



INVESTING FOR FLORIDA'S FUTURE

# **INTERNAL AUDIT REPORT**

**Report No. 2004 – 03**

**REAL ESTATE  
OPERATIONAL AUDIT**




**STATE BOARD OF ADMINISTRATION**

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EXECUTIVE DIRECTOR

July 7, 2004

Coleman Stipanovich   
Executive Director  
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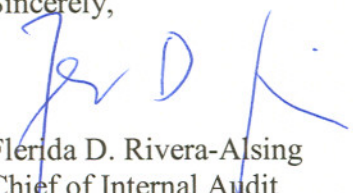
Dear Coleman:

We have completed an audit of the State Board of Administration Real Estate Asset Class. We submit this report that includes responses and action plans provided by the auditee management. We will follow up on the implementation of the action plans approximately six months after the date of this report.



We thank the management and staff of the Real Estate Asset Class for the cooperation and courtesies extended to us during the audit.

Please let us know if you need additional information.

Sincerely,

  
Florida D. Rivera-Alsing  
Chief of Internal Audit  
**Office of Internal Audit**

Enclosure-as stated

cc: Members of the Audit Committee  
 David Villa, Chief Investment Officer  
 Douglas Bennett, Senior Investment Officer of Real Estate

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## Audit Report

# REAL ESTATE OPERATIONAL AUDIT

OIA Report # 2004-03

June 25, 2004

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## EXECUTIVE SUMMARY

**This audit addresses internal controls over the Real Estate Asset Class (RE) at the State Board of Administration (SBA), including the implementation of recommendations made by external consultants. We conducted the audit as part of our risk-based auditing program. Our audit disclosed significant issues for which corrective actions are needed. These significant issues are discussed in this executive summary and the body of this report. Other issues identified for which we have recommended procedural revisions to improve internal controls and enhance accountability are also discussed in the body of this report.**

The SBA portfolio of real estate assets is valued at US\$5.5 billion as of December 31, 2003. The real estate portfolio is comprised of directly owned assets (59% of the portfolio's market value) and investments in commingled assets, REITS and cash (41% of the portfolio's market value).

Real estate assets are 5.5% of the total Florida Retirement System (FRS) fund with a 7% target allocation and 4.2% of the Lawton Chiles Endowment Fund (LCEF) with a 4% target allocation. As of December 31, 2003, the FRS RE assets are managed to outperform the Consumer Price Index (CPI) plus 450 basis points (primary benchmark)<sup>1</sup> and the secondary asset class target is a portfolio-weighted aggregation of the individual portfolio benchmarks (NCREIF property types, RESI, and T-bill.) The LCEF benchmark is the Wilshire Real Estate Security Index (WRESI).

### Policies and Procedures

RE does not have an overall investment policy and guideline that addresses, at a minimum, portfolio size and design, return requirements, risk tolerance, liquidity, and time horizon requirements. A written overall policy and guideline will serve as the roadmap to achieving RE's goals and objectives. In this regard, we recommend that the development of an over-all investment policy and guideline be given top priority.

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<sup>1</sup> Prior to July 1, 2003, FRS real estate assets' primary benchmark was the RESI, unlevered; secondary benchmark was the CPI plus 450 basis points.

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## Executive Summary

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Most of the 39 RE policies and procedures need to be updated. Senior Investment Officer-Real Estate (SIO-RE) should take the lead in updating these policies and procedures. Another matter RE should review is whether or not they need all 39 policies and procedures.

### Staffing and Execution of RE Contracts

RE contracts are not being staffed and executed in accordance with SBA Policies #10-031, Contracts and # 10-010, Investment Management Acquisition. We recommend that all RE contracts follow the same staffing procedures utilized by all other asset classes, including those relating to an individual property in which the Executive Director has delegated authority to the SIO-RE. All contracts not covered by a delegation of authority from the Executive Director must be executed by the Executive Director or the Chief Investment Officer (CIO) if the contract amount is US\$50k or less.

### Compliance Responsibilities

As of January 31, 2004, RE has a total of 87<sup>2</sup> active contracts. Responsibilities for contractual compliance monitoring of these contracts is not centralized. Different individuals within RE are responsible for components of compliance matters. Having different individuals do parts of the compliance monitoring is fine so long as there is an RE staff who gathers all these parts, puts them all together in a consolidated report, highlights the ones that need attention and brings them to the attention of the SIO-RE. The magnitude of the number of contracts and service providers and the fact that RE's allocation almost doubled as of July 1, 2003, made the need for this compliance person to be in place immediately. This recommendation can be implemented without adding personnel to the department because of the following reasons:

- 1) The same individuals will continue doing their part of the compliance monitoring. The compliance person's role is to gather the results of the compliance monitoring from these individuals and then consolidate them.
- 2) RE needs to shift the management of audit and tax activities related to directly-owned real estate properties to the Chief Operation Office (COO).

We would like to acknowledge the full support of the Executive Director and the Chief Investment Officer and the cooperation of the SIO-RE, Senior Portfolio Manager – RE, Senior Acquisitions Manager – RE, and staff during this audit. They have been receptive to recommendations contained in this report and have already taken actions on some of the recommendations.

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<sup>2</sup> Excludes contracts with six external auditors, which are not captured in SBA's Acorde system.



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## Introduction

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### Background Information

The SBA portfolio of real estate assets is valued at US\$5.47 billion as of December 31, 2003. The real estate portfolio is comprised of directly owned assets (59% of the total portfolio's market value) and investments in commingled assets, REITS and cash (41% of the total portfolio's market value). The directly owned property portfolio is diversified as to property type and geographic location. The largest component of the directly owned property portfolio is office buildings (49% of the total portfolio's market value), with the largest weightings in the western region (26% of the total portfolio's market value) of the United States.

Certain real estate investments are leveraged whereby properties are purchased through a combination of contributions from the SBA and through the acquisition of debt. As of December 31, 2003, leveraged debt is about US\$723.8 million, which is about 13.2% of the total portfolio's market value.

The RE is currently used within the SBA for the FRS Fund and the LCEF. Real estate assets are 5.5% of the total FRS fund and 4.2% of the LCEF.

As of December 31, 2003, the FRS RE assets are managed to outperform the Consumer Price Index (CPI) plus 450 basis points (primary benchmark)<sup>3</sup> and the secondary asset class target is a portfolio-weighted aggregation of the individual portfolio benchmarks (NCREIF property types, RESI, and T-bill.) The LCEF benchmark is the Wilshire Real Estate Security Index (WRESI).

RE has a staff of seven. RE staff is complemented by staff from six contracted outside Asset Managers. The Asset Managers, in turn, are supported by at least 49 sets of Property Managers. Other service providers such as outside legal counsels, environmental engineers, and property appraisers also support the RE.

***The Asset Managers' responsibilities include the following:***

***On acquisition of investments (as Investment Advisors)***

- a) Present to the SBA real estate investment opportunities. Recommend appropriate actions; identify ownership risks and transactional issues that are unique to the proposed investment, and provide the analysis, documentation and supporting schedules based on the investment underwriting guidelines.

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<sup>3</sup> Prior to July 1, 2003, FRS real estate assets' primary benchmark was the RESI, unlevered; secondary benchmark was the CPI plus 450 basis points.

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## Chapter 1 Introduction

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- b) Negotiate for services and engage such professional firms needed to perform due diligence review, coordinate the due diligence process, and review the conclusions, recommendations, and opinions of the professionals engaged to do the due diligence review.
- c) Assess the qualifications of the existing property management team and recommend either their retention or replacement.
- d) Advise the SBA on whether or not to consummate the transaction.

### On management of properties (as Asset Managers)

- a) Identify and make written recommendations on property management firms qualified to manage the SBA's property.
- b) Supervise and evaluate the property manager of each managed property.
- c) Hire, supervise, and evaluate independent contractors for on-site services for each managed property.
- d) Inspect managed properties at least twice a year. Obtain and maintain insurance for the managed property.
- e) Ensure compliance with mortgages and deeds of trusts, and pay applicable taxes in a timely fashion.
- f) Maintain complete and accurate books and records relating to each managed property.
- g) Prepare an annual leasing, marketing, and business plan for each property managed. This includes the recommendation on whether to sell or keep the property.

## Objectives of the Audit

The objectives of the audit are to evaluate the following areas:

### 1. Internal Controls

Operational audits (sometimes referred to as performance audits) encompass a wide variety of objectives, including: assessing program effectiveness and results, economy and efficiency, internal control, compliance, etc.

The RE operational audit we performed focused on internal control audit objectives. Internal control audit objectives relate to RE management plans, methods, and procedures used to meet its mission, goals and objectives. Internal control includes the processes and procedures used for planning, organizing, directing, and controlling program operations, and system put in place for measuring, reporting, and monitoring program performance.

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## Chapter 1 Introduction

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2. Status of the implementation of recommendations made by Independent Fiduciary Services (IFS), and F.M. Doyal, CPA.

### **Scope of the Audit**

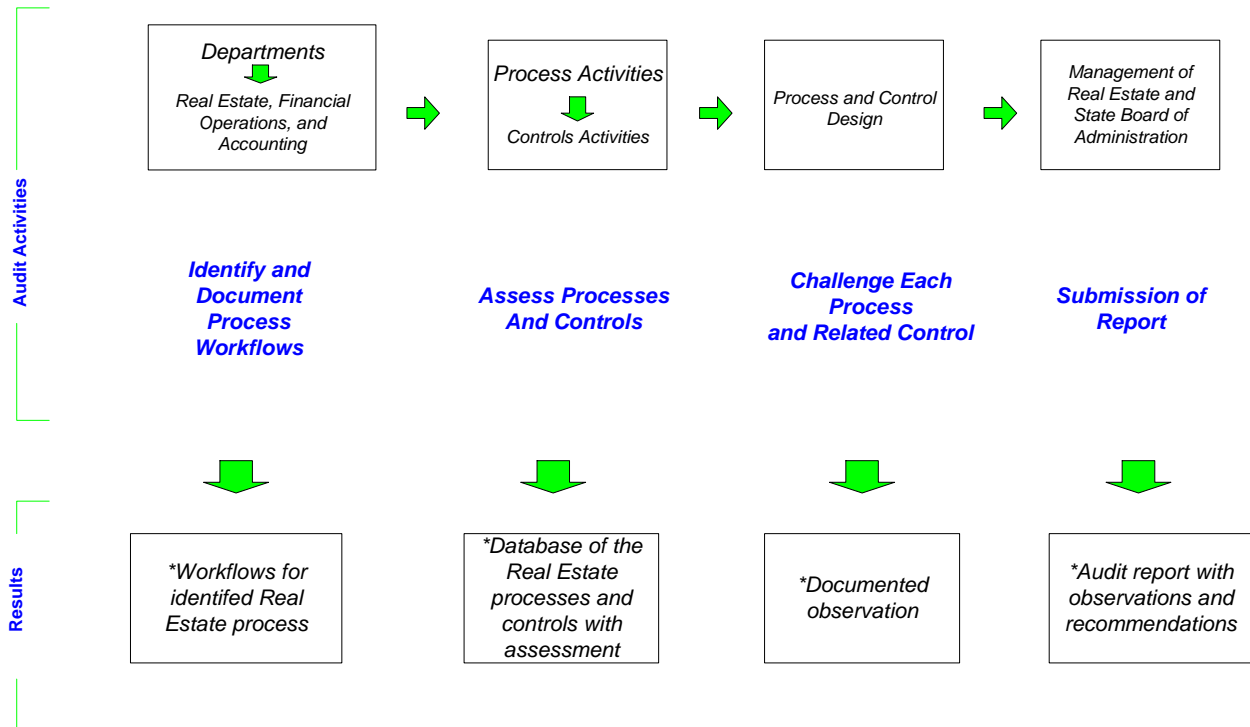
This operational audit covered RE activities in the SBA headquarters in Tallahassee, FL. The audit period for which information was collected and reviewed was from January 1, 2002 through March 31, 2003. In certain cases, subsequent information was reviewed to provide updated information regarding current processes.

Specific activities reviewed are the following:

1. *Policies and Procedures*
2. *RE Primary Processes*
  - a) Service Provider Selection, Monitoring, and Termination
  - b) Investment Acquisition
  - c) Investment Disposition
3. *Secondary Processes*
  - a) Payment of Investment Expenditures
  - b) Receipt of Investment Revenue Distribution
  - c) Payment of Asset Manager Fees
  - d) Creation and Dissolution of Title Holding Companies
  - e) Valuation of Real Estate Properties
  - f) Audit and Tax Requirements of the Title Holding Companies

## Chapter 1 Introduction

### Methodology



This audit was conducted in accordance with the International Standards for the Professional Practice of Internal Auditing.

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## Policies and Procedures

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### ***2 – A Lack of an Overall Investment Policy and Guideline***

A fundamental element of the portfolio management process is the development of an investment policy and guideline that defines the investor's investment objectives and constraints, along with the methods by which they will be attained. There are numerous approaches to developing an investment policy and guideline but the policy should address, at a minimum, the following areas:

- a) Portfolio size and design
- b) Return requirements
- c) Risk tolerance
- d) Liquidity and time horizon requirements

RE does not have an overall investment policy that addresses the above-mentioned areas. As a result, it is unclear to an individual looking from the outside where the RE portfolio is headed. Even the IAC in its September 27, 2002 meeting questioned how and who makes investment decisions in RE. IAC also asked to see a comprehensive review of how SBA approaches RE.

#### **Recommendation # 1.**

We cannot overemphasize the need for a well-written overall investment policy and guideline that will serve as RE's roadmap to achieving its goals and objectives. An overall investment policy and guideline will assist staff outside the RE asset class understand the plan and strategy of RE in managing its portfolio to achieve its goals and fulfill its fiduciary responsibilities. We, therefore, recommend that the development of an over-all investment policy and guidelines be given top priority.

Appendix A shows an example of a portfolio design that can be incorporated into an overall investment policy and guideline.

#### **Auditee Response # 1**

Agreed. The CIO working with the Executive Director, SIO-RE, and the Senior Investment Policy Officer and Economist will develop an overall-all investment policy and guideline or investment plan for the Real Estate Asset Class. An invitation to negotiate was issued on April 19, 2004 to select a RE Asset Class consultant to assist with developing over-all RE investment plan. As of June 23, 2004, the consultant selection team has submitted a recommendation to the Executive Director for approval.

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## Chapter 2 Policies and Procedures

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### **2 – B *Lack of Updated Policies and Procedures***

RE has a total of 39<sup>4</sup> policies and procedures. Most of these policies and procedures have not been updated for about three years. Appendix C of this report identifies RE policies and procedures requiring updates.

Detailed policies and procedures are written generally for the following reasons:

- a) Provide good guidance on how work is to be completed.
- b) Identify risks or exposures SBA faces should these policies and procedures not be followed. Detailed and well-written policies and procedures provide reason for having the policies and procedures and help staff better appreciate the impact their jobs have on the overall process.
- c) Serve as good control in the case of staff turnover.

The above-mentioned purposes will be achieved and the effectiveness of policies and procedures will continue only if they are reviewed regularly and updated as appropriate.

#### **Recommendation # 2.**

We recommend that RE review the policies and procedures in Appendix C and make the necessary updates as soon as possible. In updating its policies and procedures, RE must follow SBA's procedures. The SIO-RE should lead this endeavor.

Moving forward, we recommend that procedures for reviewing and updating policies and procedures be established, including the appointment of a senior member of RE management staff who will be charged with this responsibility.

#### **Auditee Response # 2**

Agreed. RE policies and procedures will be updated as discussed in the attached side letter from the OIA. In updating these policies and procedures, RE will follow SBA's procedures in developing and updating policies and procedures at the department level by involving the Executive Director, the CIO, and Senior Operating Officer Planning, Policy and Administrative Services.

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<sup>4</sup> Please see Appendix B for the full list of RE policies and procedures.

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## Chapter 2 Policies and Procedures

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### ***2 – C Lack of Coordination of Policies and Procedures that Affect Other Departments***

RE's policies and procedures with series number 900-500's are referred to as legal policies and procedures. Several of these policies and procedures discuss the assigned duties and responsibilities of the Assistant General Counsel (AGC) in different activities undertaken by RE. AGC belongs to another department and reports to the General Counsel. It is unclear, however, if these policies and procedures were discussed and agreed upon by the General Counsel, AGC's supervisor.

#### **Recommendation # 3.**

We recommend that legal policies and procedures be coordinated with the General Counsel's office. Coordination would include review of the policies and procedures and agreement as to assigned responsibilities and expectations.

Moving forward, we recommend that all policies and procedures that may affect other departments be coordinated with the affected department heads. In addition, policies and procedures should bear not only the signature of the SIO-RE and CIO, but also the signature of the affected department head to signify agreement.

#### **Auditee Response # 3**

Agreed. RE will ensure that policies and procedures affecting other departments are coordinated, and signed by the SIO-RE, CIO, and affected department head.

### ***2 – D Lack of Compliance to Existing Policies and Procedures***

As several of the existing RE policies and procedures need to be updated, our test of the level of policy compliance was minimal. Compliance and other related findings for each policy reviewed are enumerated below.

#### **Policy 900-302, Audit & Tax Program**

This policy states that:

- a) Audits will be performed on each wholly owned property on an annual basis.

Lans End, one of RE's title holding companies (THC), was incorporated on September 29, 1998, and has never been audited. Lans End's only asset is a piece of land acquired on September 29, 1998. As of December 31, 2003, the land has a market value of US\$2.1 million. As Lans End does not have any activity,

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## Chapter 2 Policies and Procedures

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except for paying minimal expenses, we agree that its financial statements need not be audited.

- b) Invitation to bid is sent to national accounting firms.

Presently, regional firms are also used to audit some of the THC's.

### **Recommendation # 4.**

RE must ensure compliance to its policies and procedures. If a change in business strategy renders compliance to an existing policy and procedure impractical, then that policy and procedure must be updated immediately.

### **Auditee Response # 4**

Agreed. These issues will be addressed when we update the policy and will ensure compliance thereafter.

### **Policy 900-304, Cash Distribution Procedures**

This policy states that audit packages sent to COO-Financial Operations Department will include the Post Specified Amount (PSA) form and any back-up documentation. The PSA form sent to COO-Financial Operations Department does not have any supporting documentation. RE keeps the supporting documents.

This policy also requires that documentation for reserves (cash held for payment of certain expenses) be sent by the external asset manager (AM) to RE for review and approval. It is unclear, however, whether these expenses are paid on time.

### **Recommendation # 5.**

- a) Basic internal controls require that each entry in the accounting records of an organization are adequately supported. As cash distribution is booked in SBA's accounting records by way of PSA form submitted by RE, we recommend that RE start attaching supporting documents on the PSA.
- b) In addition, RE should establish procedures that would create audit trail for reserved item expenditures.

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## Chapter 2 Policies and Procedures

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### **Auditee Response # 5**

- a) Agreed. RE will provide all documentation requested by Financial Operations in connection with cash disbursements.
- b) Agreed. An audit trail of reserve item expenditures is an important internal control to minimize cash held in back accounts. RE believes this is best accomplished through a variance analysis of the monthly financial statements. The Investment Manager will perform this function and RE Portfolio Management will review the analysis.

### **Policy 900-402, Selection of Managers and Service Providers**

This policy states that the SIO-RE will have the final approval of the selection of the investment firms/manager. This statement contradicts SBA Policy # 10-010, Investment Acquisition Management. Policy # 10-010 states that the Executive Director shall make the final decisions on the selection of investment management firms, investment products, and bundled providers and shall be responsible for executing contracts for these services.

Policy 900-402 also refers to an asset manager unit. The current RE organization chart does not have an asset manager.

### **Recommendation # 6.**

RE must ensure that the requirements of policy # 900-402 are consistent with the requirements of Executive Director Policy # 10-010.

RE also needs to address the references to the asset manager unit when updating this policy.

### **Auditee Response # 6**

Agreed. RE policies and procedures will be updated as discussed in the attached side letter from the OIA. In updating these policies, RE will ensure that the RE policies and procedures are consistent with the SBA's 10 and 20 level policies.

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## Chapter 2 Policies and Procedures

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### Policy 900-403, Supervision and Termination of Managers & Service Providers

a) *Written Report on Property Visits*

This policy requires a written report when RE's portfolio managers perform an annual physical inspection of each property. We understand that RE's portfolio managers visit properties with the external asset managers and that external asset managers are requested to document the results of the physical inspection with a copy forwarded to RE. We were not able to find a copy of the physical inspection report in the property folders examined.

b) *Contractual Compliance*

There is a paragraph in this policy stating, "*It is unreasonable to expect absolute compliance with all contractual agreements that we deal with in the real estate asset class. In most cases, we expect the service provider to comply with the intent and to use their best efforts to meet our expectations, in effect, we at times must be entirely subjective in evaluating the services we receive.*"

A contract is a formal, enforceable agreement between parties that defines the nature of their relationship, and their responsibilities for the term of the contract. To indicate in an RE policy that it is unreasonable to expect absolute compliance with all contractual agreements negates the importance of contractual compliance.

### Recommendations # 7 and # 8

- 7) RE should establish procedures to ensure that reports on property visits are prepared timely and filed on a consistent basis.
- 8) We recommend that the paragraph highlighted in the above section be deleted from the policy and be replaced with "Non-compliance with contractual requirements needs to be brought to the attention of the SIO-RE for proper disposition."

### Auditee Response #7 and # 8

- 7) Agreed. Copies of site visit reports were provided to the internal audit staff as requested. RE will establish a procedure to monitor property visits and timeliness of written reports.
- 8) Agreed.

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## Chapter 2 Policies and Procedures

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### *Policy 900-509, Monthly Briefing*

This policy requires AGC to provide monthly briefing to the SIO-RE.

The SIO-RE and the AGC advised us that monthly briefing is no longer required as they informally meet regularly to discuss legal issues.

### *Recommendation # 9*

We recommend that this policy be either deleted or revised.

### *Auditee Response # 9*

Agreed. Policy to be deleted.

### *Policy 900-603, Document Execution and Storage*

This policy states that documents requiring execution in the SBA's name will be signed by the SIO-RE or his authorized designee. This contradicts Executive Director Policy # 10-010, Investment Management Acquisition, and Executive Director Policy #10-031, Contracts. Policy # 10-010 states that the Executive Director shall make the final decisions on the selection of investment management firms, investment products, and bundled providers and shall be responsible for executing contracts for these services. Policy 10-031 states that the Executive Director will execute the contract if contract amount exceeds US\$50k.

We understand that the Executive Director signs a delegation of authority to SIO-RE regarding items related to individual properties. Delegated authority includes authority to (a) negotiate, enter into, and execute contracts and agreements in connection with the acquisition of a specific investment, and (b) manage and execute the SBA's investment responsibilities regarding that specific investment. This delegation of authority also includes the authority to form, operate, and manage the business entity, which holds the SBA's title to, and/or interest in the subject property.

It appears that the delegation of authority is construed to include all RE contracts. For example, Master Service Agreements that do not relate to any specific property are also signed by SIO-RE. Master Service Agreements are not covered by the delegation of authority mentioned in the previous paragraph and therefore need to be signed by the Executive Director as required by SBA policies number 10-010 and 10-031.

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## Chapter 2 Policies and Procedures

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### **Recommendation # 10**

This policy should be revised to ensure that requirements of SBA policies #10-010 and 10-031 are met and complied with. More importantly, contracts executed in SBA's name should be signed by the Executive Director or his designee in his absence in accordance with policies #10-010 and 10-031.

### **Auditee Response # 10**

Agreed. All RE contracts that are over US\$50k are now staffed and then signed by the Executive Director. At this time, the Executive Director does not delegate any authority to the SIO-RE. This new procedure will be reviewed in the near future and will advise the Chief of Internal Audit of any changes.

### **Policy 900-606, Document Maintenance Procedure**

When reviewing tax-related documents, we noticed that documents in property files are not consistently filed in accordance with this policy. Similar documents are filed in different property files. For example, for some properties, IRS determination letters are stored in tax correspondence folders and for other properties, they are stored in a different folder called tax-exempt folder. Several properties have the tax returns in the tax correspondence files and others have a separate Filed Returns Folder.

### **Recommendation # 11**

Consistent filing of documents results in efficiencies. We recommend that RE review its filing procedures to ensure documents are being consistently stored and archived. All tax-related documents should be filed together in tax correspondence folders as defined in the policy. This should include the letters of determination, Unrelated Business Income Tax issues, tax returns, and any other correspondences related to tax matters.

### **Auditee Response # 11**

Agreed. RE will review its filing procedures to ensure documents are being consistently stored and archived. Implementation to be completed by June 30, 2004.

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## Chapter 2 Policies and Procedures

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### ***2 – E Lack of Policies on Hazardous Material and Accounting of RE Investments***

RE does not have policies that cover the following areas:

- 1) Hazardous Materials (briefly discussed in policy 900-403, Supervision and Termination of Managers and Service Providers)
- 2) Accounting Policy

#### **Recommendation # 12**

The design of the above policies should ensure that managers (both internal and external), consultants, partners or other participants take prudent and careful actions while managing the SBA assets. We recommend below the minimum elements that should be present in the policies mentioned above.

#### **Policy on Hazardous Material in RE Investments**

- a) List of parties required to follow the policy (both internal and external parties)
- b) Applicable Federal and State laws (e.g., Comprehensive Environmental Response, Compensation and Liability Act (CERLA))
- c) Procedures to be followed during the acquisition, financing, and disposition processes.
- d) Required documentation to support compliance requirement

#### **Accounting Policy**

RE needs an accounting policy not because RE has to perform accounting functions but because RE has to communicate accounting standards to its external asset managers who must maintain complete and accurate books and records relating to each managed property. Communicating the policy to all concerned parties will ensure consistency.

Both the RE and the COO should develop the proposed accounting policy. Any changes or updates to the policy must be coordinated with the COO. This policy should bear the signature of the SIO-RE, CIO, and COO, and should include, at a minimum, the following elements:

- a) List of parties required to follow the policy (both internal and external parties).
- b) List of accounting standards to be used and their implementation priority when a conflict exists.

**Chapter 2**  
**Policies and Procedures**

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- c) Capitalization policy. As RE is a specialized industry, there are certain expenses that are unique to the industry that need to be capitalized to adjust the cost of the asset. These expenses, to the extent possible, should be enumerated in the accounting policy.
- d) Method of communicating accounting standards and any changes thereof to all affected parties such as the accounting staff in each THC, etc.

**Auditee Response # 12**

Agreed. Environmental policy is pending and RE will develop an accounting policy with the COO concurrence. RE will obtain COO concurrence on accounting policy issues.

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## Selection, Monitoring and Termination of Service Providers (Excluding Audit and Tax Service Providers)

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### ***3 – A Lack of Centralized Contractual Compliance Monitoring***

As of January 31, 2004, RE has a total of 87<sup>5</sup> active contracts. Responsibilities for contractual compliance monitoring of these contracts are not centralized. Different individuals within the department are responsible for components of what are considered compliance-related matters. One RE Analyst tracks insurance documentation; another RE Analyst tracks regulatory filings; the AGC monitors THC filings; and Portfolio Management staff monitors Asset Manager requirements.

Having different individuals do parts of the compliance monitoring is fine so long as there is an individual who gathers all these parts, puts them all together, highlights the ones that need attention, and brings them to the attention of the SIO-RE. The magnitude of the number of contracts and service providers RE needs to monitor, and the fact that RE's target allocation almost doubled as of July 1, 2003, has created a need for this compliance person to be in place immediately.

#### **Recommendation # 13**

We understand that RE has been attempting to develop a compliance reporting mechanism for sometime now. We recommend that the development of a compliance reporting mechanism be expedited. It should start with the appointment of a compliance person. This recommendation can be implemented without adding personnel to the department because of the following reasons:

- 1) The same individuals will continue doing their part of the compliance monitoring. The compliance person's role is to gather the results of the compliance monitoring from these individuals and then consolidate them.
- 2) RE needs to shift the management of audit and tax activities to the COO as discussed further in Chapter 4 of this report.

#### **Auditee Response # 13**

RE will continue to develop and update compliance reports. Implementation to be completed by September 30, 2004.

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<sup>5</sup> Excludes contracts with six external auditors, which are not captured in SBA's Acorde system.

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**Chapter 3**  
**Selection, Monitoring and Termination of Service Providers**  
**(Excluding Audit and Tax Service Providers)**

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***3 – B Lack of Periodic Review of the List of Pre-approved Service Providers***

Having a list of pre-approved service providers is a good preventive control, i.e., it prevents the use of unacceptable service providers. The effectiveness of this control will continue so long as the list is reviewed and updated on a pre-determined periodic basis.

It is, however, unclear how often RE reviews the universe of potential service providers and what criteria are used in their selection. This may lead to missed opportunities for price adjustments or lost investment opportunities.

**Recommendation # 14**

On a periodic basis, say biennially, RE should formally review its list of pre-approved service providers. The existence of the list of pre-approved service providers, frequency of evaluation, and criteria used to evaluate the pre-approved providers should be defined in an appropriate policy.

**Auditee Response # 14**

Agreed.

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## Monitoring of Investments

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### **4-A *Reconciliation of the Valuation of Real Estate Properties***

RE is very much involved in the valuation process of real estate properties. In instances where there are significant differences in the valuation of a property as determined by the external asset manager and external property appraisers, RE staff tries to mediate and resolve the differences. In certain cases, resolving the differences took a long time and consequently financial statements audits of the THC were delayed.

#### **Recommendation # 15**

We understand that RE has plans to revise the valuation process where an independent third party, specifically qualified to review appraisal information, will review both valuations and make recommendations to RE. This will remove RE as the mediator. We recommend that RE pursue this plan for the following reasons:

- a) Other responsibilities of the RE staff, like monitoring RE investments, may prevent them from giving this activity top priority thereby delaying the financial statement audits.
- b) The independent third party may also provide RE additional information on how well its service providers (asset manager and property appraisers) perform their responsibilities with regards to property valuation.

#### **Auditee Response # 15**

Agreed. Valuation policy that includes the above-described process is written and is pending approval.

### **4-B *Standardized Annual Business Plan***

We understand that RE staff currently reviews more than 40 Annual Business Plans (ABP). With the increase in asset allocation, it is expected that the number of ABPs will increase. The review of ABPs is time consuming, not only because RE staff have to make sure that all information makes sense, but also because each asset manager submits ABP in different formats containing different information.

We reviewed ABPs submitted by Lend Lease, L&B, and Heitman to better appreciate the ABP and the effort that goes with the review process. It took us time to finish the review of three ABPs (with allowance for our not being familiar with the properties reviewed). The review efficiency was further hampered by the differences in format and content in each ABP. The ABP from L&B does not even have a table of contents. Heitman on the other hand submitted two documents, an Asset Strategic Plan prepared by Heitman, and a Business Plan prepared by the property manager.

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## Chapter 4 Monitoring of Investments

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### **Recommendation # 16**

We understand that RE has been trying to standardize the format of the ABPs. We recommend that this be given top priority to help streamline the review process. Most of the information we found most useful was in the ABP prepared by Lend Lease. For RE management's easy reference, we summarized in Appendix D information RE may consider incorporating into its standardized ABP.

We also recommend that current information on all bank accounts maintained for each managed property be included in the ABP. This recommendation is discussed further in on page 19 of this report. Information should include, at a minimum, the type of existing bank accounts, balance as of report date, and list of authorized signatories. This will help RE monitor all bank accounts, especially the list of authorized signatories.

### **Auditee Response # 16**

Agreed.

## **4-C Review of the Cash Distribution Process**

### **Document Late Distribution of Funds**

When cash distributions are not received by the expected date, RE Investment Analyst II contacts the responsible external AM either by phone or by e-mail. When RE Investment Analyst II contacts AM by phone, an audit trail is not created. Without an audit trail, it will be difficult for anyone in RE to remember who frequently sends funds late.

To help RE monitor the performance of the AM, it is important that information such as delays in sending cash distributions is documented. Late distribution of funds, when done repeatedly, could be an indicator of a problem and therefore should be brought not only to the attention of the portfolio managers but also to SIO-RE.

### **Recommendation # 17**

We recommend that communication with AM on late distribution of funds should be by e-mail, with a copy to the portfolio manager in charge of the property to keep everybody in the loop. The e-mail that will support the final resolution should be maintained in RE's file on the AM so that it can be retrieved during the evaluation process.

RE should also develop a mechanism to monitor AM performance in regards to late distributions. Repeated late distributions should be reported to SIO-RE.

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## Chapter 4 Monitoring of Investments

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### **Auditee Response # 17**

Agreed.

### **Monitor of Overdraft Fee Assessed to Asset Managers**

There are instances where AMs are assessed overdraft fees for late distribution of funds. These create additional work for the RE Investment Analyst II as she monitors and collects these overdraft fees.

### **Recommendation # 18**

We agree with RE that, overdraft fees should be monitored and collected. While SBA cannot avoid the additional work created by assessing overdraft fees, we suggest that this responsibility be transferred to the COO, as this is an accounting function.

### **Auditee Response # 18**

Agreed.

## **4-D Monitor Bank and Escrow Accounts**

### **Update Signatories on Bank Accounts**

RE staff, who are officers of THC's, are also authorized signatories on the THC's bank accounts. It is unclear, however, whether the list of authorized signatories is updated when there is a change in personnel, i.e., personnel of RE, asset manager, and property manager. Based on the records made available to us, Luanne Good left RE to join Fixed Income in 1999, but is still a signatory in some of the THC's bank accounts.

When the list of authorized signatories on bank accounts is not kept current, SBA is exposed to unnecessary risks. It is therefore imperative that the list is updated immediately whenever there is a change in personnel.

### **Recommendation # 19**

It is possible that the list of signatories in the possession of the THC's bank is current but that a copy is not provided to RE. However, we cannot overemphasize the importance of making sure that the list of people who have access to THC's cash is limited to authorized individuals only. One effective way to do this is to keep the list of authorized signatories current.

## Chapter 4 Monitoring of Investments

We recommend that:

- As soon as practicable, request all asset managers to review the list of authorized signatories on THC's bank accounts to ensure they are current and then submit to RE the updated list.
- Moving forward, assign the responsibility of updating the list of authorized signatories to the AM. To monitor AM's compliance to this requirement without creating additional work to anybody in RE, require AMs to include current banking information in their ABP, as discussed on pages 17 and 18 of this report.
- Review the type of access its staff has on these bank accounts. Consideration should be given to requiring any withdrawal done by RE staff to require two signatures.

### **Auditee Response # 19**

Agreed. SBA employees will no longer be signatories on corporate bank accounts.

### **Close Bank Accounts After Disposition of Underlying Property**

It was noted that there are seven THC's that continue to hold cash after the disposal of underlying property. Five of these THC's have held the cash longer than 12 months. The other two THC's have approached the 12-month period.

<u><b>THC's Without Property</b></u>	<u><b>Date Underlying Asset Was Sold</b></u>	<u><b>Balance as of 3/31/03</b></u>	<u><b>Balance as of 12/31/03</b></u>
Bel Air Mobile, J.V.	12/98	US\$173,530.00	US\$179,371.00
Shea 90 Corporation	06/99	21,659.00	22,100.00
Connecticut Avenue, 1330	01/01	55,596.87	100,631.00
Caribbean Avenue, Inc.	12/01	42,988.03	0.00
Carol Stream Warehouse, LLC	06/02	24,735.00	0.00
Milk Street, 50	10/02	84,438.67	28,439.00
Rocky Point Drive, 2502	10/02	276,298.00	0.00
		<u>US\$679,245.57</u>	<u>US\$330,541.00</u>

We understand that the checking accounts are kept open until all accrued expenses are paid and the final cash distribution has been made.

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## Chapter 4 Monitoring of Investments

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We believe that keeping these accounts open for a long period of time is exposing SBA to unnecessary risks for the following reasons:

- It is unclear whether the list of authorized signatories for these bank accounts is current.
- We are unsure whether these bank accounts are now inactive. If they are inactive, we do not know the policy of the depository banks on inactive accounts, i.e., if they can garnish part of the balance for maintaining the inactive account.
- Audits for these THCs are discontinued after the majority of activities have been completed.

### **Recommendation # 20**

To help strengthen the system of internal control over cash, we recommend that:

- As soon as practicable, close the bank accounts and transfer the funds to SMA2 (cash portfolio of RE).
- Moving forward, close bank accounts of THCs without underlying property once the warranty and representation period has lapsed. If additional expenditures will be incurred due to a pending litigation or settlements, these can be paid directly from SMA2 just as during the acquisition phase.

### **Auditee Response # 20**

Agreed. Bank accounts will be closed upon expiration of representations and warranties post disposition.

### **Monitor Escrow Accounts**

Based on specific requirements of either a lender, jurisdiction or other circumstance, an impound account (also referred to as escrow accounts) might be established to escrow funds to pay certain anticipated items such as taxes as a result of a real estate transaction.

We understand that typically SBA does not have items escrowed at closing. But when SBA has to escrow funds, RE expects outside lead counsel to monitor escrow accounts and return any unused funds to SBA. An example is when SBA sold the property owned by one of its THCs, Carol Stream Warehouse, LLC.

About US\$36k was escrowed for the anticipated stamps/tax due and there is a note in the closing statement that says, *“These items are being escrowed by First American Title to cover the anticipated transfer stamps/transfer tax due for state, county and local*

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## Chapter 4 Monitoring of Investments

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government. In the event the documents are accepted for recording without the tax liability, these funds will be refunded to Seller.” It was assumed that there was a tax liability and that there was no refund needed.

### **Recommendation # 21**

Impound accounts are like “restricted” cash accounts that should be monitored to ensure proper disbursements. RE should establish procedures that would create audit trail.

### **Auditee Response # 21**

Agreed. RE will establish procedures which monitor proper and timely disbursement of funds held in escrow accounts.

#### **4-E Shift Audit and Tax Activities**

RE is presently responsible for the audit of directly-owned<sup>6</sup> real estate properties, including the monitoring of the filing and payment of required federal and state taxes. Activities such as hiring of external auditors, monitoring the progress of the audit, reviewing and approving the draft financial statements, and ensuring that required tax returns are filed on a timely basis not only require a certain level of experience but are also very time consuming.

### **Recommendation # 22**

We recommend that audit and tax activities be shifted to the COO. Shifting these activities to the COO will allow RE to have a full time compliance staff without hiring an additional full time employee. In addition, the segregation of duties will help strengthen SBA’s system of internal control.

### **Auditee Response # 22**

RE and CIO believe this is an integral part of the investment monitoring function and would like to retain the function. To address the concern as discussed by the OIA, RE will implement the following:

- 1) All contracts in connection with audit and tax service for the corporations will be staffed through the COO for concurrence.
- 2) A copy of all audit reports will be provided to COO and OIA.

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<sup>6</sup> Directly-owned real estate properties are held by title holding companies wholly-owned by the SBA.

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## Chapter 4 Monitoring of Investments

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### **4-F Streamline the Payment Process of Manager Fees**

A Senior Accountant (SA) in COO-Accounting Department receives invoices directly from the AMs. For each property managed, AMs would send an invoice, supporting documents, and wire instruction. If an AM manages six properties, the SA would receive six invoices, six supporting documents, and six identical wire instructions. However, AMs do not attach a summary of the invoices submitted. As a result, SA has to spend time preparing a summary, in addition to performing the recalculation and comparing the invoices against the underlying asset management contracts. She then copies the summary on two separate documents.

1. On a memorandum for the SIO-RE to initial, to indicate his approval of the payment of the management fees and the transfer of funds from SMA2 to SMH1. Wire instructions are also retyped in this memorandum.
2. On a document for the Senior Operating Officer-Accounting and Financial Operations (SOO-AFO) to sign, to indicate he reviewed the management fees as to accuracy and completeness of the supporting documents.

This practice of preparing two documents containing almost the same information creates additional work and increases the possibility of committing errors.

#### **Recommendation # 23.**

We recommend streamlining the processing, review, and approval process for management fee invoices. Requiring AMs to attach a summary when submitting invoices for management fees is going to help streamline the process. SA, in consultation with the SIO-RE and SOO-AFO, should design a summary format that will address her needs, and the requirements of the SIO-RE and the SOO-AFO. After agreeing on the design of the summary format, RE is responsible for communicating it to all AMs.

Preparing one document, instead of two, where SIO-RE and SOO-AFO can both sign will also streamline the process. We attach a suggested format for consideration. Please see Appendix E.

#### **Auditee Response #23**

Agreed. The streamlined process has been implemented.

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## Disposition of Investments

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### **5-A *Monitor the Dissolution of Title Holding Companies***

Once a property is sold, the THC that held the property continues to exist for an unspecified period of time. During that period, AGC sends the RE Investment Analyst II a disposition checklist that she uses to create a Sold Property Status Report for the purpose of assisting her in arranging for the THC's final audit and preparation of needed tax returns. RE Portfolio Manager will continue to receive activity reports from the AM for the purpose of monitoring activities and the General Counsel's office will continue to monitor the filing of annual corporate returns until the THC is dissolved. At the present time, there is no one individual assigned the responsibility of ensuring that when all activities have been completed, a timely notification is sent to the AGC to start the dissolution process.

When inactive title holding companies are allowed to remain open, the level of monitoring tends to be less. When this happens, the level of internal controls on any remaining assets, such as residual cash and activities done in the corporation's name, would also be less.

#### **Recommendation # 24**

We recommend that RE assign the responsibility for monitoring the completion of the dissolution checklist to the suggested compliance person discussed on page 15 of this report. This compliance person, after consulting the SIO-RE, would then notify the AGC that all activities have been completed and the THC can now be dissolved.

#### **Auditee Response # 24**

Agreed. The OGC is assigned the responsibility for monitoring the dissolution checklist. The OGC will periodically submit their checklist with their total compliance package as required to the RE compliance person.

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## Other Matters

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During a process review, it is not uncommon to find matters that may not fall into any process that need to be brought to the attention of management. These matters are discussed in this chapter.

### **6-A Staffing of Contracts**

SBA Policy 10-031 (formerly 10-018), Contracts, states that the OGC will prepare a staffing sheet and will staff the proposed contract through the appropriate parties at the SBA. “Appropriate parties” is not defined in the policy but usually include the CIO, COO (in certain situations), and the General Counsel.

The purpose of the policy is to ensure that SBA contracts accurately and adequately reflect the goals, objectives, and policies of the impacted entities within the SBA and that each individual contract has been fully coordinated within the SBA. All asset classes, except RE, utilize the staffing process for all contracts signed on behalf of the SBA.

Although Policy # 10-031, Contracts, states that the OGC will prepare a staffing sheet and will staff the proposed contract through the appropriate parties at the SBA, this matter is being brought out in this report because primary responsibility for compliance with Policy 10-031 is assigned to both the SBA General Counsel and Executive Service staff. For RE contracts, policy compliance is the responsibility of the SIO-RE.

#### **Recommendation # 25**

We recommend that all RE contracts follow the same staffing procedures utilized by all other asset classes, including those relating to an individual property in which the Executive Director has delegated authority to the SIO-RE. All contracts should comply with the requirement of SBA Policy 10-031, regardless of who executes the contract.

#### **Auditee Response # 25**

Agreed. RE contracts will be staffed according to the SBA policy.

### **6 – B Study Done by Tillinghast Towers Perrin**

Tillinghast Towers Perrin issued a report dated March 1997 on the review of investment property insurances. The study presented the following findings and recommendations:

#### **On the Insurance Program**

The Board should look to implement its own insurance program to provide consistent coverage across its investment property driven by its own needs for insurance protection at those properties.

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## Chapter 6 Other Matters

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We estimate that the Board may save up to US\$500k in insurance premiums through its own program. The program would allow the Board to benefit from its ability to retain risk (up to its tolerance); its investment in high quality low risk property; and its good loss experience.

### On the Investment Advisors' Insurances

The investment advisors are required to carry insurance for their workers compensation, general liability, automobile liability, fidelity bond, and professional liability exposures. For the most part the advisors complied with the insurance requirements, although the following should be addressed:

- b) Prudential is self-insured for Errors & Omissions. The Board should make a decision whether Prudential's financial strength is sufficient to support its responsibilities in the absence of insurance.
- c) L & B's Errors & Omissions policy should be extended to include failure to maintain insurance. If the policy cannot be extended, L & B should provide the Board with an indemnification agreement in the event that Errors & Omissions insurance is not available.
- d) Heitman and L & B all purchase general liability insurance under the same program as that applying at the properties, the premium for which is paid by the Board. This is contrary to the terms of the advisory agreements. The Board must decide whether this is acceptable, or require a separate program. If the Board effects its own insurance program, it will overcome the problem.

### On Property Management Contracts

The terms of the property management contracts prepared by the investment advisors vary considerably by property. In many cases, they provide little if any indemnification protection to the Board, and in some cases, they confer liabilities on the Board beyond that which would exist in the absence of the contract. They do not appear to have been subject to any form of risk management review, to protect the Board's interests.

The Board should require all property management contracts to contain the following provisions:

- e) Standard indemnification provisions requiring the manager to indemnify the Board for willful misconduct, negligence, breach of agreement and non-performance of obligations and duties.

**Chapter 6**  
**Other Matters**

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- f) Insurance requirements to the same level as the investment advisors (with the exception of Errors & Omissions) due to the similar risk exposure.

Actions Taken by RE

RE advised us that the investment managers were contacted by RE's consultant, provided copies of the report, and the investment managers subsequently corrected and complied with the relevant recommendations.

OIA Comment

Investment managers are not in a position to address recommendations (a) and (e). We found no audit trail that these two recommendations were addressed.

**Recommendation #26**

Moving forward, all recommendations on similar review or study should be addressed and recommended actions to be taken should be approved by the CIO and/or the Executive Director.

**Auditee Response #26**

Agreed.

## Prior Audits / Reviews

In the past four years, RE's activities were reviewed by two external consultants, in varying degrees. Independent Fiduciary Services, Inc. performed an operational audit, and F.M. Doyal, CPA, reviewed a specific issue relating to an audit of one of the THC's.

### 7-A Independent Fiduciary Services, Inc.

In October 1999, SBA hired IFS to perform an operational audit of RE to evaluate three major themes:

1. Effectiveness of the real estate program and practices in terms of daily operations
2. Adequacy of internal controls at the level of SBA and staff
3. Whether or not any perceived inadequacies contribute to the program's historic underperformance relative to NCREIF index.

The audit resulted in 36 recommendations with various levels of priority. The SIO-RE, at the direction of the former Executive Director, responded to the recommendations, and then developed a follow-up plan. The follow-up plan that was submitted to the former Executive Director had the recommendations grouped into the following categories:

Required no follow-up	29
Required RE action	5
Required top management action	<u>2</u>
	<u>36</u>

Based on the follow-up plan developed by RE, the Compliance Office<sup>7</sup> conducted a follow-up review in 2002 on the five items that required RE action. No report was issued. Of the five items that required RE action, three items are still open.

#### *Open Items:*

1. The risk assessment is not rigorous at the level of the whole portfolio. Explore more rigorous risk assessment through some external consultant, such as the one already used, PP & R.

#### Status

Open. SIO-RE said that the recommendation requires budget funding, which has not been obtained.

<sup>7</sup> Prior to the establishment of the OIA in June 2002, the SBA had a Compliance Office (July 1999 – June 2002).

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## Chapter 7 Prior Audits / Reviews

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### **Recommendation #27**

Part of RE (and consequently SBA) fiduciary responsibility is to ensure there is a rigorous risk assessment at the total portfolio level. This will demonstrate how RE (consequently SBA) exercises prudence in shaping up the asset class, i.e., composition of the portfolio with regard to diversification, current return, projected return, etc.

### **Auditee Response #27**

Agreed. Please refer to response to recommendation # 1.

### **7-B F. Marvin Doyal, CPA**

In 2002, after a conversation with the soon to depart RE Analytics Manager, the then Chief Financial Officer hired F. Marvin Doyal, CPA, to issue a statement of fact concerning the late filing of the December 31, 2000 financial statements of South Beach Marina, Inc., one of RE's THCs.

In his report, Doyal noted that one audit firm that performed annual financial statements audits did not spend much time on-site. The audit firm (Resnick, Fedder, and Silverman) has no plans to visit the properties or the asset manager. In Doyal's opinion, SBA properties, especially operating properties, may not be receiving sufficient independent scrutiny and issued the following recommendations:

1. Pursue Bennett's proposal to hire audit firms in the same general geographic area as the properties as they would have a better understanding of unique compliance matters and other conditions.

### **Status**

Open - SIO-RE has backed away from geographic synergy idea.

### **Recommendation # 28**

We agree with the recommendation of Doyal. Another option is to hire a national auditing firm that has offices and or expertise in the same area as the properties.

### **Auditee Response # 28**

Agreed. RE engages firms experienced in the geographic location of the property, however, RE does not require the auditor to be physically located in the same locale as the property. RE feels that the current audit program is sufficient when

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## Chapter 7 Prior Audits / Reviews

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combined with other management and oversight activities currently existing.

2. In cases where the audit firm does not perform extensive compliance work or even visit the property site, the SBA should consider engaging a firm that would travel to the location and perform an in-depth on-site operational evaluation. These in-depth audits should be performed every two or three years.

### Status

Open – SIO-RE feels current audit program is sufficient when combined with other management and oversight activities currently existing.

### **Recommendation # 29**

We want to clarify that financial statements audits are not compliance audits and therefore external auditors should not be expected to perform extensive compliance work unless engaged to do so. The focus of financial statements audits is the financial statements of each THC.

SBA's peers have their internal auditors perform compliance audits. CalPERS, one of SBA's peers, outsources this activity. We will evaluate this recommendation when planning its internal audit activities for the fiscal year 2004-2005. Meantime, RE should explore the possibility of obtaining a copy of the AM's internal audit reports for each property of the SBA that they<sup>8</sup> audit.

### **Auditee Response # 29**

Agreed that a compliance report should be performed on each property. RE will develop a procedure requiring each investment manager, as SBA fiduciary, to provide RE with a compliance report on each property management agreement.

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<sup>8</sup> AM's internal audit department