OFFICE OF THE CITY AUDITOR
City of Long Beach
333 W. Ocean Blvd.
Long Beach, CA 90802
Telephone: 562-570-6751
Facsimile: 562-570-6167

GARY L. BURROUGHS, CPA
City Auditor

March 11, 2005

Gerald R. Miller
City Manager

Phil T. Hester
Director of Parks, Recreation and Marine

We have conducted certain review procedures in connection with the ground lease (Lease) between the City of Long Beach (City) and Gateway Enterprises, LLC and Aba Enterprises, LLC, collectively referred to as "Lessee". The Lease governs the operation of Shoreline Village, a seven-acre property at 401 to 435 Shoreline Drive. The purpose of performing these review procedures was to determine that Lessee's rent payments, including participation rent, and other obligations have been fulfilled in accordance with the terms and conditions of the Lease during the period April 13, 2000 through December 31, 2003 (the review period).

Our procedures included reading the Lease and subleases of major subtenants to determine the proper amount of rent due, tenant improvement allowances, if any, and common area maintenance (CAM) expenses reimbursable from subtenants. Additional information concerning our review procedures and criteria for selecting samples in conducting our review procedures is presented at Appendix A.

BACKGROUND

Shoreline Village first opened in 1982. It was later renovated in 1996 as part of the City's Queensway Bay project. Located in the harbor next to the Long Beach Convention Center and the Aquarium of the Pacific, Shoreline Village is a shopping, dining, and marina complex[1] displaying New England style architecture.

Shoreline Village has seen a steady increase in revenue during recent years under the current ownership. Consequently, the City has shared in the benefit of Shoreline Village's financial success, having received over $837,000 in participation rent during our review period in addition to an annual minimum rent of $300,000. The participation rent ranged from $120,000 to $249,000 a year during our review period. Total rent revenue for calendar year 2003 was approximately $533,000.

The property's occupancy rate on December 31, 2003 was 90% and the average occupancy rate for the review period was 88%.

[1] The City operates the marina; thus the marina complex is not part of this Lease.

CONCLUSION

Contract Monitoring

Our interviews with the staff of the Contract Management and Revenue Development Division (the Division) under the Department of Parks, Recreation and Marine and a review of the files on the Lease maintained by Division staff indicate that monitoring of contract compliance requires improvement. Documentation in the Shoreline Village lease file suggests that there was correspondence from the Lessee requesting clarification on certain lease terms. These requests were either not addressed in a timely fashion or were not addressed at all. Consequently, participation rent payments to the City were delayed.

As of the date of this report, an issue raised by Lessee nearly two years ago remains unresolved. At issue is whether or not Lessee may deduct leasing commissions earned by one of its owners, who is also a licensed broker, for the subleases that were entered into by Shoreline Village subtenants. The total accumulated leasing commissions to be amortized throughout the respective sublease terms were approximately $202,000 at December 31, 2003. In calculating the 2003 participation rent, Lessee deducted $94,178 in leasing commissions earned by the broker from April 2000 through December 31, 2003. We recommend that staff take the necessary steps to arrive at a position on this issue before May 1, 2005, the next participation rent reporting date.

We have also concluded that there is no adequate process in place to facilitate the monitoring of Lessees' compliance with lease terms. Reporting requirements related to annual submission of financial statements and certification statements are not being monitored, therefore, not enforced. Additionally, annual meetings with Lessee to discuss management of Shoreline Village were not held during our review period.

We recommend that Division increase their efforts with regard to monitoring Lessees' compliance with lease terms, especially for leases with significant revenue such as this Shoreline Village lease. The Division should prioritize their use of resources by making sure that proper attention is paid to the more significant contracts. Contract administration software or another tracking mechanism should be utilized to assist management in prioritizing its monitoring efforts and allowing a proactive, rather than reactive, approach to contract monitoring.

Participation Rent

We have concluded that the City is due an additional $86,622 in participation rent for underreported adjusted net income, Lessee's failure to adjust monthly participation rent for the first half of 2004, and the use of an incorrect interest rate in the amortization of capital and tenant improvements. **The City Auditor's Office issued a claim and received this amount on December 23, 2004.**

Underreported Adjusted Net Income	$ 67,725
Participation Rent for January through June 2004	16,329
Incorrect Interest Rate in Amortizing Improvements	2,568
	$ 86,622

Regular monitoring of significant contract terms would have identified the above issues. The following report discusses in detail the additional rent due the City as well as deficiencies in contract monitoring efforts noted during our review.

We would like to take this opportunity to express our appreciation to Lessee for their cooperation over the course of this review.

Sincerely,

GARY L. BURROUGHS, CPA
City Auditor

By: Kathleen M. O'Connell

Kathleen M. O'Connell, CPA
Deputy City Auditor

GLB:KMO:ckj

c: Reginald Harrison, Deputy City Manager
Janet Day-Anselmo, Business Operations Bureau Manager
Gwendolyn Parker, Superintendent of Contract Management and Revenue Development
Michael Killebrew, Director of Financial Management

Audit Team: Kathleen M. O'Connell, CPA, Deputy City Auditor
Caroline K. James, CPA, Audit Manager
Vlad G. Marinescu, Staff Auditor

BACKGROUND

The City is a trust grantee of the State of California of certain tide and submerged lands within the city limits. On November 16, 1981, the City entered into a lease agreement with Specialty Villages, a general partnership consisting of Bryant L. Morris, Arnold L. Lipkin, Longven, Inc., Canlong, Inc., Cannina, Inc., and Marlong, Inc., for the development of approximately seven acres of such land. The improved Tidelands property is known as Shoreline Village.

The lease agreement was subsequently assigned to Shoreline Village Associates, a California limited partnership on December 5, 1986. On September 1, 1994, Northwestern Mutual Life Insurance Company acquired interest in the lease as a result of a foreclosure sale and amended and restated the ground lease (the Lease) in its entirety on January 1, 1996. On April 13, 2000, Northwestern Mutual Life Insurance Company sold its interest in Shoreline Village, with approval from the City Council, to Gateway Enterprises, LLC and Aba Enterprises, LLC (collectively referred to as Lessee), both of which are California Limited Liability Companies (LLC). As such, Gateway Enterprises, LLC and Aba Enterprises, LLC, each as fifty percent owners of Shoreline Village, are successors in interest in the ground lease dated January 1, 1996.

SUMMARY OF LEASE TERMS

The lease term is for approximately 52 years, January 1, 1996 through November 14, 2047. Lessee pays minimum annual rent of $300,000, payable in monthly installments of $25,000 and participation rent of twenty percent of adjusted net income, the calculation of which is defined in Exhibit D of the Lease: *Ground Rent Participation Manual.*

Rent is due, in advance, on the first day of each month. Participation rent is equal to one twelfth of the previous year's actual adjusted net income. On May 1st of each year, Lessee is to submit an Agreed Upon Procedures Report (AUPR), prepared by a CPA, to determine the Participation Rent due for the previous calendar year and the estimated monthly payments for the first four months of the current calendar year. Along with the AUPR, Lessee is to submit unaudited financial statements to the City.

If it is determined that excess participation rent was paid in the prior calendar year, the excess amount is to be applied against the next participation rent due. However, if it is determined that the Lessee paid less than the amount obligated to pay in the prior calendar year, Lessee is to pay the cumulative difference at the time the AUPR is submitted. The next rent payment and payments for the subsequent 12 months are to be adjusted to prior year's actual results.

Lessee is also required by the Lease to meet with the City every year to discuss their business plan, capital budget and operating budget for Shoreline Village.

Upon assuming the Lease from Northwestern Mutual Life Insurance Company, Lessee and Division staff exchanged correspondence to clarify certain lease terms. By a correspondence from the Division, Lessee is required to submit a certification statement annually on any management fees paid to an affiliate company that all such expenses were related solely to the management of Shoreline Village. In addition, as a condition for the City to waive a requirement in the Lease for Lessee to make monthly deposits of five percent of monthly gross revenues in a replacement reserve account, Lessee is required, by the same correspondence mentioned above, to submit the loan agreement with Lessee's lender pertaining to lender required reserve balance and a statement showing the balance in the lender required reserve account on an annual basis.

CONTRACT ADMINISTRATION

The City's Department of Parks, Recreation and Marine (the Department) through its Contract Management and Revenue Development Division (the Division) administers leases, permits and other agreements, collectively referred to as "contracts" in the Tidelands and upland areas. The Division, which is under the Business Operations Bureau, is headed by the Superintendent of Contract Management and Revenue Development. The Division has two sections: Contract Management Section and Registration/Reservation Section. The Contract Management Section has an Administrative Analyst dedicated to the administration of contracts.

The Division is responsible for managing approximately 175 contracts, of which 128 are revenue-generating contracts. Revenue from these contracts was approximately $6.8 million in fiscal year 2004. About half of the revenue benefits the Tidelands Funds[2], with the other half going to the City's General Fund. Lease revenue going to the General Fund is primarily attributable to a golf course lease and operations agreement ($3.03 million)[3]. Approximately 50 of the contracts administered by the Division do not generate revenue; for example, agreements governing the field use for the sports leagues.

The Shoreline Village lease is the third highest revenue-generating contract administered by the Department and revenue from this Lease goes to the Marina Fund.[4]

---

[2] The Tidelands funds receiving revenue from the contracts are the Tidelands Operations, the Marina and the Rainbow Harbor Area funds.

[3] The golf lease revenue was reduced in fiscal year 2004 due to the Skylinks golf course closure. The renovated course was reopened on October 31, 2004. The budgeted golf lease revenue for fiscal year 2005 has been increased to $4.34 million.

[4] The Department generated $16.3 million in revenue in the Marina Fund during fiscal year 2004. The $16.3 million was primarily comprised of $14.2 million in slip rentals and $1.2 million in rentals and concessions. The Shoreline Village lease revenue represents $555,000 or 46% of the $1.2 million in rental and concession revenue.

ISSUES AND RECOMMENDATIONS

Issue 1: Inadequate contract monitoring

During our review, we noted deficiencies related to contract monitoring. The deficiencies identified in issues 1A, 1B and 1C below appear to be due to both inadequate staff monitoring <u>efforts</u> as well as an inadequate monitoring <u>process</u>.

Issue 1A: Unresponsiveness to Lessee's Inquiries

Unlike Northwestern Mutual Life Insurance Company, the current owners of the Shoreline Village lease are two closely held corporations. The accounting and other reporting responsibilities related to Shoreline Village are performed by another entity jointly owned by Lessee, Pacific Ocean Management, LLC. In addition, one of the owners is also a licensed broker and performs leasing activities on behalf of Shoreline Village.

The Lease was written for the City's agreement with Northwestern Mutual Life Insurance Company, a mutual life insurance company generating multi-billion dollars in revenues. The current Lessee, a closely held family corporation, is vastly different. As a result, several issues surfaced when Lessee assumed the Lease.

In June 2001, Lessee began requesting clarification on certain clauses in the Lease pertaining to management fees. Lessee requested clarification on whether the City would regard management fees paid to Pacific Ocean Management, LLC, which is also owned by Lessee, as "ownership entity expenses", which are expressly <u>not allowed</u> as a deduction in computing Adjusted Net Income upon which the participation rent percentage is applied.

Lessee continued to request clarification without receiving a response from Division staff. During this period, Lessee submitted good faith checks when the participation rent was due in an effort to show cooperation. After hiring a consultant to review the Lease, Division staff responded to Lessee, nearly two years later, in March 2003 informing Lessee that management fees paid to Pacific Ocean Management, LLC would be an allowable deduction in computing participation rent as long as they do not exceed six percent of gross receipts and Lessee must submit an annual statement certifying that they were solely related to the management of Shoreline Village. Because Lessee did not receive adequate and timely clarification from Division staff on this issue, final settlement on actual participation rent due for 2000 through 2002 was delayed. See "Failure to Enforce Reporting Requirements" below for further discussion on reporting issues related to management fees.

Correspondence on other matters (i.e. changing the accounting method for keeping the books and permission to terminate the reserve account required by the Lease) was sent by Lessee in December 2000 and February 2001, respectively. To date, Lessee has not received a response from Division staff on the former issue, and the response to the latter issue was made over two years later in March 2003.

Issue 1B: Failure to Enforce Reporting Requirements

Lessee has not complied with certain reporting requirements. During our review period, Lessee did not submit annual financial statements as required by the Lease. In addition, as a condition to deduct the management fee paid to an affiliate company in the participation rent calculation, Lessee was required to submit an annual statement certifying that management fees do not exceed six percent of gross receipts and are solely related to the management of Shoreline Village. The statement is to also include a list of staff that provided management service and the number of hours spent. Such statements had not been submitted by Lessee and Division staff had not followed up on this deficiency at the time of our review. At our request, Lessee submitted a certification statement on management fees on February 2, 2005. The statement was retroactive, covering our review period, April 13, 2000 through December 31, 2003.

Additionally, as a condition to suspend a reserve account specified in the Lease, Lessee was to provide the City a copy of the loan agreement with Lessee's lender specifying the terms and conditions governing its lender's reserve account to ensure it meets the City's requirement. Lessee is to also provide a certification statement annually indicating the sum of the payments made to the lender required reserve account and a bank statement indicating the balance of the account. Lessee had not satisfied the two conditions for suspending the reserve account. Similarly, Division staff had not followed up on these reporting deficiencies at the time of our review. Also at our request, Lessee submitted a certification statement on the reserve account as well as a copy of the bank statement for their lender required reserve account on February 2, 2005. See section "Reserve Account Balance" below for further discussion.

Lastly, the Lease calls for annual meetings with Lessee to discuss management of Shoreline Village and for Lessee to submit and discuss with City staff the business plan for Shoreline Village and operating and capital budgets among other things. Such meetings were not being conducted during our review period.

Reserve Account Balance

The Lease requires Lessee to make monthly deposits equal to five percent of monthly gross revenues into a repair and replacement reserve account. As mentioned earlier, we obtained a bank statement for the lender required reserve account from Lessee during our review. The lender required reserve account balance as of February 1, 2005 was $91,911. Lessee deposits $1,545 each month to the reserve account as required by their lender.

Issue 1C: Lack of Effective Monitoring Tools

During our fieldwork, we discovered that the Division did not readily have a listing of the total number of contracts for which it is responsible. Consequently, it took Division staff some effort to gather the data.

Recommendation

Staff should ensure that the Division receives all rent payments due the City and that lessees satisfy all reporting and other contractual requirements. To ensure that the City receives the revenues it is entitled to, more effort should be placed toward contract monitoring. We recommend that Division staff increase their effort in monitoring lessees' compliance with lease terms, especially those leases with significant revenue streams such as the Shoreline Village Lease.

Division staff should determine whether contract administration software could be more fully utilized to facilitate the tracking and monitoring of Lessee's compliance with contract requirements. Considering the volume of the contracts under this Division's purview and the current environment of limited resources brought on by budgetary constraints, the Division should prioritize their use of available resources by making sure that proper attention is paid to the more significant contracts.

Reserve Account Balance

As mentioned above, Lessee has $91,911 in the reserve account as of February 1, 2005, which is a lower balance than required by the Lease. Division staff should determine, through discussions with Lessee, whether or not such balance is acceptable taking into account the foreseeable needs of the premises.

Assessing Late Fees

As much as practical, staff should also enforce the late fee clause in the Lease, which allows for rent not paid when due to bear interest at the rate of Wells Fargo Bank prime lending rate plus five percent, compounded monthly, commencing 5 days after the due date until paid.

Also see recommendation for issue 3 on monitoring Lessee's compliance with lease terms.

Management Response

We agree that there is a definite need for additional contract monitoring. The Contract Management and Revenue Development Division (Division) is staffed by one Superintendent and one Administrative Analyst, who is new to the Division, responsible for monitoring almost 200 contracts, as well as performing other duties. Prior to budget reductions in FY 04, there was one additional Administrative Analyst to assist with the monitoring. The current staffing is an inadequate structure for a successful operation. To address the concerns identified in the Audit report requires additional staffing for reasonable oversight and management of the growing contract inventory. In light of these conditions, the Department will be seeking assistance to bridge the gap in staffing needs. We will also seek assistance to help us fully monitor this contract, and others that are more complex. The Audit report makes another recommendation for full utilization of contract administration software to facilitate the tracking and monitoring of lessees' compliance with contractual requirements. It should be noted that the Division purchased contract-monitoring software well before the audit recommendation, and is in process of populating the database with information on existing contracts. The database should be ready to use within two to three months.

Issue 2: Leasing Commissions

Presently, there is one other outstanding issue concerning leasing commissions. As mentioned earlier, one of the owners, who is also a licensed broker (the Broker), has "earned" leasing commissions for the subleases that were entered into by Shoreline Village subtenants. The total accumulated leasing commissions at December 31, 2003 were approximately $202,000. The commissions earned by the Broker represent five percent of the lease amount for the initial term of the sublease. These amounts have not been paid by the Lessee to the Broker. Lessee has also indicated that Shoreline Village does not normally pay brokerage fees to a subtenant's broker. According to the Lease, leasing commissions are to be amortized over the life of the lease terms.

Lessee first brought up the leasing commission issue in May 2003 by contacting Division staff. After not receiving a response on this issue, Lessee deducted $94,178 in leasing commission expenses for commissions earned from 2000 through 2003 in its 2003 participation rent calculation, which had the impact of reducing the 2003 participation rent by $18,836.

Prior to 2003, Lessee did not deduct any leasing commissions for the commissions earned by the Broker. Lessee has not and prefers to not pay themselves leasing commissions but is of the position that it would be appropriate to recognize the value of leasing services provided by way of deducting leasing commission expenses in the participation rent formula.

The Lease allows for the amortization of leasing commission paid to an affiliate as an expense in calculating participation rent as long as the leasing commission is not also included as an operating expense so as to not count this line item twice in the participation rent formula.

We informed Division staff that Lessee deducted $94,178 in leasing commissions in the 2003 participation rent calculation when we became aware of it during the course of our review. As mentioned earlier, Lessee first requested a resolution to this matter in May 2003. To date, Division staff has not resolved the leasing commission issue. The additional participation rent we have identified in this report does <u>not</u> include any amount that may be due as a result of the change in the treatment of leasing commissions.

<u>Recommendation</u>

We recommend that Division staff take the necessary steps to arrive at a position on leasing commissions earned by an owner of the leased premises. In doing so, staff should consider that precedent has been set to allow expenses related to owners when

Division staff allowed management fees to be paid to another entity owned by the same owners of Shoreline Village.

The resolution to this issue is long overdue since it has been outstanding for nearly two years. We recommend that Division staff make it a priority to resolve this issue before the next reporting cycle, which is May 1, 2005 when the 2004 participation rent report will be due.

If staff deems that the leasing commissions earned by Lessee are not an allowable deduction, or if the commission rate is not deemed acceptable, Division staff should recover the disallowed portion from Lessee.

Management Response

We have obtained the City Attorney's opinion and verified that the deduction by the Lessee of reasonable management fees and/or reasonable leasing commissions in the calculation of Adjustable Net Income does not present a legal concern. We plan to work with real estate professionals in the Community Development Department to arrive at an appropriate position on the deductibility of leasing commissions based on industry practice, prior to the next reporting cycle on May 1, 2005.

Issue 3: Additional Participation Rent Due the City

Based on our review procedures, the City is due an additional $86,622 in participation rent.

Issue 3A: Underreported Adjusted Net Income	$ 67,725
Issue 3B: Participation Rent for January through June 2004	16,329
Issue 3C: Incorrect Interest Rate in Amortizing Improvements	2,568
Total Additional Participation Rent Due	$ 86,622

The City Auditor's Office issued a claim and received this amount on December 23, 2004. Details for the additional due are discussed below.

Issue 3A: Participation Rent Calculation

According to Exhibit D of the Lease, participation rent due the City is twenty percent of adjusted net income. Adjusted net income is to be calculated using the following formula:

The sum of:

+ Gross Revenues, including Recoverable Operating Expenses[5] and
+ Ownership Entity Expenses[6]

Less:

- Recoverable Operating Expenses
- Non-recoverable Operating Expenses, including Ownership Entity Expenses
- Amortization of Leasing Commission
- Amortization of Subtenant Improvements
- Amortization of Capital Expenditures
- Prior year's Negative Adjusted Net Income, i.e. prior year's net loss

The following table provides the detail on adjusted net income as reported for our review period. The table also illustrates the adjustments we have made to the previously reported adjusted net income that resulted in additional participation rent due the City.

	2000[a]	2001	2002	2003	Total
Gross Revenues	$ 2,712,472	$ 3,580,650	$ 3,803,652	$ 3,858,106	$ 13,954,880
Operating Expenses: recoverable and nonrecoverable	(1,290,552)	(1,646,577)	(1,804,415)	(1,780,204)	(6,521,748)
Leasing Commission Amortization	(52,504)	(19,300)	(15,930)	(94,178)	(181,913)
Capital Improvement Amortization	(486,963)	(456,389)	(455,935)	(450,194)	(1,849,481)
Tenant Improvement Amortization	(281,423)	(281,423)	(281,423)	(370,239)	(1,214,507)
Adjusted Net Income as Reported	$ 601,030	$ 1,176,961	$ 1,245,949	$ 1,163,290	$ 4,187,231
Net Operating Income as Reported[b]	$ 1,421,920	$ 1,934,073	$ 1,999,237	$ 2,077,902	$ 7,433,132
Net Operating Income according to Lessee's Statement of Operations	1,511,385	1,934,202	2,093,847	2,183,302	7,722,736
Underreported Operating Income	89,465	129	94,610	105,400	289,604
Auditor Adjustments					
Add back percentage rent paid to the City not allowed in the participation rent calculation	44,130				44,130
Exclude income tax preparation costs		2,580	2,350	3,275	8,205
Exclude interest income			(1,719)	(1,593)	(3,313)
Total adjustments	44,130	2,580	631	1,682	49,022
Underreported Adjusted Net Income	$ 133,595	$ 2,709	$ 95,240	$ 107,081	$ 338,626
Additional Participation Rent Due (20%)	**$ 26,719**	**$ 542**	**$ 19,048**	**$ 21,416**	**$ 67,725**

[a] Represents partial year: April 13, 2000 through December 31, 2000.

[b] Represents gross revenues less operating expenses.

[5] Including recoverable operating expenses in both revenues and expenses has the effect of not allowing those operating expenses recovered from subtenants as a deduction in calculating participation rent due the City.

[6] Including ownership entity expenses in both revenues and expenses has the effect of not allowing expenses related to ownership as a deduction in calculating participation rent due the City.

As illustrated above, our review procedures revealed that operating income during the review period was understated by approximately $290,000. In addition, we identified approximately $49,000 in disallowable net expenses as detailed in the table above. Collectively, we found an additional $339,000 in adjusted net income, which resulted in additional participation rent due the City of $67,725.

Issue 3B: Timing of Participation Rent Payments

According to the Lease, monthly participation rent paid for the current year should also be adjusted based on prior year's actual participation rent due at the time actual participation rent for the previous year is determined.

Lessee submitted the AUPR for 2003 in July 2004. At that time, Lessee paid the difference between participation rent paid for 2003 and the actual amount due. The monthly participation rent payments were adjusted based on actual 2003 participation rent due beginning with July 2004. However, Lessee did not pay the difference between the actual monthly participation rent paid and the adjusted monthly participation rent for January through June 2004. As a result, Lessee underpaid participation rent by $16,329 at the July 2004 settlement date.

Issue 3C: Excess Improvement Amortization Expense

The Lease allows Lessee to recover subtenant and capital improvement expenses incurred by Lessee over a time period specified in the Lease, with interest. Subtenant improvement costs are to be amortized over the corresponding term of the subtenant's lease.[7] Capital improvement costs are to be amortized over a 10-year period. Additionally, Lessee is entitled to include administrative fees in the amount of improvement costs to be amortized for projects managed by Lessee. The administrative fee is a percentage, ranging from five to ten percent, of the permit value.

The interest rate applied to the amortization of improvement costs is 10% as long as Lessee is Northwestern Mutual Life Insurance Company. Otherwise, the interest rate is the actual cost to borrow the money or 2.5% over Bank of America's prime lending rate at the time the expense is incurred if the costs were financed internally. All improvements made by Lessee were financed internally.

We determined that the proper interest rate for the amortization of capitalized improvements is 6.75% rather than the 10% applied by Lessee. This discrepancy in the interest rate will translate to total excess amortization of $128,387 over the ten-year amortization period, through 2013. Total cumulative impact of this excess amortization expense on the participation rent to the City would be $25,677 (20% of $128,387) for the amortization period, through 2013. At this time, the City is due additional participation rent of $2,568 for excess amortization expense taken in 2003.

[7] If the sublease is to terminate, the amortization continues over the original term.

Recommendation

On an annual basis, Division staff should compare the Statement of Operations with the AUPR to ensure that the two agree. In addition, Division staff should review the AUPR to identify any major fluctuations and determine the propriety of such fluctuations. Staff should also ensure that Lessee makes the retroactive adjustment to monthly participation rent payments to actual from estimates. Additionally, staff should review Lessee's improvements amortization schedules to ensure that proper interest rates are being used to amortize improvements.

Management Response

We agree that the AUPR and amortization schedules for improvements should be reviewed annually. We plan to seek assistance to ensure proper monitoring of this contract.

APPENDIX A

REVIEW PROCEDURES

In addition to reading the Lease and subleases of major subtenants, our review procedures included the following:

- We reviewed the files on the Lease maintained by Contract Management and Revenue Development Division (the Division) under the Department of Parks, Recreation and Marine.
- We interviewed the Division staff responsible for monitoring the Lease to obtain an understanding of the contract monitoring process in place.

Rent Revenues

- We recalculated minimum rent from subtenants using rent rolls to determine the reasonableness of minimum rent revenues reported to the City.
- We traced a random sample of subtenant's gross receipts reports to subtenants' percentage rent as a basis to form our opinion on the accuracy of percentage rent revenues reported to the City.

Common Area Maintenance Expense Reimbursements

- We also obtained reports prepared by Lessee's Certified Public Accountant (CPA) certifying CAM expenses for the premises to determine whether CAM reimbursement calculations were based on CPA certified expenses.
- We traced CAM reimbursement revenues reported to Lessee's CAM reconciliation schedules to determine whether all CAM reimbursements from subtenants have been reported to the City.
- We recalculated a random sample of CAM billings to subtenants to determine whether CAM charges billed to subtenants were calculated in accordance with the respective sublease terms.

Other Revenue Testwork

- We reviewed major subtenant accounts in Lessee's billing system to determine that proper rent and reimbursable expenses were being billed to subtenants in accordance with sublease terms.
- We traced sample deposits on the bank statements to payments posted in Lessee's cash receipts journal and payments posted in Lessee's billing system as a basis to form our opinion on the completeness of revenues reported to the City.

Expense Testwork

- We obtained payroll reports and other pertinent documentation on employee related expenses to determine the appropriateness of salary expenses claimed by Lessee.
- We reviewed detailed accounting system reports on accounting fees and professional fees to determine whether they were allowable expenses in accordance with the Lease.

- We traced supporting invoices and other pertinent documentations for all capital and tenant improvements capitalized during our review period.
- We compared significant tenant improvements to the allowance amount stated in the respective subleases to determine whether the project amounts were within the allowance limit stated in the subleases.
- We recalculated the amortization expenses for major improvements, tenant improvements and leasing commissions to determine the reasonableness of amortization expenses claimed.

Related Party Transactions

- We obtained an understanding of the basis for calculating management fees, which are paid to an affiliated company, to determine whether or not it was in accordance with the terms and conditions allowed by the City.
- We obtained an understanding of Lessee's criteria for capitalizing leasing commissions to determine whether or not it is in accordance with the lease terms.

Participation Rent Recalculation

- We compared net operating income previously reported to the amount shown on the Statement of Operations to determine the accuracy of revenues and expenses reported to the City.
- We reviewed participation rent calculations prepared by Lessee's CPA for each year during our review period to determine that the calculations are in accordance with the method prescribed in the Lease.
- We recalculated participation rent due the City to determine the accuracy of the amounts reported to the City.
- We made certain adjustments to Lessee's participation rent calculation as necessary. See report for further details on our adjustments.
- We performed an analytical review on the revenue and expense trends to ensure that net operating income has not fluctuated significantly from year to year without adequate explanation for the fluctuations, if any.

REVIEW SCOPE

In selecting our sample for performing our review procedures, we selected all subtenants with monthly minimum rent of $3,000 or more. Minimum rent revenues of our sample of eleven subtenants represent approximately 72% of total minimum rent income reported during our review period.

For the procedure of comparing tenant allowances stated in the subleases to tenant improvement projects capitalized, our sample included all project costs of more than $70,000 that are on the amortization schedule. Our sample tenant improvements represent approximately 72% of tenant improvements capitalized and amortized over the life of the respective sublease terms.