



Office of the City Auditor

**Report to the City Council
City of San José**

**AN AUDIT OF SAN JOSÉ ARENA
MANAGEMENT CORPORATION'S
COMPLIANCE WITH THE
SAN JOSÉ ARENA MANAGEMENT
AGREEMENT**

**Arena Management And The City Of
San José Need To Establish Formal
Procedures Over The Luxury Suite Fee
Process**

**Arena Management Is Not Complying With
All Of The Reporting Requirements In The
Management Agreement**

**The City And Redevelopment Agency Need
To Resolve Possessory Interest Tax
Deduction Issues**

**Report 02-02
March 2002**



CITY OF SAN JOSÉ, CALIFORNIA

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City Auditor

March 19, 2002

Honorable Mayor and Members
of the City Council
801 North First Street, Room 600
San Jose, CA 95110

Transmitted herewith is a report on *An Audit Of The San Jose Arena Management Corporation's Compliance With The San Jose Arena Management Agreement*. This report is in accordance with City Charter Section 805. An Executive Summary is presented on the blue pages in the front of this report. The Redevelopment Agency's Response is shown on the yellow page before the Appendices. The City Administration and the San Jose Arena Management Corporation elected not to provide a written response.

I will present this report to the Finance and Infrastructure Committee at its March 27, 2002, meeting. If you need additional information in the interim, please let me know. The City Auditor's staff member who participated in the preparation of this report is Mike Edmonds.

Respectfully submitted,

Gerald A. Silva
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Executive Summary

In accordance with the City Auditor's 2001-2002 Audit Workplan, we audited the San Jose Arena Management Corporation to determine whether it has complied with specific provisions of the San Jose Arena Management Agreement. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

Finding I

Arena Management And The City Of San Jose Need To Establish Formal Procedures Over The Luxury Suite Fee Process

On August 1 of each year, the San Jose Arena Management Corporation (Arena Management) is required to pay the City of San Jose (City) for Arena fees that are due. These fees include a fixed payment, Luxury Suite Net Revenues (suite revenues), and parking fees. Arena Management calculates its suite revenue payments based on an estimate of the number of suites that will be leased for the year. We found that Arena Management miscalculated the 1999-2000 suite revenue payment because it deducted too much in deemed hockey ticket proceeds. As a result, Arena Management unintentionally underpaid the City about \$40,000 for the 1999-2000 suite revenue payment. It should be noted that after we discussed this underpayment with Arena Management, they promptly paid the City an additional \$40,000 in June 2000. We also found that the Management Agreement allowed Arena Management to keep \$111,000 of the City's revenues for nearly a year. In our opinion, both Arena Management and the City need to establish formal procedures for the Luxury Suite fee process.

RECOMMENDATIONS

We recommend that Arena Management:

Recommendation #1

Develop written procedures for calculating the annual Arena fees payment to the City and include in those new procedures estimating luxury suite revenues based upon prior years' luxury suite leasing history. (Priority 2)

We recommend that the City Manager's Office:

Recommendation #2 **Assign responsibility for reviewing and approving the annual Arena fees payment. (Priority 3)**

Finding II **Arena Management Is Not Complying With All Of The Reporting Requirements In The Management Agreement**

The San Jose Arena Management Agreement (Management Agreement) requires the San Jose Arena Management Corporation (Arena Management) to submit reports and financial statements to the City of San Jose (City). The purpose of these reports is to provide the City with the information it needs to monitor those Arena activities and operations in which the City has a direct financial interest. We found that Arena Management has not provided the City with the required reports and statements. As a result, the City is not receiving all of the information the Management Agreement requires to assist the City in monitoring those Arena activities and operations in which it has a direct financial interest.

RECOMMENDATIONS

We recommend that Arena Management, the Arena Authority, and the City Attorney's Office:

Recommendation #3 **Develop a mutually agreeable delivery schedule regarding the frequency of the detailed reports and records relating to the City Related Accounts. (Priority 3)**

We recommend that Arena Management:

Recommendation #4 **Provide the past and future City Income Reports and Audit Reports in accordance with the Management Agreement. (Priority 3)**

We also recommend that the City Manager's Office:

Recommendation #5 **Assign responsibility for ensuring that Arena Management submits all Management Agreement-required reports. (Priority 3)**

Finding III The City And Redevelopment Agency Need To Resolve Possessory Interest Tax Deduction Issues

The San Jose Arena Management Agreement (Management Agreement) between the City of San Jose (City) and San Jose Arena Management Corporation (Arena Management) allows Arena Management to deduct certain possessory interest property taxes (possessory interest taxes) from the Arena fees it pays to the City. A separate agreement between the Redevelopment Agency (Agency) and the City requires the Agency to reimburse the City for possessory interest tax deductions that Arena Management deducts from its payment to the City. During our audit of Arena fees, we found that the Agency had not reimbursed the City for three years of Arena Management's possessory interest tax deductions totaling \$1,521,474. Accordingly, the City Auditor recommended that the City bill the Agency for the \$1,521,474. Subsequently:

- The Agency only reimbursed the City \$1,086,028 of the \$1,521,474 in possessory interest taxes Arena Management deducted from its 1997-1998, 1998-1999, and 1999-2000 Arena fee payments to the City because, at the time, Santa Clara County (County) had not paid the Agency all of the possessory interest taxes it was due;
- Over the last two years, the City has billed the Agency another \$525,022 and \$532,596 for the possessory interest taxes Arena Management deducted from its 2000-2001 and 2001-2002 Arena fee payments to the City; and
- The Agency has only reimbursed the City \$497,969 of these additional billings because of questions over the amount of possessory interest taxes that the County has paid it.

Thus, as of January 1, 2002, the Agency has not reimbursed the City a total of \$995,095 in possessory interest taxes that Arena Management deducted from the Arena fees it paid to the City because of questions over the amount of these monies it received from the County.

The City Auditor's Office has worked with the County to secure for the Agency all of the possessory interest taxes that Arena Management has deducted from its Arena fee payments.

In January 2002, the County paid the Agency \$1,378,492 for possessory interest taxes that Arena Management had previously paid to the County. Our analysis indicates that the Agency has received all but about \$37,000 of the possessory interest taxes that Arena Management deducted from its Arena fees. Therefore, the Agency should reimburse the City's General Fund approximately \$958,000. In addition, the Agency, the City Attorney's Office, the City Manager's Office, and Arena Management should work together to determine how Arena Management should calculate its possessory interest tax deduction. Finally, the City needs to bill the Agency for Arena Management's possessory interest tax deductions in a more timely manner. In our opinion, the City, the Agency, and Arena Management need to resolve the possessory interest tax deduction issues in order to ensure that the City is promptly and equitably reimbursed.

RECOMMENDATIONS

We recommend that the Redevelopment Agency:

Recommendation #6 **Pay the City \$958,000 for Arena Management's possessory interest tax deductions. (Priority 1)**

We also recommend that the Agency, the City Attorney's Office, the City Manager's Office, and Arena Management:

Recommendation #7 **Work together to determine how Arena Management should calculate its possessory interest tax deduction. (Priority 2)**

We also recommend that the City:

Recommendation #8 **Establish a procedure to immediately bill the Agency for Arena Management's possessory interest tax deductions when it receives Arena Management's annual Arena fee payment. (Priority 2)**

Introduction

In accordance with the City Auditor's 2001-2002 Audit Workplan, we audited the San Jose Arena Management Corporation to determine whether it has complied with specific provisions of the San Jose Arena Management Agreement. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

The City Auditor's Office thanks the San Jose Arena Management Corporation's employees, the San Jose Arena Authority, the Redevelopment Agency, the City Manager's Office, and the City Attorney's Office, who gave their time, information, insight, and cooperation for this audit.

Background

On December 17, 1990, the City of San Jose (City), the City of San Jose Redevelopment Agency (Agency), and the San Jose Arena Management Corporation (Arena Management) signed a letter of agreement which led to the design and construction of the San Jose Arena (Arena), now known as Compaq Center at San Jose (Arena). Specifically, this agreement outlined the terms and conditions that were to be negotiated in good faith to arrive at formal agreements relating to the construction, management, and maintenance of a first class, multi-purpose, hockey-ready entertainment and sports facility and adjacent parking facilities.

Subsequently, the City, the Agency, and Arena Management entered into two agreements for the design, construction, and operation of the San Jose Arena. The first agreement, the San Jose Arena Agreement to Enter, coordinated the design and construction of the Arena facilities, which occurred over six phases. The resulting Arena facility has approximately 17,500 seats, including 44 skybox suites and 21 concourse suites, and hosts a variety of sports and entertainment events year round.

The second agreement, San Jose Arena Management Agreement (Management Agreement), which became effective October 1991, sets forth the respective rights and obligations of the City and Arena Management with regard to the management and operation of the Arena. The term of the Management Agreement was to run through July 31, 2008.

In December 2000, however, the City and Arena Management amended and restated the Management Agreement. The term of the Amended and Restated San Jose Arena Management Agreement extends through July 31, 2018, and has an option to extend the agreement for an additional five years.

To provide oversight of the Arena operations, the City established the San Jose Arena Authority (Arena Authority) in 1990. In accordance with Section 1.03 of the Management Agreement, the Arena Authority is to oversee the operation of the Arena facilities on behalf of the City and to act as a liaison to the community. Thus, the Arena Authority oversees Arena Management's operation of the Arena through interpretation and application of the terms and provisions of the Agreement and monitors and develops relations with the community with respect to impacts from the operation of the Arena.

The Management Agreement requires Arena Management to pay the City several Arena fees. Specifically, the Management Agreement requires Arena Management to pay the City fees that are due annually on August 1 for the term year beginning on August 1 and ending July 31. These fees consist of the following: 1) a "fixed fee" that starts at \$500,000 for the first six years of operation, increases by \$100,000 increments in years 7 through 10, and is the greater of \$1,000,000 or five percent of the Average Annual Hockey Revenue in years 11 through 15; 2) Luxury Suite Net Revenues (suite revenues); and 3) parking fees. The Management Agreement also allows Arena Management to deduct a portion of its annual possessory interest property tax payment to Santa Clara County from the fees. This formula for calculating the Arena fee payments will continue through July 31, 2008. Beginning in August 2008, the Amended and Restated San Jose Arena Management Agreement includes a new formula for calculating the Arena fee payments.

From 1996-1997 through 2001-2002, Arena Management has paid nearly five million dollars in Arena fees to the City. Exhibit 1 shows Arena Management's fee payments to the City of San Jose for the term years 1996-1997 through 2001-2002.

**Exhibit 1 Arena Management's Payments To The City Of
San Jose For Term Years 1996-1997 Through
2001-2002**

Fee	1996-1997	1997-1998	1998-1999	1999-2000	2000-2001	2001-2002	Total
Suite Revenue Payment	\$358,294	\$389,063	\$473,707	\$491,510	\$645,517	\$803,347	\$3,161,438
True-Up ¹		(7,218)	(7,926)	19,293	39,734	(38,609)	5,274
Fixed Fee	500,000	500,000	500,000	600,000	700,000	800,000	3,600,000
Total Arena Fees	\$858,294	\$881,845	\$965,781	\$1,110,803	\$1,385,251	\$1,564,738	\$6,766,712
Less: Possessory Interest Tax		(498,320)	(507,065)	(516,089)	(525,022)	(532,596)	(2,579,092) ²
Parking Fees	115,763	121,551	127,629	134,010	140,711	147,746	787,410
Total	\$974,057	\$505,076	\$586,345	\$728,724	\$1,000,940	\$1,179,888	\$4,975,030

In addition to the amounts above, the Amended and Restated San Jose Arena Management Agreement requires Arena Management to pay the City for the naming rights to the Compaq Center at San Jose. Specifically, the Management Agreement now requires Arena Management to pay the City a total of \$22,625,000 through term year 2015-2016. The Management Agreement requires Arena Management to make the following payments to the City for the naming rights to Compaq Center at San Jose:

- \$625,000 for part of the 2000-2001 term year;
- Six annual payments of \$1,500,000 for term years 2001-2002 through 2006-2007; and

¹ True-up is an annual adjustment to reconcile any differences between Arena Management's August 1 estimate of the Arena fees due and the actual amount due as determined at the end of the term year. If Arena Management underestimates the Arena fees due, it must pay the City the additional fees. Conversely, if Arena Management overestimates the Arena fees due, Arena Management deducts the amount from its next Arena fee payment.

² Arena Management's possessory interest tax deductions include payments for tax years 1993-1996 that Santa Clara County did not assess until 1997 and Arena Management paid over a five year period beginning with term year 1997-1998.

- Eight annual payments of \$1,625,000 for term years 2007-2008 through 2014-2015.

In August 2001, Arena Management paid the City \$1,525,000 for naming rights. This amount was for the 2000-2001 partial payment of \$625,000 and the 2001-2002 annual payment of \$1,500,000, less \$600,000, for the cost of signage on the newly-named Arena.

Scope And Methodology

The primary objective of our audit was to determine whether the San Jose Arena Management Corporation (Arena Management) complied with specific provisions of the San Jose Arena Management Agreement (Management Agreement) during the term years 1996-1997 through 2001-2002. Specifically, the audit objectives were to determine whether Arena Management:

- Calculated Luxury Suite Net Revenue (suite revenues) payments in accordance with the terms of the Management Agreement;
- Paid the City of San Jose (City) suite revenues and other Arena fees in accordance with the timeframes specified in the Management Agreement; and
- Prepared and submitted required reports and financial statements to the City.

A secondary audit objective was to determine whether the San Jose Redevelopment Agency (Agency) reimbursed the City for Arena Management's possessory interest property tax (possessory interest tax) deductions for the term years 1997-1998 through 2001-2002.

To obtain an understanding of the Management Agreement, we reviewed the San Jose Arena Agreement to Enter and the Management Agreement, including all appropriate attachments. We also met with staff from Arena Management, the Arena Authority, the Redevelopment Agency, the City Attorney's Office, and the City Manager's Office to further our understanding of the relevant requirements in the Management Agreement.

To determine if the suite revenue payments were calculated in accordance with the Management Agreement, we tested the relevant components of the calculations. The components included (1) estimated gross suite revenue, (2) amortized suite

hard and soft costs, (3) amortized suite repairs and improvements, (4) deemed hockey ticket proceeds, and (5) commissions. We also toured the San Jose Arena and observed the concourse and the skybox suites. In addition, we reviewed a random sample of concourse suite and skybox leases and tested the propriety of the annual gross suite revenues.

To evaluate whether Arena Management paid the suite revenues and other Arena fees in accordance with the timeframes specified in the Management Agreement, we verified that Arena Management paid the City by the August 1 date specified in the Management Agreement.

To evaluate whether Arena Management complied with the recordkeeping and reporting requirements, we reviewed reporting requirements and attempted to obtain all of the required reports. For instance, we obtained the Certified Public Accountant's Statements of Income and Expense for City Related Accounts with a certificate which states that the calculation of City Related Accounts is fairly presented. The Management Agreement defines City Related Accounts as "*the Reserve Fund, the Ticket Account, expenditures described in the maintenance and Capital Enhancements budgets..., and all items of income and expenditure that are used to calculate Building naming Revenue, Luxury Suite Net Revenue and Allocated Hockey Gross Ticket Revenue*".

Finally, from all the documents reviewed, we analyzed the information received to determine compliance with the Management Agreement terms subject to our audit.

To determine whether the Agency reimbursed the City for Arena Management's possessory interest tax deductions, we compared the amount of Arena Management's possessory interest tax deductions to the amount the Agency reimbursed the City. To do so, we compared Arena Management's deductions to the City billings as well as the Agency's payments to the City. We also investigated the reasons why the Agency did not pay the City for the total amount of Arena Management's deductions. Finally, we worked with officials from Santa Clara County to secure payment of possessory interest taxes for the Agency.

Finding I

Arena Management And The City Of San Jose Need To Establish Formal Procedures Over The Luxury Suite Fee Process

On August 1 of each year, the San Jose Arena Management Corporation (Arena Management) is required to pay the City of San Jose (City) for Arena fees that are due. These fees include a fixed payment, Luxury Suite Net Revenues (suite revenues), and parking fees. Arena Management calculates its suite revenue payments based on an estimate of the number of suites that will be leased for the year. We found that Arena Management miscalculated the 1999-2000 suite revenue payment because it deducted too much in deemed hockey ticket proceeds. As a result, Arena Management unintentionally underpaid the City about \$40,000 for the 1999-2000 suite revenue payment. It should be noted that after we discussed this underpayment with Arena Management, they promptly paid the City an additional \$40,000 in June 2000. We also found that the Management Agreement allowed Arena Management to keep \$111,000 of the City's revenues for nearly a year. In our opinion, both Arena Management and the City need to establish formal procedures for the Luxury Suite fee process.

Arena Management Estimates

Annually, prior to the upcoming hockey season, Arena Management calculates the amount of the suite revenue payment based on an estimate of suite revenues. Arena Management's estimate of suite revenues is based upon the suites that are actually leased when the payment is due to the City on August 1. For the term year 1999-2000, Arena Management used the following methodology to calculate the suite revenue payment:

Estimate of the Gross Suite Revenue (Actual suites leased)	\$5,730,113
Less:	
Deemed hockey ticket proceeds [Emphasis added]	1,983,960
Amortized cost of constructing the suites	1,462,712
Cost of capital maintenance and repairs to the suites	25,477
Total estimated luxury suite net revenue	\$2,257,964
Percentage Paid to the City	20%
Payment to the City	<u>\$451,593</u>

As shown above, Arena Management deducts the cost of the deemed hockey ticket proceeds from the suite revenues. The deemed hockey ticket proceeds is the cost of the tickets that are included in the price of leasing the suites. The Management Agreement specifies that Arena Management's deduction for the hockey ticket proceeds is to be based on the number of leased seats at the highest priced non-club hockey ticket (\$54 for the 1999-2000 season) for all exhibition, regular, and All-star games. Arena Management, however, is not allowed to deduct the ticket costs for three suites that are excluded from the suite revenue calculations. The three suites are the City's suite and Arena Management's two suites.

**Arena Management
Miscalculated Its
1999-2000 Suite
Revenue Payment**

We identified a problem with Arena Management's calculation of the suite revenue payment for term year 1999-2000. Specifically, Arena Management deducted too much in deemed hockey proceeds. For 1999-2000, Arena Management estimated the amount of the gross suite revenues based on the suites that were leased as of August 1, 1999, when the payment was due. Because several suites were not yet leased, Arena Management reduced the gross suite revenue estimate. However, Arena Management inadvertently deducted the deemed hockey ticket proceeds as if all the suites were leased. As a result, Arena Management deducted too much in deemed hockey proceeds from suite revenues. Consequently, Arena Management underpaid the City about \$40,000.

It should be noted that after we discussed this underpayment with Arena Management, they promptly paid the City an additional \$40,000 in June 2000.

In our opinion, Arena Management and the City need to improve their procedures over suite revenue payments. Specifically, Arena Management needs to develop formal procedures on how to calculate suite revenue payments. In addition, the City needs to assign responsibility for ensuring that the suite revenue payments are reviewed for correctness.

As noted above, Arena Management estimates the annual suite revenues based on the number of suites actually leased when the payment is due on August 1. If additional suites are leased, Arena Management pays the City for any additional revenues due when it makes the next year's payment to the City in August of the following year. The Management Agreement does not require Arena Management to revise its payment when

additional suites are leased. Thus, the Management Agreement allows Arena Management, in effect, to keep a portion of the City's revenues for nearly a year. For instance, in August 1999, Arena Management estimated its gross suite revenues at \$5.7 million based on the fact that several suites were not yet leased. Subsequently, Arena Management leased these additional suites for the 1999-2000 hockey season. Arena Management leased the additional suites for about \$555,000. Although Arena Management paid the City for these additional revenues when it made its August 1, 2000 payment, the Management Agreement in effect, allowed Arena Management to keep about \$111,000 of the City's monies for nearly a year. In our opinion, Arena Management should amend its procedure for estimating suite revenues to include an estimate of the luxury suites that will be leased after the August 1 payment date. Arena Management should base its estimate of post-August 1 luxury suite leases on its prior years' luxury suite leasing history. By so doing, the City will receive its share of post-August 1 suite revenues a year sooner.

CONCLUSION

We found that Arena Management miscalculated its 1999-2000 suite revenue payment and underpaid the City about \$40,000. Furthermore, Arena Management was able to keep \$111,000 of the City's revenues for nearly a year without any penalty. Both Arena Management and the City need to establish formal procedures for the Luxury Suite fee process.

RECOMMENDATIONS

We recommend that Arena Management:

Recommendation #1 Develop written procedures for calculating the annual Arena fees payment to the City and include in those new procedures estimating luxury suite revenues based upon prior years' luxury suite leasing history. (Priority 2)

We recommend that the City Manager's Office:

Recommendation #2 Assign responsibility for reviewing and approving the annual Arena fees payment. (Priority 3)

Finding II

Arena Management Is Not Complying With All Of The Reporting Requirements In The Management Agreement

The San Jose Arena Management Agreement (Management Agreement) requires the San Jose Arena Management Corporation (Arena Management) to submit reports and financial statements to the City of San Jose (City). The purpose of these reports is to provide the City with the information it needs to monitor those Arena activities and operations in which the City has a direct financial interest. We found that Arena Management has not provided the City with the required reports and statements. As a result, the City is not receiving all of the information the Management Agreement requires to assist the City in monitoring those Arena activities and operations in which it has a direct financial interest.

Reporting Requirements

Section 10.01 of the Management Agreement states that Arena Management is required to submit detailed monthly reports and records regarding the City Related Accounts. These accounts are the Reserve Fund, the Ticket Account, expenditures described in the Maintenance and Capital Enhancements Budgets, and all items of income and expenditure that are used to calculate Building Naming Revenue, Luxury Suite Net Revenue (suite revenues), and Allocated Hockey Gross Ticket Revenue.

Section 10.02 of the Management Agreement also requires Arena Management to prepare annual Statements of Income and Expense for City Related Accounts (City Income Report) for each fiscal year during the term of the Management Agreement. The City Income Report is required to be accompanied by an opinion and statement by a Certified Public Accountant (Audit Report) that the City Income Report is fairly presented in accordance with the terms and provisions of the Management Agreement.

Article X, Accounting Records and Audits, Sections 10.01 and 10.02 of the Management Agreement state that the following reports are required to be delivered at the time interval indicated:

- Monthly Detailed Reports and Records on City Related Accounts;

- Annual City Income Report; and
- Annual Audit Report.

The purpose of these reports is to provide the City with additional information to monitor and evaluate Arena Management's activities and operations in which the City has a direct financial interest.

Arena Management Has Not Complied With All Of The Reporting Requirements In The Management Agreement

The Management Agreement requires Arena Management to report on activities and operations in which the City has a direct financial interest. However, we found that Arena Management is not complying with all of these reporting requirements. Specifically, Arena Management has not provided the City with required detailed reports and records for the City Related Accounts on a monthly basis. In addition, Arena Management has not provided the City with the required City Income Report and Audit Report on an annual basis.

According to both Arena Management and the Arena Authority, both parties mutually agreed that it was not necessary for Arena Management to give the City detailed reports and records for the City Related Accounts on a monthly basis prior to August 1, 1996. However, at the time of this mutual agreement, the City Related Accounts were not relevant because Arena Management was not required to calculate and remit suite revenues to the City. That requirement was not imposed on Arena Management until after the beginning of the fourth hockey season. As such, Arena Management was required to remit suite revenues to the City for the first time on August 1, 1996 and every August 1, thereafter. However, Arena Management has not provided the City with the detailed reports and records for the City Related Accounts since August 1, 1996.

It should be noted that the City may not need the information in the detailed reports and records for the City Related Accounts as frequently as the Management Agreement requires. In our opinion, Arena Management and City officials should agree on the frequency that the detailed reports and records for the City Related Accounts are needed.

In our opinion, the City needs to assign responsibility for ensuring that Arena Management submits all Management Agreement-required reports.

CONCLUSION The City is not receiving all the information the Management Agreement requires to assist the City in monitoring those Arena activities in which it has a direct financial interest.

RECOMMENDATIONS

We recommend that Arena Management, the Arena Authority, and the City Attorney’s Office:

Recommendation #3 **Develop a mutually agreeable delivery schedule regarding the frequency of the detailed reports and records relating to the City Related Accounts. (Priority 3)**

We recommend that Arena Management:

Recommendation #4 **Provide the past and future City Income Reports and Audit Reports in accordance with the Management Agreement. (Priority 3)**

We also recommend that the City Manager’s Office:

Recommendation #5 **Assign responsibility for ensuring that Arena Management submits all Management Agreement-required reports. (Priority 3)**

Finding III

The City And Redevelopment Agency Need To Resolve Possessory Interest Tax Deduction Issues

The San Jose Arena Management Agreement (Management Agreement) between the City of San Jose (City) and San Jose Arena Management Corporation (Arena Management) allows Arena Management to deduct certain possessory interest property taxes (possessory interest taxes) from the Arena fees it pays to the City. A separate agreement between the Redevelopment Agency (Agency) and the City requires the Agency to reimburse the City for possessory interest tax deductions that Arena Management deducts from its payment to the City. During our audit of Arena fees, we found that the Agency had not reimbursed the City for three years of Arena Management's possessory interest tax deductions totaling \$1,521,474. Accordingly, the City Auditor recommended that the City bill the Agency for the \$1,521,474. Subsequently:

- The Agency only reimbursed the City \$1,086,028 of the \$1,521,474 in possessory interest taxes Arena Management deducted from its 1997-1998, 1998-1999, and 1999-2000 Arena fee payments to the City because, at the time, Santa Clara County (County) had not paid the Agency all of the possessory interest taxes it was due;
- Over the last two years, the City has billed the Agency another \$525,022 and \$532,596 for the possessory interest taxes Arena Management deducted from its 2000-2001 and 2001-2002 Arena fee payments to the City; and
- The Agency has only reimbursed the City \$497,969 of these additional billings because of questions over the amount of possessory interest taxes that the County has paid it.

Thus, as of January 1, 2002, the Agency has not reimbursed the City a total of \$995,095 in possessory interest taxes that Arena Management deducted from the Arena fees it paid to the City because of questions over the amount of these monies it received from the County.

The City Auditor's Office has worked with the County to secure for the Agency all of the possessory interest taxes that Arena Management has deducted from its Arena fee payments.

In January 2002, the County paid the Agency \$1,378,492 for possessory interest taxes that Arena Management had previously paid to the County. Our analysis indicates that the Agency has received all but about \$37,000 of the possessory interest taxes that Arena Management deducted from its Arena fees. Therefore, the Agency should reimburse the City's General Fund approximately \$958,000. In addition, the Agency, the City Attorney's Office, the City Manager's Office, and Arena Management should work together to determine how Arena Management should calculate its possessory interest tax deduction. Finally, the City needs to bill the Agency for Arena Management's possessory interest tax deductions in a more timely manner. In our opinion, the City, the Agency, and Arena Management need to resolve the possessory interest tax deduction issues in order to ensure that the City is promptly and equitably reimbursed.

**Agreement
Between The
Agency And The
City**

By August 1 of each term year, Arena Management must remit Arena fees to the City. These fees include a fixed payment, Luxury Suite Net Revenues (suite revenues), and a parking fee.

In addition, the Management Agreement allows Arena Management to deduct its possessory interest tax payments from its Arena fees. Specifically, the Management Agreement states:

*“B. Possessory Interest Tax. Manager understands and acknowledges that its interest under this Management Agreement may subject it to possessory interest taxes... To the extent that a possessory interest property tax is assessed, **Manager shall pay any tax due and will be entitled to deduct from the Arena Fee any portion of such possessory interest property tax imposed on Manager or the Sharks (but excluding any possessory interest property taxes assessed on the Sharks offices and club) which is allocated to and received by City or Agency, less any set asides required under State law.**”*

[Emphasis added]

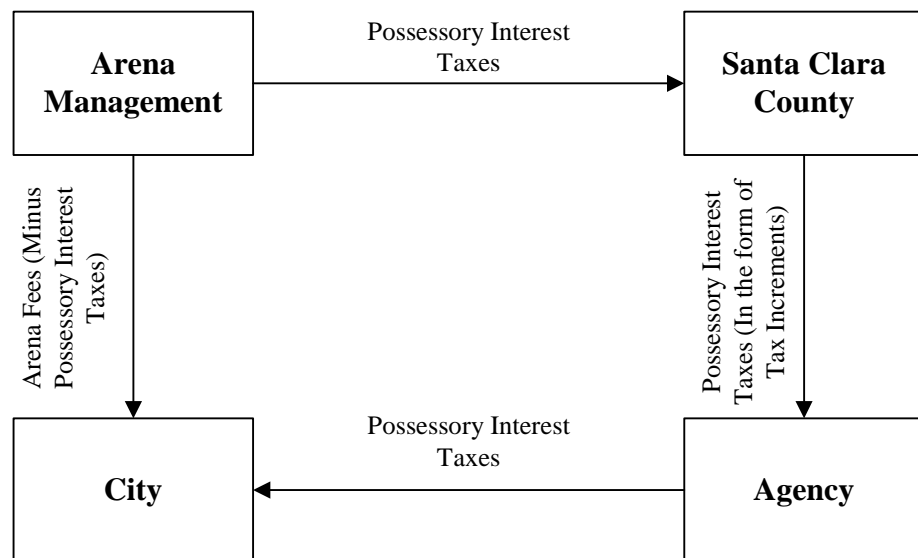
A separate agreement, The Cooperation Agreement Between The Redevelopment Agency Of The City Of San Jose And The City Of San Jose Related To The Construction Of The San Jose Community Arena (Cooperation Agreement), requires the

Agency to compensate the City for the possessory interest taxes Arena Management deducted from its Arena fees. Specifically, the Cooperation Agreement states:

“Agency agrees to reimburse City for all amounts offset by Manager (Arena Management) from, or credited against the Arena Fee, or any other amounts due City under the Management Agreement as a result of any possessory interest taxes imposed upon Manager or the San Jose Sharks, but only to the extent such amounts are actually received by Agency. All amounts to be reimbursed shall be remitted by Agency to City in the same fiscal year in which possessory interest taxes subject to offset are received by Agency.” [Emphasis added]

Essentially, the above agreements are based on the following theory. Arena Management is allowed to deduct from its Arena fee payments to the City the possessory interest taxes it pays to Santa Clara County (County). In turn, the County will eventually pay those possessory interest taxes to the Agency in the form of incremental property taxes. Therefore, the Agency should reimburse the City for the possessory interest taxes that Arena Management deducts from its Arena fee payments to the City. The theoretical flow of possessory interest tax deductions is shown in Exhibit 2 below.

Exhibit 2 Flow Of Possessory Interest Tax Deductions



The Agency Had Not Reimbursed The City For Three Years' Worth Of Arena Management Possessory Interest Tax Deductions Totaling \$1,521,474

We found that from 1997-1998 through 1999-2000, Arena Management deducted \$1,521,474 in possessory interest tax. The possessory interest tax deductions for each of the three years were as follows:

\$ 498,320	on August 1, 1997
507,065	on August 1, 1998
<u>516,089</u>	on August 1, 1999
\$1,521,474	

Therefore, in accordance with the Cooperation Agreement, the Agency should have paid the City \$1,521,474 for the possessory interest tax Arena Management deducted from the Arena fees on August 1, 1997, 1998, and 1999.

As of April 2000, however, the Agency had not reimbursed the City for any of the above possessory interest tax deductions. To account for these payments, the City established an accounts receivable for \$1.1 million and the Agency had established an accounts payable for the same amount. However, according to City and Agency staff, the City had not yet invoiced the Agency for any of the possessory interest tax deductions and the Agency would not pay the City without an invoice. Meanwhile, the City's Budget Office was trying to determine the exact amount the City should invoice the Agency.

The City Auditor's Office Issued A Memorandum To The City Manager's Office And The Redevelopment Agency Director

To help resolve this issue, the City Auditor's Office issued an April 11, 2000, memorandum to both the City Manager and the Agency Director (See Appendix B). The memorandum recommended that the City immediately invoice the Agency for the \$1,521,474 shown above and the Agency reimburse the City for the amount invoiced. In addition, the memorandum recommended that the City, upon receipt of future Arena Management annual Arena fee payments, immediately invoice the Agency for the possessory interest taxes Arena Management deducted from its payment to the City.

In response to the City Auditor's memorandum, the City invoiced the Agency \$1,521,474. However, the Agency paid the City only \$1,086,028 of the \$1,521,474 invoiced amount. According to the Agency, it did not pay the City the remaining \$435,446 because, at the time, the County had paid the

Agency only \$1,086,028 of the \$1,521,474 in possessory interest tax payments Arena Management had paid to the County.

According to an Agency consultant, the County had not paid the Agency all of Arena Management's possessory interest tax payments because the County had incorrectly apportioned certain property tax payments. Under the normal apportionment process for unsecured tax increments (such as possessory interest taxes), the Santa Clara County Controller's Office uses an assessment roll to calculate the incremental assessed valuation and the resulting tax increments. Possessory interest tax increments should be on this assessment roll and the County should pay all of those taxes to the Agency.

The County, however, has not included certain extraordinary unsecured assessments on the roll used to calculate the Agency's annual tax increment payments. The extraordinary unsecured assessments include "escapes". "Escapes" are assessments against properties that escaped assessment in a prior year. Tax payments for these extraordinary assessments appear on a separate roll and are apportioned to jurisdictions according to the normal property tax apportionment process, even when the assessments are for properties in Redevelopment areas. When this happens, the Agency does not receive its tax increments.

The County has treated a portion of Arena Management's possessory interest tax payments as an extraordinary or "escaped" assessment. Specifically, for tax years 1993-1996, the County did not assess Arena Management any possessory interest taxes. In 1997, the County assessed Arena Management \$1,378,492 for the possessory interest taxes which had "escaped" assessment. The County allowed Arena Management to pay these taxes over a five-year period. Accordingly, Arena Management has paid these possessory interest tax payments to the County and deducted the payments from the Arena fees it pays the City. However, because of the way the County has apportioned "escaped" assessments within Redevelopment areas, the Agency has not received all of the possessory interest taxes Arena Management has paid.

In addition to the 1997-1998 through 1999-2000 billings, the City has also billed the Agency \$525,022 and \$532,596 for possessory interest taxes Arena Management deducted from its Arena fee payments to the City in 2000-2001 and 2001-2002,

Arena Management Agreement

respectively. As of January 1, 2002, the Agency had paid the City \$497,969 or \$27,053 less than the \$525,022 the City billed for 2000-2001. Moreover, the Agency has not paid the City any of the \$532,596 the City billed the Agency for 2001-2002.

In summary, as of January 1, 2002, the City had billed the Agency \$2,579,092 for Arena Management possessory interest tax deductions and the Agency had reimbursed the City \$1,583,997 - a difference of \$995,095 as shown below.

<u>Term Year</u>	<u>Amount Of Possessory Interest Taxes The City Billed The Agency</u>	<u>Amount Of Possessory Interest Taxes The Agency Paid The City</u>	<u>Difference</u>
1997-1998 Through 1999-2000	\$1,521,474	\$1,086,028	\$435,446
2000-2001	525,022	497,969	27,053
2001-2002	532,596	0	532,596
	<u>\$2,579,092</u>	<u>\$1,583,997</u>	<u>\$995,095</u>

The City Auditor's Office Worked With The County To Secure \$1,378,492 For The Agency

The City Auditor's Office has worked with the County to secure for the Agency all of the possessory interest taxes that Arena Management has paid to the County. In January 2002, the County reapportioned the "escaped" assessments to the Agency. Specifically, the County paid the Agency \$1,378,492 in possessory interest taxes to correct the problem with the "escaped" assessments.

With the recent payment from the County, our analysis indicates that the Agency has received nearly all of the possessory interest taxes that Arena Management has deducted from its Arena fees. Specifically, the Agency has received all but about \$37,000 of the \$2,579,092 that Arena Management has deducted. Accordingly, we estimate that the Agency should reimburse the City about \$958,000 for the possessory interest taxes it has received but not yet paid to the City.

The \$37,000 difference noted above is the result of minor differences in the way Arena Management and the Agency calculate the possessory interest taxes subject to deduction from Arena fee payments. Based upon discussions we had with the Agency, it appears that while these differences may have been relatively minor in the past, they will become more significant in the future. In order to prevent the City from incurring significant Arena fee payment losses in the future, we recommend that the Agency, the City Attorney's Office, the

City Manager's Office, and Arena Management work together to determine how Arena Management should calculate its possessory interest tax deduction.

We also found that the City needs to bill the Agency for Arena Management's possessory interest tax deductions in a more timely manner. Arena Management deducts the possessory interest taxes it pays to the County from the annual Arena fee payment it remits to the City on August 1 of each year. The City should immediately bill the Agency when it receives the Arena fee payment from Arena Management.

We found that the City has not promptly billed the Agency for the possessory interest taxes deducted from Arena Management's payment to the City. Specifically, as noted above, the City did not bill the Agency for three years' worth of Arena Management possessory interest tax deductions totaling \$1,521,474 until May 24, 2000. This was six weeks after the City Auditor issued a memorandum to the Agency and the City regarding this issue. Furthermore, the City did not bill the Agency for Arena Management's August 1, 2000-2001 possessory interest tax deduction of \$525,022 until May 4, 2001. This billing was nine months after Arena Management deducted the possessory interest taxes from its annual Arena fee payment. Finally, the City did not bill the Agency for Arena Management's August 1, 2001-2002 possessory interest tax deduction of \$532,596 until November 5, 2001. This billing was three months after Arena Management deducted the possessory interest taxes from its annual Arena fee payment. These last two late billings deprived the City of the opportunity to use and earn interest on \$525,022 for nine months and \$532,596 for three months.

CONCLUSION

We found that the Agency had not reimbursed the City's General Fund \$1,521,474 in possessory interest taxes that Arena Management deducted from the Arena fees it paid to the City in 1997-1998 through 1999-2000. As a result of our audit, the City billed the Agency \$1,521,474 and the Agency paid the City \$1,086,000. The Agency did not pay the City the remaining \$435,446 because, at the time, Santa Clara County had not paid the Agency all of the possessory interest taxes it was due. Besides the \$435,446, the Agency has not fully reimbursed the City for Arena Management's 2000-2001 and 2001-2002 possessory interest tax deductions. In total, the City has billed the Agency \$995,095 for Arena Management

possessory interest tax deductions for which it has not yet been reimbursed. The City Auditor's Office has worked with the County to secure for the Agency all of the possessory interest taxes that Arena Management has deducted from its Arena fee payment to the City. As a result, in January 2002, the County paid the Agency \$1,378,492 for Arena Management's possessory interest taxes that Arena Management had previously paid to the County. Our analysis indicates that the Agency has received all but about \$37,000 of the possessory interest taxes that Arena Management deducted from its Arena fees. Therefore, the Agency should reimburse the City's General Fund \$958,000. In addition, the Agency, the City Attorney's Office, the City Manager's Office, and Arena Management should work together to determine how Arena Management should calculate its possessory interest tax deduction. Finally, the City needs to bill the Agency for Arena Management's possessory interest tax deductions in a more timely manner. In our opinion, the City, the Agency, and Arena Management need to resolve the possessory interest tax deduction issues in order to ensure that the City is promptly and equitably reimbursed.

RECOMMENDATIONS

We recommend that the Redevelopment Agency:

Recommendation #6 **Pay the City \$958,000 for Arena Management's possessory interest tax deductions. (Priority 1)**

We also recommend that the Agency, the City Attorney's Office, the City Manager's Office, and Arena Management:

Recommendation #7 **Work together to determine how Arena Management should calculate its possessory interest tax deduction. (Priority 2)**

We also recommend that the City:

Recommendation #8 **Establish a procedure to immediately bill the Agency for Arena Management's possessory interest tax deductions when it receives Arena Management's annual Arena fee payment. (Priority 2)**

Other Pertinent Information

The City Auditor's Office conducted an audit to determine if San Jose Arena Management Corporation (Arena Management) paid the City of San Jose (City) Luxury Suite Net Revenues (suite revenues) in accordance with the terms of the San Jose Arena Management Agreement (Management Agreement). Section 6.02 of the Management Agreement provides the method of calculating suite revenues which includes a deduction from gross suite revenue of the amortized "... 'Hard Costs' and 'Soft Costs' ... attributable to the build out of the Sky Boxes or upgrade of finishes in the Concourse Boxes...".

Arena Management estimated that the hard and soft costs of constructing the suites totaled \$9,130,063. In accordance with the terms of the Management Agreement, Arena Management was allowed to amortize this amount at an assumed rate of interest of 10.25 percent per annum over 12 years. Thus, Arena Management's total deduction for the hard and soft costs of construction over the 12-year amortization period was \$15,212,967 (\$9,130,063 in costs plus \$6,082,904 in interest).

The audit revealed challenges in determining the accuracy of Arena Management's estimate of the hard and soft costs of constructing the suites. The City Auditor's Office and Arena Management conducted an extensive review of the records to establish the amount of the hard and soft costs to be used in the calculation of suite revenues. We agreed on \$7,231,219 as the amount of the hard and soft costs in the calculation of suite revenues.

Arena Management will use the above amount in all future calculations of the City's revenue share portion of the Arena fee payment and re-calculate its suite revenues for all past payments. Reducing the amount of the hard and soft costs of constructing the suites will increase the amount of past and future suite revenue payments to the City by approximately \$633,000. Specifically, Arena Management's 1996-1997 through 2001-2002 suite revenue payments to the City increased by \$375,000 and the suite revenue payments for years 2002-2003 through 2007-2008 will increase by an additional \$258,000.

In January 2002, Arena Management paid the City approximately \$375,000 for the 1996-1997 through 2001-2002 suite revenue payments.



RECEIVED

MAR 08 2002

CITY AUDITOR

THE REDEVELOPMENT AGENCY OF THE CITY OF SAN JOSE

March 6, 2002

Gerald Silva
City Auditor
800 N. First Street
San Jose, CA 95112

Re: Compaq Arena Possessory Interest Tax

Dear Gerry:

We have reviewed your audit report "The San Jose Arena Management Corporation's Compliance with the San Jose Arena Management Agreement" and concur with your findings regarding obligations of the Redevelopment Agency.

Regarding your recommendation #6 to pay the City \$958,000 for Arena Management's possessory interest tax deductions, we concur. The Agency received funds from the County in January 2002, which will serve as the source of the transfer to the City.

We appreciate your efforts to retrieve the property tax, which had previously been misallocated.

A handwritten signature in black ink, appearing to read "Susan F. Shick".

SUSAN F. SHICK
Executive Director

APPENDIX A

DEFINITIONS OF PRIORITY 1, 2, AND 3 AUDIT RECOMMENDATIONS

The City of San Jose's City Administration Manual (CAM) defines the classification scheme applicable to audit recommendations and the appropriate corrective actions as follows:

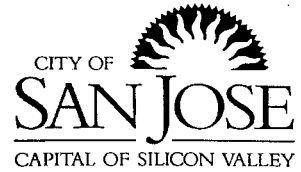
Priority Class¹	Description	Implementation Category	Implementation Action³
1	Fraud or serious violations are being committed, significant fiscal or equivalent non-fiscal losses are occurring. ²	Priority	Immediate
2	A potential for incurring significant fiscal or equivalent fiscal or equivalent non-fiscal losses exists. ²	Priority	Within 60 days
3	Operation or administrative process will be improved.	General	60 days to one year

¹ The City Auditor is responsible for assigning audit recommendation priority class numbers. A recommendation which clearly fits the description for more than one priority class shall be assigned the higher number. **(CAM 196.4)**

² For an audit recommendation to be considered related to a significant fiscal loss, it will usually be necessary for an actual loss of \$25,000 or more to be involved or for a potential loss (including unrealized revenue increases) of \$50,000 to be involved. Equivalent non-fiscal losses would include, but not be limited to, omission or commission of acts by or on behalf of the City which would be likely to expose the City to adverse criticism in the eyes of its citizens.
(CAM 196.4)

³ The implementation time frame indicated for each priority class is intended as a guideline for establishing implementation target dates. While prioritizing recommendations is the responsibility of the City Auditor, determining implementation dates is the responsibility of the City Administration.
(CAM 196.4)

APPENDIX B



Memorandum

TO: Del Borgsdorf, City Manager
Susan Shick, Director, Redevelopment Agency

FROM: Gerald A. Silva,
City Auditor

SUBJECT: ARENA POSSESSORY INTEREST TAXES

DATE: April 11, 2000

APPROVED:

DATE:

4-11-00

Summary

In connection with our audit of the San Jose Arena Management's (Arena Management) luxury suite revenues, we discovered that under the provisions of an agreement between the Redevelopment Agency (Agency) and the City of San Jose (City), the Agency owes City's General Fund \$1,521,474. Specifically, we found that the Agency has not reimbursed the City's General Fund \$1,521,474 in possessory interest taxes Arena Management deducted from the Arena Fees it paid to the City. Therefore, the City Auditor's Office recommends that the City immediately invoice and that the Agency immediately reimburse the City \$1,521,474 for Arena Management's possessory interest tax deductions. We also recommend that the City, upon receipt of Arena Management's annual Arena Fees payment, invoice the Agency for the possessory interest taxes Arena Management deducted from its payment to the City.

Background

By August 1 of each year, Arena Management must remit Arena Fees to the City. These Arena Fees are calculated as follows: 1) net luxury suite revenues, 2) a "fixed fee" that starts at \$500,000 for the first six years and increases by \$100,000 increments to year eleven, and 3) a share of parking revenues.

In addition, under the terms of the SAN JOSE ARENA MANAGEMENT AGREEMENT (Management Agreement) by and between the City and Arena Management:

"B. Possessory Interest Tax. Manager understands and acknowledges that its interest under this Management Agreement may subject it to possessory interest property taxes . . . To the extent that a possessory interest property tax is assessed, Manager shall pay any tax due and will be entitled to deduct from the Arena Fee any portion of any such possessory interest property tax imposed on Manager or the Sharks (but excluding any possessory interest taxes assessed on the Sharks offices and club) which is allocated to and received by City or Agency, less any set asides required under State law." [Emphasis added]

A separate agreement, the COOPERATION AGREEMENT BETWEEN THE AGENCY AND THE CITY RELATED TO THE CONSTRUCTION OF THE SAN JOSE ARENA, (Cooperation Agreement) requires the Agency to compensate the City for Arena Management's possessory interest tax deductions. Specifically, the Cooperation Agreement states as follows:

Arena Possessory Interest Taxes

April 11, 2000

Page 2

“Agency agrees to reimburse City for all amounts offset by Manager (Arena Management) from, or credited against the Arena Fee, or any other amounts due the City under the Management Agreement as a result of any possessory interest taxes imposed upon Manager or the San Jose Sharks, but only to the extent that such amounts are actually received by Agency. All amounts to be reimbursed shall be remitted by Agency to the City in the same fiscal year in which possessory interest taxes subject to offset are received by Agency.” [Emphasis added]

Agency Has Not Reimbursed The City For \$1,521,474 In Possessory Interest Tax Deductions

Arena Management has deducted \$1,521,474 in possessory interest tax from the Arena Fees it paid to the City as follows:

\$498,320 on August 1, 1997,
\$507,065 on August 1, 1998, and
\$516,089 on August 1, 1999.

Therefore, in accordance with the terms of the Cooperation Agreement, the Agency should have paid the City the \$1,521,474 Arena Management deducted from the Arena Fees it paid to the City.

However, as of April 5, 2000, the Agency has not reimbursed the City for any of the above possessory interest tax deductions. To account for these payments, the City has established an Accounts Receivable for \$1.1 million and the Agency has established an Accounts Payable for the same amount. However, according to City and Agency staff, the City has not yet invoiced the Agency for any of the possessory interest tax deductions and the Agency will not pay the City until the City issues an invoice. The Budget Office is trying to determine the exact amount the City should invoice the Agency.

Recommendations

Based on the above information, we recommend that the City immediately invoice and the Agency reimburse the City \$1,521,474. In addition, we recommend that the City, upon receipt of Arena Management's annual Arena Fees payment, invoice the Agency for the possessory interest taxes Arena Management deducted from its payment to the City.

Should you or anyone on your staff care to discuss the above information, please contact me or Erin Gilliam of my staff at 277-4601.

cc: Darrell Dearborn	Abe Andrade	John Guthrie
Larry Lisenbee	Rick Doyle	Mike Ryder
David Baum	Bill Hughes	Chris Morrissey

GS:bh
0309