

PERFORMANCE AUDIT
OF THE
REAL ESTATE DIVISION

DEPARTMENT OF MANAGEMENT AND BUDGET

June 2002

EXECUTIVE DIGEST

REAL ESTATE DIVISION

INTRODUCTION	This report, issued in June 2002, contains the results of our performance audit* of the Real Estate Division (RED), Department of Management and Budget (DMB).
AUDIT PURPOSE	This performance audit was conducted as part of the constitutional responsibility of the Office of the Auditor General. Performance audits are conducted on a priority basis related to the potential for improving effectiveness* and efficiency*.
BACKGROUND	RED reports to the DMB deputy director. RED's mission is to provide real estate services to State agencies. RED is responsible for securing and administering leased space for departments, acquiring and disposing of land, granting and purchasing easements, and leasing and administering State land and facilities to private tenants. RED had expenditures of \$1.2 million for fiscal year 2000-01 and 14 employees as of September 30, 2001.
AUDIT OBJECTIVE AND CONCLUSION	Audit Objective: To assess the effectiveness and efficiency of RED's administration of the sale and purchase of property, the granting and purchase of easements, and the leasing of commercial and State-owned property.

* See glossary at end of report for definition.

Conclusion: We concluded that RED's administration of the sale and purchase of property, the granting and purchase of easements, and the leasing of commercial and State-owned property was generally effective and efficient. However, we noted one material condition*:

- RED did not follow established policies and procedures when it entered into a sales agreement with a private company to sell State surplus property adjacent to the Michigan State fairgrounds (Finding 1).

We also noted reportable conditions* relating to the lease of State property, bid evaluations and recommendations, the monitoring of leases of State-owned property, public purpose sale criteria, and lease data (Findings 2 through 6).

**AUDIT SCOPE AND
METHODOLOGY**

Our audit scope was to examine the program and other records of the Real Estate Division. Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Our audit procedures included an examination of RED's records and activities covering the period October 1, 1998 through September 30, 2001.

We conducted a preliminary review that consisted of interviewing management and program staff and reviewing legislation, the DMB Administrative Guide, the Legislature's Joint Capital Outlay Subcommittee policies, RED policies and procedures, and other RED reports and manuals. The purpose of the preliminary review was to

* See glossary at end of report for definition.

obtain an understanding of RED operations and to plan our audit.

We tested internal control and procedures performed relating to the sale and purchase of property, leasing of property, and the granting of easements. We obtained sale, purchase, and lease data from individual transaction files and analyzed the timeliness of services performed; whether the services were performed in accordance with existing policies, procedures, laws, and regulations; and whether the services performed were efficient. We reviewed oversight responsibilities delegated to RED. We reviewed policies and procedures from various other states' web sites to help assess RED's effectiveness and efficiency.

**AGENCY RESPONSES
AND PRIOR AUDIT
FOLLOW-UP**

Our audit report includes 6 findings and corresponding recommendations. DMB's preliminary response indicated that it will consider the recommendations.

RED did not comply with the 2 prior audit recommendations. Both prior audit recommendations were rewritten for inclusion in this report.

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STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

June 27, 2002

Mr. Duane Berger, Director
Department of Management and Budget
Lewis Cass Building
Lansing, Michigan

Dear Mr. Berger:

This is our report on the performance audit of the Real Estate Division, Department of Management and Budget.

This report contains our executive digest; description of agency; audit objective, scope, and methodology and agency responses and prior audit follow-up; comment, findings, recommendations, and agency preliminary responses; and a glossary of acronyms and terms.

The agency preliminary responses were taken from the agency's responses subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

AUDITOR GENERAL

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Description of Agency

The Real Estate Division (RED), Department of Management and Budget (DMB), was removed as a division of the DMB Office of Property Services in fiscal year 1997-98 and established as a division reporting to the DMB deputy director.

RED's mission is to provide real estate services to State agencies. RED has two primary areas of responsibility. The Commercial Leasing Section secures and administers leased space for departments. The Special Services Section is responsible for acquiring and disposing of land, granting and purchasing easements, and leasing and administering State land and facilities to private tenants.

RED had expenditures of \$1.2 million for fiscal year 2000-01 and 14 employees as of September 30, 2001.

Audit Objective, Scope, and Methodology and Agency Responses and Prior Audit Follow-Up

Audit Objective

The objective of our performance audit of the Real Estate Division (RED), Department of Management and Budget (DMB), was to assess the effectiveness and efficiency of RED's administration of the sale and purchase of property, the granting and purchase of easements, and the leasing of commercial and State-owned property.

Audit Scope

Our audit scope was to examine the program and other records of the Real Estate Division. Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Audit Methodology

Our audit procedures, performed from May through September 2001, included an examination of RED's records and activities covering the period of October 1, 1998 through September 30, 2001.

We conducted a preliminary review that consisted of interviewing management and program staff and reviewing legislation, the DMB Administrative Guide, the Legislature's Joint Capital Outlay Subcommittee policies, RED policies and procedures, and other RED reports and manuals. The purpose of the preliminary review was to obtain an understanding of RED operations and to plan our audit.

We tested internal control and procedures performed relating to the sale and purchase of property, leasing of property, and the granting of easements. We obtained sale, purchase, and lease data from individual transaction files and analyzed the timeliness of services performed; whether the services were performed in accordance with existing policies, procedures, laws, and regulations; and whether the services performed were efficient. We reviewed oversight responsibilities delegated to RED. We reviewed policies and procedures from various other states' web sites to help assess RED's effectiveness and efficiency.

Agency Responses and Prior Audit Follow-Up

Our audit report includes 6 findings and corresponding recommendations. DMB's preliminary response indicated that it will consider the recommendations.

The agency preliminary response that follows each recommendation in our report was taken from oral discussion subsequent to our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and DMB Administrative Guide procedure 1280.02 require DMB to develop a formal response to our audit findings and recommendations within 60 days after release of the audit report.

RED did not comply with the 2 prior audit recommendations. Both prior audit recommendations were rewritten for inclusion in this report.

COMMENT, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

EFFECTIVENESS AND EFFICIENCY

COMMENT

Audit Objective: To assess the effectiveness and efficiency of the Real Estate Division's (RED's) administration of the sale and purchase of property, the granting and purchase of easements, and the leasing of commercial and State-owned property.

Conclusion: We concluded that RED's administration of the sale and purchase of property, the granting and purchase of easements, and the leasing of commercial and State-owned property was generally effective and efficient. However, we noted one material condition. RED did not follow established policies and procedures when it entered into a sales agreement with a private company to sell State surplus property adjacent to the Michigan State fairgrounds. We also noted reportable conditions relating to the lease of State property, bid evaluations and recommendations, the monitoring of leases of State-owned property, public purpose sale criteria, and lease data.

FINDING

1. Sale of State Surplus Property

RED did not follow established policies and procedures when it entered into a sales agreement with a private company to sell State surplus property adjacent to the Michigan State fairgrounds.

RED is responsible for selling State-owned property to State agencies, local units of government, and the public. The Management and Budget Act (Act 431, P.A. 1984) required the Department of Management and Budget (DMB) to issue directives that provided for the disposition process of facilities and lands that are considered surplus. The directives are included in the DMB Administrative Guide.

RED entered into a sales agreement with a private company on April 18, 2000 to sell 35.22 acres of surplus property adjacent to the Michigan State fairgrounds for \$6.1 million.

The following deficiencies were noted in our review of the purchase agreement for the sale of this surplus property:

- a. RED did not notify State agencies or local units of government that the property was declared surplus and available for acquisition.

The DMB Administrative Guide requires that, before surplus property is offered for sale to the public, State agencies must be notified of the availability of surplus property for agency use. The Guide further requires that if State agencies are not interested in the property, local units of government (counties, cities, villages, townships, universities, community colleges, and school districts) should then be notified of the property's availability. Once a local unit of government determines that it can use the property, an appraisal is required and the local unit would have the opportunity to purchase the property at the fair market value.

The Detroit Public Schools (DPS) had entered into a separate agreement to purchase the property for \$17 million. In addition, DPS had entered into an agreement to sell a portion of the property for approximately \$7.5 million.

If DPS had been notified of the availability of the property, it could have purchased the property from the State for fair market value and provided DPS and the taxpayers a significant savings. Furthermore, RED could have sold property not needed by DPS to another entity and possibly generated additional revenue to the State.

- b. RED offered to sell the surplus property directly to a private company without obtaining competitive bids from the public.

If State agencies and local units of government are not interested in the property, the DMB Administrative Guide requires that the property be offered to the public and competitively sold to the highest bidder for not less than fair market value.

Competitive bidding generally ensures that the best value is obtained for the State and that all interested parties have an equal opportunity to compete in the process.

- c. The purchase agreement did not include contract language that would have protected the State's interest.

The Legislature's Joint Capital Outlay Subcommittee Policy No. 5 governing land conveyance requires that if property the State is conveying is near State land with operations that could be adversely affected by incompatible use, a restriction should be put in place that requires prior State approval, based on compatibility, of any program or use of the property until the State operations are terminated.

Because the Michigan State Fair would continue to operate for three weeks every year, compatibility with Fair operations was a primary consideration when evaluating the benefits of selling the surplus property to the private company. Failure to include a restriction in the sales agreement prohibited the State from approving any change in program or use of the property that might have affected State Fair operations.

In addition, RED has included a clause in other purchase agreements that would protect the State's interest in case the property was resold within the first year. Such a clause has stated that if the property was resold within 1 year of the date of the sale, the State was entitled to 50% of any profit made on the resale of the property.

Once the private company completed the purchase of the surplus property, the company planned to resell it within a year to another private company for approximately \$10 million. If the clause had been incorporated in the purchase agreement, the State would have realized an additional \$2 million from the resale.

RECOMMENDATION

We recommend that RED follow established policies and procedures when selling State surplus property.

AGENCY PRELIMINARY RESPONSE

DMB indicated that it will consider the recommendation.

FINDING

2. Lease of State Property

RED did not advertise or issue a request for proposal when leasing the Michigan State fairgrounds to a private company.

RED was delegated the responsibility for leasing State-owned property to private companies by the Management and Budget Act (Act 431, P.A. 1984). Section 18.1221(6) of the Act requires that the leasing of State-owned land and facilities to private and public entities should be at prevailing market rental values or at actual costs as determined by the DMB director.

RED leased the fairgrounds to a private company on April 18, 2000. The lease covered a 30-year period from October 1, 2000 through September 30, 2030. Over the period of the lease, the State expected to realize approximately \$25 million in revenue plus a percentage of commissions from events sponsored by the lessee. The lease included conditions in which the private company would provide approximately \$20 million of capital improvements to the fairgrounds that would enhance the Michigan State Fair's appeal to the public.

Because the lease is unique in nature, sound business practices would require that RED advertise or issue a request for proposal to the public to help ensure that the State receives the prevailing rental market rate. RED stated that the uniqueness of the property precluded the soliciting of interested bidders. However, the Department of Natural Resources and the Department of Agriculture had received inquiries in prior years from interested parties.

RECOMMENDATION

We recommend that RED advertise or issue a request for proposal when leasing State property.

AGENCY PRELIMINARY RESPONSE

DMB indicated that it will consider the recommendation.

FINDING

3. Bid Evaluations and Recommendations

RED had not established formal bid evaluation criteria for leasing building space.

DMB Administrative Guide procedure 110.03 requires that RED evaluate and recommend bids to State agencies seeking space. Sound business practices require the development of formalized bid evaluation criteria.

Rather than following established procedures, each of RED's analysts independently established criteria to evaluate bids. There were no evaluation committees, uniform criteria, or standardized forms for documenting bid evaluations.

Policies and procedures would help ensure that property analysts consistently evaluate bid proposals.

RECOMMENDATION

We recommend that RED establish formal bid evaluation criteria for leasing building space.

AGENCY PRELIMINARY RESPONSE

DMB indicated that it will consider the recommendation.

FINDING

4. Monitoring of Leases of State-Owned Property

RED should improve its monitoring of State-owned property being leased by State agencies or to private companies and individuals.

RED is responsible for leasing State property, excluding State property leased by the DMB Office of Property Services, to State agencies and private companies or individuals. RED is also responsible for monitoring leases of State-owned property to ensure that there is a current lease on file of each property and that there is a current proof of insurance on file to protect the State against property losses and claims for personal injury. As of September 30, 2001, RED maintained 83 leases for State-owned property.

Our review of the 83 leases of State-owned property noted the following deficiencies:

- a. Of the 83 active leases of State-owned property, 20 (24%) had expired with expiration dates ranging from 6 to 62 months.

Maintaining a current lease helps to ensure that the State can enforce provisions in the original lease. Also, allowing expired leases to remain in place for an extended period of time could result in lost revenues to the State because of the failure to increase rental rates to reflect the current market conditions.

- b. Of the 52 current State-owned property leases that required private companies or individuals to carry insurance, RED could provide us with only 48 leases for our review. Our review of the 48 leases found that 37 (77%) leases did not have current proof of insurance on file.

Failure to carry proper insurance could result in the loss of property by the State or the State being held liable for damages or injuries. Monitoring State-owned leases could help ensure that proper insurance is being carried and that all leases are accounted for.

RECOMMENDATION

We recommend that RED improve its monitoring of State-owned property being leased by State agencies or to private companies and individuals.

AGENCY PRELIMINARY RESPONSE

DMB indicated that it will consider the recommendation.

FINDING

5. Public Purpose Sale Criteria

RED should establish and document criteria used for conveying surplus property to local governments for use as public purpose.

The Legislature's Joint Capital Outlay Subcommittee Policy No. 5 allows DMB to convey property for less than fair market value if it is to be used by a local government exclusively for public purpose. Policy No. 5 defines public purpose as use of property for government operations or use by the general public.

We reviewed 4 sales of surplus properties to local governments for similar public purposes. The intended uses of these properties were for soccer fields, school play fields, and public parks. All meet the public purpose definition. We found that 3 of the 4 properties were sold for \$1 and the remaining property was sold at fair

market value of \$1.37 million. RED stated that it does not use established criteria for conveying surplus property for public purpose. Also, it could not provide documentation that explained the range of selling prices.

Following established criteria and documenting rationale for criteria used would help ensure that conveyance of surplus property for public purpose to local governments is based on sound RED policy.

RECOMMENDATION

We recommend that RED establish and document criteria used for conveying surplus property to local governments for use as public purpose.

AGENCY PRELIMINARY RESPONSE

DMB indicated that it will consider the recommendation.

FINDING

6. Lease Data

RED did not always include complete and accurate lease data and did not always maintain documentation to support lease data reported on the computerized facility management system (ARCHIBUS).

Financial Accounting Standards Board Statement No. 13 establishes standards for financial accounting for and reporting of leases. It requires lessees to account for leases as either capital leases* or operating leases*. Under a capital lease, a lessee records leased property as an asset and an obligation equal to the present value of the lease payments. The asset is subsequently depreciated and the obligation reduced when lease payments are made. Under an operating lease, the lessee simply records the rental payments as expenses as they become payable. In the case of a building, the fair market value of the building at lease inception, the percentage of the building being leased, and the present value of lease payments (excluding the portion of the payments representing executory costs*) are key criteria in determining whether a lease is a capital lease or operating lease.

RED is responsible for entering lease data on ARCHIBUS. ARCHIBUS maintains lease data that includes the fair market value of the building at lease inception and

* See glossary at end of report for definition.

a breakdown of lease payments identifying the portion relating to executory costs. The DMB Office of Financial Management uses this data in determining whether leases must be classified as capital leases or operating leases.

As of September 30, 2001, RED maintained 845 commercial leases. Our review of 19 commercial leases disclosed:

- a. RED did not maintain documentation supporting the assignment of lease payments between rental base and executory costs for any (100%) of the leases reviewed.
- b. The fair market value was missing for 7 (37%) leases.
- c. The fair market value was incorrect for 1 (5%) lease.
- d. Supporting documentation for the fair market value was missing for 8 (42%) leases.
- e. The percentage of the building being leased was not in the system for 4 (21%) leases.

Failure to maintain complete and accurate information in ARCHIBUS could result in improper accounting treatment of the leases in the *State of Michigan Comprehensive Annual Financial Report*.

RECOMMENDATION

We recommend that RED include complete and accurate lease data and maintain documentation to support lease data reported on ARCHIBUS.

AGENCY PRELIMINARY RESPONSE

DMB indicated that it will consider the recommendation.

Glossary of Acronyms and Terms

ARCHIBUS	computerized facility management system.
capital lease	A lease that, in substance, is a purchase in which the resulting assets and liabilities are recorded at the lease's inception.
DMB	Department of Management and Budget.
DPS	Detroit Public Schools.
effectiveness	Program success in achieving mission and goals.
efficiency	Achieving the most outputs and outcomes practical with the minimum amount of resources.
executory cost	Any cost incurred by the tenant that is not directly attributable to the leased square footage (janitorial services, snow removal, etc.).
material condition	A reportable condition that could impair the ability of management to operate a program in an effective and efficient manner and/or could adversely affect the judgment of an interested person concerning the effectiveness and efficiency of the program.
mission	The agency's main purpose or the reason that the agency was established.
operating lease	A lease that constitutes a rental agreement with the resulting expenditures recognized as incurred over the term of the lease.

outcomes	The actual impacts of the program.
outputs	The products or services produced by the program.
performance audit	An economy and efficiency audit or a program audit that is designed to provide an independent assessment of the performance of a governmental entity, program, activity, or function to improve public accountability and to facilitate decision making by parties responsible for overseeing or initiating corrective action.
RED	Real Estate Division.
reportable condition	A matter that, in the auditor's judgment, represents either an opportunity for improvement or a significant deficiency in management's ability to operate a program in an effective and efficient manner.