



**CITY OF COLORADO SPRINGS
OFFICE OF THE CITY AUDITOR**

**09-03 - COLORADO SPRINGS UTILITIES
PLAZA LEASE OPERATING AGREEMENT**

PUBLIC REPORT

FEBRUARY 11, 2009

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City of Colorado Springs



Colorado Springs Utilities
It's how we're all connected



Memorial Health System



Office of the City Auditor

Public Report

Date: February 11, 2009

To: Honorable Mayor and Members of City Council

Re: 09-03 - Colorado Springs Utilities – Plaza Lease Operating Agreement

We performed an audit of the Operating Agreement between SCMC No. 1, LLC (SCMC), the City of Colorado Springs on behalf of Colorado Springs Utilities (Springs Utilities), and Plaza Two Condominium Association, Inc. (the Association).

The objective of this audit was to review the overhead calculations, allocations, and other components of the Operating Agreement as it relates to the Springs Utilities presence in the South Tower of the Plaza of the Rockies. Springs Utilities owns a portion of the second and sixth floors, and the third through fifth floor of the South Tower at the Plaza of the Rockies. Our audit included the years of 2006 and 2007.

We conclude the original overhead calculations and allocations were incorrect and not in compliance with the Operating Agreement. As items were identified during our review, all parties worked towards swift resolution to arrive with Springs Utilities paying the correct amount for their share of the services provided. In the pages that follow, we have identified these issues as well as our recommendations on how controls can be improved.

As always, feel free to contact me if you have any questions.

Sincerely,

Jeff Litchfield
City Auditor

cc: Jerry Forte, Chief Executive Officer
Tom Black, Officer, Energy Services Division
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Introduction

09-03 – Colorado Springs Utilities Plaza Lease Operating Agreement

PUBLIC REPORT

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Abbreviations and Acronyms used in this Report

Agent	Nor'wood Limited, Inc.
Association	Plaza Two Condominium Association, Inc.
SCMC	SCMC No. 1, LLC
Springs Utilities	Colorado Springs Utilities

Introduction

AUTHORIZATION

We performed an audit of the Operating Agreement between SCMC No. 1, LLC (SCMC), the City of Colorado Springs on behalf of Colorado Springs Utilities (Springs Utilities), and Plaza Two Condominium Association, Inc. (the Association). We conducted this audit under the authority of Chapter 1, Article 2, Part 7 of the City Code, and more specifically parts 703, 705, and 706, and Part 709 (B) and (C) of the Code, which state:

1.2.703: ENSURE PUBLIC ACCOUNTABILITY:

The City Auditor shall ensure that administrative officials are held publicly accountable for their use of public funds and the other resources at their disposal. The City Auditor shall investigate whether or not laws are being administered in the public interest, determine if there have been abuses of discretion, arbitrary actions or errors of judgment, and shall encourage diligence on the part of administrative officials.

1.2.705: DETERMINE EFFECTIVENESS AND EFFICIENCY OF PROGRAMS:

The City Auditor shall determine the extent to which legislative policies are being efficiently and effectively implemented by administrative officials. The City Auditor shall determine whether City programs are achieving desired objectives. The City Auditor shall review the administrative control systems established by the enterprises, department or group managers and by the City Manager, Utilities Executive Director and Memorial Hospital Executive Director and determine whether these control systems are adequate and effective in accomplishing their objectives.

1.2.706: EXAMINE BOOKS, RECORDS:

The City Auditor shall examine and inspect all books, records, files, papers, documents and information stored on computer records or in other files or records relating to all financial affairs of every office, department, group, enterprise, political subdivision and organization which receives funds from the City or under the direct or indirect control of the City Council. The Auditor may require any person to appear at any time upon proper notice and to produce any accounts, books, records, files and other papers pertaining to the receipt or expenditure of City funds, whether general or special. If that person fails to produce the papers, then the Auditor may request Council approval to search for and take any book, paper or record in the custody of that person or public official.

1.2.709: MAKE PERIODIC REPORTS TO COUNCIL:

- B. Information of proposals deemed expedient in support of the City's credit, and recommendations for lessening expenditures, for promoting frugality and economy in City affairs and for an improved level of fiscal management;
- C. Matters concerning the effectiveness and efficiency of the programs and operation of the City;

Introduction

ORGANIZATIONAL PLACEMENT

The Office of the City Auditor is structured in a manner to provide organizational independence from the entities it audits. This independence is accomplished by the City Auditor being appointed by and reporting directly to the City Council. The focus of this audit was the Operating Agreement between Springs Utilities, SCMC, and the Association. Springs Utilities is under the direction of their Chief Executive Officer, who is also appointed by City Council.

SCOPE AND METHODOLOGY

The objective of this audit was to review the overhead calculations, allocations, and other components of the Operating Agreement as it relates to the Springs Utilities presence in the South Tower of the Plaza of the Rockies. Our audit included the years of 2006 and 2007.

We conducted our audit in accordance with the *International Standards for the Professional Practice of Internal Auditing*, a part of the Professional Practices Framework promulgated by the Institute of Internal Auditors. Our audit included such tests of records and other supporting documentation as we deemed necessary in the circumstances. Sufficient competent evidential matter was gathered to support our conclusions.

BACKGROUND

In 2001, Springs Utilities purchased a portion of the second floor and the third through fifth floors of the South Tower at Plaza of the Rockies. In 2003, Springs Utilities purchase a portion of the sixth floor, arriving at the configuration in place during our audit.

There were several agreements executed in 2001, and some of those agreements have since been modified. A summary of the agreements we reviewed were:

- April 25, 2001 - an Operating Agreement was entered into between Springs Utilities, SCMC, and the Association. Springs Utilities purchased Units 2-A, 3, 4, and 5 of Plaza Two with the remainder being purchased by SCMC.
- April 25, 2001 – a Supplemental Agreement was entered into between Springs Utilities and SCMC.
- April 25, 2001 – a Management Agreement was entered into between the Association and Nor'wood Limited, Inc. (the Agent).
- October 2003 – the First Amendment to Supplemental Agreement was entered into between Springs Utilities and SCMC.

To paraphrase the agreements, as an owner of the property, Springs Utilities is charged a portion of the administrative overhead charges related to maintaining the building. These charges are assessed by the amount of square footage that Springs Utilities occupies within the building.

Introduction

There are three different categories of charges that are allotted to Springs Utilities, "Category A," "Category B," and "Category C," which are described as follows:

- "Category A" charges are allocated based on the ratio of Springs Utilities leasable square footage to the total building's leasable square footage.
- "Category B" expenses are allocated based on the ratio of the leasable square footage actually occupied in each Owner's Units throughout the year to the total leasable square footage in all Units of the building.
- "Category C" expenses are paid 100% by Springs Utilities. These expenses are specific only to the area that Springs Utilities occupies.

Springs Utilities prepays for the year their portion of expenses for the South Tower based on an estimate that is prepared by the Association. In 2006, it was estimated that Springs Utilities portion of the expenses would be \$574,681.93 and in 2007 it was estimated their portion would be \$583,122.04. The Association then takes the total estimated amount for the year and divides it by 365 days to get a per day charge that Springs Utilities pays each month to the Association.

OVERALL OPINION

We conclude the original overhead calculations and allocations were incorrect and not in compliance with the Operating Agreement. As items were identified during our review, all parties worked towards swift resolution to arrive with Springs Utilities paying the correct amount for their share of the services provided. In the pages that follow, we have identified these issues as well as our recommendations on how controls can be improved.

For the findings that follow, we have made no determination as to which findings are more important than others are. Therefore, the findings are not listed in order of importance.

Findings, Recommendations and Responses

1. SCMC did not complete the Annual Reconciliation in accordance with the time frame specified in the Agreement.

Section E of the First Amendment to the Supplemental Agreement states that the Association will provide SCMC and Springs Utilities an itemized breakdown of the actual expenses incurred by the Association for the preceding calendar year by February 15. SCMC then had two months to review and adjust “Category A” and “Category B” expenses to reflect actual ownership and occupancy of the building throughout the year. Therefore, the Annual Reconciliation should have been completed by April 15 of the year following the activity.

Springs Utilities did not receive a finalized Annual Reconciliation for 2006 or 2007 until August 27, 2008.

Auditor’s Recommendation:

We recommend The Association develop procedures to ensure the annual reconciliation can be completed by February 15 of each year as stated in the contract. We also recommend that SCMC complete their review and adjustments by April 15 of each year.

Springs Utilities Response:

Springs Utilities agrees with the Office of the City Auditor’s recommendation. The Facilities Management and Security Operations Department will institute a semiannual review of actual expenditures vs. budgeted appropriations to ensure that the annual reconciliation will be completed by February 15 as stated in the contract and that any necessary adjustments are completed within two months of the review. Springs Utilities will abide by the terms of the *First Amendment to Supplemental Agreement* section F, *Settle-up...* which states overpays and shortfalls will be paid “within 30 days following its receipt of the reconciliation.” And, per section 22.1 (b) vi, *Late Charges and Interest*, in the *Declaration of Condominium for Plaza Two a Condominium Colorado Springs, Colorado*, charges may be incurred for un-reimbursed assessments or amounts required to be paid that are over 30 days past due.

The Association’s Response:

We agree with the City Auditor’s recommendation and Springs Utilities’ Response. We need to have procedures in place to comply with the applicable time requirements, and are currently implementing those procedures.

Findings, Recommendations and Responses

2. The terms of the Supplemental Agreement between Springs Utilities and SCMC were not being followed and effectively monitored.

The following are instances where the agreements were not followed and/or effectively monitored.

- A. Section F of the First Amendment to the Supplemental Agreement states that if Springs Utilities actual payments of its share of expenses per the budget exceed what they should have paid as shown by the reconciliation, the amount of the overpayment will be paid to Springs Utilities within 30 days following the date of the reconciliation. Springs Utilities did not received a payment from SCMC reimbursing them for overpayment of the expenses in 2007 until July 31, 2008.
- B. Springs Utilities was to receive a credit for overpayment of expenses in 2006 for the South Tower. In 2007, according to the annual reconciliation sheet, Springs Utilities was to receive a credit. Springs Utilities had not requested payment for these credits at the time of our audit.
- C. In 2007, the Association collected payments from Springs Utilities that included \$10,578.92 for the purchase of a security system. This amount was also included in the annual reconciliation as an expense. The Supplemental Agreement states that only actual expenses incurred during the preceding calendar year will be considered in the annual reconciliation. As of July 22, 2008, the security system had not been purchased.
- D. The Agent for the Association indicated a credit had been issued for the overpayment of expenses in 2007. In that year, Springs Utilities overpaid the expenses. Section F of the First Amendment to the Supplemental Agreement states the overpayment will be paid to Springs Utilities within 30 days of receiving the reconciliation. In June 2008, Springs Utilities stated they would like to receive a check for the overpayment of expenses. In July 2008, Springs Utilities received an email stating they had a credit to use towards their August 2008 remittance.

On July 31, 2008, Nor'wood Limited, Inc. issued a refund check from Plaza Two Condominium Association, Inc. for \$24,912.22 for the overpayment of expenses in 2006 and 2007.

Auditor's Recommendation:

- A. We recommend that SCMC follow the terms of the contract and remit payment to Springs Utilities for overpayment of expenses by May 15 as stated in the contract. We further recommend that the contract be amended to include a clause that if payment is not received by May 15, interest will start accruing at an agreed upon rate by Springs Utilities and SCMC.
- B. We recommend Springs Utilities closely monitor the contract and require the Association to settle the account annually as specified in the contract.

Findings, Recommendations and Responses

- C. We recommend the Agent for the Association only include actual expenses on the annual reconciliation at year-end.
- D. We recommend the Association pay Springs Utilities in the form of a check, as a refund, for any future overpayments made.

Springs Utilities Response:

- A. Springs Utilities agrees with the Office of the City Auditor's recommendation. The Facilities Management and Security Operations Department will institute a semiannual review and will monitor the Association's actions to ensure that SCMC remits payments to Springs Utilities for overpayment of expenses by May 15 of each year as stated in the contract. Springs Utilities will abide by the terms of the *Declaration of Condominium for Plaza Two a Condominium Colorado Springs, Colorado*, contract section 22.1 (b) vi, which states: *Late Charges and Interest*, late fees and interest may be accrued on payments that are over 30 days past the due date.
- B. Springs Utilities agrees with the Office of the City Auditor's recommendation. The Facilities Management and Security Operations Department will monitor the contract and require the Association to settle the account annually as specified in the contract.
- C. Springs Utilities agrees with the Office of the City Auditor's recommendation that the Agent for the Association only include actual expenses on the annual reconciliation at year-end. An annual review will be conducted by Springs Utilities to verify only actual expenses charged are included on the annual reconciliation.
- D. Springs Utilities agrees with the Office of the City Auditor's recommendation that the Association pay Springs Utilities in the form of a check, as a refund, for any future overpayments made. Springs Utilities will not accept credits for overpayments made and will abide by the terms of the First Amendment to Supplemental Agreement, section F, *Settle-up*...which states that overpays and shortfalls will be paid "within 30 days following its receipt of the reconciliation." Paid does not imply crediting.

The Association's Response:

- A. We agree with the City Auditor's recommendation and Springs Utilities' Response. As noted by Springs Utilities, the Condominium Declaration already provides for interest on late payments.
- B. We agree with the City Auditor's and Springs Utilities' recommendation.
- C. We agree with the City Auditor's and Springs Utilities' recommendation. Leases with other Plaza tenants allow us to amortize expenses like this over two or more years and our accounting staff was following that procedure in Springs Utilities' billing, not realizing the specific agreement with Springs Utilities is based on actual cash payment.
- D. We agree with the City Auditor's and Springs Utilities' recommendation. Plaza leases with other tenants typically allow crediting overpayments and the Association's accounting staff was following that standard procedure, not realizing the agreement with Springs Utilities requires a cash refund. We will correct our procedures accordingly.

Findings, Recommendations and Responses

Auditor's Response

In A, we recommended “the contract be amended to include a clause that if payment is not received by May 15, interest will start accruing at an agreed upon rate by Springs Utilities and SCMC.” Springs Utilities responded by pointing out the Declaration of Condominium already contained a section governing late fees and interest. To provide further clarification on this issue, in the Background section of this report (page 3), we list the four agreements we reviewed for this audit. The Declaration of Condominium was not one we reviewed. Even though the title of this finding specifically states adhering to the terms of the “Supplemental Agreement,” we believe it is implied that all agreements, including the “Declaration” should be adhered to. Therefore, we believe our original recommendation and Springs Utilities’ response are appropriate.

Findings, Recommendations and Responses

3. The Association was not consistent in determining when the percentage allocation for expenses changed.

In 2006, the percentage of cleaning supplies expense allotted to the North and the South Towers changed three times. In 2007, the percentage allotted to the same account changed two times. This was done because a tenant moved either out of or into the building, thus changing the percentage that other tenants had to pay.

However, when reviewing the annual reconciliations, the percentage allocation only changed twice on the annual reconciliations for each year and it did not happen at the same time the percentage allocation changed on the invoices.

Auditor's Recommendation:

We recommend the Association use a consistent method when the percentage allocations change between the North and South Towers of the Plaza of the Rockies. When the percentage allocations are changed between the buildings, these changes should be carried forward and shown on the annual reconciliation sheets for all tenants.

We also recommend the Association be required to document when and why the percentage allocations changed in the building as clarification for future questions and audits.

Springs Utilities Response:

Springs Utilities agrees with the Office of the City Auditor's recommendation that the Association use a consistent method when the percentage allocations change and those changes be carried forward and shown on the annual reconciliation sheets for all tenants. In addition, Springs Utilities agrees with the Auditor's recommendation concerning the Association documenting when and why the percentage allocations changed in the building. Springs Utilities will closely monitor this activity on an annual basis.

The Association's Response:

We agree with the City Auditor's and Springs Utilities' recommendation. Again, at least in part, these discrepancies were caused by turn-over in accounting staff. We are implementing procedures to assure consistent methodology with back-up documentation for each change.

Findings, Recommendations and Responses

4. Information presented in the summary of expenses was unreliable.

In 2006, Springs Utilities was double charged for capital expenditures and not charged correctly for the salaries of personnel performing duties for the South Tower. In 2007, Springs Utilities was charged for a capital expenditure that was specifically purchased for a tenant in the South Tower. Springs Utilities was also charged incorrectly for personnel performing duties for the South Tower. As a result, the Association overcharged Springs Utilities \$23,128.85 for 2006 and 2007.

Auditor's Recommendation:

We recommended the Association pay Springs Utilities \$23,128.85 for the overcharged expenses in 2006 and 2007.

On September 3, 2008, the Association's Agent issued a check to Springs Utilities for \$23,128.85 for the incorrect charges.

Springs Utilities Response:

Springs Utilities agrees with the Office of the City Auditor's recommendation and confirms that on September 3, 2008, the Association's Agent issued a check to Springs Utilities for \$23,128.85 for the incorrect charges. Going forward, overcharges will be assessed and interest accrued for late payments per the terms of the contract section 22.1 (b) vi, *Late Charges and Interest*.

The Association's Response:

We agree with the City Auditor's recommendation and Springs Utilities' Response. We apologize for the errors in our bookkeeping, and as previously noted, are implementing procedures to try and assure these kinds of errors don't occur in the future.

Findings, Recommendations and Responses

5. Actual common expenses were overstated by 2% or more, therefore, the Association is responsible for the cost of conducting the audit.

In 2006, the expenses for the South Tower were overstated by 3.44% and in 2007; they were overstated by .57%. According to Section 8.10 of the contract, "In the event any such audit reveals that the actual common expenses have been overstated by two percent (2%) or more, then the Association shall reimburse the Owner conducting the audit for the reasonable cost of the audit." Therefore, per the contract, the Association is responsible for the cost of conducting this audit.

Auditor's Recommendation:

We recommend that the Association reimburse Springs Utilities \$26,520 for the cost of conducting this audit.

Springs Utilities Response:

Springs Utilities partially agrees with the Office of the City Auditor's recommendation. Springs Utilities agrees that the audit revealed total common expenses for both years combined were overstated by more than two percent. However, given that only one of the two years audited was overstated by more than two percent (2006, 3.44%; 2007, 0.57%), Springs Utilities recommends that the Association reimburse Springs Utilities half the cost of conducting the audit (\$13,260).

The Association's Response:

We agree with Spring Utilities' Response. Since only one of the two years (2006) was overstated by more than 2% only the portion of the audit expense attributable to that year should be reimbursed. Dividing the audit expense equally between the 2 years seems reasonable and fair. Therefore, we suggest a reimbursement of \$13,260.