



# AUDIT HIGHLIGHTS

## SkySong Residential Rent

February 11, 2016

Audit Report No. 1614

### WHY WE DID THIS AUDIT

In August 2015, the Council's Audit Committee approved adding this audit to the Council-approved FY 2015/16 Audit Plan. The Acting City Manager and the Director of Public Works requested this audit of the ASUF's submitted Residential Rent calculation.

### BACKGROUND

A 2006 amendment to the 2004 SkySong Ground Lease agreement between the City and ASUF Scottsdale, LLC (ASUF) modified the agreement to permit residential units on the premises and established provision for rent payment to the City upon the first sale of the residential units.

Residential Rent has two separate components:

1. *Residential Completion Payment* -\$9,200 per unit paid upon the completion of the residential units or applied toward the City's infrastructure commitment. For 325 units, this totaled \$2.99 million.
2. *Residential Net Revenue Payment* - 50% of the Net Revenue from the first arms-length sale of SkySong Residential, excluding the first \$40,000 per unit, or \$13 million. The Net Revenue calculation is defined within the Ground Lease agreement.

In June 2015, ASUF sold the Residential Apartments and, in July 2015, reported that no Residential Net Revenue was due to the City.

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### WHAT WE FOUND

1. Some operating costs were duplicated, and certain expense categories do not appear deductible under the Ground Lease agreement.  
SkySong Residential Rent was understated by about \$377,000. Specifically:
  - Some costs were deducted twice and interest on funding operating costs was included though the contract does not allow for it. The duplicated costs totaled about \$840,000 and related interest expense totaled about \$137,000. Similarly, duplicated gym equipment costs and interest on marketing costs totaled about \$85,000.
  - Garage revenues and operating costs prior to the construction of SkySong Residential were included. This understated Net Revenues by about \$284,000.
  - An early capital contribution of \$700,000 for project feasibility and pre-development was reported as an expense, but ASUF was not able to provide documentation of the related expenditures. Including interest, this undocumented expense totaled almost \$1.2 million.
  - Annual Reserve expense of \$81,250 was deducted although a reserve account was not established.
  - Debt service related expense was understated by about \$453,000.
  - Other expenses not within contract definitions for Operating expense were reported, including owner's association expenses prior to Apartment operations, legal fees, and disposition costs. These totaled about \$129,000.

2. Further clarification is needed to determine allowability of certain other expenses.

In addition to the costs that were inconsistent with contract definitions, we noted other expenses totaling almost \$1.1 million that need further review or legal clarification. Specifically:

- Some of the additional \$299,000 in legal fees do not appear directly related to the construction or operations of SkySong Residential.
- A \$400,000 co-development fee paid to ASUF was not clearly supported and may not meet the lease definitions.
- A \$387,000 loan fee was paid that was not stipulated in the loan agreement.

### WHAT WE RECOMMEND

We recommend the Public Works staff work with ASUF to resolve questioned costs and obtain a revised Residential Rent calculation and associated payment that complies with Ground Lease definition of Net Revenue.

### MANAGEMENT RESPONSE

The Division agreed and responded that staff will work to resolve the questioned costs and obtain a revised Residential Rent calculation and associated payment consistent with the Ground Lease definition.