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TO: Jimmy L. Morales, City Manager
FROM: James J. Sutter, Internal Auditor



DATE: August 25, 2017
AUDIT: Lincoln Plaza Project Lease Agreement Audit
TENANT: 1691 Michigan Avenue Investment LP
PERIOD: January 1, 2013 to April 8, 2016 (the closing date on which the property was sold to CLPF – Lincoln, LLC)

This regularly scheduled audit of the 1691 Michigan Avenue Investment LP's compliance with selected terms in their lease agreement with the City concerning the multi-use building located at 1691 Michigan Avenue known as The Lincoln.

INTRODUCTION

In 1998, the City of Miami Beach issued a Request For Proposal (RFP) seeking proposals for the development of public/private parking facilities at four development projects located at Michigan and 17th Street (site 1), Lenox Avenue and 17th Street (site 2), Collins Avenue and 10th Street (site 3), and Washington Avenue and 16th Street (site 4).

Terms were reached with Lincoln Plaza Partners, LLC to build at the Michigan Avenue and 17th Street location (site 1). The project was to include a 711 parking space garage, 34,510 square feet of retail space and 106,000 square feet of office space. The City Commission adopted Resolution No. 99-23236 and its corresponding lease agreement detailing the terms by which the facility is to be operated. Among other terms, the lease agreement defines the timeliness and amounts of base and percentage rent payments due, the minimum insurance coverage required, the need to pay property taxes annually and the timeframe upon which certified financial statements are to be submitted.

Subsequent ownership changes were approved as follows:

- December 20, 2000 - sale and assignment of the ground lease from Lincoln Plaza Partners, LLC to LNR Jefferson LLC.
- October 5, 2005 - LNR Jefferson LLC changed its name to The Lincoln LLC.
- July 18, 2006, sale and assignment of the ground lease to Lincoln Miami Beach Investment LLC.
- November 17, 2006, - Name change to OIK Lincoln Miami Beach Investment.
- June 17, 2009 - OIK Lincoln Miami Beach Investment LLC merged with and into 1691 Michigan Ave Investment LP (Tenant).

Resolution No. 2014-28486 was approved on February 12, 2014 authorizing Amendment 1 to the ground lease agreement which reduced the minimum number of parking spaces from 700 to 645, increasing the minimum number of parking spaces required to be maintained at all times for use by the general public from 100 to 155, and further increasing the monthly parking spaces for members of the general public from 50 to 75, etc.

Internal Audit Report
 Lincoln Plaza Project Lease Agreement Audit
 August 25, 2017

The following table lists the rounded rental payments received by the City from the Tenant during the audit period:

	01/01/13 – 12/31/13	01/01/14 – 12/31/14	01/01/15 – 12/31/15	01/01/16 – 04/08/16	Total
Base Rent *	\$336,000	\$336,000	\$336,000	\$91,467	\$1,099,467
Percentage Rent **	\$188,912	\$187,418	\$181,350	\$0	\$557,680
Total Rent Received	\$524,912	\$523,418	\$517,350	\$91,467	\$1,657,147

- * Although one base rent payment of \$28,000 was received for the entire month despite the April 8, 2016 closing date, only the prorated amount of \$7,467 is listed above (\$28,000 x (8 days/30 days in April)).
- ** The 2016 estimated and final percentage rent payments due in 2017 are the responsibility of the new City's new Tenant, CLPF – Lincoln, LLC.

Pursuant to section 10.5 of the ground lease agreement, the Tenant notified the City of the terms of the proposed transfer and/or sale of the Lincoln Plaza project. The City Commission through the passage of Resolution No. 2016-29268 authorized the City Manager to decline in writing the City's reciprocal right of first refusal per section 36.2 of the lease agreement to purchase the building for \$109,250,000. As a result, the property was sold on April 8, 2016 to CLPF – Lincoln, LLC.

Leasing Specialists in the Office of Real Estate, a division of the City's Tourism, Culture and Economic Development Department, were tasked with monitoring the Tenant's compliance with the signed lease agreement. Meanwhile, an Office Associate IV was responsible for preparing all needed City Bills for monthly base rent and annual percentage rent payments plus to invoice the Tenant for any late charges. Lastly, all payments received are to be processed by the Central Cashier and posted timely to the City's Financial System.

OVERALL OPINION

1691 Michigan Avenue Investment LP (Tenant) operated the Lincoln Plaza project known as The Lincoln during the audit period whereby they maintained sufficient complete supporting documentation that was provided promptly, remitted all tested billed payments, submitted annual certified financial statements, etc. Despite these positive attributes, the following findings were identified which are in need of corrective action:

- Over the term of the lease since its September 1, 1999 inception, the City incorrectly calculated the monthly base rent payments.
- The consistent general ledger distributions on the annual percentage rent payments received may be revised to include more monies in the general fund for the Lincoln Plaza, Lincoln Place and Pelican projects.
- The Tenant did not initially provide the Office of Real Estate with documentation verifying that the \$5,680.88 in State sales tax due on 5% of their monthly base rent payments to the City in adherence with their 2011 Florida Department of Revenue audit was remitted directly to the State of Florida.
- The Tenant's annual percentage rent payments were not always accurately calculated or properly posted into the City's Financial System.
- The Tenant did not maintain the required insurance coverage listed in the lease

agreement and City staff did not follow the established procedures to facilitate identifying the existing deficiencies to help reduce the City's risk exposure.

- The Tenant remitted eleven of the forty tested monthly base rent payments or 27.50% more than thirty days after the due date that were not invoiced interest totaling \$3,103.40 in adherence to section 4.1 of the lease agreement.
- The Tenant remitted estimated percentage rent payments within five days of the March 1st annual due date but their corresponding 2013, 2014, and 2015 calendar year final percentage rent payments were received after the completion of their certified financial statements which results in \$137.51 in associated interest that was not billed.

PURPOSE

To determine whether 1691 Michigan Avenue Investment LP complied with tested requirements set forth in the lease agreement, which includes the submittal of timely and correctly calculated rental payments; whether the required insurance coverage was maintained; whether certified annual financial statements were provided that reconcile correctly to reported project revenues; and whether all tested transactions were accurately recorded in the City's Financial System.

SCOPE

The focus of our audit was to confirm that:

1. sufficient internal controls were established and followed.
2. the tested supporting documentation is organized, sufficient and complete.
3. the Tenant made the proper payments to the City during the audit period.
4. tested rental payments received were remitted timely. If not, were the appropriate amounts of late charges billed and collected?
5. the Tenant paid all tested real estate taxes billed.
6. the Tenant maintains at least the minimum insurance coverage required in section 7 of the lease agreement.
7. certified financial statements are submitted timely each year and that the audited figures reconcile correctly to those previously reported to the City.
8. tested transactions were accurately entered into the City's Financial System.

FINDINGS, RECOMMENDATIONS AND MANAGEMENT RESPONSES

1. Finding – *Over the Term of the Lease since its September 1, 1999 Inception, the City Incorrectly Calculated the Monthly Base Rent Payments*
In accordance with section 3.2 of the signed lease agreement, it was calculated that the property's Tenants were to remit the following in base rent monies, excluding state sales taxes, since the Lincoln Plaza project's September 1, 1999 commencement date:
 - a \$50,000 lump sum payment on September 1, 1999;
 - \$14,583.33 per month from September 2000 through August 2002 which equals \$175,000 per year;
 - equal monthly payments of \$20,833.33 totaling \$250,000 in lease year's 1 through 5 (September 1, 2002 through December 31, 2007);

Internal Audit Report
Lincoln Plaza Project Lease Agreement Audit
August 25, 2017

- \$300,000 per year (\$25,000 per month) for lease year's 6 through 10 (January 1, 2008 through December 31, 2012); and
- starting in the first month of the eleventh lease year (January 1, 2013) and continuing every five years thereafter, the annual base rent will be further increased by the lesser of 12% or the cumulative CPI over the previous five year period. As a result, the actual base rent payments due for the five year period beginning January 2013 equals \$27,328.77 per month.

Although 1691 Michigan Ave Investment LP (Tenant) only owned the property from June 17, 2009 through April 8, 2016, all the Tenant's base rent payments made to the City since the agreement's inception were compared to the above figures due to the cumulative nature of the payment structure. In doing so, the following underpayments and overpayments were noted which resulted in all of the combined Tenants having net underpaid the City by a total of \$54,309.64 (excluding state sales taxes) since September 1999:

Underpayments totaling \$185,416.64:

- The Tenant did not start paying the \$14,583.33 monthly base rent until May 2001 which was eight months after September 2000 resulting in an \$116,666.64 underpayment to the City ($\$14,583.33 \times 8$ months).
- The Tenant continued paying \$14,583.33 per month until July 2003 which was eleven months after the September 2002 increase to \$20,833.33 was warranted. Consequently, the Tenant underpaid the City by a total of \$68,750 ($(\$20,833.33 - \$14,583.33) \times 11$ months) during this period.

Overpayments totaling \$131,107:

- The Tenant was charged an additional \$18,750 split evenly between August and September 2003 to help offset previous under billings.
- The Tenant was charged \$25,000 monthly in base rent beginning in January 2007 when the increase did not take effect until January 2008 per the lease agreement. Therefore, the City was overpaid by \$50,000.04 during this period ($(\$25,000 - \$20,833.33) \times 12$ months).
- The Tenant was charged \$28,000 per month ($(\$300,000 \times 1.12\%) / 12$ months) beginning in January 2012 rather than January 2013 resulting in a \$36,000 overpayment to the City ($(\$28,000 - \$25,000) \times 12$ months).
- The CPI only increased by 9.32% so the monthly base rent due is \$27,328.77 starting as of January 2013 which resulted in monthly overpayments to the City of \$671.23 ($(\$28,000 - \$27,328.77) = \671.23). Consequently, the total overpayment received through April 8, 2016 equaled \$26,356.96 ($(\671.23×39 months) + \$178.99 ($\$671.23 \times (8$ days/30 days in April)).

The Tourism, Culture & Economic Development Department's Office of Real Estate currently performs the base rent calculations and prepares the corresponding monthly City Bills from which the Tenant remits their payments. Although the audit period ended as of the April 8, 2016 closing date, the new tenant (CLPF – Lincoln, LLC) overpaid the City by \$671.23 for May 2016. The Office of Real Estate has made the proper adjustments and has continued to bill the new tenant \$27,328.77 in base rent since June 2016.

Internal Audit Report
Lincoln Plaza Project Lease Agreement Audit
August 25, 2017

Lastly, the four monthly base rent payments of \$14,583.33 for May 2002 through August 2002 were inaccurately posted to the incorrect general ledger account by the Finance Department. A prior period adjustment is not necessary given the time elapsed and the immaterial amounts.

Recommendation(s):

Going forward, the Office of Real Estate should more accurately calculate the monthly base rent payments in accordance with the lease agreement's terms. The new tenant (CLPF – Lincoln, LLC) should continue to be billed properly going forward (\$27,328.77 per month) with the next increase occurring January 2018 so as not to impact the lease term.

Management's Response (Office of Real Estate):

The miscalculation was partially an error carried forward from 2007 by the parties involved including the Tenant, the previous tenant, and the City's lease/contract managers at the time. The Office of Real Estate also believes it is equally the Tenant's responsibility to verify and pay the agreed upon rent in the contract, as they have access to the same information.

Management's Response (Tenant):

Tenant disagrees with the following sections in the finding and recommendation. 1) The audit letter dated March 10, 2016, stated the audit period to be January 1, 2013 through December 31, 2015. Tenant believes all references prior to January 1, 2013 and after December 31, 2015 are outside of the audit scope and should not be a part of the examination or this Internal Audit Report memo. 2) As stated above there is a mention of 2011 audit. However, Tenant's records show there was a 2013 audit which covers period 2009 – 2013.

Underpayments noted in the findings are for the period 2001 through 2003. This entire liability belongs to the prior Tenant/The Lincoln LLC and not 1691 Michigan Ave Investment LP (Tenant). \$18,750 of the overpayment from 2003 – 2006 belongs to Lincoln LLC and \$112,357 belongs to Tenant. The Tenant requests repayment of all overpayments from the City of Miami Beach for the audit period January 1, 2013 to December 31, 2015.

Internal Audit Observation:

Upon learning of the pending sale of the property, the audit period was extended to the April 8, 2016 closing date from December 31, 2015. No other audit results were provided other than the one performed by the State of Florida's Department of Revenue which was completed in 2011.

2. Finding – *The Consistent General Ledger Distributions for the Percentage Rent Payments Received may be Revised to Include More Monies in the General Fund for the Lincoln Plaza, Lincoln Place and Pelican Projects*

Monthly base rent and annual percentage rent payments received are processed by the Central Cashier in accordance with the designated general ledger accounts listed on the City Bills created by the Office of Real Estate. Since May 2003, 70% of the amounts paid were posted to general ledger account 480-8000-344545 (Parking) and 30% to 011-8000-362216 (General Fund). Furthermore, the state sales taxes remitted through

Internal Audit Report
 Lincoln Plaza Project Lease Agreement Audit
 August 25, 2017

February 2011 were also similarly divided with 70% of the total always being entered into 480-7000-208100 and 30% into 601-7000-229032.

Resolution No. 99-23236's terms sheet and agreement states that the Tenant was to pay \$175,000 annually during construction of the building and garage to compensate the City for their loss of parking revenues since there was previously a surface parking lot located on the property. When the project was completed, the base rents increased to \$250,000 for years 1 through 5 and so on as addressed in finding #1. If you divide \$175,000 by \$250,000, it supports the 70% parking and 30% general ledger distribution which was not changed as the base rents prospectively increased.

In addition, the agreement summarized requires the additional payment of percentage rent equaling 2.5% of gross revenues annually starting at the earlier of the sale of the project or beginning in year 9 for every lease year thereafter. The same distribution was applied to these percentage rent payments of 70% parking fund and 30% general fund. Similar logic was applied to the base and percentage rent payments for the following two public/private projects: Lincoln Place located at 16th Street and Washington Ave, which was also distributed 70%/30%, and the Pelican located at Collins Avenue and 10th Street, which is distributed 56%/44%.

Internal Audit opines that the parking fund is sufficiently compensated for its loss of surface parking lot revenues by the 70% distribution of an increasing base rent payment. As a result, 100% of the annual percentage rent payment can be entered into the general fund prospectively. The table below shows the increase in the general fund balance of \$262,907 if this logic would have been applied on the 2015 percentage rounded rent payments received from all three projects:

	Total %age Rent Payments Received (2015)	Less Parking Fund Distribution
Lincoln Plaza	\$181,350	\$126,945
Lincoln Place	\$142,120	\$99,484
The Pelican	\$65,139	\$36,478
Total	\$388,609	\$262,907

Recommendation(s):

The City Administration should consider revising the distribution of funds so that 100% of the percentage rent payments for the Lincoln Plaza, the Lincoln Place and the Pelican are recorded in the general fund going forward.

- Finding** – *The Tenant did not Initially Provide the Office of Real Estate with Documentation Verifying that the \$5,680.88 in State Sales Tax due on 5% of their Monthly Base Rent Payments in Adherence with their 2011 Florida Department of Revenue Audit was Remitted Directly to the State of Florida*

The Tenant properly increased their monthly base rent and annual percentage rent payments by the applicable of state sales tax prior to February 2011 in accordance with the lease agreement. When questioned as to the reasons for this change, the Tenant provided a copy of their Florida Department of Revenue audit dated November 19, 2010 which was not present in the Office of Real Estate's maintained files.

Internal Audit Report
Lincoln Plaza Project Lease Agreement Audit
August 25, 2017

This Florida Department of Revenue audit concluded that under rule 12A-1.070(5) Florida Administrative Code *“Only one tax on the rental or license fee payable from the occupancy or use of any real property from which the rental or license fee is subject to taxation under Section 212.031, F.S. shall be collected, and the tax shall not be pyramided by a progression of transactions; however the amount of tax due the State of Florida shall not be decreased by any such progression of transactions.”* Furthermore, the auditor calculated by dividing the taxable square footage on the ground floor by the total area of the ground lease with the City that 95% of the land lease is exempt and 5% is taxable. Internal Audit assumed that these calculations remained constant as the building’s layout has not changed.

Prior to this audit’s completion, the Tenant would increase their monthly base rent payment to the City by 7% state sales tax which was posted 70% to general ledger account number 480-8000-208100 and 30% to 601-7000-229032. In turn, the City’s Finance Department would remit these amounts monthly to the State of Florida. Once this audit was completed, the Tenant incorrectly stopped remitting any state sales taxes on their monthly base rent payments to the City as of March 2011. Consequently, Internal Audit calculated that the Tenant would owe a total of \$5,680.88 in state sales tax covering March 2011 through their April 8, 2016 sale date ($\$1,623,109.70$ base rent payments received \times 5% taxable \times 7% state sales tax).

Finally, the Office of Real Estate was able to attain the individual yearly Florida Annual Resale Certificates for Sales Tax from the Tenant for the audit period as additional support for not including state sales tax on all their lease payments.

Recommendation(s):

The Office of Real Estate should always review and approve the supporting documentation (Florida Department of Revenue audits, Florida Annual Resale Certificates for Sales Tax, etc.) prior to any changes in payment amounts. Afterwards, it should be maintained in their files to provide a proper audit trail.

The Tenant should promptly remit the \$5,680.88 in state sales taxes owed to the City so that it can be included in the next monthly remittance to the State of Florida. Also, the Office of Real Estate should increase the monthly City Bills base rent amount by \$95.65 ($\$27,328.77$ current monthly base rent \times 5% \times 7% state sales tax). The amount of sales tax going forward will have to be adjusted as the base rent changes in accordance with the lease agreement’s terms.

Management’s Response (Office of Real Estate):

The Office Of Real Estate believes that it’s more efficient for all involved to continue having the Tenant pay the taxes directly to the State of Florida. Asking for a Resale Certificate and backup for payment should be due diligence enough for our office.

Management’s Response (Tenant):

Tenant agrees with the calculated \$5,680.88 related to 5% taxable portion of the land lease from period March 2011 – April 2016. However, Tenant has paid related amounts monthly. Instead of making payment with the land lease payments, the Tenant paid amount directly to the Florida Department of Revenue each month along with the monthly Tenant sales tax deposits.

Internal Audit Observation:

Although it was verified that the Tenant properly paid the state sales tax due to the Department of Revenue, the City was not provided with any documentation annually showing that the corresponding payments were remitted until the completion of this audit. Going forward, the new Tenant should either remit the state sales tax to the City or provide the needed documentation timely to the Office of Real Estate verifying that the payment was made in full.

4. Finding – *The Tenant's Annual Percentage Rent Payments were not always Accurately Calculated or Properly Posted into the City's Financial System*

The Tenant's certified annual financial statements were computed based on the accrual basis of accounting in accordance with the Accounting Principles per section 28.1 of the lease agreement. However, their subsequent percentage rent payments were made on a cash basis so the Tenant submitted a rent reconciliation explaining the reasons for the differences in reported project revenues. However, not all the figures in the reconciliation could be found in the certified financial statements thereby diminishing their value. Upon request, the Tenant provided supporting schedules that reconciled to their tested 2013 calculated figures.

The following differences were noted upon reviewing the accuracy of the Tenant's 2013, 2014 and 2015 percentage rent payments as well as their corresponding postings into the City's Financial System (separated by calendar year):

For contract years 2011-2013 percentage rent, the Tenant did not accurately account for deductions taken for outstanding rent. They take a deduction from their accrued revenue for rent due as shown in their accounts receivable (A/R) report; however, the Tenant did not properly account for, in the following year, any rent collected after the fact, deposits withheld, and written-off bad debt. This creates a situation where the Tenant deducts write-offs twice (first time in A/R, then again as bad debt) and does not pay percentage rent on rent collected after the A/R reporting period or on customer deposits that were kept for rent owed. As a result, the Tenant owes the City \$17,140.11 for contract years 2011-2013.

2013

- The Tenant remitted a total of \$188,911.91 (\$188,253.03 on 03/06/14 and \$658.88 on 05/04/14) for their 2013 estimated percentage rent payment that was all recorded as revenue in general ledger account #s 480-8000-344545 and 011-800-362216. However, the \$658.88 payment represented state sales tax which resulted in these monies not being remitted to the State of Florida.
- The Tenant's final 2013 percentage rent calculations found that they their estimated payment resulted in the City being overpaid by \$3,369.12. As a result, they deducted the monies from their June 2014 base rent payment posted on 07/30/15 but again it was incorrectly all considered revenue. Instead, \$3,357.33 was revenue and \$11.79 was state sales tax.
- Tenant never reversed the deduction for outstanding rent, Accounts Receivable (A/R) from 2012, in the amount of \$220,077.38, in the "2013 % Rent Reconciliation Per Audited Financials" report; instead of an overpayment, Tenant owed the City \$2,132.80 plus \$7.46 in sales tax from the 2013 percentage rent

Internal Audit Report
Lincoln Plaza Project Lease Agreement Audit
August 25, 2017

true-up. Total currently due for 2013 is \$5490.13 plus \$19.22 in sales tax which includes a credit of \$3,369.12 the tenant received.

2014

- The Tenant submitted check #2000 dated 02/12/15 for \$185,094.25 for their 2014 estimated percentage rent payment. However, their submitted "2014 % Rent Reconciliation Per Audited Financials" report incorrectly listed \$185,516.06 as the amount of the prior estimated payment. As a result, the Tenant owes the City the \$421.81 difference.
- The City Bill created by the Office of Real Estate for the 2014 estimated percentage rent was incorrectly for \$185,094.25 as it inadvertently excluded the \$647.83 in state sales tax due.
- The Tenant's final 2014 percentage rent calculations found that an additional \$2,323.27 was owed to the City. However, the total payment was posted to revenue on 12/03/15 when it included \$8.13 in state sales tax that was not remitted to the State of Florida.

2015

- Tenant submitted Check 2588 dated 2/8/2016 for their 2015 estimated percentage rent payment of \$181,910.29 which included \$634.47 in state sales tax. The City incorrectly posted the sales tax as revenue.
- Tenant submitted "2015 % Rent Reconciliation per Audited Financials" report and incorrectly listed the \$181,910.29, as the estimated rent paid, instead of the \$181,275.82 actually paid. The report shows the 2015 percentage rent is equal to \$181,349.58. Tenant owes the City \$73.76 plus \$0.26 in sales tax.

Recommendation(s):

Tenants should remit their annual percentage rent payments that like their provided audited financial statements are calculated on an accrual basis to facilitate City reconciliations. Also, both the Tenant and the Office of Real Estate should closer scrutinize all payments for accuracy to help identify and correct any noted deficiencies quicker. The Office of Real Estate should create a City Bill for \$421.81 due to the 2014 identified difference and the \$74.02 due to the 2015 identified difference. Lastly, the Office of Real Estate should better ensure that prospective payments are properly posted into the City's Financial System and ensure that state sales tax equal to 5% of taxable revenues is collected and recorded in adherence with finding #3.

Management's Response (Tenant):

Tenant made monthly payments based on revenue received monthly (cash basis). The ground lease agreement requires an annual audit to attest to the accuracy of the monthly payments made during the prior year. The Tenant's audited financials are kept on the tax basis method of accounting which closely follows accrual basis accounting except for a few areas. Upon completion of each year's audit, the Tenant provides the City with the audited financial statements and a detailed Excel reconciliation to reconcile from tax basis to cash basis payments. Tenant was not previously informed of any issues with its method of reconciliation annually.

Internal Audit Report
Lincoln Plaza Project Lease Agreement Audit
August 25, 2017

For 2014, Tenant reviewed its calculation and payments and agrees \$421.81 plus \$1.48 in sales tax is due to the City. The above mentioned \$647.83 and \$8.13 were paid directly to the Department of Revenue.

Management's Response (Office of Real Estate):

In keeping with response number three, the Office of Real Estate believes it's best if the new tenant pays any sales tax directly to the State of Florida. We concur that the amounts used to calculate the percentage rent should exactly match information in the independent audit provided by the Tenant; and for the most part it does. The difference is an A/R deduction from their revenue which should be reversed the following year. Using only the accrued rent rather than the accrued rent modified for outstanding rent would result in greater error. Further, even if the amount matched what the independent auditor attested to, if the amount is not reversed the following year, there would be a miscalculation of the Percentage Rent due to the City as previously explained.

Internal Audit Observation:

The detailed Excel reconciliations were not present in the Office of Real Estate's maintained files thereby indicating that they were either not received or were misplaced. Any differences in the Tenant's reported revenues to the City from their financial statements should be reviewed and attested to by their designated independent auditor to provide a higher comfort level as to their accuracy.

5. Finding – *The Tenant did not Maintain the Required Insurance Coverage in the Lease Agreement and City Staff did not Follow the Established Procedures to Facilitate Identifying the Existing Deficiencies to help Reduce the City's Risk Exposure*
Review of the Eden System's Contract Management Module found that the entered information for the Lincoln Plaza project is very basic and there is no attached documentation present (lease agreement, insurance policies, etc.). Subsequent inquiries with Office of Real Estate staff found that they typically don't utilize the Contract Management Module as they rely instead on internally maintained spreadsheets to track needed information and expiration dates thereby potentially increasing the possibility of mistakes.

The City Commission authorized the procurement of the Certificate of Insurance Tracking System from Insurance Tracking Services, Inc. piggybacking on Palm Beach County Contract No. 13-100-MW through the May 21, 2014 adoption of Resolution No. 2014-28589. As of the completion of this audit, most of the approximately seventy lease agreements managed by the Office of Real Estate were not yet uploaded into this insurance tracking system which included the Lincoln Plaza project.

Therefore, copies of the Lincoln Plaza project's current insurance policy were requested from and promptly received from the Office of Real Estate. This policy which covers July 31, 2015 through July 31, 2016 was not approved by the City's Risk Management Division for sufficiency. Once Internal Audit brought the relevant lease agreement sections and the submitted insurance policy to the City's Risk Management Division, deficiencies were identified which significantly increased the City's risk exposure. The Risk Management Division subsequently sent an email listing these deficiencies to the Office of Real Estate which are in need of immediate correction to better protect the City.

Recommendation(s):

Going forward, all pertinent insurance information should be uploaded as quickly as possible into the insurance tracking system to help identify any deficiencies sooner. In the interim, the Office of Real Estate and any other City divisions/departments whose information is not uploaded should be immediately done so and brought to the Risk Management Division for review. Lastly, the deficiencies noted at the Lincoln Plaza project and any others subsequently identified should be immediately corrected to help reduce the City's risk exposure.

Management's Response (Risk Management Division):

Before the Risk Management Office began using the services of Insurance Tracking, Inc. ("ITS") in 2014, most contracts were handled at the department level, without any involvement from Risk Management. The Risk Management Office along with Procurement, began uploading contracts (insurance language) into ITS for tracking. As you can imagine there were many contracts that had not been monitored for insurance compliance (approximately 80% of the contracts were in non-compliance). After the majority of the City's contracts were uploaded, we began to check with individual departments to see if there were other agreements that needed monitoring. Between March and May of 2016, we began uploading real estate lease agreements into ITS, which included the Lincoln Plaza Project. Upon receipt of the certificate of insurance, several deficiencies were noted, but were cured shortly thereafter. Their coverage expired July 31, 2016. ITS sent a first and second notice (8/4 and 9/26) to Lincoln Plaza, with no response of their renewal certificate of coverage. On October 20, 2016, we received certificates from Clarion Partners (CLPF-Lincoln LLC), who has acquired Lincoln Plaza Partners. We also received certificates from Laz Parking, which is the valet parking operator, contracted with CLPF-Lincoln LLC. Their insurance was previously being monitored by ITS and is compliant.

The Tourism/Real Estate Office has access to the ITS system and is able to monitor any deficiencies for their lease agreements. For those cases where the insurance is not provided within a 30-day period, the Office of Real Estate should consult with the City Attorney's Office so that they may get advice on their contractual remedy.

6. Finding – *The Tenant Remitted Eleven of the Forty Tested Monthly Base Rent Payments or 27.50% More than Thirty Days after the Due Date but was not Invoiced Interest Totaling \$3,103.40 in Adherence to Section 4.1 of the Lease Agreement*
Section 3.2(g) of the lease agreement summarized states that the base rent shall be paid monthly in advance on the first day of each and every calendar month. Consequently, January 2013's base rent would be due on January 1, 2013; February 2013's rent would be due on February 1, 2013 and so on. Given this information, testing found that thirty-four of the forty months base rent payments in the January 2013 through April 2016 audit period or 85.00% were received after this due date.

Although the monthly base rent amount has been fixed for five year intervals per the lease agreement since September 1, 2002, eight (8) of the forty months sampled City Bills or 20.00% were created either on or after the first day of the applicable month by the Office of Real Estate. The date of these delinquent manually prepared City Bills ranged from October 2014 being created on 10/01/14 to March 2013's 03/29/13. Subsequent inquiries found that Munis (the new enterprise system that the City

Internal Audit Report
Lincoln Plaza Project Lease Agreement Audit
August 25, 2017

converted to in May 2016) does not presently have the ability to auto-bill the Tenant each month which would better ensure these City Bills future timely creation and save staff input time.

Furthermore, section 4.1 states that if the Tenant fails to make any required payment within thirty days after the first of each month, the late payment shall bear interest from the due date until the date paid at a rate equal to the lesser of the prime rate plus 4% or the maximum interest rate permitted by law. Interest was not billed to the Tenant during the audit period despite the receipt of eleven of the forty sampled payments (27.50%) after the thirty days threshold. The number of days late for these eleven months ranged from a low of 32 for March 2013 to a high of 141 for February 2015 and the total interest owed is \$3,103.40.

Recommendation(s):

The Finance Department should contact Tyler Technologies to determine whether Munis has the ability to set up the auto-bill feature. Regardless, the new Tenant should remit all prospective base rent payments prior to the first day of the month due date as the amount is fixed and the lease agreement's specified due dates are known (excludes January 2018, January 2023, etc.). If the base rent payments are not received within the thirty day grace period, then the Office of Real Estate should timely and accurately charge interest in accordance with section 4.1 of the lease agreement. Finally, a City Bill should be created invoicing 1691 Michigan Ave Investment LP a total of \$3,103.40 in interest.

Management's Response (Tenant):

Tenant disagrees with findings and recommendation regarding 27.50% was remitted more than 30 days late. Based on Tenant's check register all payments were made by mid-month. Over the years tenant has noticed a significant lag after checks are mailed and payments clear the bank.

Management's Response (Office of Real Estate):

The Office of Real Estate is looking into the possibility of implementing a lockbox which would eliminate the payment tracking issue. Generally, the Office of Real Estate only receives payments for percentage rent, all other monthly base rent payments are received directly by the Finance Department.

Internal Audit Observation:

The payment receipt dates were copied directly from the City's Financial System showing when the monies were processed by the Central Cashier's Office. Internal Audit has no direct knowledge that the Office of Real Estate and the Finance Department do not timely process all payments shortly after receipt and has no means to verify that the Tenant's checks were promptly mailed after being recorded in their check register. Regardless, the Tenant should consider sending the payments prior to their first of the month deadline and by wire transfer or credit card to better confirm a timely receipt date.

7. Finding – *The Tenant Remitted Estimated Percentage Rent Payments Within Five Days of the March 1st Annual Due Date but their Subsequent 2013, 2014 and 2015 Calendar Year Final Percentage Rent Payments were Received upon the Completion of their*

Internal Audit Report
Lincoln Plaza Project Lease Agreement Audit
August 25, 2017

Certified Financial Statements which Resulted in \$137.51 in Associated Interest Charges that were not Billed

Section 3.3 of the lease agreement summarized states that the annual percentage rent, equal to 2.5% of project revenue for each lease year, shall be paid within sixty days after the December 31st lease year end or by March 1st. These terms were in effect starting in the tenth lease year which represents the 2012 calendar year.

Although the tenth lease year occurs outside the designated audit period, it was included because the Tenant's corresponding percentage rent payments were received during the 2013 calendar year. As previously mentioned in finding #6, interest is accrued after thirty days of non-payment from the due date until the date paid at a rate equal to the lesser of the prime rate plus 4% or the maximum interest rate permitted by law.

It was concluded that the Tenant remitted the annual percentage rent payments for the 2012, 2013, 2014 and 2015 calendar years based on estimated project revenues within five days of the March 1st due date so no interest would be due. However, a second estimated percentage rent payment of \$658.88 which represented state sales tax was received on May 14, 2014 which was 74 days after the due date. In addition, the 2012, 2013 and 2014 final percentage rent payments or deductions were remitted later during the same calendar year after the completion of their audited financial statements.

Although Internal Audit finds this practice satisfactory, these final percentage rent payments were received well after the lease agreement's stated March 1st due date ranging from a low of 138 days for the 2012 calendar year payment to 277 days for the 2014 calendar year payment. The final 2012, 2013 and 2015 calendar year percentage rent payments were excluded from the interest calculations as it was determined that the Tenant had overpaid by \$1,627.99; \$3,369.12 and \$560.71 respectively which were subsequently deducted from the next monthly base rent payments. Calculations found that interest totaling \$137.51 would be due for these remaining two sampled late final percentage rent payments but no City Bills were created by the Office of Real Estate.

Furthermore, section 28.1(c) of the lease agreement states that the certified annual financial statements shall be made available no later than 150 days after the end of the December 31st lease year end (May 30th). While there was no documentation maintained to indicate when the 2013, 2014 and 2015 calendar year financial statements were received by the City, the date of the independent auditors' reports showed that were completed 4, 83 and 38 days after the due date respectively.

Recommendation(s):

The Office of Real Estate should create the City Bills necessary to invoice the Tenant for the \$137.51 due in interest from these two late final percentage rent payments. Going forward, the Tenant should remit all prospective percentage rent payments prior to the stated March 1st due date. If the percentage rent payments are not received within the thirty day grace period, then the Office of Real Estate should timely and accurately charge interest in accordance with section 4.1.

Management's Response (Tenant):

Tenant agrees with \$137.51 due to City. Section 28.1(a) of the lease agreement requires Tenant to provide an annual audit report performed by the Tenant's external auditor.

Internal Audit Report
Lincoln Plaza Project Lease Agreement Audit
August 25, 2017

Per section 28.1(c) the report is due 150 days following the end of the calendar year. The annual audit report is used to attest to the accuracy of the percentage rent payment due. Tenant has remitted estimated percentage rent payments as described above in the finding section. Since the City uses the report to verify accuracy, it is not practical for Tenant to provide final percentage rent calculations before the auditors have attested to the revenue information.

Tenant worked diligently with its auditor to deliver audit timely. Calendar years 2013, 2014 and 2015 were challenging audits which led to delays. Each year, the Tenant sent an email to the City informing the City of the status. For 2013 calendar audit, the Tenant delivered the report on June 6th, 2014.

Management's Response (Office of Real Estate):

The Office of Real Estate agrees and will bill the Tenant accordingly.

EXIT CONFERENCE

Due to the complexity of this audit, a number of meetings were held with City staff to fully discuss and analyze all issues. Any necessary revisions were made to the draft report following each meeting. In addition, the draft report was subsequently sent to the 1691 Michigan Ave Investments LP for review. Additional meetings and correspondence were subsequently held to further discuss the issues presented above as needed. Management responses were solicited and included above. All parties were in agreement as to the contents of this report.

JJS:MC:mc

Audit performed by Assistant Internal Auditor Mark Coolidge

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cc: Kathie Brooks, Assistant City Manager
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John Woodruff, Finance Director
Chris Williams, Vice President – Accounting, HQ Capital Real Estate L.P.