, did submit an annual Reconciliation Certification Form on behalf of Real Estate certifying that the agency reconciled all applicable funds for ten periods for the years reviewed within the scope of

⁶ City and County of Denver Fiscal Accountability Rule 2.2 – Reconciliations. Definitions section defines what is means to reconcile information.

the audit.⁷ We requested documentation of this activity from Accounting Services but did not receive the actual reconciliations that were performed to satisfy the annual certification requirement. Regardless, this activity does not satisfy the quarterly reconciliation of payments prescribed by Real Estate's policies and procedures.⁸ Therefore, Real Estate is not in compliance with the Division's internal policies and procedures. Without performing payment reconciliations on a consistent basis, Real Estate is at risk of not identifying all revenue that is owed to the City by lessees.

Payments Were Missing, Late, or Remitted with Incorrect Amounts

The audit also identified several instances where lease payments were missing or late, the amount remitted did not agree to the lease terms, or the payment was posted to the accounting system without identifying the lessee or the period the rent covered. We identified these inconsistencies by extracting payment-received information from PeopleSoft for the period of January 1, 2015, through September 30, 2016, for the leases we selected for testing.⁹ Although Real Estate has a master list showing the monthly payment for each lease, some payment amounts on the master list were incorrect when compared to lease terms. We determined that Real Estate personnel have not been updating the master list when rent escalations provided for in the leases took effect. The following explains in detail the inconsistencies we identified.

Lessees Have Made Incorrect Monthly Payments—The audit identified three leases where the monthly payment amounts on Real Estate's master list were incorrect because rent escalations were not monitored and the master list not updated accordingly. Two of the three lessees paid their correct amount.

For the third lease, we noted that the lessee was still paying at the 2014-2015 lease year rate of \$2,145 per month as of September 30, 2016, costing the City approximately \$700 in lease revenue between March 2015 and September 2016. This was not detected because Real Estate's master list had not been updated for two scheduled rent increases as per the lease terms, which were set for March 2015 and March 2016. In addition, Real Estate did not complete a reconciliation, which would have found the incorrect payments within the lease or the master list.

In addition to not keeping the master list of leases up to date with rent increases, it appears that Real Estate is not reconciling payments received to the terms of the lease contract. As a result, the City may not detect improper rental payments in a timely manner and may not collect all amounts due.

Lease Amendment Not Made Timely—During our test work, we identified a lessee that appeared to not have paid rent for nine months. Further audit work revealed that the nonpayment was due to lack of occupancy; despite signing a lease that commenced January 1, 2016, the lessee could not occupy the space due to a construction delay. However, the situation was not documented in the form of an amendment, which should have been executed to accommodate a delay in payments until the lessee began to occupy the property. The lease requires that any modifications to the terms be "evidenced by a written instrument executed by the parties with the same formality" as the lease.

⁷ Accounting Services is a department within the Financial Services Division in the Controller's Office that provides accounting support to City agencies and departments.

⁸ See Appendix for the Division of Real Estate's Policy and Procedure for Revenue Lease Administration and Management.

⁹ PeopleSoft is the City and County of Denver's system of record that houses all financial transactions.

As of December 31, 2016, the tenant had yet to occupy the property. In the absence of an amendment, the terms of the lease, as written, required that monthly payments commence on January 1, 2016. No payments were made during the period of our audit. Real Estate indicated that a contract amendment is being drafted to address the construction delay. When Real Estate does not execute necessary amendments in a timely manner, lessees are technically out of compliance with the terms and conditions of lease contracts.

Missing Payment Not Detected by Real Estate—During our audit, we identified one lessee who only made 11 monthly payments of \$3,300 instead of 12 during 2015. After we brought the missing payment to the attention of Real Estate personnel, they issued a lost check inquiry.

When assessing how Real Estate personnel did not detect the nonpayment when it occurred, we determined that that Real Estate personnel likely did not complete a reconciliation of amounts due under the terms of the lease. If Real Estate is routinely not reconciling amounts due, they may not be aware of numerous non-payments, which results in the City not receiving all amounts due under lease terms.

Late Payments—We noted some late payments based on posting dates in PeopleSoft. For one lease, the lessee did not pay monthly rent of approximately \$6,700 for four months and then made five payments in the fifth month. The same lease also had five additional payments that were at least one month late.

In determining why late payments were made and not remedied timely, we noted that Real Estate lacks clear, written cash handling policies and procedures. In addition, we noted that PeopleSoft lacks an accounts receivable module, making it difficult for Real Estate to track past due amounts. We also noted that reconciliations to the terms of the lease were not done or were not done timely.

Late payments represent a missed opportunity for the City to earn interest income that would have been accruing on timely deposits. In addition, a lack of timely reconciliations may cause the City to not identify unpaid amounts due in a timely manner.

Change in Contract Terms Not Accounted For—Auditors discovered one lease where an amendment was signed in January 2017 changing rent terms retroactively back to the terms as they existed on July 1, 2016. As of March 2017, Real Estate did not know whether a true-up had been completed, or when it would be completed.¹⁰ In the meantime, the lessee continued to make payments under the prior agreement through September 30, 2016. The difference between what the lessee's actual payments due and the payments made could not be determined due to the nature of the new lease terms and the unknown status of the true-up.

Real Estate did not complete the reconciliation in a timely manner. As a result, the City does not know what additional sums are due from or owed to the lessee at the time we completed our audit.

Year-End Common-Area Maintenance Charges and Utilities Not Collected—For one of the leases in our sample, Common-Area Maintenance (CAM) charges and utilities due during the period we reviewed were either not collected or not collected timely. CAM charges and utility billings totaling approximately \$14,700 for the fourth quarter of 2015 through the second quarter of 2016 were not received until December 2016. CAM charges and utility billings totaling approximately

¹⁰ A "true-up" is a reconciliation of amounts received to date under the original lease terms with the amounts that are due under the new lease terms.

\$11,000 at the end of 2016 had not been received at the time we completed our audit fieldwork. In addition, we noted that the lease contract requires past due payments to accrue interest at a rate of 12 percent per annum. It also appears that the City did not charge nor did the City receive interest due on past due payments. Real Estate stated that the late fees were not charged because the delay with assessing the CAM charges is the City's responsibility.

Two factors contributed to the CAM charges not being collected. First, we determined that Real Estate personnel did not complete a reconciliation of CAM charges timely, thereby they were not aware of the amount owed. Second, Real Estate was in negotiations with the lessee to possibly reduce their rent. Failure to properly and timely reconcile payments received to the terms of the lease contract, specifically with regard to interest on past due amounts, results in the City not receiving interest payments to which it is entitled.

Contract Calculation Error—One of the lease contracts in our sample appears to have had a calculation error that was not detected or corrected. The contract specifies that the total amount of rent due over the three-year term of the lease is \$43,200. However, the contract also specifies that the monthly rent due is \$900 per month. Over the three-year term of the lease, these monthly payments would only amount to \$32,400, resulting in a shortage of \$10,800. It is unclear whether the monthly payment due was incorrect or if the three-year total was incorrect. If the grand total was intended to be \$43,200, then the City is forgoing over \$10,000 in lease payments over the term of the lease.

Lessee Not Always Identified in Accounting Entries—Monthly accounting entries that record receipt of rental revenue are handled differently based on the type of lease. For example, the Controller's Office handles accounting for rental receipts remitted directly to the City and some leased facilities have their own accounting staff that handle the day-to-day accounting for rental receipts in separate accounting systems and report the transactions to either the agency with oversight, or directly to the City.

During our use of the PeopleSoft system to assess the payments for the leases in our sample, we noted inconsistent and inaccurate data entry. For example, some payments recorded in PeopleSoft did not include the name of the lessee that made the payment. In one case, the lessee name was input eleven different ways in during 2015 and 2016, including various abbreviations, partial names, listing the street name, using the wrong name, and simply entering "Facility Lease Rental."

We also noted numerous other payments by other lessees with the "Facility Lease Rental" description. In most cases, we could match the payments to the associated lease based on the dollar amount of the payment. However, there were three payments in March 2015 totaling \$17,231 that we could not match to a lease.

In determining why these types of imprecise entries are occurring, we found that direction was not provided to agencies that would be entering payment information into PeopleSoft. Additionally, PeopleSoft does not have an accounts receivable module. An accounts receivable module would generally allow unique, consistent identifiers to be assigned to each lessee and require that they be used once established. Without established unique identifiers, accounting staff must enter a description for each transaction that may not be consistent from month to month.

As a result, the City does not know which lessees are behind on rent and by how much, which may cause the City to either forgo rental amounts due or to receive payments belatedly, which

may cause the City to forgo interest that could have been earned had rent payments been made timely.

Several Sources Provide Guidance for the Proper Administration of Lease Payments

In accordance with Executive Order 100, Real Estate is responsible for real property transactions of all agencies that are subject to the Order.¹¹ Further, Executive Order 8, Memorandum A, requires the initiating authority for a contract to establish policies and procedures for monitoring contracts. Collectively, this City guidance clearly establishes Real Estate as the responsible party for managing the leases over the City's real property.

Executive Order 8, Memorandum A, requires the initiating authority for a contract to establish policies and procedures for monitoring contracts.

More specifically, Real Estate's written policies and procedures require certain activities that should contribute to proper oversight of lease provisions, including populating the Division's lease database with terms, square footage, and rent for each lease contract. These procedures also require Real Estate to establish a date by which quarterly rent reconciliations shall be submitted to the Controller's Office.

Another applicable piece of City guidance is found in Fiscal Accountability Rule 2.2 regarding reconciliations. The rule states that all agencies must, on a monthly basis, analyze general ledger accounts, including reviewing account activity and assessing the activity for reasonableness and completeness, documenting this work for review by the Controller's Office.

The federal government also provides useful guidance. The U.S. Government Accountability Office in its "Green Book" emphasizes the importance of establishing an effective internal control system to provide reasonable assurance that an organization will achieve its objectives.¹² Green Book section OV.4.08 characterizes documentation as necessary for the effective design, implementation, and operating effectiveness of an entity's internal control system. Green Book section 3.10 elaborates: "effective documentation assists in management's design of internal control by establishing and communicating the who, what, when, where, and why of internal control execution to personnel." Finally, Green Book section 16.05 tasks management with the responsibility of ongoing monitoring, which specifically includes performing reconciliations.

Overall, we noted that Real Estate is not reconciling lease payments in a timely manner, if at all. We also noted that there is no guidance for agencies responsible for entering lessee payments into PeopleSoft to identify the lessee and associated payment period. Real Estate also lacks a system for tracking outstanding receivables. As result, the City is at risk for not receiving rent and other payments.

¹¹ Executive Order 100 – City-Owned and Leased Real Estate provides guidance associated with the management and oversight of City property regarding acquisition, disposition, leasing, and facility management, and space planning and programming.

¹² U.S. Government Accountability Office, *Standards for Internal Control in the Federal Government* (GAO-14-704G), section OV3.02.

RECOMMENDATION 1.1

The Division of Real Estate's policies and procedures should be more clearly defined to ensure periodic reconciliations of rent and other payments (e.g. utilities, percentage of gross sales, etc.) due to the City from lease contracts. These reconciliations should be completed quarterly or more frequently if prescribed by lease terms. The procedures should address the following elements:

- Key terms to be reconciled
- Frequency of reconciliations
- Dates for completing and reviewing reconciliations and responsible parties
- Reconciliation records maintenance and retention

In addition, payment term calculations should be reviewed for accuracy for each new or amended lease.

Agency Response: Agree, Implementation Date – October 10, 2017

RECOMMENDATION 1.2

The Director of the Division of Real Estate should work with the Controller's Office to develop a procedure that requires accounting entries to be standardized to ensure that the lessee's legal name and the period the payment covers are included in the description. This policy should be used until the accounts receivable module is available in Workday and it is our recommendation that the Division of Real Estate utilize the accounts receivable module that will allow for payment identification with the use of unique identifiers for each lessee.

Agency Response: Agree, Implementation Date – October 10, 2017

Checks Mailed to the Wrong Address Cause Delays in Deposits and Increase the Risk of Lost Checks

In our test work, we noted several payments recorded several months after their due dates in PeopleSoft, the City's accounting system. For example, we noted one lease that had five payments made in the same month. Four of those rent payments, totaling nearly \$26,900, were for the preceding four months. In addition, a lost payment from 2015 was still outstanding in 2017.

Real Estate personnel indicated that there are several reasons that this occurred. Some checks were mailed to the wrong address; some were mailed to one department and then transferred to another department for deposit; others might "float" in the building until someone sends it to the proper division for deposit; and at times these checks are made payable to the wrong payee.

In addition, we noted that Real Estate does not have appropriate written check handling policies and procedures. We also noted that Real Estate does not utilize the online payment functionality established by Enterprise Cashiering Solution (ECS), a City agency that oversees online payment functionality.

Several sources of relevant guidance emphasize the importance of timely deposit of rent payments. Executive Order 100 makes Real Estate responsible for real property transactions of all subject agencies. We also noted that Executive Order 8, Memorandum A requires the initiating authority for a contract to establish policies and procedures for monitoring contracts. Payments associated with Real Estate's responsibility over lease contracts should be administered with an effective system of internal controls, as outlined in GAO's Green Book. Specifically, the guidance states that an effective internal control system provides reasonable assurance that the organization will achieve its objectives with an internal control system that is effectively designed, implemented, and operating in an integrated manner."¹³

Even if Real Estate's internal controls surrounding rental payments was stronger, there is an argument for moving away from paper checks and toward electronic funds transfer. The Government Finance Officers Association (GFOA) has positioned electronic payment systems as superior to using paper checks. GFOA's Best Practice Guide on electronic payment touts the advantages to both governments and citizens of accepting electronic collections, including accelerated receipts and availability of funds, ease of payment and customer convenience, reduced cashiering costs, and reduced return check processing costs.¹⁴

The Government Finance Officers Association has positioned electronic payment systems as superior to using paper checks.

Until Real Estate strengthens controls in this area, rental payments may not be processed timely, erroneously flagging a payment as late that was merely not processed timely. Not processing payments timely can increase the risk of a payment being lost and bear a financial cost to the city. It may also cause the city to forgo interest that may have otherwise been earned had the deposit been made timely.

RECOMMENDATION 1.3

The Director of the Division of Real Estate should create a check handling policy and procedure to account for all checks received from lessees. The procedure should include a method to log checks and guidance to alert the lessee when timely payment is not received. When possible, Real Estate should encourage lessees to use the City's on-line payment system to mitigate risk of loss associated with manual checks.

Agency Response: Agree, Implementation Date – September 10, 2017

¹³ U.S. Government Accountability Office, *Standards for Internal Control in the Federal Government* (GAO-14-704G), section OV3.02.

¹⁴ "Best Practice: Electronic Payment and Electronic Collection Systems", Government Finance Officers Association, accessed March 22, 2017, <http://www.gfoa.org/sites/default/files/GFOATIMBPECommerce.pdf>.

Lease Reporting Requirements Are Not Tracked or Monitored

For certain leases, oversight responsibility is shared between Real Estate and another agency. Some agencies use a third-party firm to oversee day-to-day operations and perform the accounting function for the lessee. This is the case for four leases in our sample that are co-managed by Real Estate and Denver Arts and Venues. As a result, we found that some performance reports are sent to Denver Arts and Venues by the third-party firm without copies being provided to Real Estate.

Contract procedures over leases (and other types of contracts) are defined in Executive Order 8 “Contracts and Other Written Instruments of and for the City and County of Denver,” dated May 31, 2011 and the related Memorandum A. The Executive Order states that monitoring contract compliance does not end when a contract is executed. “Each department or agency must ensure contract compliance throughout the life of the contract.” Memorandum A further identifies two areas as the responsibility of the initiating authority. First is to establish and implement policies and procedures to effectively monitor contracts by (a) identifying responsible parties to be accountable, (b) defining steps for addressing non-compliant lessees, and (c) establishing procedures to ensure payments are received timely. Second, performance should be monitored throughout the life of the contract, including ensuring that all terms of the contract are met, bonding and insurance requirements are met, and the monitoring process and receipt of deliverables is documented. A specific person should be responsible for oversight of all key terms in the lease throughout the life of the contract. This can include payments, reporting requirements, capital improvements, etc..¹⁵

Oversight of co-managed leases should be assigned to the authority responsible for the lease. Real Estate is the responsible authority for the leases we tested. In addition, Real Estate’s internal policies and procedures align with Executive Order 8, stating, “Lease administration and management refers to the administrative process, oversight and compliance of the lease terms.” Real Estate cannot perform all oversight and compliance activities without being informed of all activities being carried out by the third party for certain leases.

RECOMMENDATION 1.4

The Director of the Division of Real Estate should develop policies and procedures to track and ensure that all reporting requirements stated in leases are met, centralizing the responsibility in the Division of Real Estate. A lease abstract with all requirements listed should be completed and kept up-to-date for each lease and subsequent amendments, incorporating any lease escalation payment schedules and term changes. The abstract will provide an effective tool to monitor key terms in the lease and aid in reconciliation of payments.

Agency Response: Agree, Implementation Date – October 10, 2017

¹⁵ City and County of Denver, Executive Order 8, “Contracts and Other Written Instruments of and for the City and County of Denver,” accessed March 14, 2017, <https://www.denvergov.org/content/dam/denvergov/Portals/executiveorders/8-Contracts-Other-Written-Instruments-CCD.pdf>.

Certificates of Insurance Are Not Properly Tracked or Monitored

Auditors reviewed the Certificates of Insurance (COI's) for all leases in our sample, comparing the coverage in effect to the coverage required by the lease terms. Insurance requirements are written into each lease, and lessees are required to provide a current COI each year to the City. The City can then verify that all required insurance is current and meets the type and minimum dollar coverage thresholds as required in the lease. However, we found several instances where specific coverages named in the leases were missing or below the required coverage amount. For example:

- One lease tested required \$1 million liquor insurance coverage, but the COI showing proof of this coverage was missing from the file. Real Estate subsequently obtained a new COI with the liquor insurance included.
- Three insurance policies for one lease did not name the City and County of Denver as an additional insured, as required by the lease terms.
- Seven leases were missing workers' compensation insurance, and one lease was missing auto liability insurance, as required in the lease. Real Estate personnel explained that they were told by an insurance and loss analyst in the Department of Finance that the workers' compensation and the auto liability insurance coverages were not required.

Executive Order 8, Contracts and Other Written Instruments of and for the City and County of Denver, states that "the requesting Department/Agency shall provide to the City Attorney and Risk Management written evidence that the specified insurance requirements have been satisfied."

In determining why some insurance coverage is not documented or not in alignment with lease requirements, we noted that Real Estate does not consistently obtain new COIs from lessees in a timely manner when subsequent COIs expire. Furthermore, it appears that Real Estate does not consistently review COIs to ensure that they align with the terms of the lease. As a result, lessees of City property may not carry adequate insurance, exposing the City to a risk of loss.

RECOMMENDATION 1.5

The Division of Real Estate should ensure that current Certificates of Insurance are on file and monitored to ensure that they comply with all key terms of the lease. The Division of Real Estate's policies and procedures should be developed to review, track, and verify each required insurance element annually for each lease.

Agency Response: Agree, Implementation Date – October 10, 2017

Limited Documentation for Granting Below-Market Rate or Nominal Leases

Some lessees are granted rent terms that are below-market rates or nominal rates such as a \$1 per year lease rate. Decisions made to grant nominal rent terms are usually based on the benefit the business or service would bring to the community. In reviewing the justifications for 15 leases

with below-market and nominal lease rates, we found that 9 of the 14 nominal leases and one below-market lease had minimal or no documented justification for the rates on file.

According to D.R.M.C. § 3.2.6 – Leases and contracts, all real property leases and lease amendments need to be authorized by City Council through ordinance or resolution. the ordinance or resolution must state the public purpose to be served by the lease of real property. When we reviewed the ordinances and resolutions corresponding with the nominal lease rates in our sample, we found that the reasons for reducing rent were generally not documented. The criteria for each of these decisions should be defined, and a business case documented for each instance.

Executive Order 100, Memorandum No. 100A, sets out six criteria that must be addressed as part of the process of leasing property to business organizations. These criteria are required to be addressed as part of a statement summarizing the proposed terms of the lease, which is provided by a requesting agency to Real Estate for review and approval. Real Estate then determines whether to proceed with the requested lease agreement. If approved, then Real Estate completes the lease contract process, which includes submitting an ordinance for City Council approval. The Ordinance is required to address the six criteria as well. The six criteria include:

- The public purpose of the proposed lease
- Financial considerations for lessee
- City consideration
- Selection process
- Termination clause
- Reporting requirements

The City consideration step requires Real Estate to document and justify that the lease is in the best interest of the City, and whether the benefit to the City is financial or non-financial in nature.

It appears that, in some cases, Real Estate is not adequately enforcing the six criteria noted in Executive Order 100, Memorandum No. 100A. As a result, Real Estate and City Council may not be making fully informed decisions about whether or not to enter into nominal lease rate contracts with potential lessees, which may result in the City not collecting rents which it may have been able to otherwise collect under a different arrangement.

RECOMMENDATION 1.6

The Director of the Division of Real Estate should ensure that documentation for renting City real property at below-market rates or nominal rates to business organizations follow relevant criteria that establish a business case for such an agreement.

Agency Response: Agree, Implementation Date – September 10, 2017

RECOMMENDATIONS

We make the following recommendations to the Division of Real Estate to improve internal controls and monitoring of lease agreements.

- 1.1 **Payment Receipts and Reconciliations**—The Division of Real Estate’s policies and procedures should be more clearly defined to ensure periodic reconciliations of rent and other payments (e.g. utilities, percentage of gross sales, etc.) due to the City from lease contracts. These reconciliations should be completed quarterly or more frequently if prescribed by lease terms. The procedures should address the following elements:

- Key terms to be reconciled
- Frequency of reconciliations
- Dates for completing and reviewing reconciliations and responsible parties
- Reconciliation records maintenance and retention

In addition, payment term calculations should be reviewed for accuracy for each new or amended lease.

Auditee Response: Agree, Implementation Date – October 10, 2017

The Division of Real Estate will review existing policies and procedures and revise where appropriate to better define rent and operating expense reconciliations.

- 1.2 **Accounting Entry Descriptions**—The Director of the Division of Real Estate should work with the Controller’s Office to develop a procedure that requires accounting entries to be standardized to ensure that the lessee’s legal name and the period the payment covers are included in the description. This policy should be used until the accounts receivable module is available in Workday and it is our recommendation that the Division of Real Estate utilize the accounts receivable module that will allow for payment identification with the use of unique identifiers for each lessee.

Auditee Response: Agree, Implementation Date – October 10, 2017

The Division of Real Estate will work with the Controller’s Office to develop a procedure for standardizing accounting entries until Workdays accounts receivable module is active. At that time, the Division of Real Estate will work to standardize entries including legal name and payment period.

- 1.3 **Check Handling**—The Director of the Division of Real Estate should create a check handling policy and procedure to account for all checks received from lessees. The procedure should include a method to log checks and guidance to alert the lessee when timely payment is not received. When possible, Real Estate should encourage lessees to use the City’s on-line payment system to mitigate risk of loss associated with manual checks.

Auditee Response: Agree, Implementation Date – September 10, 2017

The Division of Real Estate will create a check handling policy for the collection of lease payments. The Division of Real Estate will make lessees aware of the City's on-line payment system as an alternative method for rent payments.

- 1.4 Monitoring Reporting Requirements**—The Director of the Division of Real Estate should develop policies and procedures to track and ensure that all reporting requirements stated in leases are met, centralizing the responsibility in the Division of Real Estate. A lease abstract with all requirements listed should be completed and kept up-to-date for each lease and subsequent amendments, incorporating any lease escalation payment schedules and term changes. The abstract will provide an effective tool to monitor key terms in the lease and aid in reconciliation of payments.

Auditee Response: Agree, Implementation Date – October 10, 2017

The Division of Real Estate will review policies and procedures and revise, where appropriate, to address tracking of report requirements and lease abstracting.

- 1.5 Certificates of Insurance**—The Division of Real Estate should ensure that current Certificates of Insurance are on file and monitored to ensure that they comply with all key terms of the lease. The Division of Real Estate's policies and procedures should be developed to review, track, and verify each required insurance element annually for each lease.

Auditee Response: Agree, Implementation Date – October 10, 2017

The Division of Real Estate will review policies and procedures and revise, where appropriate, to address the annual verification and tracking of Certificates of Insurance.

- 1.6 Below-Market and Nominal Leases**—The Director of the Division of Real Estate should ensure that documentation for renting City real property at below-market rates or nominal rates to business organizations follow relevant criteria that establish a business case for such an agreement.

Auditee Response: Agree, Implementation Date – September 10, 2017

The Division of Real Estate will document for the file the rationale for below market rents or nominal rents. This will be in accordance with XO100 Memo A.

APPENDIX

Real Estate Policies and Procedures

REVENUE LEASE ADMINISTRATION AND MANAGEMENT

Lease administration and management begins upon full execution of the lease. Lease administration and management refers to the administrative process, oversight, and compliance of the lease terms. Leases are uniquely managed depending on whether it is a Real Estate portfolio lease or a lease Real Estate co-manages with a City Agency as part of their portfolio.

New Lease Process:

1. When leases are being negotiated (does not apply to \$1/year), competitive lease rates are reviewed in CoStar (commercial RE database) to establish a market rates. Market conditions and deal specific conditions such as; free rent, dollars available for tenant improvement, lease duration and co-tenancy are factored into establishing the rental rate.
2. Negotiate business terms and deliver a letter of intent (LOI).
3. Upon acceptance and signature of LOI, obtain W-9 and request vendor id.
4. Enter lease terms into Alfresco in order to have a City Attorney assigned to develop the contract.
5. File Ordinance Request upon lessee's execution of the lease.
6. Follow City Council process through full City execution of the lease.
7. Upon full execution of the lease, deliver a copy to lessee with details of City contact information for lease management and remittance address for rent payment.
8. Enter lease term, square footage and rent into lease database.
9. Complete hard file including; all executed leases and amendments, insurance certificates and market comps, if applicable.
10. Apply expiration year stickers on the side of lease file and store with other leases.
11. Notify Controller's office of new lease.
12. Notify General Services, Facilities Management and Utilities, if applicable.
13. Establish date for Quarterly rent reconciliation with Controller's Office.

Amendment Process:

1. Confirm within Division of Real Estate that there is no City need for the space before renewing.
2. Confirm with Controller's Office that lessee is current in rent payment.
3. Follow steps above.

Termination Process:

1. Upon end of term, confirm with Controller's Office that lessee is current in rent.
2. Schedule a final walk thru of the space with lessee.
3. Obtain any keys and coordinate with Facilities Management, if applicable.
4. Store closed out file in the file room in terminated lease section.

AGENCY RESPONSE



CITY AND COUNTY OF DENVER

Finance Office
Division of Real Estate

201 WEST COLFAX
DEPARTMENT 1010
DENVER, CO 80202-4705
PHONE: (720) 913-1515
FAX: (720) 865-7585

July 12, 2017

Auditor Timothy O'Brien, CPA
Office of the Auditor
City and County of Denver
201 West Colfax Avenue, Dept. 705
Denver, Colorado 80202

Dear Mr. O'Brien,

The Office of the Auditor has conducted a performance audit of the Division of Real Estate Revenue Leases.

This memorandum provides a written response for each reportable condition noted in the Auditor's Report final draft that was sent to us on June 20, 2017. This response complies with Section 20-276 (c) of the Denver Revised Municipal Code (D.R.M.C.).

AUDIT FINDING 1

The Division of Real Estate's Limited Controls over Lease Management Has Resulted in Uncollected Payments and Non-Compliance

RECOMMENDATION 1.1

Payment Receipts and Reconciliations—The Division of Real Estate's policies and procedures should be more clearly defined to ensure periodic reconciliations of rent and other payments (e.g. utilities, percentage of gross sales, etc.) due to the City from lease contracts. These reconciliations should be completed quarterly or more frequently if prescribed by lease terms. The procedures should address the following elements:

- Key terms to be reconciled
- Frequency of reconciliations
- Dates for completing and reviewing reconciliations and responsible parties
- Reconciliation records maintenance and retention

In addition, payment term calculations should be reviewed for accuracy for each new or amended lease.

Agree or Disagree with Recommendation	Target date to complete implementation activities	Name and phone number of specific point of contact
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	(Generally expected within 60 to 90 days)	for implementation
Agree	90 days	Lisa Lumley 720.913.1515

Narrative for Recommendation 1.1

The Division of Real Estate will review existing policies and procedures and revise where appropriate to better define rent and operating expense reconciliations.

RECOMMENDATION 1.2

Accounting Entry Descriptions—The Director of the Division of Real Estate should work with the Controller's Office to develop a procedure that requires accounting entries to be standardized to ensure that the lessee's legal name and the period the payment covers are included in the description. This policy should be used until the accounts receivable module is available in Workday and it is our recommendation that the Division of Real Estate utilize the accounts receivable module that will allow for payment identification with the use of unique identifiers for each lessee.

Agree or Disagree with Recommendation	Target date to complete implementation activities (Generally expected within 60 to 90 days)	Name and phone number of specific point of contact for implementation
Agree	90 days	Lisa Lumley 720.913.1515

Narrative for Recommendation 1.2

The Division of Real Estate will work with the Controller's Office to develop a procedure for standardizing accounting entries until Workday's accounts receivable module is active. At that time, the Division of Real Estate will work to standardize entries including legal name and payment period.

RECOMMENDATION 1.3

Check Handling—The Director of the Division of Real Estate should create a check handling policy and procedure to account for all checks received from lessees. The procedure should include a method to log checks and guidance to alert the lessee when timely payment is not received. When possible, Real Estate should encourage lessees to use the City's on-line payment system to mitigate risk of loss associated with manual checks.

Agree or Disagree with Recommendation	Target date to complete implementation activities (Generally expected within 60 to 90 days)	Name and phone number of specific point of contact for implementation
Agree	60 days	Lisa Lumley 720.913.1515

Narrative for Recommendation 1.3

The Division of Real Estate will create a check handling policy for the collection of lease payments.

The Division of Real Estate will make lessees aware of the City's on-line payment system as an alternative method for rent payments.

RECOMMENDATION 1.4

Monitoring Reporting Requirements—The Director of the Division of Real Estate should develop policies and procedures to track and ensure that all reporting requirements stated in leases are met, centralizing the responsibility in the Division of Real Estate. A lease abstract with all requirements listed should be completed and kept up-to-date for each lease and subsequent amendments, incorporating any lease escalation payment schedules and term changes. The abstract will provide an effective tool to monitor key terms in the lease and aid in reconciliation of payments.

Agree or Disagree with Recommendation	Target date to complete implementation activities (Generally expected within 60 to 90 days)	Name and phone number of specific point of contact for implementation
Agree	90 days	Lisa Lumley 720.913.1515

Narrative for Recommendation 1.4

The Division of Real Estate will review policies and procedures and revise, where appropriate, to address tracking of report requirements and lease abstracting.

RECOMMENDATION 1.5

Certificates of Insurance—The Division of Real Estate should ensure that current Certificates of Insurance are on file and monitored to ensure that they comply with all key terms of the lease. The Division of Real Estate's policies and procedures should be developed to review, track, and verify each required insurance element annually for each lease.

Agree or Disagree with Recommendation	Target date to complete implementation activities (Generally expected within 60 to 90 days)	Name and phone number of specific point of contact for implementation
Agree	90 days	Lisa Lumley 720.913.1515

Narrative for Recommendation 1.5

The Division of Real Estate will review policies and procedures and revise, where appropriate, to address the annual verification and tracking of Certificates of Insurance.

RECOMMENDATION 1.6

Below-Market and Nominal Leases—The Director of the Division of Real Estate should ensure that documentation for renting City real property at below-market rates or nominal rates to business organizations follow relevant criteria that establish a business case for such an agreement.

Agree or Disagree with Recommendation	Target date to complete implementation activities	Name and phone number of specific point of contact
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	(Generally expected within 60 to 90 days)	for implementation
Agree	60 days	Lisa Lumley 720.913.1515

Narrative for Recommendation 1.6

The Division of Real Estate will document for the file the rationale for below market rents or nominal rents. This will be in accordance with XO100 Memo A.

Please contact Jeff Steinberg at 720.865.7505 or Lisa Lumley at 720.913.1515 with any questions.

Sincerely,


Jeffrey J. Steinberg
Director of Real Estate

cc: Heidi O'Neil, CPA, CGMA, Director of Financial Audits
Dawn Wiseman, Audit Manager