



Office of the City Auditor

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

**AN AUDIT OF THE PROPERTY
MANAGEMENT OPERATIONS OF
THE CITY OF SAN JOSÉ'S
DEPARTMENT OF PUBLIC
WORKS – REAL ESTATE DIVISION**

**The City Council Should Revisit Its Policy
On Non-Profit Leases Of City-Owned
Property At Below Market Rents**

**The Department Of Public Works Needs To
Ensure That Leases Of City-Owned
Property Are Properly Invoiced, Adjusted,
And Collected**

**Report 02-03
April 2002**



CITY OF SAN JOSÉ, CALIFORNIA

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City Auditor

April 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 Property Management Operations Of The City Of San José's Department Of Public Works – Real Estate Division*. 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 City Administration's response is shown on the yellow page before the Appendices.

I will present this report to the Finance and Infrastructure Committee at its May 8, 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 Eduardo Luna.

Respectfully submitted,

Gerald A. Silva
City Auditor

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Executive Summary

In accordance with the City Auditor's 2001-02 Audit Workplan, we reviewed the property management operations of the Department of Public Works – Real Estate Division. 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

The City Council Should Revisit Its Policy On Non-Profit Leases Of City-Owned Property At Below Market Rents

The City of San Jose (City) leases City-owned land and buildings to 12 non-profit entities at below market rents. City Council Revised Policy 7-1 governs the use of non-profit leases of City-owned land and buildings. We found that the Administration has had difficulty ensuring compliance with City Council Policy 7-1. Specifically, we found that none of the 12 non-profit leases complied with all of City Council Policy 7-1's requirements. In addition, we found that:

- Certain requirements in City Council Policy 7-1 are subjective and difficult to measure;
- Non-profits have used City-owned land and buildings for an average of 20 years, with one non-profit using a City-owned facility for over 50 years;
- The fair market annual rental value for the City-owned land and buildings non-profits lease is nearly \$540,000;
- Non-profit leases lack provisions to compel compliance with City Council Policy 7-1;
- The lack of a formal application process for non-profit leases of City-owned land and buildings exposes the City to the risk that some non-profits could receive preferential treatment from the City;
- There is limited City staff oversight of non-profit leases;

- Four of the 12 non-profit leases had expired from two to 24 years ago; and
- Three of the 12 non-profits leasing City-owned land and buildings did not have proof of insurance on file with the City.

Accordingly, in our opinion, the City Council should revisit its policy on non-profit leases of City-owned land and buildings. In addition, the Administration/Department of Public Works/Real Estate Division should 1) add language in leases of City-owned land and buildings to compel non-profits to comply with City Council Policy 7-1; 2) establish a formal application process for non-profits leasing City-owned land and buildings; and 3) designate a staff person to oversee all aspects of non-profit leases of City-owned land and buildings. By so doing, the Administration will be better able to enforce the City Council's intent regarding non-profit leases of City-owned land and buildings.

RECOMMENDATIONS

We recommend that the City Council:

Recommendation #1 Revisit its policy on non-profit leases of City-owned properties. (Priority 2)

We also recommend that the Administration/Department of Public Works/Real Estate Division:

Recommendation #2 Include language in its leases with non-profits requiring the annual submission of documents to the Division to facilitate an annual review. (Priority 3)

Recommendation #3 Establish a formal application process for non-profit leases of City-owned property including the submission of key non-profit background information. (Priority 3)

Recommendation #4 Designate a staff person to monitor non-profit leases and ensure that these leases are renewed in a timely manner, have appropriate insurance, and are in compliance with Revised City Council Policy 7-1 on Below Market Rents provision. (Priority 3)

Finding II The Department Of Public Works Needs To Ensure That Leases Of City- Owned Property Are Properly Invoiced, Adjusted, And Collected

The City of San Jose (City) has 24 leases of City-owned land and buildings with private parties. These leases generate about \$167,000 per year in rental income to the City. We found that the Fiscal Division of the Public Works Department was not properly invoicing some private entity tenants. For example, the Division 1) has incorrectly invoiced two tenants resulting in underpayments to the City since 1990 of about \$43,000; 2) has not invoiced some tenants on a timely basis; and 3) did not properly assess one tenant a \$677 late payment penalty. Further, we found that the Real Estate Division of the Public Works Department 1) did not match private entity lease payment amounts to the amounts invoiced and collected and 2) did not properly adjust rent amounts by almost \$1,000 for three private entity leases.

In our opinion, there are two primary causes for the problems we identified. First, the Real Estate and Fiscal Divisions have not finalized each division's rental administration responsibilities. Secondly, the administration of City-owned property leases to private entities is decentralized among several City departments and divisions with no one City entity overseeing the entire process. As a result, the Fiscal Division did not invoice or correctly invoice or collect rents from some private entity tenants. In addition, some private entity tenants did not maintain required insurance coverages. Accordingly, we recommend that the Department of Public Works: 1) initiate appropriate collection efforts for unpaid rents; 2) review its leases of City-owned property with private entities for proper invoicing and collection; 3) establish procedures to ensure that private entity leases of City-owned property are properly invoiced and collected; 4) designate specific Fiscal and Real Estate Division responsibilities for the leasing of City-owned property to private entities; and 5) make the Real Estate Division responsible for overseeing the entire leasing of City-owned property to private entities.

RECOMMENDATIONS

We recommend that the Department of Public Works:

Recommendation #5 **Work with the City Attorney’s Office on how best to resolve underpaid and overpaid rents. (Priority 2)**

Recommendation #6 **Identify all Real Estate leases with late payment penalty provisions and establish procedures to ensure that late payment penalties are properly assessed. (Priority 3)**

Recommendation #7 **Review all of its leases of City-owned property with private entities and ensure that the Fiscal Division has been invoicing tenants for the proper amount of rents and invoice tenants for any amounts owed. (Priority 2)**

Recommendation #8 **Establish a process to ensure that the Fiscal Division invoices tenants on a consistent and continuous basis until the tenant vacates the property or until there is a change in property ownership. (Priority 2)**

We recommend that the Department of Public Works and the Finance Department:

Recommendation #9 **Identify the leases for which there are past due payments and initiate appropriate collection efforts. (Priority 2)**

We recommend that the Department of Public Works:

Recommendation #10 **Establish a reconciliation process and formal procedures to ensure that leases of City-owned property are correctly invoiced and collected. (Priority 2)**

Recommendation #11 **Assign responsibility for calculating rent adjustments on City-owned property and establish policies and procedures to effectuate that assignment. (Priority 3)**

Recommendation #12 **Assign to the Real Estate Division the responsibility for providing oversight over leases of City-owned property. (Priority 2)**

Introduction

In accordance with the City Auditor's 2001-02 Audit Workplan, we reviewed the property management operations of the Department of Public Works – Real Estate Division. 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.

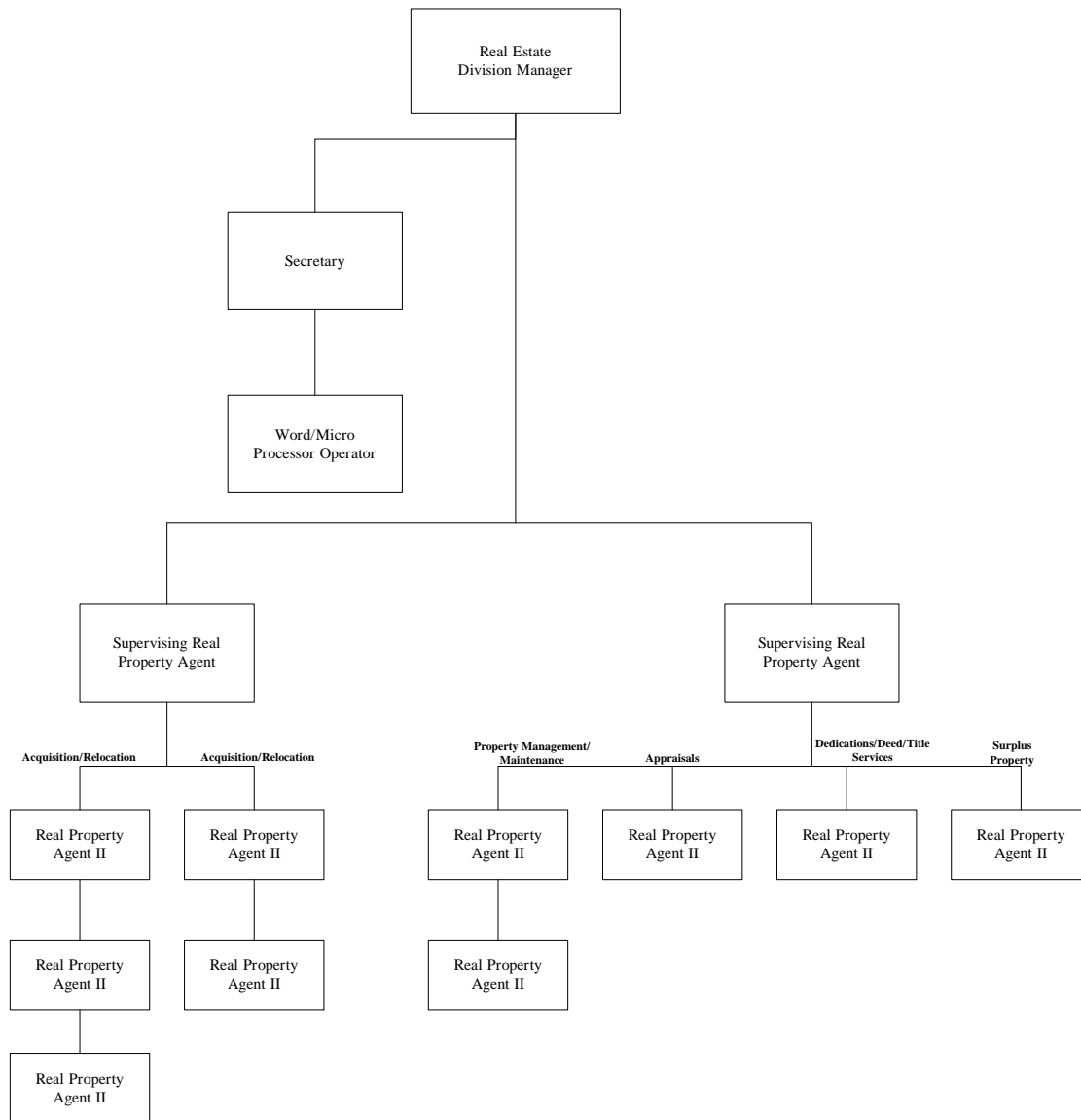
The City Auditor's Office thanks the Department of Public Works – Real Estate Division for their time, information, insight, and cooperation during the audit process.

Background

The Real Estate Division (Division) is under the Department of Public Works (DPW). The mission of the Real Estate Division is to provide quality and cost effective real estate services in a timely manner to City Departments in support of the Capital Improvement Program and for the benefit of the citizens of the City of San Jose. These services are performed while assuring the City's compliance with applicable local, state, and federal government laws and regulations. The Public Works Real Estate Division's 2001-2002 operating budget is \$1,430,064. The Division's 2001-2002 staffing is 15 full-time positions.

Exhibit 1 shows the Division's organization chart.

Exhibit 1 Department Of Public Works Real Estate Division Organization Chart



Source: Real Estate Division.

Division Services

Real Estate Division services include appraisal, acquisition, deed, title services, relocation, property management, maintenance, surplus real property sales, site feasibility analysis, and City Council-directed or City Manager-directed special projects.

Property Management

With the exception of Airport operating properties, the Division provides property management services for most City operations. These services include leasing of office space, parking, and land for various City operations. Leasing involves determining the needs of the client, verifying funding, identifying available sites, negotiating agreements, acquiring necessary approvals, coordinating tenant improvements, and on-going occupancy issues between the City and landlords. The Division also manages eleven telecommunication leases.

The Division also leases out buildings and property for the purposes of income generation, providing space to City-supported non-profit and community-based organizations, and occupied property acquired as a result of City projects.

The Division determines and verifies property ownership, coordinates the fencing and clean-up of City-owned property, and works closely with citizens to resolve any issues concerning City-owned property.

The Real Estate Division does not manage all City-owned leased facilities. In addition to Airport operating property, there are a number of leases that other City Departments handle. These include franchise and use agreements for certain facilities associated with the Department of Parks, Recreation, and Neighborhood Services; the Department of Convention, Arts, and Entertainment; and the Housing Department. The Division does not manage the use of real property in connection with certain joint operating agreements between the City and various school districts, or certain lease agreements with special use facilities, such as the San Jose Ice Center, Hayes Renaissance Conference Center, and The Village at River Park. Finally, the Division does not manage use agreements for the San Jose Historical Museum at Kelly Park, the Peralta Adobe, and the Fallon House.

Scope And Methodology

The objective of the audit was to review the efficiency and effectiveness of the Department Of Public Works Real Estate Division's property management efforts. Specifically, we reviewed property management leases to ensure that rents were properly invoiced, adjusted, and collected. Additionally, we reviewed non-profit leases to ensure compliance with City Council Policy 7-1 on below market rents. Telecommunication leases were not included in this review.

For each lease, we reviewed key lease information to determine the current rent amount, rent due date, rent adjustment date, lease expiration date, and insurance status. We also determined if there were any outstanding issues with each lease. We collected this information from the case files the Division maintained for each lease. Case files typically contained copies of the lease agreements, lease summary sheets, key memorandums, and documents associated with each lease.

Once we determined the correct amount due for rent, and if proper rent adjustments were made, we followed up with Public Works' Fiscal Division and the Finance Department's Treasury Division to determine if the City was invoicing and collecting the rents due. We utilized Columbia Ultimate Business System data both Public Works and Finance Department provided to us to determine the date of invoicing and date of collection.

We interviewed Public Works Real Estate Division and Fiscal Division personnel responsible for executing leases.

We performed only limited testing of the various computer reports and databases we used during our audit. We did not review the general and specific controls for the computer systems used in compiling the various computer reports and databases we used.

Finding I

The City Council Should Revisit Its Policy On Non-Profit Leases Of City-Owned Property At Below Market Rents

The City of San Jose (City) leases City-owned land and buildings to 12 non-profit entities at below market rents. City Council Revised Policy 7-1 governs the use of non-profit leases of City-owned land and buildings. We found that the Administration has had difficulty ensuring compliance with City Council Policy 7-1. Specifically, we found that none of the 12 non-profit leases complied with all of City Council Policy 7-1's requirements. In addition, we found that:

- Certain requirements in City Council Policy 7-1 are subjective and difficult to measure;
- Non-profits have used City-owned land and buildings for an average of 20 years, with one non-profit using a City-owned facility for over 50 years;
- The fair market annual rental value for the City-owned land and buildings non-profits lease is nearly \$540,000;
- Non-profit leases lack provisions to compel compliance with City Council Policy 7-1;
- The lack of a formal application process for non-profit leases of City-owned land and buildings exposes the City to the risk that some non-profits could receive preferential treatment from the City;
- There is limited City staff oversight of non-profit leases;
- Four of the 12 non-profit leases had expired from two to 24 years ago; and
- Three of the 12 non-profits leasing City-owned land and buildings did not have proof of insurance on file with the City.

Accordingly, in our opinion, the City Council should revisit its policy on non-profit leases of City-owned land and buildings. In addition, the Administration/Department of Public Works/Real Estate Division should 1) add language in leases of City-owned land and buildings to compel non-profits to comply with City Council Policy 7-1; 2) establish a formal application process for non-profits leasing City-owned land and buildings;

and 3) designate a staff person to oversee all aspects of non-profit leases of City-owned land and buildings. By so doing, the Administration will be better able to enforce the City Council's intent regarding non-profit leases of City-owned land and buildings.

**The City Leases
City-Owned Land
And Buildings To
12 Non-Profit
Entities**

According to Real Estate Division (Division) records, the City leases City-owned land and buildings to 12 non-profit entities¹. The City leases office space in City-owned commercial buildings, parking spaces, and open space for playgrounds and passive recreation. These leased spaces range from 60 parking spaces to 1.3 acres.

The rents the City charges to these non-profits are below market rates. Of the 12 non-profits renting City-owned land and buildings, ten paid the City \$12 or less per year in rent. Specifically, seven non-profits paid \$12 per year in rent; one paid \$3 per year; one paid \$1 per year; and one paid no rent. The remaining two non-profits paid the City \$1,200 and \$84 per year in rent, respectively. The following exhibit summarizes the 12 non-profit leases of City-owned land and buildings.

¹ We excluded a long-term lease with the San Jose Unified School District from this analysis. The school leases a portion of Watson Park for an elementary school.

**Exhibit 2 Summary Of Non-Profit Leases Of City-Owned
Land And Buildings**

| Non-Profit Entity | Address | City-Owned Space | Use | Rent |
|---|---------------------------|---|------------------------------|------------------|
| ACT for Mental Health | 441 Park Avenue | 3 units with 3,440 square feet | Community Service | \$12 per year |
| Afro-American Community Service Agency | 304 N. 6th Street | 2 story building (8,073 square foot former firehouse) on 18,500 square foot lot | Community Service | \$1,200 per year |
| Alviso Family Health Center | 1621 Gold Street | .15 acre parcel | Public Health | \$1 per year |
| Boys & Girls Club of Santa Clara County | 110 E. Jackson Street | 1.3 acre parcel | Community Service—Recreation | \$12 per year |
| Center for Training & Careers | Las Plumas & Nipper | 60 parking spaces | Parking | \$12 per year |
| Congress of Arab Americans | 416 Park Avenue | 578 square foot office | Office space | \$12 per year |
| Eastside Parents Participating Nursery School | 937 Piedmont Road | .14 acre parcel | Pre-school | \$84 per year |
| G.I. Forum Project | 765 Story Road | 41,857 square foot parcel | Parking | \$3 per year |
| Indo Chinese Resettlement & Cultural Center | 410-12,418-22 Park Avenue | 5 office units that occupy 2,916 square feet | Community Service | \$12 per year |
| Resources for Families & Communities | 1807 Sarasota Way | Single Family House on 6,534 square foot lot | Community Service | \$12 per year |
| San Jose Conservation Corps | 2650 Senter Road | 61,419 square foot lot with a single family house and garage | Youth Training Facilities | \$12 per year |
| San Jose Participating Nursery School | 2180 Radio Avenue | 10,560 square foot lot | Pre-school | No rent charged |

Source: Real Estate Division.

**City Council Policy
7-1 Governs Policy
For The Use Of
City-Owned Land
And Buildings At
Below Market
Rents**

Over 30 years ago, the San Jose City Council enacted a policy that governed the use of City-owned land and buildings. The policy specified how public or quasi-public groups could receive preferential rental rates for the use of City-owned land and buildings. On April 13, 1970, the City Council enacted Policy 7-1 that established a set of guidelines for the use of City-owned land or buildings not immediately required for public purposes. Policy 7-1 established that in order to be

approved, requests for preferential rates and use of City lands not immediately needed for public purposes must meet the following specific criteria:

1. The land or building is not immediately needed for public purposes, but will be retained for public purposes.
2. In the case of surplus property, the fair market price must be taken into consideration before leasing to a public or quasi-public group, as it is the ultimate intent of the City to return surplus property to the tax roll as soon as possible.
3. The community service group must perform a definitive community service; substantiate the community service available; must be a non-profit organization with tax exempt status from the Internal Revenue Service; and shall not be a political organization or politically oriented.
4. Permits will be authorized on a revocable basis, and the community service group shall sign a statement they will vacate the premises upon notice and at their expense.
5. The City may require prior to and during the lease the submission of such additional information as needed.
6. The facilities shall be for the exclusive use of the designated group and may not be sublet without written consent of the City Manager.

**The City Council
Revised Policy 7-1
In 1994**

On November 29, 1994, the City Council revised Council Policy 7-1 by clarifying its criteria for leasing property for below market rates. Specifically, the revised policy 1) established eligibility and property criteria, 2) required the Administration to perform annual reviews, and 3) established terms of tenancy and termination. The below market rate rental policy was established as a method of giving assistance to those non-profit organizations that provide services to the citizens of San Jose.

The Revised Policy 7-1 established almost 40 separate action items that must be completed in order to lease a City-owned facility for below market rents. For example, when initially requesting space, the non-profit agency must submit an outline

of their program and organization to the City, for Real Estate Division and other City department evaluation. Additionally, the non-profit agency must also provide:

- information on the program's objective and timeframe for completion;
- a profile of the clientele being served;
- projected staff and/or facilities expansion plans, if any;
- a current financial statement including sources of funding and constraints applied to funds; and
- evidence of adequate public liability insurance and property damage insurance on the public facilities.

Further, the agency must annually provide the City with the following:

- an organizational chart of the agency along with a list of staff employees by title and salary;
- names and addresses of current Board of Directors;
- a schedule of the agency's Board of Directors meetings and the Board's meeting minutes for the past year;
- a current financial report of the agency, including sources of funding; and
- proof that their service is still available and quantitative reports of services provided during the preceding year.

The Revised Policy 7-1 also outlines the steps City staff must undertake for determining the amount of rent applicable for use of the City-owned facility or property. Specifically, City staff is supposed to determine the fair market rent applicable to the proposed facility or property and determine a value for the services the non-profit entity will provide. The Revised Policy 7-1 requires that the City charge the non-profit entity a rent that is equal to the fair market rent less the value for the services the non-profit will provide. The Revised Policy 7-1 also sets the minimum rent the City will charge at one dollar per month. Finally, the Revised Policy 7-1 established that the tenant is responsible for all repairs and maintenance of the leased site.

The Administration Has Had Difficulty Ensuring Compliance With City Council’s Policy 7-1 On Below Market Rents Based on our review of the Real Estate Division (Division) records, we found that none of the 12 leases the City has with non-profit entities complies with the City Council’s Revised Policy 7-1 regarding Below Market Rents. In addition, we found that the Division never informed the City Council that none of the non-profit leases complied with Revised Policy 7-1. The following exhibit shows the specific Revised Policy 7-1 criteria, and whether or not the Division case files contained proof or documentation to show compliance with the specific Revised Policy 7-1 requirement.

Exhibit 3 Summary Of 12 Non-Profit Leases’ Compliance With Revised Policy 7-1

| Council Policy 7-1 Criteria | Number Of Non-Profit Leases In Compliance | Number Of Non-Profit Leases Not In Compliance |
|--|--|--|
| Proof of providing definitive community service provided primarily to citizens of San Jose | 3 | 9 |
| Designated or in the process of requesting designation as a non-profit by the California State Board of Equalization | 1 | 11 |
| Hold tax exempt status from the Internal Revenue Service | 3 | 9 |
| Proof of non-profit status shall be provided for review and verification by City Attorney’s Office | 0 | 12 |
| Substantiate that a continuing public need exists for the services provided which is not already addressed by a similar non-profit organization or public agency | 1 | 11 |
| Submit outline of program and organization to the Real Estate Division and other City Department Heads as affected by the particular space request | 2 | 10 |
| The program’s objective and a time frame for completion | 1 | 11 |
| A profile of the clientele being served | 2 | 10 |
| Projected staff and/or facilities expansion plans, if any | 1 | 11 |
| Current financial statement including sources of funding and any constraints applied to funds | 1 | 11 |
| Evidence of adequate public liability insurance and property damage insurance on the public facilities (current) | 3 | 9 |
| Evaluation of the agency’s program conducted by another governmental agency may be included if one exists | 1 | 11 |
| A list by address and monthly rental rates of any real property rented by the Agency and/or affiliated group | 1 | 11 |
| The group shall not be a political organization or politically oriented and may not use the rented premises to promote religious or political purposes | 1 | 11 |
| Annual Review—the Agency must provide the City on an annual basis with various documents | 0 | 12 |
| Staff will determine fair market rent applicable to the proposed facility | 2 | 10 |
| Staff will place value on the services to be provided by non-profit | 1 | 11 |

Source: City Auditor analysis of Real Estate Division records.

As shown above, the lack of compliance with the Revised Policy 7-1 is pervasive. Not one of the 12 leases fully complied with Revised Policy 7-1's below market rent requirements. Further, we found no evidence that any of the 12 non-profit leases complied with the following elements of the Revised Policy 7-1:

- Proof of non-profit status shall be provided for City Attorney Office's review and verification; and
- Annual Review—the Agency must provide the City on an annual basis with the following documents:
 - An organizational chart of the Agency along with a list of staff employees by title and salary;
 - Names and addresses of current members of the Board of Directors;
 - A schedule of the Agency's Board of Directors meetings and the Board's meeting minutes for the past year;
 - A current financial report of the Agency or group including sources of funding and any constraints on receivable or received funds; and
 - Proof that their service is still available and quantitative reports of services provided during the preceding year.

Further, we found that only the lease with the San Jose Conservation Corps complied with the requirements to:

- Substantiate that a continuing public need exists for the services provided which is not already addressed by a similar non-profit organization or public agency.

Certain Requirements In City Council Policy 7-1 Are Subjective And Difficult To Measure

We found that the Revised City Council Policy 7-1 section on below market rents contains certain elements that are subjective and are, therefore, difficult and impractical to measure. These criteria included the following:

1. Proof of providing definitive community service provided primarily to citizens of San Jose;
2. Substantiate that a continuing public need exists for the services provided which is not already addressed by a similar non-profit organization or public agency; and

3. Staff will place value on the services to be provided by non-profit.

The Division does not have an established process to measure the above criteria for granting a non-profit lease. Further, we found that for the most part Division files do not contain evidence that the above criteria were satisfied as explained below.

*Proof Of Providing
Definitive
Community Service*

We found that only three leases had documentation to support the first criterion. Specially, the Boys and Girls Club of Santa Clara County, San Jose Conservation Corps, and the Congress of Arab Americans had submitted information to the City to show they provided a definitive community service to the citizens of San Jose.

*Substantiate That A
Continuing Public
Need Exists In The
Services Provided*

We found that only one non-profit lease file had documentation that showed a continuing public need existed for the services the non-profit provided. The Director of Public Works reported that specifically, the San Jose Conservation Corps is the only non-profit organization in the South Bay that provided both vocational training and specialized education to at-risk adults between the ages of 18 and 24. On the other hand, the G.I. Forum lease file contained documentation that seemed to indicate that various City departments tried but were unable to document that the G.I. Forum provided a definitive community service primarily to the citizens of San Jose.

*Staff Will Place A
Value On The
Services Provided*

We did not find any evidence that Division staff had a methodology to place a value on the services the non-profits provide. In the one instance where staff did place a value on the services the non-profit provided, there was no support to show how staff derived the value of the services. Specifically, Division staff established that the value of the services the G.I. Forum provided was \$25,162 per year. While there is no indication as to how Division staff determined the \$25,162 per year, it is only \$3 less than the G.I. Forum's annual rent. As a result, the G.I. Forum pays the City only \$3 per year as shown below.

| | |
|---|------------|
| G.I. Forum Annual Fair Market Rent | \$25,165 |
| Less: | |
| Value of The Service The G.I. Forum Provides Annually | (25,162) |
| G.I. Forum's Annual Rent Payment to City | <u>\$3</u> |

Non-Profits Have Used City-Owned Land And Buildings For An Average Of 20 Years With One Non-Profit Using A City-Owned Facility For 50 Years

We found that non-profits have leased City-owned facilities for an average of 20 years with one non-profit leasing a City-owned space for over 50 years, as shown in the next exhibit.

Exhibit 4 Summary Of The Number Of Years Non-Profits Have Leased City-Owned Property

| Non-Profit Entity | Number Of Years The Entity Has Leased The City-Owned Property |
|---|---|
| ACT for Mental Health | 26 |
| Afro-American Community Service Agency | 24 |
| Alviso Family Health Center | 35 |
| Boys & Girls Club of Santa Clara County | 54 |
| Congress of Arab Americans | 7 |
| Eastside Parents Participating Nursery School | 26 |
| G.I. Forum Project | 4 |
| Indo Chinese Resettlement & Cultural Center | 17 |
| Resources for Families & Communities | 2 |
| San Jose Conservation Corps | 25 |
| San Jose Participating Nursery School | 12 |
| Center for Training & Careers | 3 |

Source: Auditor analysis of Real Estate Division leases.

In our opinion, Revised City Council Policy 7-1 was never intended to provide for non-profits' long-term use of City-owned land and facilities at nominal rents. Instead, Revised City Council Policy 7-1 was intended to regulate the use of City-owned land or buildings not immediately required for public purposes, with the ultimate intent to return the surplus property to the tax roll as soon as possible. In one instance, a non-profit that initially leased a City-owned property for an

interim period has occupied the space for seven years. In our opinion, the City needs to reconsider how long non-profits should be able to lease City-owned facilities and evaluate the best means to dispose of surplus properties.

The Fair Market Annual Rental Value For The City-Owned Land And Buildings Non-Profits Lease Is Nearly \$540,000

In the case of surplus property, Revised City Council Policy 7-1 requires the City to consider the fair market rental value of the City-owned property before leasing to a non-profit or for public purposes. The Division estimated that as of November 2001, the fair market rental value for the properties non-profits currently occupy is \$539,681 per year. The following exhibit compares the current rents non-profits pay for City-owned properties to the estimated fair market rents.

Exhibit 5 Comparison Of Current Rents Non-Profits Pay For City-Owned Properties To Fair Market Rents

| Non-Profit Entity | City-Owned Space | Rent | Estimate Of Yearly Fair Market Rent |
|---|--|------------------|--|
| ACT for Mental Health | 3 units with 3,440 square feet | \$12 per year | \$37,152 |
| Afro-American Community Service Agency | 2 Story Building (8,073 square foot former fire house) on 18,500 square foot lot | \$1,200 per year | \$121,095 |
| Alviso Family Health Center | .15 acre parcel | \$1 per year | \$9,792 |
| Boys & Girls Club of Santa Clara County | 1.3 acre parcel | \$12 per year | \$91,476 |
| Center for Training & Careers | 60 parking spaces | \$12 per year | \$28,800 |
| Congress of Arab Americans | 578 square foot office | \$12 per year | \$6,240 |
| Eastside Parents Participating Nursery School | .14 acre parcel | \$84 per year | \$9,150 |
| G.I. Forum Project | 41,857 square foot parcel | \$3 per year | \$26,972 |
| Indo Chinese Resettlement & Cultural Center | 5 office units that occupy 2,916 square feet | \$12 per year | \$31,500 |
| Resources for Families & Communities | Single Family House on 6,534 square foot lot. | \$12 per year | \$21,000 |
| San Jose Conservation Corps | 61,419 square foot lot with a single family house and garage | \$12 per year | \$138,000 |
| San Jose Participating Nursery School | 10,560 square foot lot | No rent charged | \$18,504 |
| Total | | \$1,372 | \$539,681 |

Source: Real Estate Division.

Given that 1) certain requirements of Revised City Council Policy 7-1 are subjective and difficult to measure, 2) non-profits have used City-owned land and buildings for an average of 20 years, and 3) the fair market annual rental value for City-owned land and building non-profits lease is nearly \$540,000, in our opinion, the City Council should revisit its Revised Council Policy 7-1.

We recommend that the City Council:

Recommendation #1
Revisit its policy on non-profit leases of City-owned properties. (Priority 2)

**Non-Profit Leases
Lack Provisions To
Compel
Compliance With
City Council Policy
7-1**

We found another factor that contributed to the non-compliance with City Council Policy 7-1 is that the leases did not contain provisions to require non-profits to comply with the Policy. Specifically, none of the leases we reviewed contained language that required non-profit operators to comply with the requirements of an annual review. According to the City Attorney's Office, without the specific language mandating compliance with the Annual Review, staff can only request, not demand, the submission of the documents necessary to facilitate an annual review.

We also recommend that the Administration/Department of Public Works/Real Estate Division:

Recommendation #2
Include language in its leases with non-profits requiring the annual submission of documents to the Division to facilitate an annual review. (Priority 3)

The Lack Of A Formal Application Process For Non-Profit Leases Of City-Owned Land And Buildings Exposes The City To The Risk That Some Non-Profits Could Receive Preferential Treatment From The City

We found that the lack of a formal application process for non-profit leases of City-owned facilities has resulted in certain aspects of the Council Policy not being met. The absence of a formal application process for non-profit leases of City-owned property made it difficult for department staff to comply with Revised Policy 7-1. Further, the lack of an application process exposes the City to the risk that some non-profits could receive or appear to receive preferential treatment from the City.

In our opinion, assuming space is available, the Administration should require any non-profit requesting a lease with the City to complete an application form that would provide the information necessary to ensure compliance with City Council Policy 7-1. Such information would include the following:

- proof of designation or in the process of requesting designation as a non-profit by the California State Board of Equalization;
- proof of holding tax exempt status from the Internal Revenue Service;
- an outline of their program and organization;
- information on the program's objective and timeframe for completion;
- a profile of the clientele being served;
- projected staff and/or facilities expansion plans, if any;
- a current financial statement including sources of funding and constraints applied to funds;
- an organizational chart of the agency along with a list of staff members;
- names and addresses of current Board of Directors;
- a schedule of the agency's Board of Directors meetings and the Board's meeting minutes for the past year; and
- proof of service availability and quantitative reports of services provided during the preceding year.

Further, the application could also include references from Administration or City Council members. If the City obtains this type of information, it would have added assurance that

only those non-profits that satisfy the intent of Revised City Council Policy 7-1 would receive below market rents of City-owned property.

We also recommend that the Administration/Department of Public Works/Real Estate Division:

Recommendation #3

Establish a formal application process for non-profit leases of City-owned property including the submission of key non-profit background information. (Priority 3)

There Is Limited City Staff Oversight Of Non-Profit Leases

We found that the Division performed limited monitoring of the non-profit leases of City-owned property. This lack of monitoring contributed to Division staff not noticing non-profit non-compliance with City Council Policy 7-1. Additionally, we found that over the last 10 years, nine different Division staff had a hand in managing non-profit leases. More notably, since July 2001, three Division staff persons, at different periods, were assigned responsibility for non-profit leases. Of these three Division staff persons, one was also responsible for acquiring office space for City use. In the Spring of 2001, this staff person had almost 40 assignments, in addition to the non-profit leases. In other situations, it was not entirely clear who in the Division was responsible for monitoring the leases. For example, the Division executed certain non-profit leases for nursery schools on behalf of Parks, Recreation, and Neighborhood Services (PRNS). However, based upon our review of the case files it does not appear that oversight responsibility for these leases was ever established.

Real Estate Division staff indicated that at the time Policy 7-1 was revised they were aware that there was not adequate staffing to do all the necessary follow-up work the Policy required. In 1996-97, the Real Estate Division requested but did not receive .5 FTE of a Real Property Agent for increased property management activities.

To improve oversight, the Department of Public Works has taken steps to transfer the responsibility for Property Management and surplus property functions to the General Services Department. This will involve the transfer of 3 FTEs from Public Works to General Services. The Department expects to complete the transfer by April 2002.

Four Of 12 Non-Profit Leases Had Expired From Two To 24 Years Ago

Upon further review of the case files, we found that several non-profit leases had expired. Specifically, we found that as of January 2002, four of the 12 leases had expired. As shown below, one of the 12 non-profit leases had expired 24 years ago, while three other leases expired three to four years ago.

Exhibit 6 Summary Of Expired Non-Profit Leases As Of January 2002

| Non-Profit Entity | Date Of Lease Expiration |
|---|--------------------------|
| Afro-American Community Service Agency | 1/31/1999 |
| Alviso Family Health Center | 3/7/1977 |
| Boys & Girls Club of Santa Clara County | 12/14/1998 |
| Eastside Parents Participating Nursery School | 12/31/1997 |

Source: Auditor analysis of Real Estate Division records.

According to Real Estate Division staff, they are in the process of negotiating lease renewals with the Boys and Girls Club of Santa Clara County and the Afro-American Community Services Agency. Division staff also said that both entities would prefer longer lease terms so they can make necessary improvements to the facilities.

Three Of The 12 Non-Profits Did Not Have Proof Of Insurance Coverage On File With Risk Management

We also found that Risk Management did not have evidence of current insurance coverage, Office Commercial General Liability, for three of the 12 non-profits. According to Risk Management staff, these three non-profits are: the Afro-American Community Service Agency, Alviso Family Health Center, and Eastside Parents Participating Nursery School. This situation occurred when these three leases expired and were put in a holdover status until a new lease was executed.

We also recommend that the Administration/Department of Public Works/Real Estate Division:

Recommendation #4
Designate a staff person to monitor non-profit leases and ensure that these leases are renewed in a timely manner, have appropriate insurance, and are in compliance with Revised City Council Policy 7-1 on Below Market Rents provision. (Priority 3)

CONCLUSION

City Council Revised Policy 7-1 governs the use of non-profit leases of City-owned land and buildings. We found that the Administration has had difficulty ensuring that the 12 non-profit leases have complied with all of City Council Policy 7-1's requirements. We found a multitude of issues with these leases, including expired leases; no proof of insurance on file with the City; average of 20 years of tenancy; and a fair market annual rental value of non-profit leases of over \$500,000. We also found that non-profit leases lack provisions to compel compliance with City Council Policy 7-1, and certain requirements in City Council Policy 7-1 are subjective and difficult to measure. Finally, we found there is limited City staff oversight of non-profit leases and the lack of a formal application process for non-profit leases exposes the City to the risk that some non-profits could receive or appear to receive preferential treatment from the City.

Accordingly, in our opinion, the City Council should revisit its policy on non-profit leases of City-owned land and buildings. In addition, the Administration/Department of Public Works/Real Estate Division should 1) include language in leases of City-owned land and buildings to compel non-profits to comply with City Council Policy 7-1; 2) establish a formal application process for non-profits leasing City-owned land and buildings; and 3) designate a staff person to oversee all aspects of non-profit leases of City-owned land and buildings. By so doing, the Administration will be better able to enforce the City Council's intent regarding non-profit leases of City-owned land and buildings.

RECOMMENDATIONS

We recommend that the City Council:

Recommendation #1 **Revisit its policy on non-profit leases of City-owned properties. (Priority 2)**

We also recommend that the Administration/Department of Public Works/Real Estate Division:

Recommendation #2 **Include language in its leases with non-profits requiring the annual submission of documents to the Division to facilitate an annual review. (Priority 3)**

Recommendation #3 **Establish a formal application process for non-profit leases of City-owned property including the submission of key non-profit background information. (Priority 3)**

Recommendation #4 **Designate a staff person to monitor non-profit leases and ensure that these leases are renewed in a timely manner, have appropriate insurance, and are in compliance with Revised City Council Policy 7-1 on Below Market Rents provision. (Priority 3)**

Finding II

The Department Of Public Works Needs To Ensure That Leases Of City-Owned Property Are Properly Invoiced, Adjusted, And Collected

The City of San Jose (City) has 24 leases of City-owned land and buildings with private parties. These leases generate about \$167,000 per year in rental income to the City. We found that the Fiscal Division of the Public Works Department was not properly invoicing some private entity tenants. For example, the Division 1) has incorrectly invoiced two tenants resulting in underpayments to the City since 1990 of about \$43,000; 2) has not invoiced some tenants on a timely basis; and 3) did not properly assess one tenant a \$677 late payment penalty. Further, we found that the Real Estate Division of the Public Works Department 1) did not match private entity lease payment amounts to the amounts invoiced and collected and 2) did not properly adjust rent amounts by almost \$1,000 for three private entity leases.

In our opinion, there are two primary causes for the problems we identified. First, the Real Estate and Fiscal Divisions have not finalized each division's rental administration responsibilities. Secondly, the administration of City-owned property leases to private entities is decentralized among several City departments and divisions with no one City entity overseeing the entire process. As a result, the Fiscal Division did not invoice or correctly invoice or collect rents from some private entity tenants. In addition, some private entity tenants did not maintain required insurance coverages. Accordingly, we recommend that the Department of Public Works: 1) initiate appropriate collection efforts for unpaid rents; 2) review its leases of City-owned property with private entities for proper invoicing and collection; 3) establish procedures to ensure that private entity leases of City-owned property are properly invoiced and collected; 4) designate specific Fiscal and Real Estate Division responsibilities for the leasing of City-owned property to private entities; and 5) make the Real Estate Division responsible for overseeing the entire leasing of City-owned property to private entities.

The City's 24 Leases Of City-Owned Land And Buildings With Private Entities Generate About \$167,000 Per Year In Rental Income

The City has 24 leases of City-owned land and buildings with private parties. The City-owned space leases vary in size, type, and rent charged. For example, leased space ranges from a 180 square foot portion of land to 77 acres of land. Private party uses of City-owned space include installation of gas pipelines, single family homes, a service station, and office space. The monthly rents the City charges range from \$50 for a 12,000 square foot lot used for a trucking yard, to \$5,604 for the service station. On an annual basis, the City is supposed to collect about \$167,000 from the tenants using City-owned properties. In addition, the City leases some City-owned land for minimal amounts or in exchange for services. Exhibit 7 summarizes the City's leases of City-owned land and buildings with private entities.

**Exhibit 7 Summary Of City Leases Of City-Owned Land And
Buildings With Private Parties**

| User Name | Address | Property Description | Lease Commenced | Lease Expiration Date | Current Rent | Payment Term |
|------------------------------------|---------------------------------|--|------------------------------|------------------------------|---------------------|---------------------|
| Air Products and Chemicals, Inc. | Montague Expressway & Hwy I-880 | 2,029 square foot lot for gas pipeline | 1996-July-23 | 2011-July-22 | \$3,732 | Annually |
| Almaden Welding Company | 1397 Almaden Ave | 15,246 square foot of triangular shaped land | 1985-February-01 | 2034-January-31 | \$100 | Monthly |
| Alviso Post Office | 1525 Gold Street | Ground lease for post office | 1984-January-12 | 2001-October-01 | \$4,709 | Annually |
| Arzino, Andrew V. & Arzino, Margie | Adjacent to WPCP | 77 acres adjacent to WPCP | 1990-October-01 | 1995-September-30 | \$1,540 | Monthly |
| Barry Swenson Builder | Mid-Town Park | 15,300 square foot portion of Mid-Town Park | 2000-September-01 | 2001-September-01 | \$0 | N/A |
| Bellarmino College Preparatory | Hedding St, Overpass | Property under Hedding Street Overpass for storage and parking | 1999-May-12 | 2029-May-12 | \$0 ² | N/A |
| Birkeland, Steve & Lucille | 630 3rd Street | Vacant undeveloped lot for parking, adjacent parcel held by lessee | 2000-May-01 | Month-To-Month | \$210 | Monthly |
| Devcon Construction | 495 Almaden Blvd | 180 square foot portion of Convention Center property | 2000-September-01 | 2002-August-31 | \$4,176 | One-time |
| Ferrari, Olivia | 1900 Senter Road | Mobile home & single family unit plus 4 acres | 1978-November-15 | Month-To-Month | \$500 | Monthly |
| Green Valley Corporation | Julian & Market | 7,458 square foot of landscaped strip | 1980-July-28 | 1985-July-28 | \$1 | Annually |
| Jubilee Christian Center | 175 Nortech Parkway | 1.3 acres open space | 1998-October-01 ³ | 1999-August-31 | \$201 | Annually |
| Knight-Ridder | 801 North 1st Street | Room 206 in City Hall | 1992-July-01 | Month-To-Month | \$350 | Monthly |
| Lin, Kico & Young, Rudy | Bird Ave, 1095 & Willow Street | Ground Lease for office building consisting of .41 acres | 1985-March-12 | 2035-April-01 | \$739 | Monthly |

² Leased in exchange for use of cafeteria up to six times per year.

³ Jubilee Christian Center assumed lease from IDEC Corporation.

Property Management Operations

| User Name | Address | Property Description | Lease Commenced | Lease Expiration Date | Current Rent | Payment Term |
|---------------------------------|-------------------------------|--|-------------------|-----------------------|--------------|--------------|
| Maciel, George | Dearborn Street | 12,000 square foot lot used as a trucking yard | 1980-June-01 | Month-To-Month | \$50 | Monthly |
| McCarthy Trust | Across from WPCP | 6 acres plus a house, portable dwelling unit, well, and water storage tank | 2000-August-17 | 2005-August-16 | \$800 | Annually |
| Mendoza, Emilio | 414 Park Ave | Office space | 1987-June-01 | Month-To-Month | \$525 | Monthly |
| Pacific Bell | 5285 Doyle Road | 20,000 square foot lot for off-street parking | 1996-November-15 | 2006-November-14 | \$3,016 | Monthly |
| Pacific Gas and Electric | Lake Cunningham Park Property | Gas regulator facility | 1993-September-07 | 2018-September-07 | \$5,000 | One-time |
| PraxAir/Union Carbide | River Oaks Park | Gas pipeline | 1992-June-30 | 2002-June-29 | \$4,193 | Annually |
| River Street Development Agency | St James & Julian | Historic District | 1996-June-04 | 2046-June-04 | \$1 | Annually |
| SCC Hazardous Waste Collection | 10th Street & Phelan | 8,000 square foot site of Central Service yard for County hazardous waste collection | 1996-February-01 | 2001-January-31 | \$1 | Annually |
| Shell Oil/Equilon Enterprises | 1699 Story Road | Service station | 1985-June-01 | 2005-May-31 | \$5,604 | Monthly |
| David & Maryleigh Wilson | William Street @ Coyote River | .47 acre undeveloped parcel with creek access | 2000-April-01 | Month-To-Month | \$167 | Monthly |
| Zanotto's Market, Inc. | 40 South 2nd Street | Sub-surface access to City-owned property for alarm system | 2000-June-12 | 2005-June-11 | \$725 | One-time |

Source: Real Estate Division records.

**Public Works
Fiscal Division Is
Not Properly
Invoicing Some
Private Entity
Tenants**

We found that the Fiscal Division of the Public Works Department was not properly invoicing tenants using City-owned property. Specifically, we found that the Fiscal Division 1) since 1990 has incorrectly invoiced two tenants resulting in underpayments to the City of about \$43,000 and 2) has not invoiced some tenants on a timely basis. Further, we found that the Fiscal Division was not adjusting some rents as required in the lease agreements.

**Since 1990 The
Fiscal Division
Incorrectly
Invoiced Two
Tenants Resulting
In Underpayments
To The City Of
About \$43,000**

We found at least three instances where the Fiscal Division invoiced tenants for incorrect rent amounts which resulted in underpayments of about \$43,000 to the City.

- In October 1990, Andrew and Margie Arzino signed a 5-year lease (with two five-year renewal options) for use of 77 acres. The tenant’s previous lease with the City had expired in May 30, 1988. The rent for the use of 77 acres was set at \$1,540 per month—an increase of \$300 from the previously expired lease. Andrew and Margie Arzino, and Terrance E. Dunning, Real Estate Administrator signed the new lease. However, we found that the Director of the Water Pollution Control Plant, and the Deputy City Attorney never approved the lease, and the City Clerk never recorded the lease. As such, the lease was never properly executed.

In a letter addressed to Mr. Arzino, dated November 8, 1990, a Real Property Agent informed Mr. Arzino that the Real Estate Division had returned the \$1,540 rent check for October. He asked Mr. Arzino to submit the October and November 1990 rent at the \$1,240 rate. The Real Property Agent also informed the tenant that the \$1,540 would take effect with the commencement of the new lease. Consequently, the tenant was billed at the old rate of \$1,240 per month. Because this lease was not properly executed in October 1990, the City did not receive over \$40,000 in lease payments as of January 2002.

- We found another lease where the Fiscal Division invoiced the tenant \$100 less per month than required. This resulted in an underpayment of \$1,700 to the City.
- Finally, the City leases a 12,000 square foot lot for use as a trucking yard on a month to month basis. Invoices indicate that over the last two years, the Fiscal Division

has invoiced the tenant \$750 and collected \$700. According to the lease, the Fiscal Division should have invoiced the tenant and collected \$1,200. However, the Fiscal Division staff indicated that they did not invoice the tenant the full amount because the Real Estate Division was negotiating to sell the parcel. As of February 1, 2002, the Real Estate Division had not sold the parcel.

**The Fiscal Division
Did Not Invoice
Some Tenants On
A Timely Basis**

Of the 24 leases we reviewed, there were 15 leases with rents greater than \$50 per month that the Fiscal Division was supposed to invoice either on a monthly or annual basis. However, we found that the Fiscal Division did not invoice some of these tenants in a consistent manner. For example, we found that the Fiscal Division did not invoice some tenants on their lease anniversary dates, as required. In other instances, we found that the Fiscal Division did not invoice some tenants for specific months. The following is an example of some of the problems we saw related to the Fiscal Division invoicing of tenants for leases of City-owned properties.

- The Fiscal Division is supposed to invoice Air Products and Chemicals, Inc. about \$3,700 each July. We found that the Fiscal Division did not invoice this tenant as required for over three and half years. On January 19, 2001, the Fiscal Division invoiced Air Products \$11,132 in back rent for a three-year period ending June 30, 2000. Without explanation, the Fiscal Division invoiced Air Products another \$11,132 on May 30, 2001. Up to this point, the City had invoiced the tenant twice for same amount. We found that on March 5, 2001 and April 3, 2001, the City received \$22,264 in payments from Air Products. Then on June 1, 2001, the City issued another invoice for \$11,132, which Air Products paid on June 26, 2001. Consequently, as of June 26, 2001, the City had invoiced and Air Products had paid \$33,396. However, we estimate that the Fiscal Division should have invoiced Air Products \$18,612, plus \$3,492 for penalties. As a result, Air Products overpaid the City \$11,292.

We recommend that the Department of Public Works:

Recommendation #5

Work with the City Attorney’s Office on how best to resolve underpaid and overpaid rents. (Priority 2)

The Fiscal Division Did Not Assess A \$677 Late Payment Penalty

The Air Products lease noted above contains a provision for assessing a specific late payment penalty. We found, however, that the Fiscal Division did not assess and collect applicable late payment penalties for this lease. Specifically, on May 19, 1998, the City received a payment of \$3,652 from the tenant. This payment was originally due on July 23, 1996 and was 665 days late. As such, the Fiscal Division should have assessed a 10 percent per annum late penalty of \$677 but did not. According to a Fiscal Division staff person, it was not her responsibility to assess late payment penalties and she was not aware of any late penalty provisions associated with this lease.

In January and February 2001, the Real Estate Division held meetings with representatives of the Fiscal Division and Finance Department Treasury Division staff to discuss the various roles related to billing lessees and receipt of payments. At this meeting, Real Estate staff learned that the Finance Department Treasury Division could only identify payments received within 30 days of the invoice due date but could not calculate late fees. According to Real Estate Division staff, their meeting with the Treasury Division did not result in any changes.

In our opinion, Public Works needs to work with the Finance Department to establish procedures to identify late payments and assess applicable penalties. Further, the Real Estate Division should identify all leases that have late payment provisions.

We recommend that the Department of Public Works:

Recommendation #6

Identify all Real Estate leases with late payment penalty provisions and establish procedures to ensure that late payment penalties are properly assessed. (Priority 3)

Recommendation #7

Review all of its leases of City-owned property with private entities and ensure that the Fiscal Division has been invoicing tenants for the proper amount of rents and invoice tenants for any amounts owed. (Priority 2)

Recommendation #8

Establish a process to ensure that the Fiscal Division invoices tenants on a consistent and continuous basis until the tenant vacates the property or until there is a change in property ownership. (Priority 2)

We recommend that the Department of Public Works and the Finance Department:

Recommendation #9

Identify the leases for which there are past due payments and initiate appropriate collection efforts. (Priority 2)

The Real Estate Division Did Not Match Lease Terms And Conditions To Private Entity Rental Payments

We found that the Real Estate Division staff did not match lease terms and conditions to private entity rental payments to ensure that the Fiscal Division had properly invoiced and collected rents. Further, the Real Estate Division lacks formal procedures to ensure that its staff monitored lease payments to verify that the Fiscal Division had properly invoiced and collected rents. In January and February 2001, the Real Estate Division organized meetings with staff from the Public Works' Fiscal Division and Finance Department's Treasury Division to discuss the invoicing and tracking of lease payments. Meeting notes revealed that the participants agreed to the following roles:

- Real Estate Division—negotiate contracts and process contract execution;
- Fiscal Division—prepare and send invoices to lessees; and
- Treasury Division—receive payment and credit the payment to the proper revenue account.

After these meetings, the Real Estate Division staff provided updated invoicing instructions and copies of lease agreements to the Fiscal Division.

In our opinion, a matching of rents invoiced and collected to the actual lease terms and conditions was an issue that should have been addressed in the meetings. Such matching is an important control to ensure that lessees were invoiced the correct amount of rents. In our opinion, given the agreed upon separation of duties, the Real Estate Division is the appropriate entity to perform this function. If the Real Estate Division would have matched the lease amounts the Fiscal Division invoiced and collected to the actual lease terms and conditions, the incorrect invoicing may have been noticed and appropriate collection action taken. However, in order for this to occur, the Real Estate Division needs to receive appropriate payment information on a monthly basis. Real Estate Division staff revealed that from July 2000 to January 2002, they did not receive notifications of unpaid rents.

We recommend that the Department of Public Works:

Recommendation #10

Establish a reconciliation process and formal procedures to ensure that leases of City-owned property are correctly invoiced and collected. (Priority 2)

The Real Estate Division Did Not Properly Adjust Rent Amounts By \$1,000 For Three Private Entity Leases

We found that certain leases have specified rent adjustment factors. These leases require annual or bi-annual rent adjustments based on certain Consumer Price Index (CPI) factors. We found that the Real Estate Division did not properly adjust rents for three leases, as required in the lease agreements. As a result, the City lost \$1,000 in rental income. The following exhibit shows the three leases with rent adjustment factors.

Exhibit 8 Leases With Annual Or Bi-Annual Rent Adjustments

| Lease | Adjustment Date | Rent Adjustment Factor | Base Year | Base Area |
|----------------------------------|------------------------|---|------------------|-----------------------|
| Air Products and Chemicals, Inc. | Bi-annual | CPI for Urban Wage Earners and Clerical Workers | 1995 | San Francisco-Oakland |
| | | Produce Price Index for Finished Goods | 1995 | San Francisco-Oakland |
| Lin and Young | Bi-annual | CPI for Urban Wage Earners and Clerical Workers | 1984 | San Francisco-Oakland |
| | | Produce Price Index for Finished Goods | 1984 | San Francisco-Oakland |
| Pacific Bell | Annual | CPI for All Urban Consumers, All Items | 1996 | San Francisco-Oakland |

Auditor’s note: The lease agreements with Air Products and Chemicals, Inc., and Lin and Young require the City to calculate the rent increase based on the CPI factor that results in the least monthly increase.

We found that the Real Estate Division did not make timely rent adjustments as required for any of these three leases:

- The Air Products and Chemicals, Inc. lease required a rent adjustment in July 1998 and July 2000. We found that the Real Estate Division did not make the July 1998 rent adjustment of \$88 until February 2000, or 20 months later. Further, we found that as of November 2001, the Real Estate Division had not made the July 2000 rent adjustment of \$297 it should have made 17 months earlier.
- The Lin and Young ground lease required a rent adjustment in May 1999 and May 2001. We found that as of November 2001, the Real Estate Division had not increased the monthly rent to \$775 as required. Further, the last rent adjustment of \$739 the division made for May 1997, was actually made in September 1998, or 17 months later.
- The Pacific Bell lease requires an annual rent adjustment every November. We found that the Real Estate Division did not initiate rent adjustments for this lease as required. However, because Pacific Bell proactively notified the Real Estate Division of the rent adjustments, the City did not lose any rental income.

The Real Estate And Fiscal Divisions Cannot Agree On Each Division's Rent Calculation Responsibilities

We found that the Real Estate Division and Fiscal Division staff have not agreed as to which division should be responsible for calculating and initiating rent increases for City-owned property. The January 2001 meeting notes discussed above revealed that staff discussed a procedure whereby the Real Estate Division would calculate the amount of rent due and rent due date. The Real Estate Division would then forward this information to the Fiscal Division 30 days prior to the due date. Staff also discussed the Real Estate Division sending a memorandum to the Fiscal Division explaining how rent increases are to be calculated and the due date of the adjustment. However, staff could not decide at this meeting which division would be responsible for calculating the actual rent adjustment. In our opinion, the Real Estate and Fiscal Divisions need to agree on each division's responsibility in the rent calculation and collection process and formalize that decision in written policies and procedures.

We recommend that the Department of Public Works:

Recommendation #11
Assign responsibility for calculating rent adjustments on City-owned property and establish policies and procedures to effectuate that assignment. (Priority 3)

The Administration Of City-Owned Property Leases To Private Entities Is Decentralized

Our review of Real Estate Division records revealed that the City administers leases of City-owned property in a decentralized manner. Specifically, different City departments and divisions are involved in the administration of the leases. For example, while the Real Estate Division negotiates the leases and maintains case files for each lease 1) the Fiscal Division issues monthly or annual invoices for rents due, 2) the Finance Department Treasury Division collects rents and follows up on any non-payment of rents, and 3) the Finance Department Risk Management Division is supposed to collect and maintain insurance information on the leases. Finally, other City departments, such as PRNS, monitor selected leases.

According to Real Estate Division staff, the model for invoicing and collecting rents has changed within the last 10 years. Real Estate staff informed us that up to 1992-93 the Real Estate Division handled invoicing and collecting functions. Beginning in 1992-93, the account clerk responsible for these functions was transferred to the Public Works' Fiscal Division.

*Limited Oversight
Over Leases*

Despite the current decentralized structure over leases of City-owned property, the Real Estate Division provides limited oversight over the management of the leases. Instead, the division relies on other City departments or divisions to do the invoicing, collecting, and monitoring activities for the leases. Therefore, the Real Estate Division does not consider itself responsible for invoicing tenants, collecting or adjusting rents, or verifying adequate insurance coverage. According to Real Estate Division staff, their job is to negotiate and execute contracts for leases of City-owned property. As a result, the Fiscal Division did not invoice or correctly invoice some private entity tenants or collect some rents from private entities. Furthermore, some private entity tenants did not maintain required insurance coverages. Generally, private entity tenants are required to maintain Office Commercial General Liability Insurance and Workers' Compensation and Employers' Liability. We found that the City did not have current insurance information for 16 private entities that leased City-owned property.

We recommend that the Department of Public Works:

Recommendation #12

Assign to the Real Estate Division the responsibility for providing oversight over leases of City-owned property. (Priority 2)

CONCLUSION

We found that the City's administration of leases for City-owned property is decentralized among several City departments and divisions with no one City entity being responsible for providing oversight. As a result, the City lost at least \$44,000 because the Administration did not 1) invoice or correctly invoice some tenants, 2) collect some rents, and 3) maintain accurate lease information. Finally, the Administration needs to ensure that tenants maintain adequate insurance coverage.

RECOMMENDATIONS

We recommend that the Department of Public Works:

Recommendation #5 Work with the City Attorney’s Office on how best to resolve underpaid and overpaid rents. (Priority 2)

Recommendation #6 Identify all Real Estate leases with late payment penalty provisions and establish procedures to ensure that late payment penalties are properly assessed. (Priority 3)

Recommendation #7 Review all of its leases of City-owned property with private entities and ensure that the Fiscal Division has been invoicing tenants for the proper amount of rents and invoice tenants for any amounts owed. (Priority 2)

Recommendation #8 Establish a process to ensure that the Fiscal Division invoices tenants on a consistent and continuous basis until the tenant vacates the property or until there is a change in property ownership. (Priority 2)

We recommend that the Department of Public Works and the Finance Department:

Recommendation #9 Identify the leases for which there are past due payments and initiate appropriate collection efforts. (Priority 2)

We recommend that the Department of Public Works:

Recommendation #10 Establish a reconciliation process and formal procedures to ensure that leases of City-owned property are correctly invoiced and collected. (Priority 2)

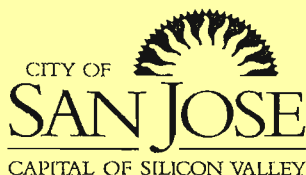
Recommendation #11 Assign responsibility for calculating rent adjustments on City-owned property and establish policies and procedures to effectuate that assignment. (Priority 3)

Recommendation #12 Assign to the Real Estate Division the responsibility for providing oversight over leases of City-owned property. (Priority 2)

RECEIVED

APR 12 2002

CITY AUDITOR



Memorandum

TO: Gerald A. Silva
City Auditor

FROM: Katy Allen

**SUBJECT: RESPONSE TO THE AUDIT OF
PROPERTY MANAGEMENT
OPERATIONS**

DATE: 04-12-02

APPROVED:

Katy Winer

DATE:

4/12/02

BACKGROUND

The Department of Public Works has reviewed the audit report for property management operations managed by the Real Estate Division. This report was transmitted to Public Works with your cover letter dated April 4, 2002. In general, the Department agrees with the findings of the audit. Specific responses to the recommendations requiring Public Works action are listed below.

As mentioned on page 16* of the Audit Report, in order to improve oversight, the Department of Public Works has taken steps to transfer the responsibilities for Property Management and Surplus Property functions to the General Services Department.

RECOMMENDATION #2 *That the Department of Public Works/Real Estate Division include language in its leases with non-profits requiring the annual submission of documents to the Division to facilitate an annual review. (Priority #3 – 60 days to one year)*

Staff will work with the Office of the City Attorney to develop appropriate language for inclusion in all new non-profit leases.

RECOMMENDATION #3 *That the Department of Public Works/Real Estate Division establish a formal application process for non-profit leases of City-owned property including the submission of key non-profit background information. (Priority #3 – 60 days to one year)*

Staff will develop a formal application process for non-profit leases of City-owned property taking into consideration suggestions made in the Auditor's report.

* Auditor's Note: Due to changes in the final typesetting of this report, this information actually appears on Page 17 of this report.

RECOMMENDATION #4 *That the Department of Public Works/Real Estate Division designate a staff person to monitor non-profit leases and ensure that these leases are renewed in a timely manner, have appropriate insurance, and are in compliance with the Revised City Council Policy 7-1 on Below Market Rents provisions. (Priority #3 – 60 days to one year)*

As noted in the body of the Audit Report, the Real Estate Division has not been adequately staffed to do all the necessary follow-up work required by Council Policy 7-1. As a part of the FY 2001-2002 Operating Budget process, the Department requested the addition of a Real Property Agent Position to support the Property Management Services the Division provides. This request was not approved in the budget process. In addition, one of the three positions assigned to property management and surplus property services is currently vacant.

RECOMMENDATION #5 *That the Department of Public Works work with the City Attorney's Office on how best to resolve underpaid and overpaid rents. (Priority # 2 – within 60 days)*

Public Works' staff and the City Attorney's Office will take steps to best resolve the underpaid and overpaid rents.

RECOMMENDATION #6 *That the Department of Public Works identify all Real Estate leases with late payment penalty provisions and establish procedures to ensure that late payment penalties are properly assessed. (Priority #3 – 60 days to one year)*

Staff will identify all current leases with late payment penalties and work with the Finance Department to establish a procedure to ensure that late payment penalties are assessed and collected when applicable.

RECOMMENDATION #7 *That the Department of Public Works review all of its leases of City-owned properties with private entities and ensure that the Fiscal Division has been invoicing tenants for the proper amount of rents and invoice tenant for any amounts owed. (Priority #2 – within 60 days)*

Staff will review both leases and current invoice amounts to ensure that the fiscal division has been invoicing tenants for the proper amount of rents.

RECOMMENDATION #8 *That the Department of Public Works establish a process to ensure that the Fiscal Division invoices tenants on a consistent and continuous basis until the tenant vacates the property or until there is a change in property ownership. (Priority #2 – within 60 days)*

Currently there is a physical separation between Public Works Real Estate and Fiscal staff that results in very limited face-to-face contact. In order for the two groups to meet to go over leases and invoices together, one of the two groups must travel approximately 1.5 miles. As stated, previously, the Department of Public Works has taken steps to transfer the responsibilities for Property Management and surplus property functions to the General Services Department. One of the benefits of this move is that in its new location the Property Management group will be situated in space contiguous to the space occupied by the Fiscal Section of the General Services Department which will provide for better interaction and communication between the two groups.

The Real Estate Section and Fiscal Section will work together to establish the process to ensure that invoices to tenants are done consistently and continuously.

RECOMMENDATION #9 *That the Department of Public Works and the Finance Department identify the leases for which there are past due payments and initiate appropriate collection efforts. (Priority #2 – within 60 days)*

Staff will work closely with the Treasury Division of the Finance Department to determine the appropriate level of efficient roles and responsibilities pertaining to the application of late fees / penalties and collection of past due accounts.

The collection process for real estate lease payments currently begins with the invoicing of tenants who have an agreement with the City. Original invoices are generated by the Public Works Fiscal Section in accordance with the terms of each agreement. Once an invoice is past due, provisions for assessing applicable late fees and penalties, as outlined in each lease agreement, should be enacted and applied accordingly. Invoiced amounts remaining unpaid for more than 30 days past the original due date are candidates for the delinquent collections process.

Staff will identify leases for which there are past due payments and will work closely with the Finance Department to ensure the application of appropriate late fees and penalties to past due lease invoices.

RECOMMENDATION #10 *That the Department of Public Works establish a reconciliation process and formal procedures to ensure that leases of City-owned property are correctly invoiced and collected. (Priority #2 – within 60 days)*

Both Property Management and Fiscal staff will coordinate a joint effort with the Finance Department to review collection and invoicing practices with respect to lease accounts to ensure that leases are correctly invoiced and collected. This process will include increased information sharing between the various departments and divisions with an acknowledgement of appropriate roles and responsibilities.

Gerald A. Silva

04-12-02

Subject: Response to the Audit of Property Management Operations

Page 4

RECOMMENDATION #11 *That the Department of Public Works assign responsibility for calculating rent adjustments on City-owned property and establish policies and procedures to effectuate that assignment. (Priority #3 – 60 days to one year)*

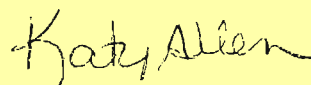
Staff will establish policies and procedures necessary to effectuate the timely calculation of rent adjustments on City-owned Property and assign the responsibility for calculating these adjustments to appropriate personnel.

RECOMMENDATION #12 *That the Department of Public Works assign to the Real Estate Division the responsibility for providing oversight over leases of City-owned property. (Priority #2 – within 60 days)*

The Department agrees that the responsibility for providing oversight over leases of City-owned property should most appropriately be handled by Property Management staff. As stated earlier, the Department of Public Works has taken steps to transfer the responsibilities for Property Management and Surplus Property functions to the General Services Department and believes that this realignment better matches the core responsibilities and services of both Departments.

The administration appreciates the time and effort put into this assignment by the Auditor's staff. We believe all actions necessary to address the recommendations can be implemented within the timeframe allowed for priorities 2 and 3.

Please call me at extension 4333 if you have any questions or need additional information.



Katy Allen
Director of Public Works

PP/ha/jb

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)