Port of Seattle

Internal Audit Report

Comprehensive Operational Audit

Real Estate Portfolio Department

January 1, 2011 – June 30, 2012

Issue Date: November 13, 2012
Report No. 2012-19

Table of Contents

Transmittal Letter

Audit Committee
Port of Seattle
Seattle, Washington

We have completed an audit of the Real Estate Portfolio Department. We reviewed information relating to significant department activities from January 1, 2011 – June 30, 2012.

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

We extend our appreciation to the Real Estate Portfolio Department staff for their assistance and cooperation during the audit.

Joyce Kirangi, CPA
Internal Audit, Director

Executive Summary

Audit Scope and Objective The purpose of the audit was to determine whether the Real Estate Portfolio Department has sufficient controls to reasonably ensure:

1. Real Estate Division lease agreements comply with the Port's Real Estate Policies 1 and 2.
2. Real Estate and Seaport Division agreements are effectively managed within PROPWorks.

We reviewed information for the period January 1, 2011 – June 30, 2012.

Background The Real Estate Portfolio Department (REP) is a department of 14 FTEs with an annual operating budget of approximately $1.3 million. REP is responsible for developing business agreements for the Real Estate Division's properties. This includes lease agreements for commercial office space, maritime industrial, retail locations, as well as negotiating preferential use and right-of-way access for business and local governments. REP also develops and oversees third-party operational agreements to support specialized operations such as conference facilities and event planning. Further, the Department oversees the day-to-day management of its agreements as well as agreements developed externally by the Seaport Division. To manage these agreements, the Department uses PROPWorks, which is the Port's system for managing real estate agreements.

Audit Result Summary The Department has effective controls to manage Real Estate and Seaport Division agreements within PROPWorks. However, in select instances, we noted that the controls to ensure full compliance in the development of lease agreements weren't consistently applied.

Background

Department Activities:
The Real Estate Portfolio Department (REP) resides within the Port's Real Estate Division. REP has two primary responsibilities: develop business agreements for the Real Estate Division's properties and manage those agreements for the extent of the lease terms. REP also manages agreements developed for the Real Estate and Seaport Division's properties.

The business agreements developed for the Real Estate Division's properties generally include all non-aviation and non-seaport container properties owned by the Port. The majority of agreements are business leases to private companies engaged in retail activities, commercial operations, maritime industries, and freight operations. The department also negotiates temporary and long-term use of properties through right-of-way agreements with local governments and utilities. Business development agreements must comply with state laws governing Washington State Port Districts' leasing activities (Chapter 53.08 RCW), as well as the Port's policies for real estate development: RE-1 and RE-2.

In order to manage these lease agreements, REP has a staff group, the Lease Administration Specialists (LAS), who oversee the Port's PROPWorks lease management system. The LAS support the Real Estate and Seaport property managers by identifying key lease terms and adding them into PROPWorks. Such information includes rent levels and dates, utility calculations, and insurance requirements. The LAS use PROPWorks to identify key tenant obligations, such as insurance expiration dates and/or applying seasonal utility rate adjustments. The LAS perform these services for both Real Estate managers as well as Seaport's property managers.

Department Finances:
Although the development of business agreements contribute a significant portion of the Real Estate Division's $30 million in annual revenues (up to 5% of the Port's total annual operating revenues), the Department does not collect any revenue directly from its own leases or other business agreements; revenues are collected by the Port's Accounts Receivable Department. The majority of the Department's $1.3 million budget supports staff salaries and benefits (averaging 84% each fiscal year). REP has limited expenses for supplies and services, including office supplies temporary staffing, and legal services.

Real Estate Portfolio Department Expenses

Expense Category	2011 Expenditures	% of 2011 Expenditures
Salaries & Benefits	$1,118,097.00	84.84%
General Expenses	$100,121.00	7.60%
Outside Services	$42,367.00	3.21%
Travel & Other Employee Expenses	$17,329.00	1.31%
Wages & Benefits	$15,835.00	1.20%
Other Expenses	$24,096	1.83%
Grand Total	**$1,317,844.00**	**100.00%**

Source: PeopleSoft

Department Highlights and Accomplishments

During the course of the audit, we observed the following improvements in management processes related to lease agreement development and management.

- Continuing refinement of the Lease Analysis Template, which evaluates several critical real estate metrics include return-on-investment, prevailing market conditions, and associated risks.
- Launch of a SharePoint site for managing draft agreements for quality assurance.
- Implementation of the most significant upgrade to the PROPWorks system.

Audit Scope and Methodology

We reviewed information for the period of January 1, 2011 – June 30, 2012. We utilized a risk-based audit approach from planning through testing. We gathered information through interviews, observations, and analytical reviews, in order to obtain a complete understanding of the Real Estate Portfolio Department activity. We conducted an assessment of significant risks and identified controls established to mitigate those risks. We evaluated whether the established controls were functioning effectively as intended.

We applied additional detailed audit procedures to areas with the highest likelihood of significant negative impact as follows:

1. To determine whether the Department has developed lease agreements in compliance with significant Port real estate leasing policies and guidelines:

    - We developed a risk-based sample of 15 agreements for testing
    - We validated the efforts to identify prevailing market conditions for each agreement
    - We verified that a Tenant Risk Assessment was completed to evaluate the tenants financial suitability for the lease agreement terms
    - We verified that the department routed draft agreements to Port legal and received confirmation of their consent

2. To determine whether the Department has adequate controls in place to effectively manage multiple Real Estate and Seaport Division agreements in the Port's PROPWorks systems, we developed separate risk-based samples for the three major periods in an agreement's lifespan:

    New Lease Agreements executed between January 1, 2011 – June 30, 2012

    - We reviewed five Real Estate and five Seaport agreements to determine whether they were signed by Port management prior to the effective date (i.e., first date of the agreement)
    - We determined whether those new agreements were entered into PROPWorks within two weeks of the effective date

Active Lease Agreements from January 1, 2011 – June 30, 2012

We reviewed ten Real Estate and ten Seaport agreements against the following:

- We verified the Department's use of auto-letters to remind tenants of their obligations to remit updated insurance policies to the port annually within 30-days of their expiration
- We reviewed to see how many updated insurance agreements were entered into PROPWorks within 30 days after the policy's effective date
- We identified Consumer Price Index (CPI)-adjustment clauses in the agreements and reviewed how many adjustments were added to PROPWorks within 30 days of the effective dates
- We identified billing rules for seasonal/annual utility rate adjustments and reviewed how many of these updates were completed within 30 days of the effective date

Leases Terminated between January 1, 2011 – June 30, 2012

We reviewed five Real Estate and five Seaport agreements for the following attribute:

- We verified that agreements were only designated as 'terminated' after the final rent, concession, and/or utility payments were received.

Conclusion

The Department has effective controls to manage Real Estate and Seaport Division agreements within PROPWorks. However, in select instances, we noted that the controls to ensure full compliance in the development of lease agreements weren't consistently applied.

Schedule of Findings and Recommendations

1. **The Department's Controls For Its Real Estate Agreement Development Process Were Inconsistently Applied To Ensure Compliance With The Port's Real Estate 1 Policy**

The Real Estate Portfolio Department (REP) must develop its agreements in accordance with the requirements of the Port's Real Estate 1 (RE-1) policy. One of the key RE-1 requirements is the following financial analysis of new and potential tenants to determine acceptable risk to the Port:

> **G. Financial Analysis**:
> The User's ability to meet the financial obligations called for by the Agreement (including rental payments, costs of required improvements, operations, etc.) shall be analyzed. Among other means this could be done by:
> - Obtaining and reviewing financial statements;
> - Making credit checks and inquiries,
> - Inquiries of bankers and other references.

In two of seven agreements reviewed, REP developed agreements for tenants with no prior leasing history without developing a Tenant Risk Analysis. The real estate staff used unverified information in place of the Department's Tenant Risk Analysis process.

Further, this same issue of inconsistent financial analysis was noted as an audit finding (No. 5) in the Washington State Auditor's January 2010 report of Port Real Estate management and programs:

> "The Port's financial analyses of proposed leases or renewals were inconsistent, incomplete and sometimes inaccurate…Real estate managers did not sufficiently document financial analyses and did not obtain independent third-party review to make sure they were accurate, complete and consistent. Port real estate policies require the divisions to prepare financial analyses but they are not specific enough and should be revised…"

REP continued to inconsistently use its financial analysis control during the audit period, mirroring the same conditions identified by the State Auditor in their 2010 audit report.

Recommendations:

We recommend management:

- Continue with improvements to the lease agreement development process, to ensure that the Tenant Risk Analysis is used and consistently applied in the determination of an acceptable financial risk.

Management Response

Portfolio Management agrees that the finding is accurate and also that an appropriate level of financial risk analysis of new customers should be done on every transaction.

While acknowledging that the two agreements did not have full financial risk analysis, a review of the relative risk to the Port was done and it was decided at the time that further review was not necessary due to a combination of characteristics: short lease terms (one year and five years), minimal or no Port investment (zero in one case, less than $3000 in the other), amount of surety to be received, and the apparent stability of both tenants (one was subsidiary of large Port tenant, the other was an Alaska State agency).

In the future, this level of analysis will be better documented. Portfolio Management is currently working with Seaport Finance (who supports our financial analytical needs) to refine the threshold for and depth of financial analyses on all transactions.