



OFFICE OF INTERNAL AUDIT

Stan Sewell, City Auditor

December 28, 2012

Mayor and City Council
City of Chattanooga
Chattanooga, TN 37402

RE: Real Estate Leases, Audit #12-05

Dear Mayor Littlefield and City Council Members:

Attached is the Office of Internal Audit's report on Real Estate Leases.

We thank the management and staff of the General Services, Finance, Parks and Recreation and Public Works Departments for their cooperation and assistance during this audit.

Sincerely,

Stan Sewell, CPA, CGFM
City Auditor

Attachment

cc: Dan Johnson, Chief of Staff
Audit Committee Members
Dan Thornton, Director, General Services
Daisy Madison, Chief Financial Officer
Larry Zehnder, Administrator, Parks and Recreation
Steve Leach, Administrator, Public Works
Mike McMahan, City Attorney

**GENERAL SERVICES DEPARTMENT
REAL ESTATE LEASES
AUDIT 12-05
November 24, 2012**



Auditor



City Auditor

**GENERAL SERVICES DEPARTMENT
REAL ESTATE LEASES
AUDIT 12-05**

INTRODUCTION

The City of Chattanooga rents or leases many properties throughout the City to various entities/companies. The terms of the leases (monetary and/or non-cash benefits) received as payment vary greatly, dependent upon the type of property being leased or rented, as well as the type of organization (non-profit, business, etc.) involved in the rental. Most properties are leased or rented for cash, but payment may be in other forms. For instance, in return for the use of an indoor softball facility, UTC women's softball is contractually obligated to hold clinics for youngsters from City recreation centers as partial payment, along with paying associated utility bills.

STATISTICS

Cash receipts for rental/lease of real property for fiscal 2011 and fiscal 2012 are as follows:

Fiscal 2011	\$ 1,003,020
Fiscal 2012	\$ 1,073,773

STATEMENT OF OBJECTIVES

This audit was conducted in accordance with the Internal Audit Division's 2012 Audit Agenda. The objectives of this audit were to determine if:

1. All leases contain minimum standard language to provide for the City's best interests, are properly approved, filed and recorded for tracking.
2. Renters/lessees comply with financial and special terms of contracts.
3. Timely follow-up is performed on missed or late lease/rental payments.
4. Collection and deposit of lease/rental payments are in compliance with City Collection Policy.

STATEMENT OF SCOPE

The audit period covered the lease/rental agreements in place as of December 31, 2011, as well as related payment collections. Excluded are leases related to recently completed audits for waterfront dock rentals, Marine Max and Friends of the Festival.

STATEMENT OF METHODOLOGY

We reviewed lease contracts between several entities and the City for pertinent facts related to our audit. We obtained records from various City departments, performing tests to ensure lease/rental terms were followed. Discussions were held with appropriate personnel in departments leasing property to outside entities to determine the duties they performed related to property leases.

Collection reports were tested for adherence to City Finance Department policy. The sample size and selection were statistically generated using a desired confidence level of 90 percent, expected error rate of 5 percent, and a desired precision of 5 percent. Statistical sampling was used in order to infer the conclusions of test work performed on a sample the population from which it was drawn and to obtain estimates of sampling error involved. When appropriate, judgmental sampling was used to improve the overall efficiency of the audit.

To achieve the audit's objectives, reliance was placed on computer-processed data contained in the City financial systems. The City's financial system was previously determined to be reliable and no additional work was necessary.

STATEMENT OF AUDITING STANDARDS

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require 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 the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

AUDIT CONCLUSIONS

Based upon the test work performed and the audit findings noted below, we conclude:

1. Recently prepared leases contain minimum standard language to provide for the City's best interest and proper approvals were obtained. Older leases lacked consistency with

regard to some minimum protective language, such as late payment provisions or audit clauses. Further, all leases are not filed in Finance as the City Code requires;

2. All lessees do not comply with financial or special terms of leases;
3. Timely follow-up is not always performed on missed or late lease payments;
4. Processing of lease/rental payments are not always in compliance with the City Cash Collection Policy.

While the findings discussed below may not, individually or in the aggregate, significantly impair the management of City property, they do present risks that can be more effectively controlled.

FINDINGS AND RECOMMENDATIONS

Inconsistent lease administration

Real property lease management is currently performed by various City departments. Departments managing property leases are Finance, Parks and Recreation, General Services and Public Works. No Citywide policies or procedures have been established for real property lease management.

Only the General Services Department has personnel dedicated to management of property. Some property leases within the City are not tracked for timely payment, have not had applicable late payment fees collected and lack tracking of compliance with non-cash terms. No group within the City is responsible for ensuring real property lease terms are met and renewal/termination of leases occurs upon expiration.

Payments for leases are not received through a single location, but rather are spread among Public Works, General Services, Finance and Parks and Recreation. Many contracts do not specify where payment should be sent (leaving this to the discretion of the lessee). Some payments are billed and received haphazardly, with no assigned collection responsibility if payments are missed.

Some property leases require the lessee to pay the City total revenue received less management fees and certain expenses. Other leases require larger lease payments if revenues from the property exceed a certain amount. We found no instance in the leases reviewed during this audit of a City employee requesting a lessee validate sales amounts or expenses reported in these cases (such as comparison of sales tax returns to sales reported or requesting paid invoices or payroll information to spot check expenses).

The following examples are provided to demonstrate some specific instances of problems noted:

- An entity has leased a portion of a City property for the past several years. The last period billed and payment received was January 2011 because no responsibility had been assigned to bill and receive the funds.
- The City leases garages to an outside company and receives revenue less certain expenses each month. A financial report is received each month from the lessee, but no verification has been performed to determine the financial representations forwarded to the City are correct.
- A property lease requires the lessee to provide annual proof of revenue for the property, with additional payment due if revenue exceeds a certain amount. The information required to determine the correct payment was not provided by the lessee and City personnel did not request the information.
- A property is leased that requires 4% of revenue be placed in a capital improvement fund. No verification of compliance has been performed.
- A lease contract states (in error) the monthly lease payment is \$1,000, while a Council resolution approves the lease with the correct payment of \$1,400 monthly.

Contract administration works best when responsibility and authority are clearly assigned and procedures are documented. No specific procedures exist for directing how leases should be managed, or by whom.

Recommendation 1:

We recommend all responsibility for development and management of property leases within the City be moved to General Services by Executive Order or Ordinance. This department is currently charged with management of City property.

Auditee Response: (Chief of Staff)

We concur.

Auditee Response: (General Services)

We concur with the recommendation if supported by ordinance. Currently, General Services has a small staff with real estate experience. We cannot take the added responsibility for all City leasing unless changes are made to the City Code. As per your recommendations, the following process needs to be approved by Ordinance and added to section 256.

- 1. All leases must be negotiated and executed by the Director of General Services or the Mayor with approval by the Regional Planning Agency and City Council.*
- 2. A boilerplate lease will be developed by the City Attorney and we shall not deviate from this document (WalMart Syndrome).*

3. *All leases will be set up as accounts receivable in the Oracle system, with checks for collection (A/R) sent to a central address: 101 East 11th, Suite 100 and posted against the receivable, with attachments forwarded to General Services to allow confirmation of percentage payments, etc.*
4. *General Services budget analysts must be provided access to the accounts receivable portion of Oracle to generate delinquency reports as necessary.*
5. *Departments will report compliance with non-cash lease activities to General Services at scheduled intervals.*
6. *General Services will contact tenants regarding late payment and enforce any late fees.*
7. *General Services will enforce the terms and conditions of the lease.*
8. *General Services will contact tenant 6 months before termination in order to get approvals by Regional Planning Agency and Council for a new lease term.*

There are approximately 40 known leases on city properties and the city is a lessee at several locations. When a department administrator receives an inquiry on leasing, they should pass it on to General Services with a recommendation. General Services will either go forward or tell the prospect we are unable to complete their request.

Recommendation 2:

We recommend written policies be created and put in place clearly defining responsibilities in the leasing process. The policies and procedures should address, but not be limited to the following:

- Lease negotiation (with input from the affected department) with prospective lessees;
- Interface with the Legal Department on lease development and terminology;
- Acquisition of approval for leases from Regional Planning Authority and City Council;
- Ensuring the lease and Council Resolution have matching terms;
- Cash receipts/collections reports;
- Collection procedures (including monitoring and aging) for late payment/non-payment;
- Work in conjunction with the Legal Department when a breach of contract occurs;
- Collecting data necessary to measure compliance with non-cash terms;
- Request on a regular basis all lessees provide documentation needed to verify the accuracy of payments when the lease is not a set fee, and perform calculations to authenticate proper payments have been made;
- Verification of required insurance coverage.

We also recommend the City Attorney provide a clear set of criteria for General Services to use when developing leases, as well as a clear representation of responsibility and assurances being provided by the City Attorney when legal reviews are conducted. Further, we recommend General Services and City Attorney offices work together to develop timelines and standard procedures to follow when lessees are out of compliance with contract payment terms.

Auditee Response (General Services)

We Concur.

Auditee Response (City Attorney)

We Concur.

Improper filing of lease documents

A copy of all real property leases are not filed in the Finance Department. Per City Code Sec. 2-548 (b) – “The original of all contracts shall be delivered to and kept by the City Finance Officer”. As a result of non-compliance with this code section there is not a central point to collect information related to properties the City has leased to outside entities. This issue has been addressed in previous audits.

Recommendation 3:

We recommend the Finance Department send an annual reminder to all departments that the original of all signed contracts and leases must be filed with the City Finance Office.

Auditee Response: (Finance)

We Concur.

City Collection Policy not followed

We found some lease collections not in compliance with the City Cash Collection Policy. The City Collection Policy was revised in January 2011 to include the requirement checks should be date stamped on the face of the check showing the date received. Twenty-five percent of checks sampled after that date were not date stamped, making it impossible to determine if they were deposited timely. All checks reviewed that had a date stamp had been deposited within the required three days of receipt.

Recommendation 4:

We recommend Finance/Treasury reinforce with employees who review incoming collection reports the need for all checks to have date stamps. We further recommend Finance/Treasury notify City department heads of staff that fail to follow policy.

Auditee Response: (Finance)

We concur.