TO: Chair and Members
Audit and Administration Committee

WARD(S) AFFECTED: CITY WIDE

COMMITTEE DATE: June 2, 2010

SUBJECT/REPORT NO:
Audit Report 2010-01 - Real Estate Asset Management (AUD10019) (City Wide)

SUBMITTED BY:
Ann Pekaruk
Director, Audit Services
City Manager’s Office

PREPARED BY:
Ann Pekaruk 905-546-2424 x4469

SIGNATURE:

RECOMMENDATION

(a) That Report AUD10019 respecting Audit Report 2010-01, Real Estate Asset Management, be received; and

(b) That the management action plans as detailed in Appendix “A” of Report AUD10019 be approved and the General Manager of Planning and Economic Development and the City Treasurer direct the appropriate staff under their responsibility to have the plans implemented.

EXECUTIVE SUMMARY

The 2009 Internal Audit work plan approved by Council included an audit of the City’s real estate assets as they relate to leasing, acquisitions and disposals. Adherence to Council adopted strategies and plans for disposition, acquisition and retention was also reviewed.

The results of the audit are presented in a formal audit report containing observations, recommendations and management responses, along with an Addendum, attached as Appendix “A” of Report AUD10019.

Alternatives for Consideration –Not Applicable

Vision: To be the best place in Canada to raise a child, promote innovation, engage citizens and provide diverse economic opportunities.
Values: Honesty, Accountability, Innovation, Leadership, Respect, Excellence, Teamwork
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FINANCIAL / STAFFING / LEGAL IMPLICATIONS (for Recommendation(s) only)

Financial: The implementation of the first recommendation under #4 would result in a single accountability for the administration and management of all City leases. Management has indicated that this would conservatively increase the budget in the Real Estate section by $200,000. Errors in a sample of gain/loss calculations on the sale of assets resulted in an overstatement of the gains by $926,000.

Staffing: Management has indicated that the implementation of the first recommendation under #4 would result in an additional 2 FTEs.

Legal: No proof of the lessee’s liability insurance naming the City as an additional insured could place the City at risk in the event of third party liability issues on a City leased property (recommendation #6).

HISTORICAL BACKGROUND (Chronology of events)

The audit fieldwork was completed in February, 2010. The results of this audit are attached as Appendix “A” of Report AUD10019. The Audit and Administration Committee receives and approves final audit and review reports as part of its responsibilities for the oversight of governance and control.

POLICY IMPLICATIONS

None.

RELEVANT CONSULTATION

The attached report includes management action plans which reflect the responses of management and staff responsible for the administration of the City’s real estate holdings and transactions (leasing, acquisitions and disposals) – Real Estate, Economic Development and Real Estate, Planning and Economic Development Department and Accounting Services and Accounts Receivable, Financial Services, both in the Corporate Services Department.
ANALYSIS / RATIONALE FOR RECOMMENDATION

The Real Estate section for the City of Hamilton is responsible for the management of the City’s real estate asset portfolio, including acquisitions, disposals and most leasing of City-owned properties. The portfolio includes close to 3,000 properties (per Tangible Asset Database – 1,926 land areas and 921 buildings) totalling more than 10,000 acres.

City Council has approved a number of plans and strategies related to the disposition, acquisition and retention of real estate assets: Hamilton Real Estate Portfolio Strategic Plan, Policy and Guidelines for the Renting and Demolition of Residential Buildings Owned by the City and By-law 04-299 which establishes procedures governing the sale of City-owned land. Adherence to Council adopted plans and strategies was assessed.

The audit focused on the acquisition, disposal and leasing processes associated with real estate assets. Excluded from the scope of this review were environmental audits (performed by the Real Estate section) and leasing by the City of third party owned properties. The audit also reviewed the inclusion of the City’s real estate portfolio in the accounting of fixed assets for financial statement purposes.

The audit identified opportunities for increased controls and accountability, potential operational efficiency improvements and risk mitigation.

A formal audit report containing observations, recommendations and resulting management action plans was issued and is attached as Appendix “A” of Report AUD10019. Fourteen (14) recommendations were included in the Report and Addendum. Among them are:

- A system to provide accurate and complete property inventory data and lease agreement information from a single source. Such a system should be able to update the real estate portfolio as changes occur and calculate gains/losses for disposals.
- The restrictive endorsement of all sale deposits upon receipt by the Real Estate section.
- A more accurate method of administrative cost allocation for property purchases.
- The assignment of the administration and management of all City leases to the Real Estate section of Planning and Economic Development.
- A proactive approach to lease renewals before their expiration date.
- Provision of proof of liability insurance from all lessees.
- Billing and collection of all amounts due according to lease terms.
- Effort to confirm original acquisition costs when calculating gains/losses on disposals of property assets.
Management and staff have agreed to implement all the recommendations as stated except:

- **#2 (Main Report)** – Although agreed, in principle, management feels that the implementation of this recommendation would not be cost or time effective.

- **#4 (Main Report)** – Implementation of the administration and management of all City leases in the Real Estate section falls outside the section’s strategic focus and is estimated to cost an additional $200,000 and require 2 new FTEs.

- **#4 (Addendum)** – Even though the recommendation would result in more accurate gain/loss calculations, in the interest of cost, time and materiality, using an estimated historical cost (as per the current practice) is considered appropriate and adequate by staff, the external auditors and the CICA’s Public Sector Accounting Board.

Specific action plans to address the balance of the recommendations can be found in the attached audit report.

### ALTERNATIVES FOR CONSIDERATION

(Include Financial, Staffing, Legal and Policy Implications and pros and cons for each alternative)

Not applicable.

### CORPORATE STRATEGIC PLAN (Linkage to Desired End Results)


**Financial Sustainability**

- Delivery of municipal services and management of capital assets/liabilities in a sustainable, innovative and cost effective manner

### APPENDICES / SCHEDULES

Appendix “A” to Report AUD10019
1. Despite the City tracking its real estate holdings in a number of different ways, there is no single database that is complete, up-to-date and can be relied upon to manage the inventory of City-owned properties.

A manually prepared set of binders kept in the Real Estate section is supposed to catalogue property details by ward. However, this system does not provide an ongoing count of properties owned nor their historic cost. In addition, it was learned that the information in the binders has not been updated for purchases and sales since the summer, 2009.

The Archibus system, used extensively for building maintenance management, is another source of information. Even though it captures the cost of the property itself, it does not include other purchase related costs (e.g. land transfer tax, legal fees, environmental assessment fees, etc.) to its capital base. Therefore, it cannot be used in the gain/loss calculations for sales of properties. Properties must be identified by a unique property roll number which may not always be possible.

The property database maintained by the Tangible Capital Asset Accounting (TCAA) Specialist was developed to track the City’s capital assets as a financial statement requirement. Once again, various identification and valuation methodologies particular to this data (e.g. exclusion of land parcels less than .15 Ac., update of purchases and sales only at the end of the fiscal year) result in differences from other databases.

Several other applications (e.g. Vailtech, ReCapp, GIS) all contain information regarding the City’s real estate holdings but the data is specific to the particular use of the application.

An attempt to compare totals across the various databases resulted in many differences as no single record was considered complete and up to date.

Without a single, complete record of all real estate holdings, asset management and administration are less efficient.

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<tr>
<th>#</th>
<th>OBSERVATIONS OF EXISTING SYSTEM</th>
<th>RECOMMENDATION FOR STRENGTHENING SYSTEM</th>
<th>MANAGEMENT ACTION PLAN</th>
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<tr>
<td>1.</td>
<td>Property Inventory</td>
<td>That the Real Estate section either implement a new system or modify one of the existing systems in order to provide accurate and up-to-date property inventory data (including identification of purchases and sales) to facilitate real estate asset management from a single source.</td>
<td>RE - Agreed. The Real Estate database is currently being integrated into the Real Estate module within the Archibus program administered by Transportation, Energy and Facilities, Public Works, for sales and acquisitions. Discussion will ensue with the administrator to seek input on the capabilities of expanding the Archibus program to catalogue property assets as a single database within the control of the Real Estate Section. Expected completion – Q1, 2011</td>
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<td>That the system implemented above be updated to reflect changes in the real estate portfolio as they occur.</td>
<td>RE – Agreed. All current working files are being integrated into the Archibus database.</td>
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<td>That the system implemented have the data required and the capability of calculating the gain or loss on each property sold.</td>
<td>AS – Agreed. A system would be beneficial for ongoing tangible capital asset accounting and asset management. A more accurate and up-to-date system would reduce the likelihood of a material error occurring from the omission of a major acquisition, sale or disposal. Staff from Accounting Services will be assigned to ensure that the system captures data required from a tangible capital asset accounting perspective and processes for timely updates are implemented.</td>
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## OBSERVATIONS OF EXISTING SYSTEM

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<th>Property Purchases</th>
<th>Recommendation for Strengthening System</th>
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<td>2</td>
<td>Property Purchases, there are administrative costs incurred. These include appraisal fees, environmental assessment fees, legal fees and land transfer taxes. Even though these costs are available for each property purchase, they are accumulated in an account for the year and then equally distributed to the properties purchased in the time period. Even though the costs are accounted for as a whole, they are unfairly allocated as small properties (which would generally be expected to incur less administrative costs than larger property purchases) are allocated the same expense as larger properties. For example, in 2008, average administrative costs of $9,600 were equally added to properties which cost $10,000 and $1,000,000. This, in turn, would affect the calculation of the gain or loss on the sale of the property.</td>
<td>That the actual administrative costs incurred for each specific property acquired be accounted for in the cost of the applicable purchase.</td>
<td>AS – Agreed, in principle. From an accounting perspective, this recommendation would increase the accuracy of our financial statements since actual costs would be identified by specific properties, where available. However, it would not make a material difference overall as all costs are accounted for. Some group costs, such as staffing costs of the Real Estate section, would still have to be allocated in the current manner for each real estate holding. Specific details of expenditures for each property acquisition through regular analysis and categorization of transactions would also require more Real Estate section staff time which may not be cost beneficial.</td>
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<td>3</td>
<td>A purchaser wanting to acquire a City-owned property that is for sale must submit a deposit (in the form of a cheque) equal to 10% of the agreed upon purchase price. Currently, the cheque is not restrictively endorsed when it is accepted by the Real Estate staff. It is stored in a petty cash box until Legal Services acknowledges the acceptance of the purchaser’s offer. This may take from a few days to a few weeks. Cheques that are not restrictively endorsed upon receipt may be more susceptible to misappropriation.</td>
<td>That all cheques be restrictively endorsed immediately upon receipt by the Real Estate section.</td>
<td>RE - Agreed. Upon receipt, the cheques will be endorsed through the stamping of the back of the cheque with “For deposit only to the City of Hamilton”.</td>
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<td><strong>Leases - General</strong></td>
<td>That the Real Estate section of Planning and Economic Development be assigned accountability for the administration and management of all City leases.</td>
<td>RE - Disagreed. The Real Estate Section provides realty services to the various client departments. Upon completion of lease negotiations, administration of the terms and conditions for premises, wherein the City is a tenant, is currently being administered by Transportation, Energy and Facilities, Public Works and for all other leases administered by the respective client departments/divisions. Real Estate does not become involved in the lease arrangements/ negotiations for users groups within Parks, Parking and Recreational facilities, nor to the administration of same. The assignment and accountability is more of a corporate issue - having all client departments maintain and input data into one centralized corporate database, such as the Archibus program, and assigning accountability for the accuracy of information and continued implementation to a lead department. The tasks to consolidate, input and effectively maintain a leasing portfolio for the entire organization would have an extensive impact on the section’s resources. Implementation to centralize this program will have a budget and staffing impact conservatively estimated at $200,000 and 2 new FTE’s. In addition, the section’s focus is more on strategic real estate planning and portfolio management as set out in Council’s approved plan. The recommendation is beyond the scope of the service provided by Real Estate and will be referred to the Portfolio Management Committee with its recommendations to be forwarded to Senior Management Team for discussion and direction. The Portfolio Management Committee, chaired by the Director of Economic Development and Real Estate, meet on a monthly basis. RE – Agreed. See the Management Action Plan for recommendation #1.</td>
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<td>4.</td>
<td>As is the case for the City’s property holdings noted in point 1 above, a complete profile of the City’s lease arrangements detailing lease duration, type of lease and lessor/tenant information is not currently available. The Environmental Services section (Parks) maintains its own unique database for its leases as does the Corporate Facilities section. These databases differ from the lease information noted in Archibus. As a result, there is no one complete system for tracking all information involving lease agreements. With such separation of information, roles and responsibilities may be unclear in terms of the management of such leases.</td>
<td>That a new system or a modified existing system be implemented to provide complete and accurate information regarding lease agreements for all City-owned properties from a single source. This recommendation should be considered in conjunction with the decision made for recommendation #1 above.</td>
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<td><strong>Leases - Expiring Agreements</strong></td>
<td>That management consider a process that will alert staff well in advance of the expiration of a lease in order that a more proactive approach to re-negotiating the lease can be taken.</td>
<td>RE - Agreed. Implementation of the Archibus program will alert staff well in advance of the expiration date of leases within the current year to assist staff to act upon renewals in a timely manner. However, on occasion, negotiations may extend beyond the lease term (due to the complexity of the lease conditions thereby requiring further instructions from the client department) and create a gap before the new lease takes effect.</td>
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<td>Even though the Archibus system sends expiry notices to staff six months in advance, Accounts Receivable sends e-mail reminders one month before a lease expires and the Real Estate section’s work plan lists leases up for renewal, it was noted that, in several files reviewed, new lease agreements had not been completed and were not ready to take effect as the existing leases expired. The gaps between the time the existing leases expired and the time that the new leases took effect ranged from four months to as long as thirteen months.</td>
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<td><strong>Leases - Liability Insurance</strong></td>
<td>That the existing provision requiring the lessee to provide proof of liability insurance annually be enforced.</td>
<td>RE - Agreed. Steps have already been undertaken with the appropriate client department administering the terms and conditions of City leases for ensuring that the City is protected by proof of insurance coverage from the lessee(s). As noted above, staff will be alerted through the Archibus program in advance for subsequent follow ups.</td>
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<td>All lease agreements include a provision in which the lessees agree to obtain and maintain liability insurance that names the lessor (the City) as an additional insured. The lessees are obligated to deliver certificates of insurance once a year to the lessor as proof of such insurance. A review of a sample of the current lease agreements revealed that such certificates are not collected. This could place the City at risk in the event of third party liability issues at one of the City’s leased properties.</td>
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ADDENDUM

The following items were noted during the course of the audit. Although they do not present internal control deficiencies, they are indicated in this Addendum so management is aware of the issues, risks and inefficiencies and can address them appropriately.

(RE: Real Estate / AS: Accounting Services / AR: Accounts Receivable)

Existing Lease – Billing and GST

1. During the review of rent billings, it was noted that an existing lessee had not been invoiced for rent from the time the lease came into effect on July 1, 2005. Instead, the lessee simply deposited a cheque with the Municipal Service Centre (MSC) every month in accordance with the lease terms as he understood them. There is the risk that staff at the MSC processing the payments would not know whether the amount paid was accurate or complete. For example, it was found that this lessee had not been paying GST on the lease even though the lease agreement expressly stated that this was required. The oversight has totalled approximately $1,500 in unpaid GST to the end of January, 2010.

It is recommended:
That all leases be invoiced through the City’s Accounts Receivable section.

Management Response:
RE - Agreed. All leases will be invoiced through the City’s Accounts Receivable section.
AR - Agreed. Accounts Receivable is prepared to process any invoices for leased premises requested from Facilities or the Real Estate section.

That the outstanding amount of GST due be recovered from the lessee and that it be remitted to the Canada Revenue Agency (CRA).

Management Response:
AR - Agreed. The required information will be obtained immediately and be invoiced.

Existing Lease – Lease Terms - Adjustment for Inflation

2. A particular lease agreement reviewed provided for a lease rate adjustment for inflation every year on the anniversary date of the lease. Despite the fact that this lease had been in effect since June 1, 2007, the responsible division was not aware that the operating costs should be reviewed and the rate charged the lessee should be adjusted for the impact of inflation on these costs. A review, in this particular case, indicates that, due to the low level of inflation, no change in the rate was necessary.

It is recommended:
That, once a lease agreement has been finalized, the Real Estate section inform the responsible division of its role in properly administering the terms of the lease.

Management Response:
RE - Agreed. Effectively immediately, once a lease agreement has been finalized/executed, the Real Estate section will forward all supporting documentation and inform the respective client division of its role in properly administering the terms and conditions of the lease.
Existing Lease – Lease Terms - Rate Setting

3. Per Council directive, lease rates, where the City is the landlord, are to be set at or above the fair market rate with the fair market rate determined by an appraisal. In some cases, it may not be possible to perform such an appraisal because the property is unique or not readily comparable due to location. Therefore, in such cases, management has decided that the rate should cover the operating costs of the property being leased. In two cases reviewed, it was found that the lease rate was either set below the operating costs or no documentation for the operating costs existed in the files to support the rate. Therefore, these properties may be generating less revenue than directed. Without adequate cost information for each property, it is difficult to evaluate the financial performance of individual properties as well as make effective leasing decisions.

It is recommended:
That the lease rates charged for all properties be supported by the appropriate documentation.

Management Response:
RE - Agreed. Effective immediately, lease rates charged for all properties will be supported by the appropriate documentation.

Gain/Loss Calculations

4. The Tangible Capital Asset Accounting (TCAA) Specialist does not have access to Real Estate files and generally does not know the amount paid for a property or when it was acquired (if pre 2007). Therefore, in calculating the gain/loss on the sale of a property in cases where such information is not known, an acquisition price calculated using inflation figures and a backtracking method, pushes values back to 1959. In Internal Audit’s testing of six gain/loss on disposal calculations, two sizeable errors resulted from this methodology – one for a difference of approximately $729,000 and another for a difference of $197,000. As there are not a significant number of sales in a year, the TCAA Specialist needs to confirm original acquisition data and transactions against records maintained in the Real Estate section.

It is recommended:
That the TCAA Specialist confirm acquisition costs with the Real Estate section’s records prior to the calculation of the gain/loss on disposal of City-owned property.

Management Response:
AS - Disagreed. A property inventory was obtained from the Real Estate section in the form of an Access database but no cost information was included. In the interest of cost and time, an estimated historical cost was assigned based on assessment values for vacant land. Estimating techniques were recommended by the CICA’s Public Sector Accounting Board for tangible capital asset accounting and audited by our external auditors. Furthermore, much of the City’s land holdings were acquired for no monetary consideration (i.e. airport lands transferred from the Federal government, Housing lands downloaded from the Province, developer contributions related to parklands and Water and Wastewater facility lands). Although these lands were acquired by the City for no consideration, a fair value cost is still needed and Real Estate records would not provide the required cost information.