

## **Enhance Focus on Lease Administration of City-owned Properties**

**Date:** June 28, 2018

**To:** Audit Committee

**From:** Auditor General

**Wards:** All

### **SUMMARY**

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This report provides the results of the Auditor General's review of lease administration of City-owned properties.

In 2017, the Auditor General identified that the City was not billing or collecting certain rents and operating costs from tenants at Union Station. As a result of the findings in that audit, concerns were raised about whether similar issues existed with leases of other City-owned properties. As a result, the Auditor General conducted an audit of lease administration of the two divisions that manage the majority of the City's lease revenue: Real Estate Services and Parks, Forestry and Recreation.

Consistent with previous reports issued by the Auditor General, this audit highlights the need to focus on effective lease administration and to ensure the City receives all entitled revenue from leasing out City-owned properties. The City needs to effectively review and monitor leases in order to bill and collect the right amount of rents and recoveries.

As the City moves forward with the City-wide Real Estate Transformation, leasing activities across the City will be consolidated. Management recognizes and is prioritizing the need to improve lease administration processes. There is new leadership of the portfolio and this audit will provide a roadmap to support leadership going forward.

The audit makes 19 recommendations to help ensure that the City meets its program and strategic objectives, maximizes rent revenues, and recovers operating costs. Implementing the recommendations will improve how the City manages its leasing agreements going forward as well as how the City collects its rental income.

## RECOMMENDATIONS

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The Auditor General recommends that:

1. City Council request the Director, Real Estate Services, in consultation with all City divisions that negotiate and administer leases, to develop a standard City-wide policy to ensure negotiated rents are consistent with market conditions at the time agreements are executed; and, that appropriate supporting research and financial analysis is retained.
2. City Council request the Director, Real Estate Services, in consultation with all City divisions that administer leases, to develop and implement monitoring controls to ensure all commitments for capital improvements in current and future lease agreements are fulfilled. Such controls to include:
  - a. specifying in sufficient detail in formal agreements, the nature, expected value, and timing of capital work to be completed
  - b. logging or tracking all agreements and the related capital commitment
  - c. obtaining and retaining documentation, such as invoices, to support the value and nature of work completed.
3. City Council request the Director, Real Estate Services, in consultation with all City divisions that negotiate and administer leases, to:
  - a. establish standard City-wide lease terms that include rent escalations and/or periodic market rent reviews in longer-term lease agreements; and, where the terms are not applied, ensure justification for the exception is documented and reviewed by management
  - b. implement monitoring controls to ensure required rent increases or periodic market reviews are completed in a timely manner.
4. City Council request the Director, Real Estate Services, in consultation with the City Solicitor, to review all leases currently in overhold to determine whether the City can and should retroactively bill and collect all rents owing in accordance with the overhold rate specified in the respective agreement.
5. City Council request the Director, Real Estate Services, in consultation with the City Solicitor, to establish criteria for determining when a month-to-month overhold rate should be included in new, extended, or amended lease agreements.

6. City Council request the Director, Real Estate Services to establish a process to ensure the lease management system is accurately set up to automatically alert staff to:

- a. agreements where negotiations for the next term should commence in order to prevent unnecessary overholding
- b. charge the appropriate overhold rate upon agreement expiry, where appropriate; and take action to address expired agreements in a timely manner.

7. City Council request the Director, Real Estate Services, in consultation with other City divisions that administer leases, to perform a complete review of all leases to:

- a. identify any accounts where percentage rents were missed and obtain all necessary financial information from occupants to calculate applicable percentage rents
- b. identify any accounts where utilities (such as water, gas, and hydro), as well as all operating expense recoveries have been missed
- c. recover, where possible, any amounts that have gone unbilled or uncollected from prior periods.

8. City Council request the Director, Real Estate Services to establish and implement a process, including appropriate monitoring controls, to:

- a. ensure pending percentage rent reviews are efficiently and effectively identified and actioned, leveraging where possible available functionality in the City's financial system
- b. ensure percentage rents are calculated based on verifiable financial information and are billed and collected on a timely basis.

9. City Council request the Director, Real Estate Services, in consultation with other City divisions that administer leases, to establish and implement a process, including appropriate monitoring controls, to ensure all utilities billed to the City that should be recovered from occupants in accordance with their respective agreements are recovered in a timely manner.

10. City Council request the Director, Real Estate Services, in consultation with other City divisions that administer leases, to establish and implement a process to:

- a. review all properties with occupancy agreements to identify any space that needs to be assessed for property tax purposes and notify the Municipal Property Assessment Corporation accordingly
- b. ensure that when new occupancies are established on City-owned properties that the Municipal Property Assessment Corporation is notified promptly so that they can be assessed for property taxes.

11. City Council request the Director, Real Estate Services, in consultation with the City Solicitor, to determine the City's contractual right to retain any property tax rebates at commercially-occupied City-owned properties and, if necessary, ensure refunds are distributed to the respective occupants.

12. City Council request the Director, Real Estate Services, to review all active leases to ensure reconciliations of recoveries for all periods up to December 31, 2017, are completed and any settlement amounts are recorded in the City's financial system, and appropriately billed and collected from the respective occupants in a timely manner.

13. City Council request the Director, Real Estate Services, in consultation with other City divisions that administer leases, to implement a standardized process that ensures ongoing, timely and accurate billing and collection of estimated and actual recoveries in accordance with all lease agreements.

14. City Council request the Director, Real Estate Services, in consultation with any City divisions managing leases, to:

- a. identify all City-owned properties where a cost allocation model is required to allocate the appropriate proportionate share of operating costs to respective occupants
- b. develop a cost allocation model that clearly defines how annual operating costs will be allocated to and recovered from the respective occupants including details on the type and source of information for appropriate cost recovery
- c. ensure the implemented cost allocation models are used to accurately calculate and allocate operating cost estimates and year-end settlements to the respective occupants.

15. City Council request the Director, Real Estate Services, in consultation with the Director, Accounting Services, to establish and implement a process, including monitoring controls, to

- a. review the accuracy and completeness of customer accounts in the City's financial system
- b. ensure that customer account balances are reviewed annually for accuracy and completeness.

16. City Council request the Director, Real Estate Services, as part of the development of a City-wide leasing strategy and in consultation with relevant program areas, to:

- a. establish and maintain an accurate and up-to-date consolidated inventory of leasable space across the City
- b. establish a process to identify available vacant leasable space on an ongoing basis and prioritize such space to be marketed to interested parties on a timely basis.

17. City Council request the Director, Real Estate Services, as part of the development of a City-wide leasing strategy, to establish performance measures and track and analyze performance over time to monitor whether the leasing portfolio is performing as expected, and in line with industry benchmarks. Consideration should be given to establishing different measures based on the objectives for different categories of agreements within the portfolio.

18. City Council request the Director, Real Estate Services to review whether the City should be including an administrative fee in lease agreements to help recover the cost of lease administration. Such review to consider the appropriate fee structure to be applied and any criteria for exempting lessees from such an administrative charge.

19. City Council City request the Director, Real Estate Services, as part of the development of a City-wide leasing strategy and in consultation with all City divisions that administer lease agreements, to:

- a. review and update the existing set of policies and procedures to ensure sufficient specific guidance is provided for staff to effectively carry out lease administration duties
- b. establish processes for monitored ongoing compliance with established policies and procedures.

## **FINANCIAL IMPACT**

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The implementation of recommendations in this report will likely result in the collection of increased rents and recoveries. The precise extent of any resources required or potential revenues generated from implementing the recommendations in this report is not determinable at this time.

The potential financial impact of observations related to leases we reviewed (covering 40 per cent of 2017 leasing revenues excluding Union Station) are included in the table below.

<b>Description of leasing revenues at risk</b>	<b>Retroactive over time</b>	<b>Estimated annual recurring impact</b>
Insufficient evidence that rents reflect market rates	*	*
Insufficient evidence that commitments for capital improvements have been fully received	\$14.1 million	*
Expired leases not renewed on a timely basis	\$0.9 million+*	*

Description of leasing revenues at risk	Retroactive over time	Estimated annual recurring impact
Additional rents and recoveries not billed	\$4.5 million+*	\$728,000
Potential to charge administrative fees on recoveries	-	\$500,000

\* The full extent of the financial impact is not readily determinable at this time based on the information retained by the City.

**DECISION HISTORY**

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This audit was initiated as a result of the findings from the Auditor General's 2017 report, "Real Estate Services Division: Restore Focus on Union Station Leasing". That audit identified that the City was not billing or collecting certain rents and operating costs from tenants at Union Station. This finding caused concern about other leases. The Auditor General amended her 2017 Audit Work Plan to include an audit of lease administration of City-owned properties.

<https://www.toronto.ca/legdocs/mmis/2017/au/bqrd/backgroundfile-105133.pdf>

**COMMENTS**

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The City generated approximately \$53 million in leasing revenue in 2017. The Real Estate Services Division manages more than 900 leases that generated over \$45 million in revenues. The Parks, Forestry and Recreation Division manages approximately 170 leases that generated nearly \$6 million.

Through our audit, we wanted to answer three questions:

- Are leasing revenues being maximized? (or in the case of Community Space Tenancies, is the City cost-neutral?)
- Are rents and operating cost recoveries being billed and collected on a timely basis?
- Is there compliance with agreements?

The systemic deficiencies in basic lease administration practices we observed during this audit are not new. Many of the issues identified in this audit are the same as those raised in the Auditor General's 2006 Review of the Administration of Leases on City-owned Property.

This current audit highlights the need for an enhanced focus on lease administration including:

- A. Effective monitoring and oversight to ensure lease revenues are maximized
- B. Immediate action to address billing and collection of additional rents and recoveries

C. A strategic and coordinated approach to leasing, effective performance measures, standardized City-wide policies and procedures, and appropriate resourcing of the leasing function.

In the sample of leases we reviewed (covering 40 per cent of 2017 leasing revenues), we found:

- Rents may not be based on market rates – documents to support the basis for negotiated rents were not retained in 11 of 24 commercial leases (46 per cent). We noted better record retention in support of more recent agreements.
- The City is not ensuring tenants fulfill their obligations for contracted capital improvements – there was insufficient evidence to support the receipt of \$14.1 million in required capital improvements.
- Incremental rent revenues are lost when rent escalations, rent reviews, and lease renewals are not performed – an additional \$931,000 could have been generated if expired agreements were promptly renewed, with rents annually adjusted in line with inflation (using the Consumer Price Index).
- In addition to basic rent, commercial leases may require percentage rents, utility costs, property taxes, and/or other eligible operating expenses to be calculated and recovered. In nearly half the leases we reviewed (22 out of 45), the City did not calculate, bill, or collect additional rents and recoveries.
- We identified at least \$4.5 million that have not been billed for prior periods, of which at least \$728,000 relates to 2017. 65% of this amount pertains to below market rent tenants. However, as reflected in the agreements we reviewed, it is expected that these below market tenancies be cost-neutral to the City.

It is likely that additional concerns exist and amounts have gone unbilled over time in the leases we did not review.

As the City moves forward with the City-wide Real Estate Transformation, leasing activities across the City will be consolidated. Management recognizes and is prioritizing the need to improve lease administration processes. There is new leadership of the portfolio and this audit will provide a roadmap to support leadership going forward.

This is the opportune time to establish a coordinated strategy to maximize value from City-owned property, develop effective performance measures, standardize City-wide policies and procedures, and ensure appropriate resourcing of the leasing function. A 15 per cent fee applied to operating cost recoveries for commercial agreements could generate over \$500,000 annually to help recover the cost of lease administration.

Implementation of the 19 recommendations contained in this report will improve how the City manages its leasing agreements going forward as well as how the City collects its rental income. The findings from this audit may also be relevant to other City divisions, agencies and corporations which are responsible for leasing out City-owned properties.

## **CONTACT**

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## **SIGNATURE**

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Auditor General

## **ATTACHMENTS**

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Attachment 1: Enhance Focus on Lease Administration of City-owned Properties