



AUDIT AND ADVISORY SERVICES

Leased Real Property
Audit
Project No. 11-570

September 7, 2011

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September 7, 2011

Robert Hatheway
Assistant Vice Chancellor
Real Estate Services

Assistant Vice Chancellor Hatheway:

We have completed our audit of Leased Real Property as per our annual audit plan in accordance with the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing* and the University of California Internal Audit Charter.

The purpose of the audit was to assess the management of University-owned leased real property, specifically, whether the lease payments are collected timely, lease documentation and accounting records are properly maintained, lessees are compliant with laws and standards of care related to hazardous materials, and capital improvements are properly authorized prior to work beginning.

The Real Estate Services Office (RESO) serves as the office of record for the campus providing lease information to the Office of the President regarding new leases, amendments and other modifications to leases, as well as, projections of future leasing activity. RESO coordinates with Environmental Health and Safety, Facilities Maintenance, and the Office of Ethics, Risk & Compliance Services to ensure that the proposed leased facility has been built and maintained to applicable federal and state codes and University policies. RESO also offers recharge services to campus departments in need of off-campus space or leasing existing campus space. They assist departments to articulate space requirements, identify potential locations, and negotiate the lease agreement.

As a result of our fieldwork, we had observations related to the following areas:

- Adequacy of documentation provided by tenants to support variable lease payments.
- Delegation of authority for executing property management agreements.

We had no observations related to the compliance of lessees with laws and standards of care related to hazardous materials or the proper authorization by the University of capital improvements.

The aforementioned observations with management responses and action plans are expounded upon in the accompanying report. Thank you to the Real Estate Services Office and other departmental staff for their cooperative efforts throughout our audit process. Please destroy all copies of draft

reports and related documents. Please do not hesitate to call on Audit and Advisory Services if we can be of further assistance in this or other matters.

Respectfully reported,

Wanda Lynn Riley
Chief Audit Executive

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**University of California, Berkeley
Audit and Advisory Services
Leased Real Property**

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OVERVIEW

Executive Summary

The purpose of the audit was to assess the management of University-owned leased real property, specifically, whether the lease payments are collected timely, lease documentation and accounting records are properly maintained, lessees are compliant with laws and standards of care related to hazardous materials, and capital improvements are properly authorized prior to work beginning.

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Purpose of the Audit

The purpose of the audit was to assess the management of University-owned leased real property, specifically, whether the lease payments are collected timely, lease documentation and accounting records are properly maintained, lessees are compliant with law and standards of care related to hazardous materials, and capital improvements are properly authorized prior to work beginning.

Scope of the Audit

Based on our risk assessment, the scope of the audit focused on properties where the University is the landlord as opposed to the University being the tenant.

The audit scope included 84 University-owned leased properties totaling approximately \$8.3 million in annual lease payments in which the University was the landlord as of March 4, 2011.

Background Information

RESO is the focal point for market information on real estate in the Berkeley area, maintaining knowledge of market availability and fluctuations in prices and also serving as the office of record

for certificates of insurance, lease agreements, correspondence, and other documentation pertaining to the property. RESO coordinates tenant improvements and initial move-in, as well as, obtains additional lease approvals from Space Management & Capital Programs, Office of the President, and the Board of Regents, as necessary. RESO also serves as the University's liaison with landlords for any landlord/tenant issues during the term of the lease and works with departments to determine whether renewal or relocation is the best alternative prior to lease expirations. RESO manages certain leases directly, whereas individual departments manage other leases. For five University properties RESO has retained Grubb & Ellis as a property management company on behalf of the Regents.¹

Additionally, RESO offers assistance services on a recharge basis to campus departments needing off-campus space or leasing existing campus space. Specifically, they assist departments to articulate space requirements, identify potential locations, negotiate the lease agreement, arrange applicable building inspections, and ensure that properties are in compliance with California Environmental Quality Act (CEQA), Americans with Disabilities Act (ADA), seismic, and fire and life safety codes. As of June 2011, of the approximately 85 lease agreements in place where the University is the landlord, approximately 59% were managed by the campus departments, 27% were managed by Grubb & Ellis, and 14% were managed by RESO. In addition, 13 (approximately 15%) of the agreements had variable lease payments based on business activity of the lessee, typically reported gross sales. All of the agreements with variable payment components were managed by campus departments.

In addition to RESO's role and responsibilities, the following central campus units oversee other areas related to leased real property.

Space Management & Capital Programs

Space Management and Capital Programs (SMCP) is responsible for the overall management of vacant campus spaces. SMCP works with EH&S, the UC Police Department, Capital Projects, and Physical Plant-Campus Services to develop and implement plans for the proper security and maintenance of vacant space.

The Space Assignments and Capital Improvements Committee (SACI) advises campus administration on plans and policies for use of existing space and for capital improvements needed for the Berkeley campus. This administrative committee is chaired by the Vice Provost of Academic Planning and Facilities and receives staff support from SMCP. The Committee reviews and evaluates the use of space and requests for space, determines or recommends space reassignments, advises administration on individual proposals for major and minor capital improvement projects, and recommends priorities for the campus state-funded Capital Improvement Program.

Environmental, Health & Safety

Designated Campus Fire Marshals (DCFM) in the Fire Prevention Division (FPD) have the authority to approve building plans and inspect construction on campus on behalf of the California

¹ The five properties managed by Grubb & Ellis are 1995 University Avenue, 2440 Bancroft Way, and 2850 Telegraph Avenue in Berkeley as well as 3200 Regatta Way and 3300 Regatta Way in Richmond.

State Fire Marshal. DCFMs also grant final occupancy to buildings when they are substantially complete in accordance with approved plans. DCFMs work closely with campus units and outside contractors to ensure that campus construction complies with state fire and building codes. DCFMs are required to conduct an inspection of all potential leased space for use by University employees prior to entering into a lease agreement. If new construction is required to meet program requirements, an inspection by the DCFM may be required. The FPD can assist in determining the breadth of inspections required by the campus and the City of Berkeley.

General Accounting

At fiscal year end, campus General Accounting requests RESO provide the outstanding facility lease information. This lease information includes purchase order numbers, facility location, and lease expiration date information. General Accounting reviews the lease information, compares it to the prior year's lease information and lease documents for new leases, and calculates the future year facility lease liability which then is submitted to the Office of the President for fiscal year-end reporting purposes.

Office of Ethics, Risk & Compliance Services

OERCS is responsible for providing uniform interpretation, operation, and administration of the University's Risk Management Program. OERCS provides standard form insurance language for use in lease agreements and assists the Office of the President and campuses and laboratories in the development and review of alternate language. OERCS works in conjunction with the campus departments to resolve matters related to insurance requirements and advises on the types of coverage available under the University's programs.

Audit Methodology

The Principal Auditor met with management from RESO, SMCP, OERCS, General Accounting, and Disbursements to discuss potential risks associated with leased real property. The Principal Auditor selected 14 leases for detailed testing of which 12 were leases to third-party tenants totaling \$2.1 million that were managed by eight campus departments and the other two leases totaling \$1.3 million in annual lease payments were managed by Grubb & Ellis Property Management Company. These annual lease payments will vary in the future depending on whether lease payments are based upon lessee activity, such as gross sales, or there are lease payment escalation provisions. The basis for the selection of these 14 leases consisted of examining the RESO lease database records for 84 lease agreements in place as of March 4, 2011 where the University is the landlord and judgmentally selecting a representative sample based on annual lease payments, lease square footage, and location of the property.

We noted in our sample that rent income is generally recorded by individual departments on a cash basis, rather than an accrual basis. An exception exists for properties currently managed by Grubb & Ellis, who keep financial records related to those properties on an accrual basis. Additionally, reports prepared by Grubb & Ellis and provided to RESO are presented on an accrual basis.

As part of the audit, we interviewed cognizant department management regarding the processes for acquiring lease space, approving tenant improvements and alterations, rent collection, safeguarding hazardous materials, and the maintenance of lease records. Our objective in surveying these

campus departments was to assess the current processes and controls and to identify potential areas of improvement related to lease management based on the current practices implemented by these departments of the sampled leases. Additionally, we reviewed the respective terms of the lease agreement to gain an understanding of lessee and lessor responsibilities related to the management of the leases in our sample.

Summary Conclusion

The process for leasing real property is a shared responsibility of campus departments with RESO as the focal point, whereby they identify potential campus locations, provide lease negotiating services, assist landlords with any landlord/tenant-related issues during the term of the lease, and serve as the office of record for the campus. The management of the leased real property is a concerted effort by campus units and departments to ensure that the executed lease is efficient in communicating lessee and lessor obligations and mitigating risks associated with type of business or activities that occur on the leased property, while protecting the University from reputational degradation and/or punitive damages.

As a result of our fieldwork, we had observations related to the following areas:

- Adequacy of documentation provided by tenants to support variable lease payments.
- Delegation of authority for executing property management agreements.

We had no observations related to the compliance of lessees with laws and standards of care related to hazardous materials or the proper authorization by the University of capital improvements.

A detailed description of these observations and management responses follows.

SUMMARY OF OBSERVATIONS & MANAGEMENT RESPONSE AND ACTION PLAN

Adequacy of Documentation Provided by Tenants to Support Variable Lease Payments

Criteria / Risk

For certain leases where the University is the lessor, the lease payment due from the lessee is not necessarily a fixed monthly amount but rather varies based upon a calculation, such as percent of gross monthly sales revenues of the lessee. Typically, in such cases, the lease agreement would contain a definition of gross sales for which the percentage rent calculation will apply. The agreement also usually specifies the format and means of providing the lessor with a periodic report of gross monthly sales which should support the amount paid by the lessee. In addition, the agreement typically specifies a requirement by the lessee to maintain adequate books and records so that the lessor may examine or audit them to determine if there has been a deficiency in the payment of percentage rent.

When lease payments are not fixed but instead are determined by information self-reported by the lessee, there is a risk that the lessee will under-report activity, such as gross monthly sales revenue, to the lessor and thereby will pay less rent than is contractually due.

Observation

We selected a sample of four leases for which lease payments due were calculated as a variable amount. These four leases are managed by four campus departments: ASUC Auxiliary, Haas School of Business, Boalt School of Law, and the Library.

We inspected copies of the documentation provided by the lessee to support variable rent payments made. In some circumstances, this documentation consisted of handwritten amounts with no other supporting documentation. In addition, we noted that the documentation does not include a written statement, as required by the lease, from the lessee certifying the truth and accuracy of the information provided. As a result, which we confirmed through inquiry with departmental staff, we observed that campus departments did not routinely perform a validation of rents paid to self-reported activity and as a result could not obtain relative assurance that lease payments are not being underpaid.

Furthermore, we observe that departments have not exercised their rights under the lease agreements to examine the books and records of the lessee or have an audit conducted of the lessee's business activity. Although there is a cost-benefit trade-off for conducting an examination or audit, we did not observe management periodically considering the risk of underpayment by the lessee and conducting steps toward reaching an informed management decision as to whether further procedures to assess the likelihood of underpayment were warranted.

Management Response and Action Plans

Management Response and Action Plan – RESO

By January 2, 2012, RESO will develop a Tips Sheet of best practices for managing leased property and will determine the most effective approach for disseminating those practices to relevant campus staff and departments.

If needed, RESO will host an annual forum of campus staff with leased property responsibilities for purposes of communicating issues and practices related to managing leased properties. Additionally, RESO will evaluate the risks related to variable lease agreements to determine if random audits based on specific risk criteria of campus departments are warranted.

Management Response and Action Plan – ASUC Auxiliary

We concur. Without reviewing the financial reporting of our lessees, we cannot be certain that gross sales are being properly reported. Depending on the location of the lessees' business office and the size and reputation of the vendor, we reserve the right to modify our review practices. For instance, we would obtain audited financial statements and management letters from our large corporate vendors. For smaller, local vendors, tenant sales audit procedures would be applied.

Management Response and Action Plan – Haas School of Business

Management is currently in the middle of the RFP process to determine the vendor for the Haas café. As of right now, our lead finalists operate businesses that use a POS system, which they each intend to implement for the Haas café (if chosen). As part of the new lease, we will require that they submit their monthly rent check with a verification report from their POS system.

A&AS has agreed with management on an expected completion date for this management action plan of April 1, 2012.

Management Response and Action Plan – Boalt Hall School of Law

We acknowledge the Leased Real Property Draft Audit Report's findings about the lack of audit on financial records that would support the rent levels paid by the lessee for our cafe space. Unfortunately, a full-fledged on-site audit as allowed in the lease terms would be prohibitively expensive and time consuming for the relatively small amount of revenue involved. That said we agree that controls could be strengthened and we propose the following two remedies:

Beginning August 5, 2011, Stradavarius Catering shall provide, on a quarterly basis:

1. Statements generated by their software showing gross sales, signed by Daryl Ross, and a statement from him verifying information as true and correct.
2. A report generated from their POS system (Micros) showing gross sales, which Daryl Ross also verify and sign.

Our lease agreement gives us the right to request that the owner of Stradavarius Catering provide us with a copy of the company's annual tax returns. However, since his return reflects income for his entire company, which includes a number of non-UCB operations and is not broken down per unit, the tax return would not be a useful tool for verifying sales numbers for individual cafes. Items 1 and 2, above, seem more than adequate to address our concerns, since they allow us to examine the data from the actual point of sale. Therefore we will not automatically request annual tax returns, but will request them only if the information provided in 1 and 2, above, is inadequate.

We believe that these remedies will strike the right balance between control on the one hand and minimizing administrative investment in audit and control on the other.

A&AS has agreed with management on an expected completion date for this management action plan of October 1, 2011.

Management Response and Action Plan – The Library

A&AS notes that the tenant for The Library space in our testing sample is the same (Stradivarius Catering) as for the Boalt Hall School of Law space. The Library and the School of Law have worked collaboratively with the tenant to jointly develop the management action plan detailed above that will apply to both locations.

Delegation of Authority for Executing Property Management Agreements

Criteria / Risk

The President of the University has delegated authority for many actions to the Chancellors. Chancellors may redelegate certain authorities to Vice Chancellors, Deans, or other campus administrators following a prescribed systemwide procedure. In some instances, persons to whom a Chancellor has delegated authority are permitted to further redelegate that authority to managers within their control unit.

In the absence of delegated authority, there may be a lack of clarity as to who has the authority to execute particular types of contracts on behalf of the University, resulting in confusion or inconsistent contracting practices.

Observation

The property management agreement with Grubb & Ellis was executed by the Assistant Vice Chancellor for Real Estate Services. We did not observe specific delegated authority for this type of agreement among the Chancellor's re delegations to either that position or the Vice Chancellor – Facilities Services. That being said, in the absence of a delegated authority, it appears that the Assistant Vice Chancellor for Real Estate Services may be an appropriate function to review and approve such an agreement given that the services relate to management of University properties. Alternatively, given that services nature of the agreement, the Associate Vice Chancellor for Business and Administrative Services, as the designated Materiels Manager for the campus under Business and Finance Bulletin BUS-43, may also be an appropriate function as the Business

Contracts Office (BCO) in that organization has delegated authority to review and sign other types of business contracts.

Management Response and Action Plan

RESO will request delegation of authority to execute property management agreements. Within 30 days, Real Estate will work with the Vice Chancellor – Facilities Services Office to initiate the delegation request.