

The logo for UCIrvine, featuring the letters 'UCI' in a large, bold, serif font, followed by 'RVINE' in a smaller, all-caps, serif font. A vertical line separates the 'UCI' and 'RVINE' parts.The text 'INTERNAL AUDIT SERVICES' in a serif font, positioned to the right of the UCIrvine logo. A vertical line is to the left of this text.

Real Property Lease Income

Internal Audit Report No. I2018-201

December 31, 2018

Prepared By

Larry Wasan, Senior Auditor

Reviewed By

Niran Joshi, Associate Director

Approved By

Mike Bathke, Director



INTERNAL AUDIT SERVICES
IRVINE, CALIFORNIA 92697-3625

December 31, 2018

Neil Myers, Controller, UCI Health Finance Administration
Daniel Isenberg, Executive Director, Real Estate Services

RE: Real Property Lease Income Audit
Report No. I2018-201

Internal Audit Services has completed the review of Real Property Lease Income processes and the final report is attached.

We extend our gratitude and appreciation to all personnel with whom we had contact while conducting our review. If you have any questions or require additional assistance, please do not hesitate to contact me.

Mike Bathke

Mike Bathke
Director
UC Irvine Internal Audit Services

Attachment

C: Audit Committee

I. MANAGEMENT SUMMARY

In accordance with the fiscal year (FY) 2018-2019 audit plan, Internal Audit Services (IAS) conducted a review of Real Property Lease Income of both the UCI Medical Center and University Campus. Based on the audit work performed, some internal controls need improvement and should be strengthened to minimize risks, ensure compliance with University policies and procedures and/or best business practices. Specifically, the following observations were noted.

Lease Payments – Management did not obtain adequate documentation from a lessee (CHF-Irvine) to support their calculations of multi-million dollar lease payments made to UCI. This observation is discussed in Section V.1.

Lease Agreements – Management was unable to locate a copy of a signed lease agreement between SFFCU and UCI for a lease related to an ATM located at the Medical Center. This observation is discussed in Section V.2.

Late Fees – Management did not collect late fees from two lessees who appeared to have been consistently late over a three-year period. Records show that one Medical Center lessee was late 28 out of 29 times, sometimes for several months past the due date, and a Campus lessee appeared to have been late 31 out of 34 times. This observation is discussed in Section V.3.

II. BACKGROUND

The Regents of the University of California (University) owns a variety of real property - land and buildings located at the UC Irvine Campus and Medical Center - that are leased to outside organizations. These organizations are the tenants or lessees, and the University is the lessor. Leases are governed by signed lease agreements or contracts between the two parties, and the lease terms can be effective for just a few months or years, or they can be as long as 40 years or more, as is the case with a ground lease, which is described below.

There are approximately two dozen lessees with annual lease payments totaling approximately \$12.74 million, and 95 percent of that or \$12.1 million comes from multiple ground leases between the University and two companies – The Irvine Company and CHF-Irvine, LLC. The Irvine Company leases land from the

University, upon which the Irvine Company has built office buildings, such as the University Research Park, which it then leases to the University. CHF-Irvine, LLC leases land from the University, upon which student housing is built, including the ACC apartment communities Vista Del Campo, Camino Del Sol, and Puerta Del Sol.

Other types of leases include, among others, research facilities located at the Beckman Laser Institute (BLI), Miss Kelly's Café at the Medical Center, space for ATM machines located both at the Medical Center and on campus, and a UPS Store located at the Student Center. The lease payments for these ranges from \$50 to approximately \$6,300 dollars per month.

Management of lease agreements and the collection of lease payments is a manual process. Excel spreadsheets are typically used to log and track payments, and there is no automated system to remind staff of payments due. However, due to the small number of lease agreements, monitoring and collection of lease payments is manageable, and therefore, this is deemed to be of low risk.

Real Estate Services is responsible for initiating all lease agreements for both the Medical Center and the University Campus, maintaining and archiving copies of all signed lease agreements, and collecting lease payments from The Irvine Company and CHF-Irvine, LLC.

Collections of the other much smaller lease payments are performed by various departments, depending on the location of the leased property. For example, lease payments for ATM machine space and other leases located at the Student Center are collected by Student Center staff, payments for leased facilities located at the Beckman Laser Institute are collected by Beckman Laser Institute staff, etc. However, all payments are entered and accounted for within the Kualu Financial System.

III. PURPOSE, SCOPE AND OBJECTIVES

The primary purpose of the audit was to perform a general review of UC-owned real property leases, where UCI is the lessor, to verify that lease payments are in compliance with the terms of the lease agreements. The scope focused on real

property located on the UCI campus as well as the Medical Center and lease payments for the period of July 1, 2015 to April 31, 2018.

The audit included the following objectives:

1. Verify that documented policies and procedures for the management of UC-owned real property lease agreements and lease payment collections are in place and are being followed;
2. Verify compliance with the terms of the lease agreements;
3. Verify accuracy of lease payments collected;
4. Verify that lease payments are paid timely and that late fees are assessed in accordance with the lease agreements; and
5. Verify that management has captured all lease agreements where UCI (Campus and Medical Center) is the lessor/landlord and that all payments due have been collected and recorded.

IV. CONCLUSION

In general, certain internal controls regarding University-owned real property leases have been implemented. However, some concerns and improvement opportunities were noted regarding the collection of lease payments, maintenance of lease agreements, and assessment of late fees.

Observation details and recommendations were discussed with management, who formulated action plans to address the issues. These details are presented below.

V. OBSERVATIONS AND MANAGEMENT ACTION PLANS

1. Lease Payments

Background

According to a ground lease agreement between UCI/UC Regents and CHF-Irvine, LLC, calculation of rent is based on the base rent, the Consumer Price Index for a given period, Fair Market Value of the leased property, and any

remaining amount in a Surplus Fund. Annual lease payments collected from CHF-Irvine, LLC was approximately \$3.3 million for FY14/15, \$6.2 million for FY15/16, and \$6.5 million for FY16/17.

Observation

Management did not obtain documentation from CHF-Irvine, LLC to show calculations used to determine the exact amount of annual lease payments made to UCI. According to the lease agreement, "Upon Lessor's direction, Lessee shall request the Manager to calculate the amounts of the payments and to submit such calculations to Lessor for Lessor's approval." Although this statement does not require UCI management to request such calculations from the lessee, it is good business practice to do so in order to confirm that the lease payments collected are accurate and in compliance with the terms of the lease agreement.

Management Action Plan

Going forward, management will obtain lease payment calculations from the above lessee for management's review and approval. Management will independently verify and document that the lessee's calculations are accurate per the lease agreement prior to approval. In addition, management will request calculations for the previous two annual lease payments and review for accuracy and compliance with the terms of the lease agreement. This management action plan will be completed by February 28, 2019.

2. Lease Agreements

Observation

IAS was unable to obtain a copy of a lease agreement between UCI/UC Regents and Schools First Federal Credit Union (SFFCU) for an ATM machine located at the Medical Center. Real Estate Services and staff at the Medical Center Controller's Services, who is responsible for collecting lease payments for this lease, did not have a copy, and other departments that IAS was referred to also did not have a copy. Not having a copy of a lease agreement creates the risk of non-compliance with its terms.

Management Action Plan

Management reached out to SFFCU and was able to obtain a copy of the fully executed agreement and has forwarded the agreement to the Medical Center accounting office to make sure they have the correct monthly rent schedule on file.

3. Late Fees

a. Medical Center

Observation

According to a lease agreement between UCI/UC Regents and Fresenius, a lessee of a Medical Center facility, a 6 percent late fee was to be assessed if a monthly lease payment was received more than 10 days past the due date. Although Fresenius payments were received more than 10 days past the due date (28 out of 29 times) over a three-year period, no late fees were assessed. A majority of the 28 late payments were received about six weeks to five months past the due date. Management did not have a process in place for collecting late fees. The total amount of lease payments that were late was \$526,210. Note: This contract had already expired at the time of review by IAS.

Management Action Plan

Going forward, for all late lease payments, the staff member responsible for collecting lease payments will assess a late fee in accordance with the lease agreement, and management will verify that late fees are assessed accordingly.

b. Campus

Observation

- According to a lease agreement between UCI/UC Regents and UPS, a late fee of \$20 plus a percentage equal to the percentage earned from UCI's Short Term Investment Program (STIP) is to be assessed if a monthly lease payment is late more than 10 days past the due date. A review of lease payment records showed that lease payments from UPS,

totaling \$41,851, were received and posted more than 10 days past the due date (31 out of 34 times) over a three year period. Twenty-two of the 31 late payments were received about two weeks to one month past the due date, and nine payments were received about six weeks to three months past the due date. According to management, this was due to mail delivery issues. IAS could not independently verify that all of the above late payments were actually due to mail delivery issues.

- A review of Wells Fargo lease payment records, dated July 2015 to April 2018, for two ATM machines and a mini branch located at the Student Center showed that three payments totaling over \$16,000, which were for the months of November 2015, March 2016, and December 2016, still had not been received. Based on email communication between management and Wells Fargo, the payments were still unaccounted for as of July 2, 2018. The same email revealed that payments for April and May 2018 were not received until June, but no late fees were assessed. According to management, this was also due to mail delivery issues. Again, IAS could not independently verify that these late payments were actually due to mail delivery issues.

Management Action Plan

Going forward, management will assess late fees for any lease payments that are considered late per the lease agreement or as deemed necessary; the date as noted on the check will be used to make this determination and not when received from mail services. Holidays and University closed dates will also be considered. The Finance Manager at the Student Center will work with the finance team to ensure lease payments are received and followed-up on with tenants through documented correspondence (i.e. email).

Mail services has lost a lot of our mail, including many checks, therefore, the date received from them and the date cashed are not used to determine the lateness. It was determined that the payments were lost by mail services, and the checks have been reissued and cashed on August 14, 2018.