

County of Ventura
AUDITOR-CONTROLLER
MEMORANDUM

To: Lyn Krieger, Director, Harbor Department

Date: November 3, 2014

From: Jeffery S. Burgh

Subject: AUDIT OF HARBOR DEPARTMENT LEASE ADMINISTRATION

We have completed our audit to evaluate the effectiveness of the lease administration efforts of the Channel Islands Harbor Department ("Harbor Department"). The audit was conducted in conformance 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 report.

EXECUTIVE SUMMARY

Overall, we found that the Harbor Department effectively managed the lease administration of the Channel Islands Harbor. For example, our audit confirmed that lease terms were current and valid for master leases and that lease amendments were approved properly. Rent payments were received timely, percentage rent multipliers were applied accurately, and security deposits were sufficient.

However, our audit disclosed areas where improvements could further strengthen lease administration. Through our audit samples, we identified specific instances of approximately \$10,300 in uncollected revenue. Specifically, lease administration could be improved by:

- Assessing and collecting rent and interest in accordance with lease provisions.
- Recording accurate and complete lease information within the contract management system.
- Monitoring lessee compliance with insurance requirements more closely.

Except as noted in the attached report, Harbor Department management initiated corrective action to address our findings. Harbor Department management stated that corrective actions were completed during the course of the audit.

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

Attachment

cc: Honorable Steve Bennett, Chair, Board of Supervisors
Honorable Kathy I. Long, Vice Chair, Board of Supervisors
Honorable Linda Parks, Board of Supervisors
Honorable Peter C. Foy, Board of Supervisors
Honorable John C. Zaragoza, Board of Supervisors
Michael Powers, County Executive Officer

County of Ventura
Office of the Auditor-Controller



AUDIT OF HARBOR DEPARTMENT LEASE ADMINISTRATION

November 3, 2014

Jeffery S. Burgh
Auditor-Controller

AUDIT OF HARBOR DEPARTMENT LEASE ADMINISTRATION

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AUDIT OF HARBOR DEPARTMENT LEASE ADMINISTRATION

BACKGROUND

The Channel Islands Harbor Department ("Harbor Department" or "Harbor") operates the Channel Islands Harbor, which consists of approximately 200 land acres and 110 water acres. For fiscal year ("FY") 2012-13, operating revenues totaled \$7.3 million, which consisted of charges for services as well as rents and royalties generated from recreational and business use of the harbor. The Harbor Department oversees approximately 25 master leases with private sector businesses, which accounted for \$3.1 million (42%) of Harbor's operating revenue during FY 2012-13. Examples of leasehold operations include marinas, apartments, retail shops, boatyards, hotels, and restaurants.

General terms for land and facility leases include requirements to pay base rent and percentage rent. Base rent is a fixed monthly amount, while percentage rent is required when a percentage of lessee gross receipts exceeds the base rent. Certain lessees may elect to qualify for lease extensions upon completion of capital improvements. Other standard lease terms include security deposit, insurance coverage, and environmental protection requirements as appropriate.

SCOPE

Our overall audit objective was to determine the effectiveness of Harbor's lease administration efforts. Specifically, we evaluated the effectiveness of Harbor's 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 penalties/fees;
- lessee insurance coverage and bonding; and
- liability for and mitigation of environmental degradation.

Our audit procedures focused on leaseholds in effect during FY 2012-13. The audit was performed in conformance with the *International Standards for the Professional Practice of Internal Auditing* promulgated by The Institute of Internal Auditors using documents from October 1984 through October 2014.

FINDINGS

Overall, we found that Harbor effectively managed the lease administration of the Channel Islands Harbor. For example, lease terms were current for master leases, lease amendments were approved properly, and lease files were accounted for properly. Rents were collected timely, percentage rent multipliers were applied accurately, and security deposits were in compliance with contract provisions. In addition, Harbor verified compliance with capital improvement expenditure requirements prior to recommending lease extensions. We also confirmed that lease agreements properly transferred liability for potential environmental damages to the lessee.

However, our audit disclosed areas where Harbor lease administration could be improved. Specifically, Harbor needed to assess base rent as stated in the lease agreements, pursue unpaid percentage rents, and assess interest appropriately. As a result, our audit samples identified approximately \$10,300 in uncollected rent and interest. In addition, enhancement of records within the contract management system and controls over insurance coverage monitoring were needed to ensure compliance.

Following are details of the areas where improvements were needed. Except as noted in Findings 1, 2, 3, and 5(A), Harbor management initiated corrective action during the audit.

1. **Base Rent Assessment.** Harbor did not always assess monthly base rent according to lease terms. Our sample of base rent for five lessees noted that one (20%) lessee's monthly payment did not match the amount stated in the agreement. Specifically, although the monthly base rent in the agreement approved by the Board of Supervisors ("Board") was defined as \$12,300, Harbor asserted the amount was merely a placeholder, with the calculation of the actual monthly rent to occur shortly after Board approval. However, the lease agreement did not identify the \$12,300 rent amount as a placeholder, nor was the lease amended when Harbor subsequently determined the base rent to be \$12,100. As a result, \$10,000 in base rent was not collected over the 4-year period from February 2006 through March 2010 when the \$12,100 base rent amount was applied. This undercollection was partially offset by the resulting overcollection of approximately \$2,000 in percentage rents from April 2010 through August 2013. While we acknowledge that Harbor notified the Board that the rent amount was an estimate, the lease stated the amount to be absolute and an amendment was never pursued.

Management Response. Harbor management stated: "The Harbor Department strenuously disagrees with this finding. The finding asserts, '...one lessee's (20%) monthly payment did not match the amount stated in the agreement.' The letter to the Board of Supervisors on November 1, 2005 recommended approval of the Amended and Restated Lease document for Marine Emporium Landing, and also recommended that minimum rent be calculated at the end of the quarter, for ease and clarity in future rent re-sets that are completed periodically under the terms of the lease. The Board letter was very clear that the minimum rent figure set in the proposed lease was a placeholder, and this matter was included in the recommendations section, adopted by the Board of Supervisors. This Board letter was reviewed and signed off by CEO, County Counsel and Auditor Controller and placed on the Board agenda. The recalculation was done as planned at year-end, the rent was set, accepted by the Lessee, and paid. The effective date of the lease was February 6, 2006, so that the rent re-set affected only rent payments beginning in 2006. When minimum rents are re-set, the lease is not changed to reflect the new rent number. The audit indicates that there was an underpayment of rent because the amount in the original lease approved by the Board of Supervisors was not collected. The rent ultimately charged was as intended by the Board's action."

Auditor's Comment. We acknowledge that the lease would not be amended when minimum monthly rent is re-set because the lease provided specific provisions to define the terms of the rent re-set. Section 6.1 of this lease stated: "For the first five (5) Lease Years of the Term, the Minimum Monthly Rent shall be \$12,300. Commencing with the sixth (6th) Lease Year, the Minimum Monthly Rent shall be adjusted in accordance with the provisions of Section 6.1.1." Along with providing detailed terms of the rent re-set methodology, Section 6.1.1 specifically stated in pertinent part: "...in no event shall the Minimum Monthly Rent as adjusted be less than the 'Minimum Monthly Rent Floor' as determined as follows: (i) the Minimum Monthly Rent Floor for the first Adjustment Date shall be \$12,300...In no event shall the Minimum Monthly Rent ever be adjusted to an amount that is less than the Minimum Monthly

Rent Floor last in effect..." These provisions clearly defined the minimum monthly rent as \$12,300 and did not allow rent to be adjusted below that amount. Therefore, we recommend that Harbor consider incorporating any potential modifications to minimum monthly rent or other provisions within the lease agreements to allow for such circumstances.

2. **Percentage Rent Collection.** Harbor did not always enforce collection of monies due to the County as the result of Harbor's periodic revenue reviews, which determine accuracy of percentage rents paid. We sampled two revenue reviews and observed that one (50%) identified additional percentage rent owed to the County of \$148, which Harbor did not pursue collection of because the amount was deemed de minimis. However, according to the lease agreement, any deficiencies in percentage rent discovered as the result of an audit immediately become due and payable to the County and needed to be pursued by Harbor.

Management Response. Harbor management stated: "This finding concerns a three-year revenue review of the Marine Emporium Landing leasehold, from 2010 through 2012. Several of the quarters indicated some potential under-reporting of income, with the total amounting to \$148 over the three-year period. The Harbor's periodic revenue reviews are for the purpose of confirming good-faith reporting of rents due, and to indicate whether further investigation is required to develop a documented underpayment of rent. These reviews generally consist of comparing revenue reported on quarterly reports to annual tax returns or other official documents where gross revenue is reported. If the preliminary review does not indicate substantial variance in rents owed, the matter is not pursued. Again, these revenue reviews are intended to ensure that the County is receiving rent on all income, without deductions, and is not intended as a detailed true-up of rent owed. Since gross receipts are not reconciled to the penny, some amount of minor 'rounding error' is anticipated and there may be small variances due to issues related to timing or year-end adjustments. Amounts are deemed de minimus when the costs related to staff time required to document any potential misstatement of revenue would, de facto, exceed the value of the rent to be collected and, therefore, be unwarranted. While the lease does not specifically allow for waiving even de minimus amounts, the cost of work required to convert this estimated the deficiency to a proved up amount in order to issue a collection notice would far outweigh any additional revenue that might be received."

Auditor's Comment. We noted that Harbor deemed the amounts in question as de minimis; however, as mentioned in the finding, the lease document did not provide Harbor the executive authority to waive the amount due. Section 6.4.6 of this lease stated: "If it is determined as a result of an audit that there has been a deficiency in the payment of any Percentage Rent, then such deficiency shall immediately become due and payable, together with interest at the Maximum Rate from the date when said payment should have been made until paid." Therefore, if Harbor may deem these amounts as de minimis, this authority needs to be incorporated within the applicable section of the lease document.

3. **Interest Assessments.** Lessees were not always assessed interest for deficiencies in or late payments of base and percentage rent. Our review of 18 base rent payments and 2 revenue reviews of percentage rents disclosed 3 instances of either deficient or late payments. None of these instances resulted in interest assessments, which we estimated would have totaled \$169 during the course of our field work. Harbor did not calculate the interest at the time of the deficiency or late payment, although Harbor asserted during our audit that each interest assessment was deemed de minimis. However, the lease agreements did not provide Harbor the discretion to waive interest due regardless of the amount.

Management Response. Harbor management stated: "The audit may be correct that interest assessments of \$167 divided across multiple leaseholds were not collected. In this instance, the audit includes three events: one for \$.78 from a Lessee who pays over \$150,000 per year, one of \$152 from a Lessee who pays over \$140,000, and a third of \$14.13 from a Lessee who pays \$96,000 in annual rent. As in item 2, above, the cost of staff time to pursue such minor interest assessments would exceed the value of the collections."

Auditor's Comment. We noted that Harbor believed the cost of pursuing the interest assessments would exceed the value of the collections. However, as Harbor did not calculate the interest at the time, Harbor could not evaluate the cost/value involved. In addition, each lease stated: "If Lessee fails to pay any of the Rents when the same is due and payable, such unpaid amounts shall bear interest at the Maximum Rate from the date due until the date of receipt by County of such payment." Therefore, if Harbor may use discretion in assessing and collecting interest, this authority needs to be incorporated within the lease document.

4. **Contract Life-Cycle Monitoring.** The records within Contract Assistant, the software used to monitor key elements of lease agreements, were not always current, accurate, or complete. For example, our review of database records for five lessees disclosed the following: the lease agreement expiration date in Contract Assistant was shorter than the actual expiration date for one lessee by 17 years; the rent adjustment review for one lessee was conducted 2 years early based on an incorrect rent adjustment date in Contract Assistant; and 4 out of 10 insurance expiration dates in Contract Assistant were not current. Further, Contract Assistant was not populated to monitor all types of insurance and coverage amounts required by lease agreements. Because Harbor uses the database to monitor agreements, inaccuracies could contribute to noncompliance with certain essential requirements.

Management Action. Harbor management stated: "In the draft Audit it states that 'software used to monitor key elements of lease agreements were not always current, accurate, or complete.' Information and documents tend to arrive at the Department in batches, due to timing at end of quarter or year. These items are checked for conformance to the lease, and then entered in the system once verified. The Department also experiences periodic delay in entering data due to software updates, one of which was underway at the time of the audit. This was explained to the audit team at the start of the engagement. There were a few non-monetary errors, cited here, that have been corrected, including one instance where the lease end date was incorrectly recorded, a clerical error in data entry that has since been corrected. There was also an instance of an early rent adjustment date. The Department will try to increase its data entry accuracy, while noting that from time to time human error will occur. Also, from time to time accounting staff fall slightly behind in recording new data, such as year-end closing or budget preparation. As stated above, during those time periods management places a priority on receiving and filing required information, such as updated security deposits or rent reports, and not on immediately updating dates in the software. This was the case during the original audit exam period, which primarily occurred during year end closing. To clarify, Contract Assistant is a tool for record keeping and notices. However, it is almost never the only source checked before an action is taken."

5. **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. **Insurance Monitoring.** Harbor did not monitor all types of insurance required by individual lease agreements. As a result, we were unable to determine whether lessees possessed all required insurance policies because Harbor's files did not contain the documentation needed for our confirmation. Harbor only monitored 2 types of insurance, Comprehensive General Liability and Workers' Compensation, while the leases we sampled required anywhere from 7 to 13 different types of insurance. Harbor believed the onus lies with the lessee to ensure that required insurance is maintained. However, without Harbor's monitoring of all required types of insurance as the administrator of these leases, Harbor cannot be assured that risk to the County has been adequately mitigated in the event of an incident.

Management Response. Harbor management stated: "Lease requirements in Harbor ground leases place all responsibility for insurance coverage on the Lessee. However, as a safeguard to protect the County, the Harbor Department does regular insurance checks to ensure that Lessees are protecting the County from liability. The Harbor Department conducts an annual check on both general liability and workers compensation, which are areas that might create liability and potential expense for the County. Other insurance requirements are checked from time to time. For example, some specialty insurance may be provided by subtenants, such as yacht brokers, and are needed only if there is such a subtenant. The Harbor Department wishes to point out that in cases of casualty or other similar losses, no amount of insurance, whether casualty or business interruption, guarantee that a business will be financially able to continue operations."

Auditor's Comment. Although we have noted that Harbor conducts annual checks on General Liability and Workers' Compensation insurance, we were informed during the audit that none of the other insurance requirements were checked. We believe that Harbor needs to ensure lessee compliance with all applicable insurance requirements set forth in the lease to help protect the County against potential liability or loss of revenue due to interruption of the lessee's business.

- B. **Insurance Coverage Requirements.** Specific insurance requirements mandated by the lease agreements were not always confirmed upon receipt of the insurance certificates. As a result, our review of insurance certificates for five lessees disclosed that, although two (40%) leases required \$2 million in Comprehensive General Liability insurance, certificates only supported \$1 million of coverage. In addition, we identified instances where insurance certificates did not list the County as an additional insured or include: endorsements for waiver of subrogation; the required 30-day cancellation notice; or loss payee endorsements. Verification of required coverage is necessary upon initial receipt of insurance certificates to minimize liability risk to the County.

Management Action. Harbor management stated: "The audit is correct that there were two instances of insurance coverage having a lower face value than required by the lease. The amount required in the lease will be corrected (reduced) in the next lease amendment on these leaseholds. While the Harbor Department requests that County Risk Management review lease requirements each time a lease is amended or replaced, in general the County standard for Harbor leases is \$1 Million in Comprehensive General Liability coverage. The two examples noted, where \$2 Million was required, were either the result of miscommunication between County departments, or an oversight in lease drafting, or may have reflected the insurance already in place on the leasehold. Some lessees do elect to carry insurance in excess of County requirements. There was nothing exceptional about the two leases at issue that would require coverage above the County standard, which was on file for each of the leases."

AUDITOR'S EVALUATION OF MANAGEMENT ACTION

Except for Findings 1, 2, 3, and 5(A), we believe that management actions taken or planned were responsive to the audit findings. Harbor Department management stated that corrective actions were completed during the course of the audit.