County of Ventura
AUDITOR-CONTROLLER
MEMORANDUM

To: Todd McNamee, Director, Department of Airports — Date: March 3, 2008

From: Christine L. Cohen

Subject: AUDIT OF VENTURA COUNTY DEPARTMENT OF AIRPORTS LEASE/LICENSE AGREEMENT ADMINISTRATION

EXECUTIVE SUMMARY

We have completed our audit of the Ventura County Department of Airports ("Airports") lease/license agreement administration ("lease administration"). Our overall objective was to determine whether Airports' lease administration efforts effectively and efficiently maximized revenues and minimized risks to the County. The audit was conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing* promulgated by the Institute of Internal Auditors. Our findings are summarized below with details provided in the attached.

During our audit, we noted that Airports took certain measures to maximize revenues and minimize risks related to lease administration. For example, Airports developed an electronic database to help monitor contract terms. We also noted good management practices concerning lease file accountability, property appraisals and corresponding rent adjustments, and environmental responsibility awareness. We also verified that rents and fees were on par with other airports with similar operations.

However, overall, our audit disclosed that further improvements were needed to strengthen lease administration. Through our audit samples, we also identified specific instances where approximately $1,500 in fees and deposits were not assessed. Specifically, during our audit, we noted that lease administration could be improved by:

- Dedicating specific resources to lease administration and/or implementing administration software.
- Including contract language to transfer environmental hazard liabilities to tenants.
- Improving management of the collection of rent and fees.
- Strengthening oversight of lessee compliance with capital improvement requirements.
- Enhancing controls over contract life-cycle monitoring.
- Monitoring lessee compliance with insurance requirements more closely.

Airports management initiated corrective action to address our audit findings. Corrective action is planned to be completed by August 31, 2008. Any item not completed by this date will have documentation detailing progress and a new estimated completion date assigned.

We appreciate the cooperation and assistance extended by you and your staff during this audit.

Attachment

cc: Honorable Peter C. Foy, Chair, Board of Supervisors
Honorable Steve Bennett, Board of Supervisors
Honorable Linda Parks, Board of Supervisors
Honorable Kathy Long, Board of Supervisors
Honorable John K. Flynn, Board of Supervisors
John F. Johnston, County Executive Officer

AUDIT OF VENTURA COUNTY DEPARTMENT OF AIRPORTS LEASE/LICENSE AGREEMENT ADMINISTRATION

BACKGROUND:

The Ventura County Department of Airports ("Airports") operates the County's two regional airports in Oxnard and Camarillo with a $12.6 million budget for fiscal year ("FY") 2007-08 and 32 authorized positions. In an effort to maximize operations, Airports leases certain land and facilities to private parties for both aviation (e.g., leasing of hangars) and non-aviation (e.g., rental of office space) purposes. Additional revenue sources include license fees, daily tie down fees, aircraft landing fees, automobile parking, and fuel and oil charges.

General terms for land and facility leases include requirements to pay base rent or percentage rent as determined by the agreement. Capital improvements to both land and buildings were also required for 23 leases in effect during FY 2006-07. Other standard lease terms include security deposit, insurance coverage, and environmental protection requirements as appropriate. Airports' 74 combined leases along with other license agreements and related fees generated over $4.7 million (58%) of Airports' total revenue of $8.1 million recognized during FY 2006-07.

SCOPE:

Our overall audit objective was to determine whether Airports' lease/license agreement administration ("lease administration") efforts effectively and efficiently maximized revenues and minimized risks to the County. Specifically, we evaluated Airports' policies and procedures related to: contract life-cycle management; capital improvement monitoring; controls over collection of monies due, including base rents, percentage rents, security deposits, and fees; lessee insurance coverage monitoring; and environmental hazard mitigation.

We performed audit tests and evaluations using documents and files provided by Airports. Our tests and evaluations focused on administration of lease/license agreements, although we also reviewed collections management of other related revenue, such as landing fees. These fees were not necessarily tied to a formal contract, and instead were governed by the annual Rent and Fee Schedule approved by the Board of Supervisors.

The audit was conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing* promulgated by the Institute of Internal Auditors. For our audit, we used documents and records for the period January 2006 through June 2007.

FINDINGS:

We noted that Airports took certain measures to maximize revenues and minimize risks related to lease administration. For example, Airports developed an electronic database to help monitor each contract, and lease files were stored and accounted for properly. Property appraisals occurred in a timely manner, and rents were properly adjusted according to reassessed property values. In addition, Airports proactively encouraged environmental responsibility to tenants through a public awareness/information campaign, using tools such as a quarterly newsletter and promotion of the department's Used Oil and Filter Recycling Program. We also verified that rents and fees were on par with other airports with similar operations.

However, overall, our audit disclosed that further improvements were needed to strengthen lease administration. Specifically, we believe that Airports could benefit from committing dedicated resources to manage the lease administration function, such as through implementation of lease administration software. We also found that contract language was needed to formally transfer environmental hazard liabilities to tenants and protect the County from financial damages.

In addition, processes to collect rent and fees were not always sufficient, resulting in low collection rates for outstanding accounts. Our audit samples also identified fees and deposits of approximately $1,500 that were not assessed. We also found that oversight of capital improvement requirements was in need of improvement. Further, enhancement of controls over contract life-cycle and insurance coverage monitoring was needed to ensure compliance.

Summarized below are details of the areas where improvements were needed. Airports management initiated corrective action during the audit as noted.

1. Lease Administration Resources. Although Airports generally demonstrated a hands-on approach to lease administration, we believe that the effort could be further strengthened by dedicating specific resources to the lease administration function. Given the relatively large volume and variety of contract terms, efficiency and effectiveness was limited using the current process, which likely contributed to the findings described in this report. Therefore, considering other enhancements could streamline the administration process and help to eliminate the weaknesses noted during our audit. For example, we are aware of another County agency's pursuit of lease administration software as an option to strengthen controls.

   Management Action. Airports management concurred with the finding and stated: "Department of Airports staff agrees that dedicated resources are needed for lease administration. Staff has researched many software solutions currently available off the shelf, however short of having a custom solution designed specifically for the airports none seemed to fit the needs of the department. Department of Airports staff has created a lease management database that began its trial run during the beginning of this audit. Several deficiencies noted in the audit were due to a lack of fields tracking specific objectives, which have now been added, or fields which were empty in the database due to the addition of these items as a result of auditor comments, but not yet in use while awaiting data entry. This database once fully utilized shall provide sufficient tracking of all related deficiencies in this report. Department of Airports staff will begin the process of completely entering each lease into the new database, while at the same time creating new filing folders and completing a checklist for all required items. Any deficiencies noted on the checklists will be rolled up to a master deficiency list which will track all corrective action taken and deadlines for each item. This 'lease clean-up' process will begin mid-March 2008, with an estimated completion date of June 30, 2008."

2. Environmental Hazard Liability Transfer. Lease agreements did not always contain a clause transferring liability to the tenant for clean-up costs related to contamination and/or pollution due to tenant activities. Of the seven leases selected for review, three (43%) did not fully transfer liability to the tenant for the full costs associated with environmental hazards caused by the tenant. Rather, liability for cost recovery was limited to the amount held as a security deposit by the County, which

would not likely be sufficient to cover aggregate clean-up costs. Airports estimates that ongoing clean-up costs for spills caused by tenants in prior years have reached $2.5 million. By not formally transferring this liability to the tenant, the County is exposed to significant liability for paying all clean-up costs, fines, penalties, and other damages.

Management Action. Airports management concurred with the finding and stated: "All new leases executed by the department do contain language which transfers liability to the tenant for clean-up costs related to contamination and/or pollution due to tenant activities. Several older leases do not have language as strong as the current language; these leases will be noted during the lease clean-up project and listed on the master deficiency list. Department of Airports will attempt to negotiate amendments that update the language with the affected tenants."

3. Collections Management. Management of the collections process was not always sufficient. Specifically, we found that the collection of rent and fees could be improved by: performing percentage rent reviews; requiring support for percentage rent payments; collecting outstanding accounts; and accurately calculating fees. Further, improvements could be made by: assessing and expanding late fees; sending default notices for delinquent payments; performing fuel flowage reconciliations; monitoring security deposit amounts; and endorsing checks upon receipt.

   A. Percentage Rents Reviews. Reviews of lessee records have not been performed to provide reasonable assurance that reported revenues used to calculate over $250,000 in percentage rents are accurate. Relying strictly on lessee-prepared documents without independent verification of gross receipts leaves Airports vulnerable to error and/or fraud. At least one other County agency with percentage rent tenants has taken proactive measures to create a revenue exam schedule, whereby external accounting firms verify lease revenues on a cyclical basis. We encourage Airports to pursue similar measures as necessary.

      Management Action. Airports management concurred with the finding and stated: "Staff will consult with other County agencies to help set up a system consisting of a revenue examination schedule and verification of lease revenues."

   B. Percentage Rents Documentation. Percentage rent payments were not always supported with proper documentation to confirm the accuracy of reported revenues used to calculate percentage rents. In our review of four lease agreement files, one file (25%) did not have sufficient documentation detailing the sales date(s), sale amount(s), or actual allowed expense(s) for a rent payment of $19,664. Without proper documentation, Airports is not able to verify that the amount paid is the correct amount due.

      Management Action. Airports management concurred with the finding and stated: "Department of Airports will request further documentation (i.e. delivery receipts, invoices) be included with all percentage rent payments."

   C. Collecting Outstanding Accounts. Airports' rent and fee collection process did not appear adequate to collect on outstanding accounts. In reviewing the Transient Parking Report for June 2006 through May 2007, approximately 650 transient fees were charged totaling $9,965 with a collection rate of only 51 percent. Also, the Open Invoices Report, as of April 23, 2007, disclosed that outstanding rent and fees of $12,287 from 2005 and 2006 had not been collected.

Improvements to the collection process were needed to facilitate higher collection rates and fewer accounts becoming uncollectible due to the inability to locate the debtor and/or terminated tenants.

Management Action. Airports management concurred with the finding and stated:

"Department of Airports will conduct a peer review with other airports for ideas on other collection methods for transient aircraft. Many airports do not charge a fee due to the difficulty in collecting a fee from persons from other airports with no contractual agreement with the airport. At this time airport staff feels that even given the low collection rate, the airports do benefit from having the fee in place.

"Each month several tenants fail to make a payment prior to the due date. Staff feels that adequate procedures are in place to address this item, however with the current procedures amounts that total less than a month's rent can be overlooked. Staff will add a date component to our follow-up procedures to eliminate any overlooked smaller fees before they become more than ninety (90) days past due."

D. Accuracy of Fee Calculations. Airports did not always accurately calculate fees assessed. For example, our review of the Transient Parking Report for June 2006 through May 2007 disclosed that 16 (2.5%) out of 653 fees were incorrect due to manual calculations. Although the loss of transient fees amounted to only $71, automating the calculation of fees and reviewing fees assessed would decrease the likelihood of billing anomalies.

Management Action. Airports management concurred with the finding and stated: "Transient parking is currently tracked in software that does not provide for automatic calculations. Staff will switch to a different application to avoid potential errors by manual calculations."

E. Assessment of Late Fees. Lessees were not always assessed late fees for delinquent payments as allowed by contract terms and as approved by the Board of Supervisors in the Rent and Fee Schedule. Our review of 20 base rent payments and 22 percentage rent payments disclosed 2 instances where late fees totaling $1,088 were not assessed. Airports acknowledged that the one base rent late fee of $354 was not assessed because the tenant historically paid rent on time. Management stated that the second percentage rent late fee of $734 was not pursued because the proper late fee amount was unknown until the percentage rent payment was submitted with appropriate documentation. However, a late fee was not assessed even after the percentage rent payment and supporting documentation were submitted. Although the number and dollar amount of the exceptions were not significant, without a penalty for noncompliance, a sense of urgency is not instilled in tenants to make timely payments.

Management Action. Airports management concurred with the finding and stated: "Department of Airports will review percentage rent due dates as part of the lease clean-up project and institute a system to collect late fees from percentage rents."

F. Expanding Late Fees. Certain late fee provisions in the Rent and Fee Schedule could be expanded to foster more equitable application of late fees and reduce delinquency rates. For example, the Rent and Fee Schedule allows late fees to be assessed for delinquent aircraft storage and fuel flowage payments, but not for delinquent payment of landing fees. Our review of the Landing Fee Report as of June 4, 2007, disclosed that 150 line item fees (38%) out of 392 were more than 30 days overdue. Had Airports assessed a $15 late fee for every payment that was 30 days overdue, for instance, potential revenue of $5,430 could have been generated. In addition, application of a late fee may serve as an additional method to discourage delinquency.

Management Action. Airports management concurred with the finding and stated: "Department of Airports will conduct a peer review with other airports for ideas on other collection methods for landing fees. Many airports do not charge a fee to unscheduled aircraft due to the difficulty in collecting a fee from persons from other airports with no contractual agreement with the airport. At this time airport staff feels that even given the low collection rate, the airports do benefit from having the fee in place."

G. Notices of Default. Notices of default were not always issued to tenants on a timely basis. For example, our audit disclosed that a notice of default was not sent to one lessee until May 2007, when outstanding late fees totaling $4,650 dated back to 2005 and 2006. Another audit sample disclosed that, of 22 payment dates for 4 lessees tested, 6 (27%) percentage rent payments were late for 2 (50%) of the lessees. One of the tenants did not receive a notice of default until 20 days after the notice should have been sent according to contract terms. Documentation was not available to support that Airports ever notified the second tenant of five delinquent payments.

Management Action. Airports management concurred with the finding and stated: "Notice of defaults are issued to tenants when rent is two months past due and every month a statement showing all amounts due is sent to every tenant. Staff will revise the procedures to issue notices of default when any fees become two months past due regardless of the actual monetary amount."

H. Fuel Flowage Reconciliation. Airports did not verify that fuel flowage usage reported by tenants reconciled to the fuel company's reported amounts. Rather, Airports strictly relied on tenants to report the number of gallons of fuel delivered. Fuel flowage fees represent a significant portion of Airport fee revenues, accounting for over $200,000 during FY 2006-07. Therefore, confirmation of tenant-reported numbers to fuel company records would be prudent to mitigate any risk of improper reporting and payment shortages.

Management Action. Airports management concurred with the finding and stated: "Department of Airports will request further documentation (i.e. delivery receipts, invoices) be included with all percentage rent payments (including fuel flowage)."

I. Insufficient Security Deposits. Security deposits did not always meet or exceed the required amounts as set forth in the contract terms. Our review of five contracts disclosed that one lessee's base rent had increased, thus increasing the security deposit required by $309. However, the deposit on file was not sufficient to meet the new security deposit requirement. Although management took immediate action to notify the tenant of noncompliance upon our disclosure of the finding, lack of oversight resulted in tenant noncompliance for over 90 days. Ensuring security deposits are sufficient will reduce the risk that Airports will need to cover the full costs associated with a noncompliant tenant should the tenant be terminated.

Management Action. Airports management concurred with the finding and stated: "Staff will add language to the thirty day notice of rental rate increase to include any required increase to the security deposit on file. Existing leases will be reviewed as a part of the lease clean-up project with any deficiencies to security deposit added to the master deficiency list."

J. Check Endorsement. Airports did not restrictively endorse checks received from tenants immediately upon receipt. Although the collections process appeared to be adequately segregated, checks were endorsed late in the process, which increases the risk of misappropriation. Restrictive endorsement of checks upon receipt would reduce the risks associated with loss, theft, alteration, and/or misappropriation.

Management Action. Airports management concurred with the finding and stated: "It was brought to the Fiscal Manager's attention by one of the Auditors on June 1, 2006 that the checks needed to be endorsed upon receipt. Immediately thereafter, the Management Assistant started endorsing the checks upon receipt."

4. Capital Improvements. Airports' oversight of capital improvements required by lessees was not always sufficient to properly monitor, verify, and document compliance. Twenty-three lease agreements required that capital improvements be completed during the contract term, and the County receives the significant benefit that capital improvements are made to County property at the lessees' expense. However, weaknesses in capital improvement monitoring could undermine the intended benefit to be derived.

A. Inspections. Periodic inspections were not performed and documented to verify lessee compliance with capital improvement obligations. Airports does not currently have a process in place requiring inspection by the Fire Marshal, Building and Safety, and the Federal Aviation Administration to ensure capital improvements meet federal and state regulations. Without proper inspection, significant risks exist that capital improvements may not be in compliance with codes and ordinances, resulting in potential additional liability for the County.

Management Action. Airports management concurred with the finding and stated: "A requirement to provide a copy of construction permits and sign offs prior to occupancy will be added to the departmental approval letter issued for each tenant project. The lease management database will also be updated to include permit sign off if applicable. Any outstanding obligations will be noted during the lease clean-up project."

B. Documentation. Airports did not always request supporting documentation for capital improvements made by certain tenants. Proper documentation includes invoices and/or expense receipts showing the cost of the capital improvement. In our review of four lease files, two (50%) did not have appropriate documentation supporting that the capital improvements met the minimum required amount in the agreement. Proper documentation is essential for Airports to confirm that tenants have met the capital improvement thresholds.

Management Action. Airports management concurred with the finding and stated: "Existing leases will be reviewed as a part of the lease clean-up project with any deficiencies to capital improvement documentation added to the master deficiency list."

C. Notices of Default. Airports did not always issue 30 day notices to cure default to noncompliant tenants. In our review of three selected lessees required to perform capital improvements, two

(66%) of the lessees had not completed capital improvements by the specified date in the terms of contract. Both lessees' capital improvements were to be completed by the end of July 2006; however, letters of default were not sent to the tenants notifying the tenants of noncompliance. Sending notices of default to tenants in a timely manner ensures that tenants are made aware of the delinquency and allows tenants an opportunity to comply.

Management Action. Airports management concurred with the finding and stated: "Tenant projects often take longer than anticipated due to permitting and other issues. Staff was working with/in communication with the tenants in the instances mentioned, and will provide better documentation in the future."

D. Surety Bonds. Tenants did not always provide proof of a surety bond when capital improvements were required. The surety bond is a guarantee that the tenant will perform the required improvements as described in the contract terms, providing liability and asset protection to the County. Our review of three lessees disclosed that two (66%) did not have proof of surety bonding either prior to beginning capital improvements or at any time during the capital improvement process. Given that the capital improvements amounted to over $2.5 million, the County was exposed to significant risk of tenant default.

Management Action. Airports management concurred with the finding and stated: "A requirement to provide proof of a valid surety bond prior to breaking ground will be added to the departmental approval letter issued for each tenant project."

5. Contract Life-Cycle Monitoring. Contract life-cycle monitoring was in need of improvement to facilitate proper tracking of contract milestones. During our audit, we noted instances where the electronic database was not accurate, license agreements were not valid, and lease extensions were not exercised properly. As a result, the potential for tenant noncompliance was elevated.

A. Inaccurate Database. The electronic database used to monitor the terms of contracts was not current, accurate, or complete. For example, database fields relating to insurance coverage were not adequate to track details of insurance coverage requirements. In addition, although the database indicated that insurance coverage had expired for six agreements, file documentation disclosed that five policies had been renewed, but the database had not been updated. Further, the database did not indicate the need for one lessee to complete capital improvements, which was the main purpose of the land lease. Other fields that were not always completed included such items as security deposit type and amount, bank information, and contract expiration date. Because Airports uses the database to monitor agreements, inaccuracies could contribute to noncompliance with certain requirements.

Management Action. Airports management concurred with the finding and stated: "Staff has modified the database to better track insurance requirements per the recommendations from the first auditor assigned. Staff will ensure accuracy in the database during the lease clean-up project."

B. Updating License Agreements. Airports' contract monitoring was not sufficient to identify two license agreements that were not valid. Management acknowledged that both agreements had become null and void in 1998 when an advertising board replaced the telephone carousel referenced in the agreements. In addition, one agreement did not have a County representative's signature. The second agreement had been assigned to a new company owner although Airports did not formally contract with this third party. However, Airports continued to enforce the original agreements without appropriate authority.

Management Action. Airports management concurred with the finding and stated: "The telephone board at the Oxnard Airport has not been consistently handled in the past. Staff will develop a new agreement and work with all current users to switch to the new agreement."

C. Lease Extensions. Airports did not always properly exercise lease extensions in accordance with contract provisions. Our review of 12 lease agreements disclosed in one (8%) instance that the holdover clause, which would have allowed a month-to-month extension upon contract expiration, had been deleted. However, the tenant was allowed to continue on a month-to-month basis for 4 months before we brought the issue to management's attention. Although Airports immediately executed a lease amendment to include a holdover clause, attention was needed to ensure that formal authority was established prior to allowing lease extensions.

Management Action. Airports management concurred with the finding and stated: "This specific instance was an oversight; tenant is now on a long term lease. Holdover language was left out of the lease in anticipation of the tenant moving to a different portion of the building, this move did not happen due to permitting issues."

6. Insurance Coverage. Lessee compliance with insurance requirements was not always monitored adequately, thereby increasing financial liability risks to the County. As a result, improvements were needed to ensure tenant compliance with the various types and levels of insurance coverage required by each lease agreement.

A. Expired Insurance Certificates. Airports did not always follow-up on expired insurance certificates in a timely or consistent manner. In our review of 13 lease files, we found that 2 (15%) lessees had expired insurance certificates. Specifically, for one tenant with an expired $1 million general liability policy, Airports did not notify the tenant until nearly 2 years after the policy expiration. In addition, although a reminder notice was sent 30 days prior to expiration of another tenant's general liability insurance, Airports did not follow-up until the renewal certificate was received. Without current and valid certificates of insurance on file, Airports cannot be assured that County liability has been adequately mitigated.

Management Action. Airports management concurred with the finding and stated: "Each tenant has several different insurance requirements which in the past were difficult to track. Several fields were added to the database as recommended by the first auditor assigned which will enable staff to track each type of insurance required. Existing leases will be reviewed as a part of the lease clean-up project with any deficiencies to insurance added to the master deficiency list."

B. Noncompliance with Insurance Coverage Requirements. Specific insurance requirements mandated by the lease agreements were not always confirmed or documented upon receipt of the insurance certificates. As a result, our review of three lease agreements disclosed that two (67%) tenants did not meet the required insurance coverage and amounts. Specifically, we found that one tenant did not provide evidence of the required $50,000 in fire legal liability and $300,000 in business auto insurance. The other noncompliant tenant did not provide evidence of the required $500,000 in business auto and $1 million in fuel truck insurance. Verification of required coverage is necessary upon initial receipt of insurance certificates to minimize liability risk to the County.

Management Action. Airports management concurred with the finding and stated:

"Staff will work with Risk Management and insurance providers to ensure proper coverage is in place when the policy specifies limits with different language than the agreement.

"The Department of Airports Rent and Fee Schedule allows for a waiver of the fire legal liability requirement if such insurance is deemed not procurable. Staff will work with Risk Management on a case by case basis if tenant claims they are not able to claim the required coverage."

AUDITOR'S EVALUATION OF MANAGEMENT ACTION: We believe that management actions taken or planned were responsive to the audit findings. Management planned to complete corrective actions by August 31, 2008. Any item not completed by this date will have documentation detailing progress and a new estimated completion date assigned.

We appreciate the cooperation and assistance extended by you and your staff during this audit.