CAMPUS SERVICE ENTERPRISES

UCLA REAL ESTATE DEPARTMENT

AUDIT REPORT #19-2212

Audit & Advisory Services

October 2019

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Background

In accordance with the Campus fiscal year 2018-19 audit plan, Audit & Advisory Services (A&AS) performed an audit of internal controls and business practices over the UCLA Real Estate Department.

The Real Estate Department is responsible for the review and analysis of all off-campus requests for leasing or acquisition of a space. The department acts as a liaison between UCLA user groups (tenants) and third-party landlords. When real estate space is needed by a user group, Real Estate Department leasing agents perform the market research and comparisons of multiple spaces to find the best possible options. In this role, the department receives fees from the landlord in lieu of brokerage commissions, which are typically paid to real estate brokers. Sometimes, third-party brokers may be engaged by the Real Estate Department to share the responsibilities of finding an appropriate space. In such instances, the fees received from the landlord are divided between the Real Estate Department and the third-party broker. The fee-in-lieu revenue was approximately $1.2 million for fiscal year 2017-18.

On a monthly basis, the Real Estate Department is responsible for lease administration on behalf of all user groups. Monthly rent rolls are processed in order to remit rent, operating expenses, and other miscellaneous payments to the landlords. The Real Estate Department in return recharges the user group departments on a monthly basis for services provided. Similar to all other campus sales and service activities, the recharge rates are required to be approved by the Policy Committee on Sales and Service Activities and Service Enterprises (POSSSE).

Purpose and Scope

The primary purpose of the review was to ensure that the related systems and procedures are conducive to accomplishing the Real Estate Department’s business objectives. The secondary purpose of the review was to evaluate the adequacy and efficiency of the internal controls. Where applicable, compliance with campus and University policies and procedures were also evaluated.

The scope of the audit focused on the following:

* New Leases
* Fee-in-Lieu
* Tenant Improvements
* Property Taxes
* Acquisitions

The audit was conducted in conformance with the *International Standards for the Professional Practice of Internal Auditing* and included interviews, tests, and other procedures considered necessary to achieve the objective.

Summary Opinion

Based on the results of the work performed within the scope of the audit, the Real Estate Department’s organizational structure and controls, and the related systems and procedures surrounding real estate activities were generally conducive to accomplishing the department’s business objectives. However, controls and business practices could be further strengthened by implementing the following:

* Management should ensure that documentation that evidences the approval of insurance and indemnification language is consistently maintained for all leases.
* Management should maintain copies of fire safety inspections within Real Estate Department’s lease files. If the UCLA Fire Marshal or other authority determines that an inspection is not necessary, supporting documentation to that effect should also be maintained.
* During the audit, the Real Estate Department Director acknowledged the benefit of providing additional project management oversight for tenant improvements for departments that do not have their own project managers. The Real Estate Department Director is currently working with Campus Services Enterprises leadership to determine whether a project manager from the Asset Management department could be assigned to assist these campus departments. A&AS supports the idea of assigning a project manager with construction management expertise to help oversee complex tenant improvement projects.

The audit results and corresponding recommendations are detailed in the following sections of the report.

Audit Results and Recommendations

New Leases

Lease Reviews & Approvals

1. Department Authorization for Leased Space

The head of a department, school, or unit completes a Department Authorization for Leased Space form, which contains basic requirements as well as both program and funding authorizations. After completion, the form is submitted to the Real Estate Department. A judgmental sample of 10 new leases were selected for review to verify completion of the Department Authorization for Leased Space form. For all 10 sample leases tested, a Department Authorization for Leased Space form was properly completed for each lease.

There were no significant control weaknesses noted in this area.

1. Insurance and Indemnification Language Review

The insurance and indemnification language for the sample of 10 leases was reviewed and approved by the UCLA Real Estate Contract Specialist and UCLA Insurance Risk Management. However, for three of the leases, there was no documentation in the lease files to evidence the approvals.

Recommendation: Management should ensure that documentation that evidences the approval of insurance and indemnification language is consistently maintained for all leases.

Response: Implemented. Real Estate changed its procedure about a year ago to require an explicit statement by a UCLA Insurance Risk Management professional that the insurance and indemnification language was approved and that this be included in lease closing package prior to execution of a lease. All documents in the closing package are included in the lease file. Previously, the insurance and indemnification language was being properly reviewed and approved but we realized there was not always an explicit statement of this from a Risk Manager in the lease file. Therefore we modified our procedure to require this.

1. Lease Signing

Lease agreements are required to be signed by individuals that have appropriate delegation of authority. The same judgmental sample of 10 new leases cited earlier were reviewed for appropriateness of the individual signing the lease. For all 10 leases examined, the lease was signed by an individual that had an appropriate delegation of authority.

There were no significant control weaknesses noted in this area.

1. New Lease Set-up Checklist

A New Lease Set-up checklist is used by lease administrators to ensure that all required approvals, inspections, and other tasks and supporting documents are maintained for each lease. The judgmental sample of 10 new leases cited earlier were reviewed to verify that a New Lease Set-up checklist had been completed. Audit testing disclosed that all 10 leases had an associated New Lease Set-up checklist properly completed.

* Lease Comparables

UCLA Real Estate Department leasing specialists help UCLA user groups negotiate and ensure the leasing cost for targeted lease space is comparable to the going market rate. For the judgmental sample of 10 new leases noted earlier, A&AS reviewed each lease to verify that market comparisons were performed. Our review showed that the overall lease cost including the base rent, rent concessions, rent escalations, operating expenses, estimate of tenant improvement costs, and allowances for the targeted lease spaces were compared to three comparable buildings and spaces nearby.

There were no significant control weaknesses noted in this area.

* Life Safety Inspections

For targeted lease space, life safety inspections are required to confirm compliance with seismic safety, fire safety, the Americans with Disabilities Act (ADA), and Environment, Health & Safety (EH&S) requirements. For the sample of 10 new leases discussed earlier, A&AS verified whether life safety inspections were performed and noted the following below.

* *Seismic Safety Inspections*

University of California has a Seismic Safety Policy to help provide an acceptable level of earthquake safety for students, employees, and the public who occupy University Facilities and Leased Facilities. According to the policy, a Certified Structural Engineer (CSE) or a licensed architect must complete a "UC Certificate of Applicable Code" form; certifying that the building was constructed under a permit approved by the local jurisdiction and was designed to meet either (1) the 1998 or subsequent editions of the California Building Code, or (2) the 1976 or subsequent editions of the Uniform Building Code. The certification also notes that the building does not contain certain conditions such as unreinforced masonry, apparent additions, modifications, or repairs to structural systems done without a building permit. (A complete list of conditions can be found in the UC Seismic Safety Policy).

If the targeted lease building does not meet the conditions on the "UC Certificate of Applicable Code" form, an independent CSE must perform a seismic review or obtain a landlord's independent seismic review report that must be verified by the University of California Office of the President (UCOP) Seismic Advisory Board. For all 10 sample leases reviewed, a "UC Certificate of Applicable Code" form was properly completed and signed by a CSE or an independent seismic review was performed.

There were no significant control weaknesses noted in this area.

* *Americans with Disabilities Act Inspections*

UCLA Real Estate leasing specialists visually check for ADA compliance during their tour of targeted lease space. They check for ramps for handicap access, elevators for multi-floor buildings, and handicap-accessible bathrooms. Leasing specialists documented that they performed the ADA compliance checks on a "UCLA Lease Check List", for all 10 leases reviewed.

There were no significant control weaknesses noted in this area.

* *Environment, Health & Safety Inspections*

UCLA Real Estate Department leasing specialists check for visible EH&S issues during their tour of the targeted lease space. In addition, owners are required by law and terms in the lease agreements to disclose to the University any EH&S issues. If there are any issues or concerns, the University will either not lease the space or consult with UCOP’s EH&S staff or hire an outside EH&S vendor to inspect the location to determine whether it is safe to lease and occupy. UCLA Real Estate Department staff indicated that UCLA's EH&S department does not have sufficient resources to assist with these reviews. UCLA Real Estate Department document that they performed these visual inspections on a "UCLA Lease Check List". For all 10 sample leases reviewed, leasing specialists noted on the "UCLA Lease Check List" that an EH&S review was performed.

There were no significant control weaknesses noted in this area.

* *Fire Safety Inspections*

UCLA Real Estate Department submitted fire safety inspection requests to the UCLA Fire Marshal for each of the 10 leases reviewed; however, there was no record of completion of the inspections for any of the sample items within the Real Estate Department lease files. The Real Estate Department indicated that they rely on the UCLA Fire Marshal's expertise, authority, and responsibility to prioritize and decide which spaces will be inspected.

Recommendation: Management should maintain copies of fire safety inspections within Real Estate Department lease files. If the UCLA Fire Marshal or other authority determines that an inspection is not necessary, supporting documentation to that effect should also be maintained.

Response: Real Estate makes the request of the UCLA Fire Marshal to inspect premises for new leases and lease renewals when tenant improvements are being performed by the landlord. These requests are contained in the lease files. The UCLA Fire Marshal has been exempting annually leases where no tenant improvements are being performed. When no tenant improvements are being performed we keep a copy of the Fire Marshal exemption letter in the lease file. Real Estate will request copies of UCLA Fire Marshal fire inspection reports and keep such reports we receive in the lease files.

Fee-in-Lieu

The UCLA Real Estate Department at times receives fees from the landlord in lieu of brokerage commissions, which are typically paid to real estate brokers. Sometimes, third-party brokers may be engaged by the Real Estate Department to share the responsibilities of finding an appropriate space. In such instances, the fees received from the landlord are divided between the Real Estate Department and the third-party broker. A judgmental sample of eight leases were reviewed to verify whether a fee-in-lieu agreement was documented and signed by UCLA and the landlord or outside broker. Additionally, the same eight sample leases were reviewed to verify whether the fee-in-lieu payments were received timely and were in accordance with the fee-in-lieu agreement. For all eight leases tested, fee-in-lieu agreements were appropriately signed and payments were timely received.

There were no significant control weaknesses noted in this area.

Tenant Improvements

1. Tenant Improvement Reimbursements

The UCLA Real Estate Department is responsible for administering and monitoring tenant improvement reimbursements to landlords. Based on terms agreed upon in the lease work letter or reimbursement agreement, the landlord provides UCLA a tenant improvement (TI) allowance towards the actual construction costs incurred for the office space and UCLA is required to reimburse the landlord for any excess costs. UCLA Real Estate Department staff reviews and approves reimbursement requests, including supporting documentation, before processing reimbursement payments to the landlord.

A&AS reviewed a sample of 10 leases to verify whether terms and conditions for tenant improvements, including the agreed upon TI allowance, were documented and signed in the lease agreement by UCLA and the landlord. Additionally, A&AS reviewed a sample of reimbursement requests selected from the 10 leases to verify that proper supporting documentation was received from the landlord and reimbursement requests were approved by authorized personnel from the tenant’s department and UCLA Real Estate Department staff.

There were no significant control weakness noted in this area.

1. Project Management Oversight

Tenant improvement projects for UCLA campus departments are typically smaller and more straightforward in scope; however, there are some complex, large-scale tenant improvement projects as well. Although some departments have construction project managers on staff such as UCLA Health, Housing & Hospitality Services, and UCLA Extension, the majority of campus departments do not. Within our audit sample of 10 tenant improvement projects, there were five significant projects for campus departments, for which the individuals designated the authority and responsibility for overseeing the tenant improvement work were campus department employees, but were not construction project managers. See table below.

|  |  |  |  |
| --- | --- | --- | --- |
| Lease Address | Amount over Term | Department | Employee designated authority for overseeing tenant improvements |
| 10880 Wilshire Blvd, #400 | $2,417,495 | Administration | Principal IT Consultant |
| 3691 Lenawee Ave | $2,293,957 | Architecture & Urban Design | Program Director |
| 3443 S. Sepulveda Blvd | $1,840,720 | Architecture & Urban Design | Director of Operations |
| 10880 Wilshire Blvd, #520 | $1,162,825 | Student Affairs Information Technology | Manager of Student Affairs IT |
| 10880 Wilshire Blvd, #1860 | $539,164 | Counseling & Psychological Services | Director of Student Affairs IT |

Recommendation: During the audit, the UCLA Real Estate Department Director acknowledged the benefit of providing additional project management oversight for tenant improvements for departments that do not have their own project managers. The Real Estate Department Director is currently working with Campus Services Enterprises leadership to determine whether a project manager from the Asset Management department could be assigned to assist these campus departments. A&AS supports the idea of assigning a project manager with construction management expertise to help oversee complex tenant improvement projects.

Response: Real Estate has been working toward this goal and will continue to do so. We are working with Asset Management to ensure a project manager with construction management expertise is assigned to help oversee tenant improvement projects in cases where tenants do not already have a project manager. Asset Management is increasing its construction staffing which will enable it, in conjunction with Real Estate, to begin providing project management to UC tenants with landlord performed tenant improvements. Our efforts are being supported by the Executive Director of Campus Service Enterprises who both Real Estate and Asset Management report to.

Property Taxes

Property used exclusively for public schools, community colleges, state colleges, and state universities is exempt from property taxation (article XIII, section 3, subd. [d] of the State of California Constitution; Revenue and Taxation Code section 202, subd. [a]{3}). The property is exempt from taxation on the basis of its exclusive use for public school purposes. If the property is not owned by the public school, the owner of the property is required to file a claim for the Lessor's Exemption. If the owner of the property does not claim the exemption, the public school may file the Public School Exemption claim.

The landlords are responsible for paying the property taxes to the county and the proportion of the taxes based on the UCLA tenants’ percent occupancy in the building is passed along to the tenant in rent expenses. Previously, the landlords would claim the exemption from the county and UCLA would need to collect the tax refunds from each landlord. This practice created additional administrative issues for UCLA because some landlords were 2-3 years behind in claiming the exemption and some landlords mistakenly disbursed the refund to all of their tenants, not just UCLA. However, since 2013, UCLA applies for the property tax refund through the County Assessor’s Office instead of the landlord. Thus, UCLA only needs to deal with one entity, instead of all the landlords. In addition, the County pays interest on the property tax refunds, which the landlords did not.

The UCLA Real Estate Department is responsible for submitting an application for property tax exemption for each space leased every year. A&AS reviewed the property tax refund application for fiscal year 2017-18 and discussed it with the UCLA Real Estate Property Tax Specialist. It was noted that all of the active and upcoming leases, as of January 2017, had been reviewed to determine whether the leased space is eligible for property tax exemption and to include in the application for tax recovery from the Los Angeles County Assessor's Office. Leases must have commenced on or before January 1, 2017, to be eligible for property tax exemption for the property tax year July 1, 2017 to June 30, 2018. If the Property Tax Specialist notices leases with an anticipated commencement date of shortly after January 1, an inquiry will be made with the department to suggest moving up the commencement date to on or before January 1 to qualify for the property tax exemption. If a lease commences on January 2, UCLA will lose out on the property tax exemption for the entire tax year. Leases for which there is on-going construction do not qualify for property tax exemption. The 2017-18 property tax refund applications were submitted on February 7, 2017, before the February 15 deadline.

County assessors perform site visits of leased spaces to confirm eligibility for property tax exemption. UCLA Real Estate Department staff provides general information to UCLA tenants about the site visits to help prepare them for county assessors’ visits. The site visits for the 2017-18 property tax fund applications occurred during the summer of 2018.

After the site visits were completed, around August 2018, the Los Angeles County Assessor's Office provided a determination of the assessed value of the percentage of spaced leased by UCLA that qualified for the property tax exemption. The UCLA Real Estate Property Tax Specialist reviewed the exemptions granted and compares them to prior year amounts and the applications.

When the actual property tax refunds were received in November 2018, the UCLA Real Estate Property Tax Specialist reviewed the tax refund amounts to verify they include all of the exemptions that were expected and compares them to the prior year assessed and exemption values and refunds for each leased building. The total property tax refunds received for the 2017-18 applications was approximately $5.9 million.

The UCLA Real Estate Property Tax Specialist distributes the property tax refunds back to the UCLA departments that leased the spaces. The UCLA Real Estate Department retains a 5% fee for helping with the property tax applications.

There were no significant control weaknesses noted in this area.

Acquisitions

All real estate acquisitions must be reviewed and approved by UCOP (per UC Facilities Manual Volume 2, Chapter 7.7 “Authorization for Acquisitions, Dispositions, or Ground Lease of Real Property.”) An Authorization Request must be completed and submitted to the UCOP Executive Director of Capital Asset Strategies requesting assignment of UCOP staff prior to commencing with negotiations. The UCLA Real Estate Department Director assists with completing the Authorization Request form, which must be approved by the UCLA Vice Chancellor / Chief Financial Officer before submitting to UCOP. The Authorization Request must include the following:

* Programmatic Purpose – How the transaction will serve the University’s mission.
* Project Description – Terms, parties to the transaction, description of the property, other property alternatives (e.g., lease vs. acquisition) that have been considered and why the selected alternative is preferred. If construction or remodeling is required, a description of the planned work and the estimated cost (however preliminary) should be included. Any special issues or concerns, such as political, environmental, or community relations sensitivities, and any related transactions (e.g., the University leasing back space in a project to be developed on its land pursuant to a ground lease) must be noted.
* Funding, Financing and Feasibility – Provide a summary of the total cost of acquisition (or ground rent) and the estimated cost of any improvements or renovations. Summarize funding sources and University financing required for the project through completion, including preliminary financial feasibility, in the one-page format accompanying Regents’ Items.
* Additional Resources – Provide a description of resources necessary or desired to complete the desired transaction and identification of funding to support the resources or services. This should include legal support through the Office of General Counsel and outside counsel, brokers, financial advisors, third-party consultants, and any other specialized assistance.

Following receipt of the Authorization Request, the Executive Director of Capital Asset Strategies will either:

(i) send a letter assigning appropriate UCOP staff, including requesting the Office of General Counsel to assign counsel, to pursue formal negotiations and advance the transaction process through final approval, or

(ii) request additional information and clarifications. In some instances, the Executive Director may also request a meeting with appropriate campus and UCOP staff to review the proposed transaction.

An independent appraisal of property being acquired is mandatory. The UCLA Real Estate Department hires the appraiser in coordination with UCOP. Life and safety inspections are required and coordinated by the Real Estate Department and the UCLA Campus Building Official.

UCLA Real Estate Department staff sometimes conducts informal negotiations in determining whether there is a potential deal. The ultimate decision to buy or sell a property rests with UCOP and not with UCLA or the UCLA Real Estate Department. Upon approval from UCOP, the UCLA Real Estate Department Director drafts a letter on behalf of UCOP and sends it to the UC Regents for their approval.

A&AS reviewed a recent acquisition that occurred in 2018, the purchase of the Crest Theater, and noted the following:

* An Authorization Request was completed by the UCLA Vice Chancellor / Chief Financial Officer and included all of the information required by the UC Facilities Manual Volume 2, Chapter 7.7 “Authorization for Acquisitions, Dispositions, or Ground Lease of Real Property.” The request was submitted to the UCOP Executive Director of Capital Asset Strategies.
* A financial feasibility analysis was performed and included all applicable costs. An outside construction consulting firm, Totum Corporation, was hired by the Real Estate Department and provided a cost estimate for needed construction improvements to the Crest Theatre including seismic upgrades. UCLA Capital Programs will be performing the building renovations, and hired another project and cost management company called Cumming to review Totum's cost estimate. Cumming identified areas where they believed Totum's cost estimates were low or may not have included all costs, with an overall additional construction cost of $530,022 compared with Totum's estimates. Estimates of the income and costs of operating the Crest Theater were prepared by the Arts & Architecture department and reviewed by the UCLA Administrative Vice Chancellor and the Executive Director of Campus Service Enterprises. The acquisition and initial remodeling costs will be funded by a combination of campus funds and gift funds.
* An appraisal of the Crest Theater was performed by an independent certified general appraiser.
* Life and safety requirements of the Crest Theater were inspected by outside construction consulting firms and included the identification of needed construction improvements and cost estimates to meet requirements related to seismic safety, fire safety, and the Americans with Disabilities Act, which were factored into the decision of whether to acquire the theater. The seismic review concluded that the theater does not meet the UC required seismic safety rating of IV; however, recommendations to strengthen the building to meet the required seismic rating and estimated costs were provided. The need for new ADA compliant restrooms, seating, lift, and modifications to doors were identified. With regard to fire safety, upgrades to the existing fire sprinklers and fire alarms will also be needed.
* The Purchase and Sale Agreement was properly approved and signed by the UCOP Executive Director of Capital Asset Strategies.

There were no significant control weaknesses noted in this area.

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