Office of Audits
Office of Inspector General
U.S. General Services Administration

Audit of the PBS Great Lakes Region's Lease Financial Performance

Report Number A170047/P/5/R19007
August 23, 2019

Executive Summary

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Why We Performed This Audit

The PBS leasing program's objective is to generate sufficient revenue in order to "break even" or recover all costs of administering the program. PBS measures the financial performance of its leases through the funds from operation (FFO) performance metric. PBS calculates lease FFO by deducting lease expenses (excluding depreciation) from lease revenue. PBS achieves its break even goal when a lease asset's revenue is 0 to 2 percent greater than expenses. The objectives of this audit were to determine whether PBS Great Lakes Region (Region 5) leases meet the goals of the PBS pricing policy and GSA's annual performance plans and to determine the reasons for any excessive variances in lease FFO.

What We Found

PBS Region 5 met its overall FFO performance goal for Fiscal Year 2016. However, we found a wide range of excessive gains and losses on individual leases, which were attributable to three major factors. First, PBS Region 5 lease administration and accounting errors caused FFO variances. Specifically, we found that PBS Region 5 made an error in a lease modification, did not properly adjust lease payments to reflect changes in lease terms, overpaid real estate taxes, overstated expenses attributable to a lease buyout that did not occur, did not apply offset payments to account for broker credits, and improperly retained refunds from overpayments. Second, general and administrative expenses were misstated due to administrative errors, resulting in FFO distortions. Finally, PBS Region 5 leases with the U.S. Postal Service include unfavorable provisions that increase the risk of extended vacancies and FFO losses.

What We Recommend

We recommend that the PBS Commissioner:

1. In conjunction with the GSA Office of the Chief Financial Officer:
    a. Return refunds of overpayments to the appropriate tenant agencies.
    b. Develop and implement a process to return refunds of overpayments to the appropriate tenant agencies as required.
2. Evaluate U.S. Postal Service-owned space leases for terms and conditions allowing for the risk of long term vacancies and FFO loss and implement necessary safeguards to protect PBS against this risk.

We recommend that the Regional Commissioner, PBS Region 5:

3. Implement a process to ensure timely and accurate execution of lease actions, such as, adjustments to lease payments, real estate tax adjustments, buyouts, broker commission credits, and operating costs.
4. Develop and implement appropriate internal controls to ensure PBS Region 5 leasing actions include the appropriate terms and conditions.
5. Develop management reports that would exclude the effect of all prior year expense entries from FFO calculations as well as their effect on general and administrative allocations.
6. Develop and implement internal controls for employee time coding to prevent erroneous direct hour charges to building locations.

In its response to our draft report, PBS generally agreed to implement our recommendations except for Recommendations 1 and 5. With regard to Recommendation 1, PBS provided technical comments citing certain legal authorities to support its position that PBS can retain recoveries of overpayments. However, the authorities cited in the technical comments do not provide a legal basis for retaining tenant agency funds related to the overpayments. Accordingly, PBS must return refunds of these overpayments to tenant agencies. With regard to Recommendation 5, we made minor adjustments to the recommendation after discussion with PBS officials.

PBS's response is included in its entirety in ***Appendix C***.

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Introduction

We performed an audit of the financial performance of leases in the PBS Great Lakes Region (PBS Region 5).

Purpose

This audit was included in the Office of Inspector General's *Fiscal Year 2017 Audit Plan*. PBS's leasing program is one of GSA's core functions. PBS administers over 7,000 leased properties, resulting in $5.87 billion in annual rent. PBS Region 5 leases over 42 percent of the space it provides to federal agencies. As of the end of Fiscal Year 2016, PBS Region 5 accounted for about 8 percent of PBS's leased inventory with 14.7 million rentable square feet out of a total of 187.9 million nationwide. The financial performance of its leasing program is critical.

Objectives

Our objectives were to determine whether PBS Region 5 leases meet the goals of the PBS Pricing Policy and GSA's annual performance plans, and the reasons for any excessive variances in lease funds from operation (FFO).

See ***Appendix A*** – Scope and Methodology for additional details.

Background

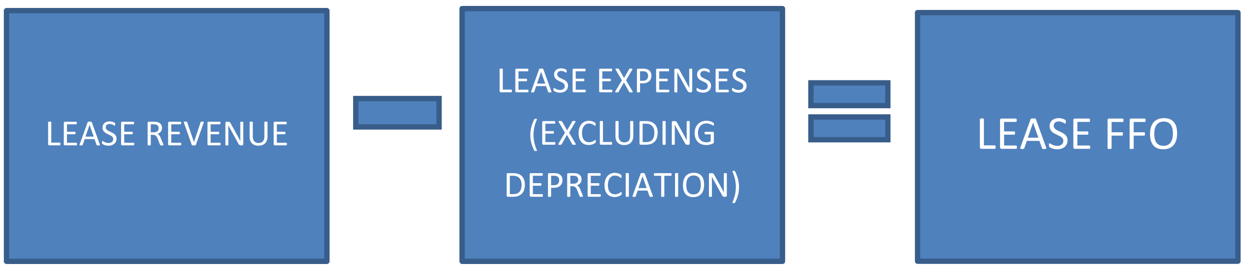
PBS's mission is to provide effective workplace solutions for federal agencies at best value. As part of this mission, PBS leases space from the private sector to meet customer needs. The leasing program strives to generate sufficient revenue to break even after covering all administrative costs.

When PBS leases space for a tenant agency, PBS and the tenant agency enter into an occupancy agreement that establishes each party's responsibilities. The occupancy agreement establishes the rent that the tenant agency will pay PBS. According to PBS's pricing policy, the rent the tenant agency pays to PBS is a pass-through of the underlying lease contract rent PBS pays to the lessor, plus any standard operating costs not performed through the lease, the PBS lease fee, and security charges. Additionally, both the operating cost and the real estate taxes that PBS pays to the lessor as part of the lease are passed through to the tenant. The PBS fee is 7 percent for cancellable occupancy agreements. The PBS fee is designed to cover contract risk, lease acquisition services, and lease administration. Contract risk includes the risk that PBS will be responsible for rent payments to the lessor if the tenant agency vacates the space before the lease has terminated.

The *U.S. General Services Administration Annual Performance Plan and Report Fiscal Year 2017* (GSA Performance Plan) included a performance goal for the Agency to generate sufficient FFO to effectively operate GSA leased buildings. Specifically, the goal stated that "GSA will improve the efficiency of the leasing program so that revenue available after administering the program is between zero and two percent in FY 2015 and FY 2016."

Lease FFO is PBS's performance measure for determining the efficiency of its leasing program. PBS calculates lease FFO by taking the revenue collected from tenant agencies minus all expenses (excluding depreciation) associated with the leased space, as shown in *Figure 1*.

Figure 1 – How to Calculate Lease FFO



PBS Region 5 officials told us that they work in collaboration with the Office of the Chief Financial Officer (OCFO) to track lease FFO performance. The GSA Performance Plan states that the OCFO is the lead office for the overall strategic goal of increasing efficiency of GSA operations. The OCFO tracks the revenue and expense performance of the PBS inventory nationwide and provides financial management support services to PBS regions, including PBS Region 5. The OCFO generates monthly lease financial performance reports and collaborates with PBS Region 5's Office of Portfolio and Office of Leasing to follow up on leases with excessive FFO losses or gains. This is an important process as a previous independent audit of GSA's financial statements noted that GSA needs to improve the effectiveness of its controls over the processing of leases to ensure that leases are accurately and timely recorded in the financial management system.[1]

Fiscal Year 2016 Lease FFO Results

In Fiscal Year 2016, GSA's lease FFO had an overall loss of $67.9 million, while regional performance varied. PBS Region 5's lease FFO had a gain of $4.6 million, as shown in *Figure 2*. PBS Region 5's overall FFO gain equates to 1.1 percent of its revenue, which meets GSA's Performance Plan goal to have between 0 and 2 percent revenue available after administering the leasing program.

[1] KPMG's FY14 Independent Auditors' Report on GSA's Financial Statements (November 2014).

Figure 2 – Fiscal Year 2016 Lease FFO Results by Region

Region	Lease FFO (Loss) or Gain
Central Office	($1,008,497)
New England Region	($1,293,547)
Northeast And Caribbean Region	($21,187,201)
Mid-Atlantic Region	$1,835,418
Southeast Sunbelt Region	$3,862,195
Great Lakes Region	$4,563,308
Heartland Region	$2,056,092
Greater Southwest Region	($8,687,518)
Rocky Mountain Region	$252,622
Pacific Rim Region	$5,769,636
Northwest/Arctic Region	($4,197,708)
National Capital Region	($49,819,811)
Nationwide Total	**($67,855,013)**

FFO losses in the leasing program adversely affect both PBS's owned and leased inventory. The Federal Buildings Fund (FBF) was established by the Federal Property and Administrative Services Act of 1949 (as amended) to provide for the space needs of GSA tenants and to maintain buildings in the federal inventory.[2] Revenues deposited into the FBF are made available for the necessary expenses of real property management and related activities. The FBF is expected to generate sufficient funds to cover new construction, operations and maintenance, repair and alteration, and leasing. If lease FFO does not break even, PBS has to use the FBF to cover the loss using revenue from its owned properties, diverting funds that could be used for repair and renovation projects.

Excessive FFO gains and losses for individual leases indicate a problem with the lease's financial results. The objective of PBS's pricing policy is for leases to break even as all direct costs are passed on to customer agencies and operational costs are supposed to be covered by the leasing fee. However, excessive FFO gains and losses indicate that the pricing policy objective was not achieved and that management attention is required.

[2] 40 USC 592.

Results

PBS Region 5 met its overall FFO performance goal for Fiscal Year 2016. However, we found a wide range of excessive gains and losses on individual leases, which were attributable to three major factors. First, PBS Region 5 lease administration and accounting errors caused FFO variances. Specifically, we found that PBS Region 5 did not pay the correct rent to lessors, overpaid real estate taxes, overstated expenses attributable to a lease buyout that did not occur, did not apply offset payments to account for broker credits, and improperly retained refunds from overpayments. Second, general and administrative expenses were misstated due to administrative errors, resulting in FFO distortions. Finally, PBS Region 5 leases with the U.S. Postal Service include unfavorable provisions that increase the risk of extended vacancies and FFO losses.

Finding 1 – PBS Region 5 lease administration and accounting errors caused variances in FFO.

Based on our testing, we found the primary causes of lease FFO variances were lease administration and accounting errors. In performing our testing, we judgmentally sampled 20 of the 925 lease locations in Region 5 in which the FFO was either negative or had at least a 2 percent gain. Our sample included 12 leases with lease FFO losses of $3,003,833 and 8 leases with lease FFO gains of $5,923,704. These leases represent 12 percent of the 14.7 million rentable square feet of space under lease in Region 5. For details on the leases that we tested, see ***Appendix B***.[3]

In testing these lease locations, we determined that the lease FFO for multiple leases was distorted due to a variety of administration errors. Specifically, we found deficiencies in PBS Region 5's lease administration practices that led to errors in lease modifications, lease payment adjustments, real estate tax bills, buyouts, application of broker commission credits, and recovery of operating costs. We also found that PBS Region 5 did not reimburse tenant agencies for overbillings.

These errors are discussed in detail below.

An Error in a Lease Modification Wasted Taxpayer Dollars

In one lease we reviewed, a PBS Region 5 lease contracting officer included the wrong terms in a lease modification. This error contractually obligated the Region to pay double the amount it agreed to with the lessor. As discussed below, this error wasted taxpayer dollars and led to an FFO loss.

[3] For the report findings, we identified common root causes in FFO losses and excessive gains. However, each lease location may have had other factors that contributed to its Fiscal Year 2016 FFO. For this reason, the Fiscal Year 2016 FFO total in ***Appendix B*** may not match the financial effect of the individual issues discussed in the report narrative.

In 2010, the lease contracting officer negotiated a $38,726 increase to the annual rent for the 900 E. Linton Avenue lease to settle the lessor's claims of increased costs. The lease contracting officer memorialized this agreement in a supplemental lease agreement issued in January 2011. However, in doing so, the lease contracting officer incorrectly inserted language providing that the rent amount "will increase by $38,726.22 annually, effective November 1, 2010 through the remainder of the lease period in the contract…." This language created a repetitive, annual rent increase of $38,726, not the one-time rent increase that the lease contracting officer had negotiated with the lessor. Although this error contractually obligated PBS Region 5 to include the annual increase in its rental payments beginning in 2011, the Region initially paid only the intended increase to the rent.

In November 2015, a PBS Region 5 lease official determined that the Region should have increased the lease payments annually to meet the lease terms and authorized a catch-up payment of $387,262 (see *Figure 3*) to cover the unpaid rent increases from 2012 to 2015.

Figure 3 – Unpaid Rent for 900 E. Linton Avenue

	2011	2012	2013	2014	2015	Unpaid Rent
Agreed-Upon Rent Increase (Paid by PBS)	$38,726.22	$38,726.22	$38,726.22	$38,726.22	$38,726.22	$ -
First Annual Rent Increase (Not Paid by PBS)		$38,726.22	$38,726.22	$38,726.22	$38,726.22	$ 154,904.88
Second Annual Rent Increase (Not Paid by PBS)			$38,726.22	$38,726.22	$38,726.22	$ 116,178.66
Third Annual Rent Increase (Not Paid by PBS)				$38,726.22	$38,726.22	$ 77,452.44
Fourth Annual Rent Increase (Not Paid by PBS)					$38,726.22	$ 38,726.22
					Total Unpaid Rent	$ 387,262.20

In October 2016, PBS Region 5 withheld rental amounts from the lessor "to recapture an erroneous overpayment." The lessor objected to this, asserting that it was entitled to the catch-up payment based on the lease terms as written. After consultation with GSA Region 5 legal counsel, PBS Region 5 reversed the withholding, allowing the lessor to retain the full $387,262 catch-up payment. The tenant agency refused to pay this amount to PBS, contributing to a Fiscal Year 2016 FFO loss for this lease of $542,483. PBS Region 5 continues to pay the repetitive, annual rent increase, costing the government an additional $697,072 through Fiscal Year 2018.

PBS Region 5 Did Not Properly Adjust Lease Payments to Reflect Changes in Lease Terms

Some leases have contractual adjustments that increase or decrease lease payments over time. However, PBS Region 5 leasing personnel did not properly revise lease payments for these contractual adjustments in 4 of 20 leases we reviewed. Specifically, we found that PBS Region 5 overpaid the lessors on three leases and underpaid one lease in our sample. As shown in *Figure 4* below, the overall effect on FFO was $3.9 million, which accounted for most of the Fiscal Year 2016 FFO variances for these leases.

Figure 4 – Overpayments and Underpayments

Lease Location	Overpayment	Underpayment	Overall FFO Effect
Ambassador Bridge (Detroit, Michigan)	$ 3,307,314		
Marquette Plaza (Minneapolis, Minnesota)	46,497		
Chiquita Center (Cincinnati, Ohio)	24,126		
BP Tower (Cleveland, Ohio)		$511,233	
Totals	**$3,377,937**	**$511,233**	**$3,889,170**

For example, for the Ambassador Bridge, PBS Region 5 failed to process scheduled decreases in annual rent dating back to 2009. This error was identified in 2016 and resulted in an overpayment of $3,307,314. According to PBS officials, the decrease in rent was not identified previously because it was "lost" during a system transition. The lessor agreed to a repayment schedule starting in 2017; however, the error contributed to an FFO gain for this lease of $3,765,925 in Fiscal Year 2016.

PBS Region 5 Overpaid Real Estate Taxes

In one lease we reviewed, PBS Region 5 overpaid the lessors for prior years' real estate taxes. PBS Region 5 recognized that the overpayments occurred and issued a claim for the real estate tax overpayments. The accounting entry to record this claim had a positive effect on FFO, contributing to a Fiscal Year 2016 gain of $1.1 million.

PBS Region 5 can usually recover overpayments to lessors by withholding future lease payments. For the Mid-Continental Plaza (Chicago, Illinois) lease, however, PBS Region 5 was unable to recover the overpayment because representatives of the lessor claimed that the business had dissolved. PBS Region 5 notified the lessor (a limited liability company) about the overpaid taxes. The original claim amount was $1.1 million, which GSA revised downward to $695,039 in October, 2016. The lessor acknowledged it owed the $695,039 but would not pay. Subsequently, PBS Region 5 officials determined that the lessor had sold the building and the lessor had dissolved. The new owner claimed the owed amount is the responsibility of the original lessor and refused to pay.

A PBS Region 5 attorney, who was involved with discussions with the original lessor, told us that he concluded that nothing could be done to recover the funds since PBS Region 5 had not notified the original lessor of the liability prior to the lessor dissolving. Nonetheless, on September 12, 2016, GSA turned the debt over to the U.S. Treasury for collection, where it remains uncollected as of January 2019.

PBS Region 5 Did Not Timely Release Funds Set Aside for a Lease Buyout

In some leases, PBS sets aside funds to buy out the remaining years of the lease when a tenant agency vacates its space early. FFO distortions occur if these funds are not used and released in a timely manner. This occurred for one lease in our sample, resulting in an FFO gain of $315,206 for Fiscal Year 2016.

For this lease, the Park Bank Plaza lease (Madison, Wisconsin), PBS Region 5 wanted to buy out the lease in Fiscal Year 2013 and set aside $375,000 for this purpose. The buyout did not occur and the funds were not used. As a result, PBS Region 5 overstated expenses for the lease in Fiscal Year 2013. In Fiscal Year 2016, when the lease ended, a PBS Region 5 official realized that the $375,000 set aside was no longer needed and released the funds. The correction resulted in an offset of lease payments for Fiscal Year 2016, which led to an FFO gain of $315,206.

PBS Region 5 Did Not Process Broker Commission Credits in a Timely Manner

GSA uses broker contractors to provide lease support services to the regions in an effort to manage each region's lease workload. For GSA leases that are awarded using a broker, the lessor pays a commission. The broker retains part of the commission for its services, while the rest of the commission is applied as a rent credit, which reduces the rent payment to the lessor. For the Bank of America lease (Chicago, Illinois), PBS Region 5, due to a processing error, did not apply the commission credit to the rental payment and as a result, overpaid the lessor by $61,110 in Fiscal Year 2013. In Fiscal Year 2016, PBS Region 5 corrected this error, by reducing rent, which contributed to an FFO gain of $72,228.

PBS Region 5 Did Not Bill Tenant Agencies for All Operating Costs

Normally, PBS awards fully serviced leases, which include such services as cleaning, utilities, maintenance, and repair. However, some leases are not fully serviced and PBS contracts for the services separately and bills the tenant agency for reimbursement. In our sample lease involving the Midway Airport lease (Chicago, Illinois), PBS Region 5 did not pass on operating costs to the tenant agency, resulting in an FFO loss of $17,506.

PBS Region 5 Improperly Retained Overpayment Refunds from Lessors

PBS Region 5 did not and is not fully reimbursing tenant agencies after recovering overpayments from lessors. During our audit, we found that PBS retained over $2.4 million from recoveries of overpayments of real estate taxes and rent.

According to PBS's Review Requirements Document for occupancy agreements, GSA should reimburse tenants if a recovery is within 5 years and over $50,000. However, we are not aware of, and PBS did not identify, any express statutory authority for retaining these overpayments. Absent such authority, PBS is required to pass on refunds to tenant agencies at the time when lease overpayments are collected. Therefore, PBS Region 5 should have refunded to the tenant agencies the full amounts recovered for these overpayments.

As discussed below, FFO was distorted for three leases in our sample when PBS Region 5 made corrections for overpayments for missed rent decreases and real estate taxes, but improperly retained the resulting refunds for these leases.

- For the Ambassador Bridge lease (Detroit, Michigan), PBS Region 5 overpaid the lessor $3.3 million between 2009 and 2016 due to missed rent reductions. The lessor is making monthly installment payments of $94,200 which includes interest (from April 2017 to March 2020) to repay this amount. Those monthly payments have not been passed on to the tenant agency. This caused an FFO gain for the Ambassador Bridge of over $3 million in Fiscal Year 2016.

- In the Metro Office Park lease, PBS Region 5 did not credit the tenant agency for $21,922 for overpayments for real estate taxes.

- In the IRS National Distribution Center lease, PBS Region 5 credited to the IRS only $157,968 of $160,277 in tenant agency overpayments (for real estate taxes) over a period of 3 years. As a result, in Fiscal Year 2016, PBS Region 5 retained $2,309 for this lease that should have been reimbursed to the tenant agency. This situation also caused an FFO gain.

In sum, lease administration and accounting errors have resulted in FFO variances for individual leases. These variances adversely affect the reliability of the FFO results, which impairs management's ability to rely upon this data for decision making purposes. Therefore, PBS Region 5 management should strengthen its controls surrounding lease administration to prevent similar errors from occurring in the future. Among other things, these controls should be designed to improve the reliability and accuracy of the lease FFO metric, and ensure that recoveries of overpayments are properly reimbursed to tenant agencies.

Finding 2 – General and administrative expenses are misstated in multiple leases, resulting in distortions to FFO.

General and administrative (G&A) expenses are costs incurred to carry-out day-to-day operations. These expenses include, among other things, costs for salaries, travel, office supplies, and information technology and telecommunications services and equipment. GSA has three levels of G&A expenses based on whether these expenses originate at the national, regional, and field office levels. The GSA OCFO applies an allocation methodology to distribute these G&A expenses to individual buildings.

During our testing, we found that administrative errors resulted in allocations of regional and field office G&A expenses that distorted FFO for six leases in our sample. This prevented management from having reliable information for use in evaluating the financial performance of individual leases.

These misstatements are discussed in detail below.

Regional G&A

OCFO Region 5 allocates regional G&A to building classes or groupings of similar buildings and then to individual buildings within each group based on the building's share of direct expenses. Under this allocation methodology, a building with higher direct costs will have more Regional G&A expense applied than a building with lower direct costs. During our testing, we found that OCFO Region 5's treatment of a claim for Ambassador Bridge (Detroit, Michigan) as an offset to direct expenses resulted in regional G&A allocations that skewed FFO for the Ambassador Bridge lease and three other leases in our sample.

In Fiscal Year 2016, PBS Region 5 processed a claim against the Ambassador Bridge lessor because the lessor had not passed along contractual decreases in lease payments dating back to 2009. OCFO Region 5 recorded this as a reduction to direct expenses, which offset all the lease payments made in Fiscal Year 2016. Although PBS Region 5 incurred direct costs for Ambassador Bridge of over $1.2 million in Fiscal Year 2016, the offset for the claim reduced direct expenses for the lease to $0. Consequently, the Ambassador Bridge lease was assigned no regional G&A, which resulted in a $111,232 FFO gain.

The offset of the Ambassador Bridge's direct expenses also caused the 14 other buildings included in the GSA operated leased buildings grouping – 3 of which were included in our audit sample – to absorb a much higher share of regional G&A than they should have. As shown in *Figure 5* below, this led to FFO losses for these buildings totaling $746,890.

Figure 5 – FFO Losses in Sample

Non-Fully Serviced Ports-of-Entry	FFO Loss
O'Hare Airport (Chicago, Illinois)	$ (442,620)
Blue Water Bridge (Port Huron, Michigan)	$ (214,088)
Midway Airport (Chicago, Illinois)	$ (90,182)
Total FFO Loss	**$ (746,890)**

Field Office G&A

Field Office G&A, which has a direct effect on FFO, is distributed by OFCO Region 5 based on direct hours charged to specific buildings within the field office area. The buildings are assigned field office G&A based on the percentage of direct hours billed during the fiscal year. According to Region 5 officials, an employee in one field office erroneously charged their time to the Richie (Rice Lake, Wisconsin) and Reuss (Milwaukee, Wisconsin) buildings, rather than allocating it across multiple buildings as required. Because there were a limited number of buildings with direct expenses in this field office, the error resulted in the allocation of an excessive amount of field office G&A to the Richie and Reuss buildings. This led to FFO losses totaling $757,981 for these buildings in Fiscal Year 2016.

FFO is a key performance indicator used by management to assess the financial health of its leased portfolio. The misallocation of regional and field office G&A expenses in Region 5 described above resulted in FFO distortions that impaired management's ability to rely on FFO results for individual leases and make informed decisions about PBS's leased portfolio. Therefore, PBS and OCFO Region 5 should develop management reports that would exclude the effect of the application of prior year refunds on G&A expenses to ensure the reliability and accuracy of FFO results for individual leases.

Finding 3 – Unfavorable provisions in U.S. Postal Service leases leave PBS exposed to long-term FFO losses for vacant space.

Federal Management Regulation Parts 102-73.10 and 102-73.20 require federal agencies to first seek space in government-owned and government-leased buildings. After considering the availability of PBS-controlled space and determining that no such space is available to meet its needs, federal agencies (through PBS) must extend priority consideration to available space in buildings under the custody and control of the U.S. Postal Service (Postal Service). In 1985, PBS and the Postal Service signed an agreement covering real property relationships and associated services.

This agreement states that, for partial releases of space, the Postal Service "shall have final approval on the space the tenant-agency will be allowed to retain and the space to be released." This provision, which is incorporated into the individual leases (called tenancy agreements), allows the Postal Service to refuse to take space back from PBS. When this occurs, the vacant space leads to an FFO loss for PBS.

For example, the tenancy agreement between the Postal Service and PBS for the Evansville, Indiana, Postal Service-owned space states that "GSA may terminate this agreement or relinquish a portion of the space if fully marketable, *as determined by the USPS in its sole discretion*, at any time by giving four (4) months' prior written notice to USPS." [emphasis added] This clause creates budgetary risk for PBS. This is because under occupancy agreements with PBS, tenant agencies are allowed to vacate the Postal Service-owned space with 4 months' notice to PBS, after which time PBS can no longer bill the tenant agencies for the space. However, the Postal Service is not obligated under the agreement to take the space back, forcing PBS to continue to pay the Postal Service for the vacant space.

As a result of this clause, PBS Region 5 paid the Postal Service for almost 13,000 square feet of vacant space at the Evansville facility. A majority of the vacant space was due to the Social Security Administration's decision to cancel its occupancy agreement for the space in February 2016. According to PBS Region 5 officials, the Postal Service would not take the space back because the security screening station in the lobby made the space unmarketable. This forced PBS Region 5 to absorb the cost of the vacant space for Fiscal Year 2016, leading to an FFO loss of $122,432.

PBS Region 5 should work with PBS Central Office to evaluate Postal Service-owned space leases for terms and conditions allowing for the risk of long term vacancies and FFO loss and implement necessary safeguards to protect PBS against this risk.

Conclusion

PBS Region 5 met its overall FFO goal of breaking even on leases. However, we found that PBS and OCFO Region 5 should improve existing lease administration and G&A allocation practices that had resulted in individual leases with large FFO variances. In our sample, we noted issues with the timely and accurate execution of lease actions and improper retention of reimbursements for overpayments. We also found that administrative errors resulted in misstatements of G&A expenses that led to FFO distortions. Finally, PBS leases with the Postal Service are subject to long-term FFO losses when tenant agencies move out and the Postal Service does not take space back.

To improve FFO performance at the individual lease level, PBS Region 5 should strengthen controls to more effectively administer leases and pass on reimbursements from lessors for overpayments to tenant agencies. Additionally, PBS Region 5 should implement procedures to ensure that claims from prior year overpayments and employee time coding errors do not result in misstatements of general and administrative expenses that cause FFO variances. PBS Region 5 management should also work with PBS Central Office to mitigate the risks associated with Postal Service leases.

Recommendations

We recommend that the PBS Commissioner:

1. In conjunction with the GSA Office of the Chief Financial Officer:
    a. Return refunds of overpayments to the appropriate tenant agencies.
    b. Develop and implement a process to return refunds of overpayments to the appropriate tenant agencies as required.
2. Evaluate U.S. Postal Service-owned space leases for terms and conditions allowing for the risk of long term vacancies and FFO loss and implement necessary safeguards to protect PBS against this risk.

We recommend that the Regional Commissioner, PBS Region 5:

3. Implement a process to ensure timely and accurate execution of lease actions, such as adjustments to lease payments, real estate tax adjustments, buyouts, broker commission credits, and operating costs.
4. Develop and implement appropriate internal controls to ensure PBS Region 5 leasing actions include the appropriate terms and conditions.
5. Develop management reports that would exclude the effect of all prior year expense entries from FFO calculations as well as their effect on general and administrative allocations.
6. Develop and implement internal controls for employee time coding to prevent erroneous direct hour charges to building locations.

GSA Comments

In its response to our draft report, PBS generally agreed to implement our recommendations except for Recommendations 1 and 5. With regard to Recommendation 1, PBS provided technical comments citing certain legal authorities to support its position that PBS can retain recoveries of overpayments. However, the authorities cited in the technical comments do not provide a legal basis for retaining tenant agency funds related to the overpayments. Accordingly, PBS must return refunds of these overpayments to tenant agencies. With regard to Recommendation 5, we made minor adjustments to the recommendation after discussion with PBS officials.

Audit Team

This audit was managed out of the Great Lakes Region Audit Office and conducted by the individuals listed below:

Adam Gooch	Regional Inspector General for Auditing
Franklin Moy	Audit Manager
Mikhail Kostikov	Auditor-In-Charge
Rachel Story	Auditor
Robert Lange	Auditor
Misty Deckard	Auditor

Appendix A – Scope and Methodology

We examined PBS Region 5's processes and controls in place over lease administration, tenant billing, and accounting, and their effect on FFO.

To accomplish our objectives, we:

- Examined PBS lease management, leasing, pricing and rent bill management guides; OCFO budget and financial guides; G&A allocation methodology; accounts payable and receivable operational policies; independent public accountant's reports; profit recovery contractor's managerial reports; and the Office of Management and Budget's Circular A-11 and other relevant policy;
- Selected and analyzed a judgmental sample of 20 leased locations in Region 5 (out of 925) that had FFO losses and excessive gains at the end of Fiscal Year 2016, which was the most recently completed year at the time of our sample selection;
- Reviewed lease and tenant occupancy agreements for the selected leased locations;
- Evaluated PBS Region 5 internal controls over lease payments to lessors and billings to tenant agencies including other requested services for non-fully serviced leases;
- Analyzed the input and flow of lease and billing transactions in GSA's systems: Pegasys (main accounting system), REXUS (lease administration system), Galaxy 2 (budget tracking system), and OA Tool (tenancy administration system);
- Reviewed the analysis performed by GSA's recovery auditor, and held discussions with the recovery auditor;
- Performed a walk-through of the United States Department of Agriculture's Financial Services Division processing of GSA lease and billing actions;
- Evaluated criteria related to Agency guidance, GSA's lease and tenancy contracts, accounting for accruals, revenue, and claims recognition;
- Reviewed GSA OIG Audit Report A120023/P/4/R12011 (*Audit of the Public Buildings Service, Southeast Sunbelt Region's Lease Administration Practices,* September 27, 2012); and
- Held discussions with PBS Region 5 and OCFO officials on what caused the FFO losses and excessive gains on the selected lease locations, and with GSA Region 5's Office of Legal Counsel.

We conducted the audit between May 2017 and March 2018 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Internal Controls

Our assessment of internal controls was limited to those necessary to address the objectives of the audit.

Appendix B – Summary of Findings for Leases in Audit Sample

The purpose of this appendix is to summarize the results of our judgmentally selected sample of 20 leases in PBS Region 5. We identified common root causes in FFO losses and excessive gains. The Fiscal Year 2016 FFO column is the official lease FFO figure for each location as reported by the OCFO. Numbers in parenthesis represent an FFO loss; positive numbers represent an FFO gain.

For the report findings, we identified common root causes in FFO losses and excessive gains. However, each lease location may have had other factors that contributed to its Fiscal Year 2016 FFO. The Fiscal Year 2016 FFO column below will not necessarily match the financial effect of the individual issues discussed in the report narrative, or in the supporting notes in this appendix, as the report focused on common root causes.

Note	Building Name	Building Number	Fiscal Year 2016 FFO	Finding(s) (Note 1)
2	101 West Ohio, Indianapolis, IN	IN1659ZZ	($18,434)	1
3	900 East Linton Avenue, Springfield, IL	IL2493ZZ	($542,483)	1
4	Ambassador Bridge, Detroit, MI	MI1873ZZ	$3,765,925	1,2
5	Bank of America, Chicago, IL	IL2625ZZ	$72,228	1
6	Blue Water Bridge, Port Huron, MI	MI19800ZZ	($260,669)	2
7	BP Tower, Cleveland, OH	OH2152	($393,304)	1
8	Chicago FBI Building, Chicago, IL	IL2485ZZ	($94,831)	2
9	Chiquita Center, Cincinnati, OH	OH2300	($11,420)	1
10	IRS National Distribution, Bloomington, IL	IL2525ZZ	$245,303	1
11	Marquette Plaza, Minneapolis, MN	MN1672ZZ	$77,438	1,2
12	Metro Office Park, Minneapolis, MN	MN1583ZZ	$66,260	1,2
13	Mid-Continental Plaza, Chicago, IL	IL1894ZZ	$1,126,625	1
14	Midway Airport, Chicago, IL	IL2474ZZ	($17,506)	1,2
15	O'Hare International, Chicago, IL	IL2459ZZ	($427,290)	2
16	Oakbrook Terrace, Oakbrook Terrace, IL	IL2499ZZ	$254,719	1
17	Park Bank Plaza, Madison, WI	WI1645ZZ	$315,206	1
18	Reuss Plaza Tower, Milwaukee, WI	WI1542ZZ	($379,549)	2
19	Richie Building, Rice Lake, WI	WI1791ZZ	($488,033)	2
20	USPS Building, Evansville, IN	IN0127ZZ	($122,432)	3
21	Westwood of Lisle, Lisle, IL	IL2470ZZ	($247,882)	N/A

Notes:

1. This column identifies the finding related to the building. The findings are as follows:
    - Finding 1 – PBS Region 5 lease administration and accounting errors caused variances in FFO.
    - Finding 2 – General and administrative expenses are misstated in multiple leases, resulting in distortions to FFO.
    - Finding 3 – Unfavorable provisions in U.S. Postal Service leases leave PBS exposed to long-term FFO losses for vacant space.

2. 101 West Ohio – The $18,434 FFO loss largely resulted when PBS Region 5 did not bill the customer agency for estimated real estate tax escalation for Fiscal Year 2016 as required. The PBS Region 5 employee responsible for billing tenant agencies told us that they believed the real estate escalation was for Fiscal Year 2014 and that it was too late to bill the tenant agency.

3. 900 East Linton Avenue – The $542,483 FFO loss was largely due to a drafting error by the PBS Region 5 lease contracting officer. In January 2011, the lease contracting officer issued a supplemental lease agreement increasing lease payments by $38,726 annually, effective November 1, 2010. The lease contracting officer intended the new terms to reflect a one-time increase to the rent; however, they incorrectly inserted terms requiring PBS Region 5 to annually increase rent by an additional $38,726 through the life of the lease.

    Subsequent to lease ratification, PBS Region 5 increased its rent payments by $38,726 as the lease contracting officer had originally intended. However, a November 2015 lease review found that these payments did not comply with the terms and that the lessor had been underpaid. In response, PBS Region 5 made a catch up payment of $387,262 to the lessor, but did not bill the tenant agency to offset the loss. This catchup payment, in addition to $155,221 in other FFO adjustments totaled the $542,483 FFO loss recognized in 2016.

4. Ambassador Bridge – The $3,765,925 FFO gain resulted from the settlement of a claim due to a missed decrease in annual lease payments. PBS Region 5 did not act on a scheduled decrease in annual lease payments dating back to 2009. PBS Region 5 officials decided not to submit a request to the PBS Rent Billing Management office to reimburse the tenant agencies until they agreed on payment terms with the lessor. In Fiscal Year 2017, the claim was reduced to $3.3 million. Rent Billing Management approved the request to reimburse the tenant agency for $833,087, which was for 2 years only. This leased location showed an FFO gain for Fiscal Year 2016 because the claim amount exceeded lease payments.

Ambassador Bridge did not have direct expenses, which are normally lease payments. This was because the claim amount completely offset the regular lease payments. This location would typically incur over a million dollars in direct expenses.

Lastly, GSA officials advised that the lease decrease was flagged in the prior lease payment system but was "lost" during the conversion to the new payment system (REXUS).

5. <u>Bank of America</u> – The $72,228 FFO gain mostly resulted from human error in correcting lease actions affecting GSA's financial system. Most of the gain was traceable to a broker commission credit that GSA processed in error. The error occurred when a lease analyst requested GSA's finance center to process a lease payment outside of the automated payment system to correct a previous action.

6. <u>Blue Water Bridge</u> – The $260,669 FFO loss resulted from the allocation of regional G&A. Blue Water Bridge received 17 percent of direct expenses in regional G&A. The excess G&A was due to the Ambassador Bridge lease having no direct expenses (see *Note 3*). Had PBS Region 5 allocated the appropriate portion of regional G&A to the Ambassador Bridge lease, this FFO loss would not have occurred.

7. <u>BP Tower</u> – The $393,304 FFO loss was mostly due to an erroneous interpretation of the lease. GSA reduced lease payments after the completion of tenant improvements, but should not have.

8. <u>Chicago FBI Building</u> – The $94,831 FFO loss came from PBS Region 5's improper application of G&A. The fee collected for Fiscal Year 2016 totaled $1,006,079. However, the G&A applied to the project for the year was $1,100,205. The difference was negative $94,126, or more than 99 percent of the FFO variance.

9. <u>Chiquita Center</u> – The $11,420 FFO loss was mostly due to an overpayment to the lessor on tenant improvement costs. The tenant improvements were completed and the tenant agency had finished paying for the tenant improvements. However, a GSA employee did not reduce lease payments to the lessor.

10. <u>IRS National Distribution</u> – The $245,303 FFO gain was mostly because PBS Region 5 did not obtain adjusted real estate tax payments to the lessor to reflect a lower tax liability, resulting in overpayments to the lessor. PBS Region 5 determined that $160,277 was tenant agency overpayments over the 3 year period; however, it only credited $157,968 back to the tenant.

11. Marquette Plaza – Most of the $77,438 FFO gain was traceable to PBS Region 5 not adjusting for a lease payment decrease, thus overpaying the lessor. PBS Region 5 corrected this by reduced payments to the lessor but did not reduce its billings to the tenant agencies.

12. Metro Office Park – The $66,260 FFO gain was traceable to the profit recovery contractor returning their fee for a claim filed in 2013 that was later determined to be overstated.

13. Mid-Continental Plaza – The $1,126,625 FFO gain resulted from a claim for overpayment of real estate taxes by PBS Region 5. PBS Region 5 had not obtained updated real estate taxes bills, which had decreased. Most of the gain is traceable to a recovery claim for $1,093,656 that was later reduced to $695,039.

    The profit recovery contractor's claim showed PBS Region 5 overpaid real estate taxes from 2009 through 2014. PBS Region 5 officials explained that the original lessor had sold the building and the lessor had dissolved. The new owner said the debt is the responsibility of the original lessor. On September 12, 2016, GSA referred the debt to the U.S. Treasury for collection. As of January 2019, the referral remained open with the U.S. Treasury. In addition, the tenant agencies also overpaid, as PBS Region 5 made no adjustments to their occupancy payments to GSA.

14. Midway Airport – Most of the $17,506 FFO loss was traceable to $48,119 in cleaning fees that PBS Region 5 paid, but did not bill to the tenant agency. The responsible PBS Region 5 billing manager was not properly trained in billing tenant agencies and misinterpreted a system code.

15. O'Hare International – The $427,290 FFO loss resulted from application of regional G&A. O'Hare absorbed excess G&A due to the misapplication of regional G&A expense for the Ambassador Bridge lease (see Note 3). O'Hare had the most direct expenses within its group and thus was burdened with 32 percent of the group's regional G&A expense.

16. Oakbrook Terrace – The $254,719 FFO gain occurred because PBS Region 5 mistakenly created a claim against the former lessor when it should not have. The claim reduced lease payments, resulting in an FFO gain. The mistake was corrected in the following fiscal year.

17. Park Bank Plaza – The $315,206 FFO gain resulted from an OCFO Region 5 accounting adjustment. In December 2012, PBS Region 5 considered buying out the Park Bank Plaza lease because a tenant agency had vacated 72 percent of the leased space and set aside funds for the buyout. The buyout did not occur and, in Fiscal Year 2016, PBS Region 5

released the vacant space back to the lessor. Consequently, PBS Region 5 eliminated the set aside expense for the buyout, resulting in an FFO gain for 2016.

18. Reuss Plaza Tower – The $379,549 FFO loss was due to an inaccurate allocation of field office G&A caused by an employee incorrectly charging time. An employee in PBS Region 5's Northern Service Center charged too much time to a small group of buildings, which included the Reuss Building. There were a limited number of Northern Service Center buildings with direct expenses, thus an inaccurate amount of field office G&A was applied.

19. Richie Building – The $488,033 FFO loss was due to inaccurate field office G&A allocation caused by an employee incorrectly charging time. According to GSA officials, an employee in PBS Region 5's Northern Service Center charged too much time to a small group of buildings, which included the Richie Building. There were not many Northern Service Center buildings with direct expenses, thus an inaccurate amount of field office G&A was applied.

20. USPS Building in Evansville – The $122,432 FFO loss was due to a national issue with Postal Service tenant agreements. For this lease, when the tenant vacated, the Postal Service would not take the vacant space back. Because access to the space was limited by building security requirements, PBS was unable to find a succeeding tenant; however, the contractual agreement between PBS and the Postal Service required PBS to continue to hold and pay for the space.

21. Westwood of Lisle – The $247,882 FFO loss was due to intra-GSA payments between PBS and FAS that were incorrectly posted. These payments were made as part of a reimbursable work authorization agreement between PBS and the tenant agency for the procurement and installation of audio equipment. FAS procured the equipment for PBS. When the interfund billing from FAS to PBS took place, Pegasys had a system-wide issue which prevented the system from matching FAS invoices to the correct reimbursable work authorization based on a referenced obligation document number. As a result, the transactions posted against the interfund operating expense general ledger account instead of the cost of goods sold general ledger account. For the FFO reporting purposes, the interfund operating expenses were included in the FFO calculation leading to an FFO loss in Fiscal Year 2016. On September 19, 2016, a fix was applied to Pegasys to correct this system error.

Appendix C – GSA Comments

GSA

Public Buildings Service

June 28, 2019

MEMORANDUM FOR: ADAM GOOCH
REGIONAL INSPECTOR GENERAL FOR AUDITING
GREAT LAKES REGION AUDIT OFFICE (JA-5)

THROUGH: DANIEL W. MATHEWS
COMMISSIONER
PUBLIC BUILDINGS SERVICE (P)

GERARD BADORREK
CHIEF FINANCIAL OFFICER
OFFICE OF THE CHIEF FINANCIAL OFFICER (B)

FROM: JOHN COOKE
REGIONAL COMMISSIONER
GREAT LAKES REGION
PUBLIC BUILDINGS SERVICE (5P)

SUBJECT: Response to the Office of Inspector General (OIG) *Audit of the PBS Great Lakes Region's Lease Financial Performance* (A170047-3)

The Public Buildings Service (PBS) and Office of the Chief Financial Officer (CFO) appreciate the opportunity to comment on the above draft audit report. PBS and CFO reviewed the report and concur with five of the six recommendations made by your office.

Please see the attached Technical Comments document for specific comments regarding the recommendations. If you have any questions regarding this information, please contact Ken Schelbert on 202-501-1109 or by e-mail at kenneth.schelbert@gsa.gov.

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Technical Comments

OIG recommended that the PBS Commissioner:

1. In conjunction with the U.S. General Services Administration (GSA) Office of the Chief Financial Officer:

   a. Return refunds of overpayments to the appropriate tenant agencies.

   b. Develop and implement a process to return refunds of overpayments to the appropriate tenant agencies as required.

   As a general matter, PBS agrees that funds retained within the Federal Buildings Fund (FBF) contrary to PBS policy should be returned to the tenant agency in question. However, regarding the statement on page 7 of the report that "we are not aware of, and PBS did not identify, any express statutory authority for retaining these overpayments," PBS submits the following for your office's consideration. In *Accounting for Rebates from Travel Management Center Contractors*, B-217913.3 (June 24, 1994), GAO stated: "As a general rule all funds received for the use of the United States must be deposited in the general fund of the Treasury to the credit of the appropriate receipt account, *unless deposit to the credit of an appropriation or other fund account is authorized by law.*" (emphasis added). The FBF is, in fact, such a fund authorized by law into which PBS is required to deposit tenant agency Rent payments pursuant to 40 U.S.C. § 592. Any overpayments received by PBS from a private sector lessor are credited to the FBF, and are distinguishable from the "approximate commercial charges" PBS imposes on tenant agencies pursuant to 40 U.S.C. § 586. Moreover, while 31 U.S.C. § 3302(b) refers to monies being deposited in the Treasury, the Draft Report does not recognize that the FBF is, in fact, a fund within the Treasury. *See* 40 U.S.C. § 592(a) ("There is in the Treasury a fund known as the Federal Buildings Fund."). Thus, PBS' crediting of refunds and overpayments from landlords in the FBF complies with fiscal law, including 31 U.S.C. § 3302(b).

   With respect to the Ambassador Bridge lease, to date, PBS has reimbursed the tenant agency for $833,087, and is in the process of addressing the remaining overpayments.

2. Evaluate U.S. Postal Service-owned space leases for terms and conditions allowing for the risk of long-term vacancies and FFO [funds from operation] loss and implement necessary safeguards to protect PBS against this risk.

   PBS agrees with this recommendation. While the leases with the U.S. Postal Service (USPS) do provide PBS with termination rights if the space is fully marketable, GSA has found that in practice that the USPS typically refuses to release GSA from its lease obligations. Accordingly, since March 2016, GSA has been negotiating a Lease Agreement template with the Postal Service so that the appropriate terms and conditions are included to protect the Government from financial loss.

OIG recommended that the PBS Regional Commissioner, Great Lakes Region:

1. Implement a process to ensure timely and accurate execution of lease actions, such as, adjustments to lease payments, real estate tax adjustments, buyouts, broker commission credits, and operating costs.

   PBS agrees with this recommendation. Please note that the lease contract administration function is a national program managed by the PBS Office of Leasing. On January 19, 2018, GSA issued GSA Order ADM 5440.715 to change the organizational structure and functional alignment of lease contract administration in PBS. This Order establishes a zonal structure for Lease Contract Administration that consolidates the processing of PBS's lease contract administration functions (i.e., operating cost escalations, real estate tax adjustments, step rents and change of ownership) from 11 separate Regions to 4 Zones. The regional makeup of these zones is consistent with the zonal structure of GSA's OCFO organization and allows for increased process efficiencies. GSA implemented this new zonal structure for Lease Contract Administration in July 2018.

2. Develop and implement appropriate internal controls to ensure PBS Great Lakes Region leasing actions include the appropriate terms and conditions.

   PBS agrees with this recommendation with a clarification. Current PBS policy and internal controls, as identified in Leasing Alert LA 18-09 - Revisions to Leasing Forms and Templates, issued October 31, 2018, address lease terms and conditions. However, this recommendation emanates from a single finding that is unique to the specific lease reviewed (lease number GS-05B-16943, effective 10/14/2005, and amended effective 11/1/2010) in the draft audit and not due to an absence of internal controls.

3. Implement controls to ensure that claims for prior year overpayments do not affect general and administrative expense allocations.

   PBS disagrees with this recommendation. GSA follows standard accounting practices. In accordance with traditional accrual accounting standards, immaterial adjustments to prior periods are reported in the period costs/adjustments are recognized.

4. Develop and implement internal controls for employee time coding to prevent erroneous direct hour charges to building locations.

   PBS agrees with this recommendation. On April 2, 2019, PBS issued the "Direct Charging for Services Implementation Guide" that identifies services that are not covered by GSA fees and whose costs should be recovered by direct charging. Additionally, this document gives guidance on how to estimate and track direct labor for billing purposes. This guidance provides PBS personnel with a consistent approach to direct charging.

Appendix D – Report Distribution

GSA Administrator (A)

GSA Deputy Administrator (AD)

Commissioner (P)

Deputy Commissioner (P)

Chief of Staff (P)

Regional Administrator (5A)

Regional Commissioner (5P)

Director of Financial Management (BG)

Chief Administrative Services Officer (H)

Audit Management Division (H1EB)

Assistant Inspector General for Auditing (JA)

Director, Audit Planning, Policy, and Operations Staff (JAO)