



**New Jersey State Legislature
Office of Legislative Services
Office of the State Auditor**

**Department of the Treasury
Division of Property Management and Construction
Building Leases**

July 1, 2010 to July 31, 2012

**Stephen M. Eells
State Auditor**

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The Honorable Sheila Y. Oliver
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Mr. Albert Porroni
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Enclosed is our report on the audit of the Department of the Treasury, Division of Property Management and Construction for the period of July 1, 2010 to July 31, 2012. If you would like a personal briefing, please call me at (609) 847-3470.

A handwritten signature in black ink, appearing to read "Stephen M. Eells".

Stephen M. Eells
State Auditor
November 26, 2012

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Scope

We have completed an audit of the Department of the Treasury, Division of Property Management and Construction (the division) for the period July 1, 2010 to July 31, 2012. Our audit included activities in the state's General Fund. The division is responsible for the operation and maintenance of state-owned facilities in the Capitol Complex, the leasing of office and warehouse space, the sale and acquisition of state-owned real property, and the procurement and project administration of all professional and construction services for state-owned facilities. Our audit was limited to the procurement and management of leases acquired by the division. Total expenditures for leases were \$240 million for fiscal year 2012.

Objectives

The objectives of our audit were to determine whether General Fund transactions were related to the lease agreements, were reasonable, and were recorded properly in the accounting system. Additional objectives were to determine the reasonableness of lease escalations, the adequacy of the lease procurement process, and the efficient space utilization of state-owned and leased properties. We also tested for resolution of significant conditions noted in our prior report dated January 12, 2006.

This audit was conducted pursuant to the State Auditor's responsibilities as set forth in Article VII, Section I, Paragraph 6 of the State Constitution and Title 52 of the New Jersey Statutes.

Methodology

Our audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States.

In preparation for our testing, we studied legislation, the administrative code, circular letters promulgated by the Department of the Treasury, and policies of the agency. Provisions we considered significant were documented and compliance with those requirements was verified by interview, observation, and through our testing of financial transactions. We also reviewed financial trends and interviewed agency personnel to obtain an understanding of the programs and the internal controls.

A nonstatistical sampling approach was used. Our samples of financial transactions were designed to provide conclusions about the validity of transactions, as well as internal control and compliance attributes. Sample populations were sorted and transactions were judgmentally selected for testing.

To ascertain the status of significant findings included in our prior report, we identified corrective action, if any, taken by the agency and walked through the system to determine if the corrective action was effective.

Conclusions

We found that the General Fund transactions included in our testing were related to the lease agreements, were reasonable, and were recorded properly in the accounting system. We also found lease escalations were reasonable, the lease procurement process was adequate, and the utilization of state-owned and leased space was efficient. In making these determinations, we found certain internal control weaknesses and inefficiencies meriting management's attention. We also found the agency resolved the significant issues noted in our previous report.

Site Visits

Periodic or annual site visits are not performed for all state leased properties.

The division conducts site visits of leased office space to inspect the condition of the properties. New Jersey Administrative Code 17:11-2.2 states that the division make periodic site visits to leased property and report to the State Leasing and Space Utilization Committee instances of improper use of leased space by a tenant agency, including misuse, abuse, and neglect, which pose safety problems and or damage to the building space by any agency employee, client and/or visitor. As of June 14, 2012, 30 of 248 total office leases had not been visited in 12 to 23 months. As a result of the division not visiting the leased properties at least annually, certain safety and security issues may be neglected. Management contends there is a shortage of staff within the unit that performs the site-visit function.

Recommendation

We recommend the division reallocate existing personnel so that site visits can be completed timely.



Escalations

Lease escalation clauses should be standardized.

An escalation is an upward rate adjustment based on an increase in specified factors identified in the lease contract. These factors usually pertain to such items as taxes, operating expenses, and utility expenses. The state acknowledges increases may occur and agrees to pay a pro rata share of these increased costs based upon the percentage of occupancy of the building. At July 2, 2012 there were 295 active leases. The division does not keep track of the number of leases that contain escalation clauses. We identified 170 leases with escalation reimbursement clauses. Fiscal year 2012 escalation payments totaled \$10.6 million.

We performed tests to determine if escalations paid per square foot were reasonable. Of 12 sampled leases, we found two had escalation rates that were 81 percent and 65 percent higher than the averages in our sample. These higher rates were the result of higher janitorial, landscaping, and administrative costs. In one of these leases, the landlord hired family members to perform janitorial and administrative duties. Although the state can dictate what is allowable by the lease terms, it cannot dictate who the landlord uses for services. Best practices suggest that lease clauses be as specific as possible. The division does not use standard lease escalation language, and lease terms for allowable escalation costs have been too broadly interpreted. As a result, the state may overpay for services.

Recommendation

We recommend lease contracts with escalation clauses contain standardized language giving the state the ability to limit operating and administrative expenditures to reasonable amounts. We further recommend the division identify those leases with escalation clauses.



Internal Control Weaknesses

Controls over escalation reimbursements can be improved.

We noted the following internal control weaknesses over lease escalation payments that would ensure services were actually provided and reported to the division in a timely manner.

- During our review, we noted questionable, hand-written third-party documentation being used to support the landlord's cost. The division accepted this type of documentation as valid and processed payment for reimbursement. Better scrutiny and skepticism of questionable third-party invoices along with the requirement of the submission of vendors' IRS Form 1099-MISCs may provide the division with better assurance that services reported by the landlord were actually rendered for the amounts reimbursed.
- Leases with escalation clauses require that the landlord submit escalation expenses within a certain amount of time after the end of a lease period. We noted one instance in fiscal year 2011 where a landlord submitted a lump sum escalation package totaling \$1.2 million for expenses incurred from 1994 to 2010. Better monitoring of escalations would ensure that escalation costs are properly accounted for.

Recommendation

We recommend the division strengthen controls over escalations by requiring landlords to submit trustworthy documentation, including IRS Form 1099-MISCs, to support services provided by their vendors. We further recommend monitoring of escalations to ensure escalation costs are accounted for timely.





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CHRIS CHRISTIE
Governor

KIM GUADAGNO
Lt. Governor

ANDREW P. SIDAMON - ERISTOFF
State Treasurer

MEMORANDUM

TO: John J. Termyna, Assistant State Auditor
Office of Legislative Services

FROM: David Ridolfino, Associate Deputy State Treasurer

DATE: November 14, 2012

SUBJECT: **FY2012 AUDIT REPORT RESPONSE**
Division of Property Management and Construction
Building Leases July 1, 2010 to July 31, 2012

On behalf of State Treasurer Andrew P. Sidamon-Eristoff, please accept this memorandum in response to your office's audit of the Department of the Treasury, Division of Property Management and Construction (DPMC) for the period of July 1, 2010 to July 31, 2012. DPMC's management confirms, to the best of its knowledge and belief, that the representations made to you during your review are correct. DPMC agrees with the audit and has provided the following responses to each of the audit's observations/recommendations:

Site Visits

Periodic or annual site visits are not performed for all state leased properties.

The division conducts site visits of leased office space to inspect the condition of the properties. New Jersey Administrative Code 17:11-2.2 states that the division make periodic site visits to leased property and report to the State Leasing and Space Utilization Committee instances of improper use of leased space by a tenant agency, including misuse, abuse, and neglect, which pose safety problems and or damage to the building space by any agency employee, client and/or visitor. As of June 14, 2012, 30 of 248 total office leases had not been visited in 12 to 23 months. As a result of the division not visiting the lease properties at least annually, certain safety and security issues may be neglected. Management contends there is a shortage of staff within the unit that performs the site-visit function.

Recommendation

We recommend the division reallocate existing personnel so that site visits can be completed timely.

Division of Property Management and Construction Response

DPMC is considering reallocation of existing personnel to the Lease Compliance unit as well as simultaneously pursuing the hiring of new staff to be dedicated to lease compliance.

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We performed tests to determine if escalations paid per square foot were reasonable. Of 12 sampled leases, we found two had escalation rates that were 81 percent and 65 percent higher than the averages in our samples. These higher rates were the result of higher janitorial, landscaping, and administrative costs. In one of these leases, the landlord hired family members to perform janitorial and administrative duties. Although the state can dictate what is allowable by the lease terms, it cannot dictate who the landlord uses for services. Best practices suggest that lease clauses be as specific as possible. The division does not use standard lease escalation language, and lease terms for allowable escalation costs have been too broadly interpreted. As a result, the state may overpay for services.

Recommendation

We recommend lease contracts with escalation clauses contain standardized language giving the state the ability to limit operating and administrative expenditures to reasonable amounts. We further recommend the division identify those leases with escalation clauses.

Division of Property Management and Construction Response

DPMC agrees with the OLS audit that Lease Escalation clauses be standardized to give the State the ability to limit operating and administrative expenditures to reasonable amounts. In fact, as older leases expire, the new leases contain the updated standardized language affording that flexibility. The two leases cited in the audit are among the division's older leases that do not yet contain updated language.

DPMC will identify and track those leases with escalation clauses.

Internal Control Weaknesses

Controls over escalation reimbursements can be improved.

We noted the following internal control weaknesses over lease escalation payment that would ensure services were actually provided and reported to the division in a timely manner.

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Recommendation

We recommend the division strengthen controls over escalations by requiring landlords to submit trustworthy documentation, including IRS form 1099-MISCs, to support services provided by their vendors. We further recommend monitoring of escalations to ensure escalation costs are accounted for timely.

Division of Property Management and Construction Response

DPMC lease escalation staff will continue to review and question all typed as well as hand-written third party documentation used to support the landlord expense costs. DPMC's Office of Escalation Review will not authorize any payments without receiving original copies of invoices to support the landlord's request for reimbursement. DPMC will similarly continue to reinforce and emphasize timely reporting of escalation expenses by landlords and disallow any requests inconsistent with contractual agreements.

c: Andrew P. Sidamon-Eristoff, State Treasurer
Robert Romano, Deputy State Treasurer
Jim Leonard, Chief of Staff
Steve Sutkin, Director, Division of Property Management and Construction