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Audit Follow-Up Report #10, May 2006

Building Leases

Background

The Auditor's Office issued the audit report *Building Leases: Review Policies and Improve Practices* in May 2004. The purpose of the audit was to determine if building leases were properly initiated, maintained and renewed or terminated, and whether the County was following adopted policy to house long-term programs in owned space.

There have been significant changes in the last two years. Formerly housed under the Contracts and Procurements section, staff in charge of administering leases has been reorganized into the Asset Management section and report directly to the Facilities and Property Management Division (FPM) Director. The Asset Management section is also responsible for managing dispositions of County leased and owned property as guided by the County's Consolidation and Disposition Strategy. Since the audit was issued, all staff administering leases are new to that function and have significant real estate or fiscal experience.

Scope and Methodology

We followed up on all lease recommendations made in the 2004 building leases audit. To accomplish this we reviewed lease files where the County is a tenant and where the County is a landlord. We also read the Consolidation and Disposition Strategy issued in November 2004 and Facilities Strategic Plan issued in August 2005 and a new draft of lease administrative procedures (FAC-3). We interviewed Asset Management and fiscal staff, and looked at the new lease administration database. We reviewed

various internal reports such as the Master Lease Listing, Annual Report of Subsidized Leases, and real estate tax exemption and insurance tracking summaries. This follow-up audit was conducted in accordance with generally accepted government auditing standards.

Accomplishments

Over the last two years, FPM has fully implemented or made significant progress on all of the previous audit's recommendations except one that was directed more towards departments. The recommendations from the 2004 building leases audit and the steps FPM took to address them are detailed below. We commend FPM for their efforts to improve lease administration.

Lease management

In our previous audit we found that departments in the County were independently initiating leases. As a result:

- Space planning suffered because county-wide space needs were not sufficiently taken into account.
- FPM was put in the position of trying to fix leases once they were in process or manage leases that had been poorly set up.
- There was a lack of expertise in negotiation and analysis of leases increasing the risk of higher facility costs.

The 2005 Strategic Facilities Plan, approved by the Board in August 2005, emphasized making facility decisions from a county-wide perspective. To accomplish this objective, all facilities management functions are consolidated into the Facilities and Property Management Division (FPM) in the Department of County Management. While working closely with departments on their space needs, there is clear policy for FPM to manage all stages of the lease process.

Lease procedures

FPM has also worked with departments to draft an administrative procedure (FAC-3) that defines leasing roles and responsibilities for cases where the County is a tenant or a landlord. FPM has hired experienced personnel with two Senior Property Management Specialists who are both licensed Oregon Real Estate Brokers and one Property Management Specialist with extensive fiscal experience.

The draft of administrative procedure FAC-3 defines responsibilities between FPM and departments. At the time of the previous audit, there were few written, internal lease administration procedures for FPM. During the follow-up we found good examples of internal procedures for the real estate tax exemption process and for monitoring and collecting rental income.

Lease initiation

FPM developed a standard space form used to initiate a new lease, change the size of leased space, and renew or terminate a lease. The space form includes a section to capture cost information and must be approved by department management.

In cases where the County is a tenant, we were concerned in our previous audit that the County, by using the landlord's lease form, was less able to effectively monitor its leases and that some critical lease language could be omitted. FPM, working with the County Attorney's Office, has developed standard lease language that is included in all leases. An electronic copy of the lease is available to property managers. Further, as part of their web-based lease administration database, FPM has a system in place to enforce lease maintenance clauses. To further improve enforcement of service commitments in leases, FPM is planning to develop

a quick reference summary sheet of operating and expense responsibilities for the Dispatch section.

While FPM does not have written internal procedures addressing analysis and comparison of lease offers, we found good practices were in place through our review of lease files.

Lease enforcement

There was not a system in place at the time of the previous audit to monitor or enforce leases. Since the audit, FPM has worked with a contractor to develop a web-based lease administration system that is maintained off-site by the contractor. The system monitors important lease dates such as renewals, expirations, or CPI adjustments and sends advance e-mail notifications to FPM staff so they can consistently and timely enforce leases. FPM staff have quick access to the database to interpret lease requirements or conduct other types of analysis. Currently, FPM is working on developing an in-house lease administration system to replace the current system.

Payment monitoring

At the time of the 2004 building leases audit, one-third of tenants leasing space from the County were late making their rental payments—some by months. Currently, all rent from building tenants is up-to-date. FPM has implemented written internal procedures for monitoring rental income and taking appropriate actions when a tenant is past due.

Insurance coverage

At the time of the 2004 building leases audit, there was little evidence that tenants maintained insurance coverage as required by the lease. A process is now in place that tracks the status of all tenant insurance requirements. Past due notices are sent when tenants have not provided evidence of insurance. Periodic updates of leases are sent to the County Risk Management section.

Property taxes

Since our audit, a strong system was developed and supported with written procedures to ensure that businesses were paying for their property taxes. As part of the process, FPM provides notice to Assessment and Taxation of all new leases, lease amendments, renewals and terminations.

Lease renewal and termination

During our lease file review, we found that changes to leases were brought before the board as recommended by our previous audit. FPM's web-based lease administration system automatically monitors expiration dates of leases. The system allows the user to define the number of months before expiration they wish to be notified.

Rent subsidies

The revised administrative procedure FAC-3 will address rental subsidies and will lay out responsibilities of FPM and departments. Departments are responsible for fully justifying any subsidies to tenants.

Some subsidy tenants now have a Tenant Services Obligation in the lease which ties the lease to a County services agreement detailing services to be provided by the tenant. The department is responsible for monitoring the tenant for compliance with the services agreement. Failure of the tenant to perform agreed upon services is considered a default of the lease.

FPM now produces a subsidy report comparing space costs to the rent charged on a tenant-by-tenant basis and in the aggregate. Subsidies were also documented in the lease files. Because it is not always practicable to obtain market rates in all circumstances, FPM focuses instead on the County's cost of leased space in comparison to the amount charged to the tenant for rent. If the County's cost is below the rent charged, the sponsoring department is responsible for funding the difference. This information is captured on the Request for Space Form and is also disclosed to the Board.

The previous audit reported a for-profit renting County space significantly below market rates. The lease to the for-profit referred to was adjusted to market rates. The draft of leasing administrative procedure FAC-3 distinguishes between subsidy and market rate tenants.

Policy for leased space

At the time of the 2004 building leases audit, it was a County policy to locate long-term County programs in owned, not leased space. The amount of leased property had continued to increase as other objectives such as forming partnerships with other jurisdictions, co-location of services with nonprofits

and mixed-use took priority over housing long-term programs in owned space.

The 2005 strategic facilities plan changes the County's policy. In this plan, space decisions weigh the advantages and disadvantages of leasing and owning without a stated preference for either. Advantages and disadvantages for owning versus leasing property are described in the plan. To avoid conflicting objectives, the 2005 plan places partnership, co-location and mixed use objectives into a better context with county-wide space decisions.

Improvements Needed

The new draft of the county-wide administrative procedure FAC-3 that defines roles and responsibilities between FPM and departments should be approved and issued.

FPM should formalize internal lease administration procedures. Documentation of lease administration procedures is especially helpful if employees involved with lease administration happen to leave or new staff are hired. Although there appeared to be good practices in place during our follow-up, we only found written procedures for a few of FPM's internal processes. For example, we did not find any written procedures for negotiating and analyzing leases. Once written, a lease administration manual would be useful to consolidate all internal lease procedures.

The current lease administration system is a critical system for effective lease management. Accordingly, development of the in-house lease administration system should be closely monitored by management to ensure its success. We also encourage integrating a description of the in-house system's processes into internal lease administration procedures.



MULTNOMAH COUNTY OREGON

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June 1, 2006

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Subject: Facilities Division Response to Follow-Up Building Leases Audit

Dear Suzanne:

Thank you for your thoughtful and insightful analysis of the County's building leases. As the responsible division for this work, the Facilities and Property Management Division (FPM) appreciates your efforts to improve our performance.

We were in total agreement with all of the recommendations in the original May 2004 audit report and we have worked very hard to address them all. As your follow-up report notes, we have made substantial progress during the past two years. Though we clearly have work left to do, we are particularly proud of the gains that have been made. We entrusted this work to staff with a high level of professional competence and dedication and empowered them to do what is necessary. Their results speak for themselves and I want to take this opportunity to express my appreciation publicly.

The Chair's Office and I agreed when I was hired that lease management was an area in need of substantial improvement. We then experienced a period of major budget and FTE cuts, along with the subsequent loss of the two incumbent staff dedicated to lease management. After an interim period, we were able to staff with the professionals this area of responsibility warrants and requires. It has been a challenging process, but, the progress has been remarkable nonetheless and includes the following accomplishments:

- Completed the shift of maintenance/operations responsibility from Departments to FPM
- Completed the shift of lease research, negotiation, and documentation to FPM
- Transferred the remaining collections/payments duties from Departments to FPM
- Completed a reorganization to allocate additional staff/expertise to lease management
- Documented lease processing workflow
- Developed Lease Description form for fiscal tracking
- Initiated Request for Space Change form

- Developed Prioritized Work Action Plan
- Created electronic lease data master file for tracking all leases
- Created a Lease Matrix for FPM Dispatch to summarize tenant-landlord duties
- Implemented file checklists and file standards
- Instituted standard lease clauses, including tax-exemption and program funds termination
- Implemented short-term use permit policy (Resolution 05-182)
- Adopted lease payment workflow procedure, including Master Payment file
- Instituted lease expiration/termination procedures for premises
- Developed database and procedures for tracking tax-exempt status of leaseholds
- Updated FAC 3 to document and communicate improved policies and procedures

The follow-up report notes the need for FPM to "...formalize internal lease administration procedures." We fully concur with this conclusion and we are committed to completing this work during the next fiscal year. We have worked hard to develop and implement standard procedures which reflect current "best practices" and we want to document and integrate these procedures into our existing system.

Finally, we thank you and your staff for your thoughtful consideration of our input and your assistance in making our efforts more effective. We would particularly like to thank Craig Hunt of your staff for his hard work and consideration on this project.

Sincerely,

Doug Butler
Director
Facilities and Property Management Division
Department of County Management
Multnomah County, Oregon