CITY AUDITOR'S OFFICE

SkySong Residential Rent

February 11, 2016 AUDIT REPORT NO. 1614

February 11, 2016

Honorable Mayor and Members of the City Council:

Enclosed is the audit report for *SkySong Residential Rent*, which was added to the Council-approved FY 2015/16 Audit Plan with approval of the Council's Audit Committee. This audit was requested by the Acting City Manager and the Public Works Division Director.

Our audit found that some costs deducted in the Residential Rent calculation were duplicated and certain expense categories may not be deductible under the Ground Lease agreement. As a result, Residential Rent was understated by about $377,000. Additionally, further clarification is needed to determine the allowability of certain other expenses that total almost $1.1 million.

If you need additional information or have any questions, please contact me at (480) 312-7867.

Sincerely,

Sharron Walker

Sharron E. Walker, CPA, CFE, CLEA
City Auditor

Audit Team:

Lai Cluff – Senior Auditor

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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.

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 provisions for rent payment to the City upon the first sale of the residential units.[1] The Division of Public Works, Capital Projects Management's Real Estate Unit, monitors this and other real estate leases and contracts for the City.

> *Ground Lease Agreement*
> *2004-119-COS*
>
> In 2004, the City purchased a 42-acre property southeast of McDowell and Scottsdale Rd for $41.5 million, and then leased 37 acres of this property to ASUF. The City committed to make up to $44.5 million of infrastructure improvements (Infrastructure Cap). After other changes, the City's investment in the leased property totaled $81.4 million (Total Cost Cap).
>
> In return for a 99-year ground lease, ASUF agreed to construct about 1.2 million square feet of commercial office space in phases and share 50% of Net Revenues with the City, up to a maximum of the City's total cost.

The first phase of SkySong Residential Apartments opened to tenants in late 2013, and remaining construction was completed by April 2014. A property management company handled apartment leases and day-to-day operations. When completed, the Residential Apartments included 325 units, a clubhouse, a fitness center, a pool and a parking garage.

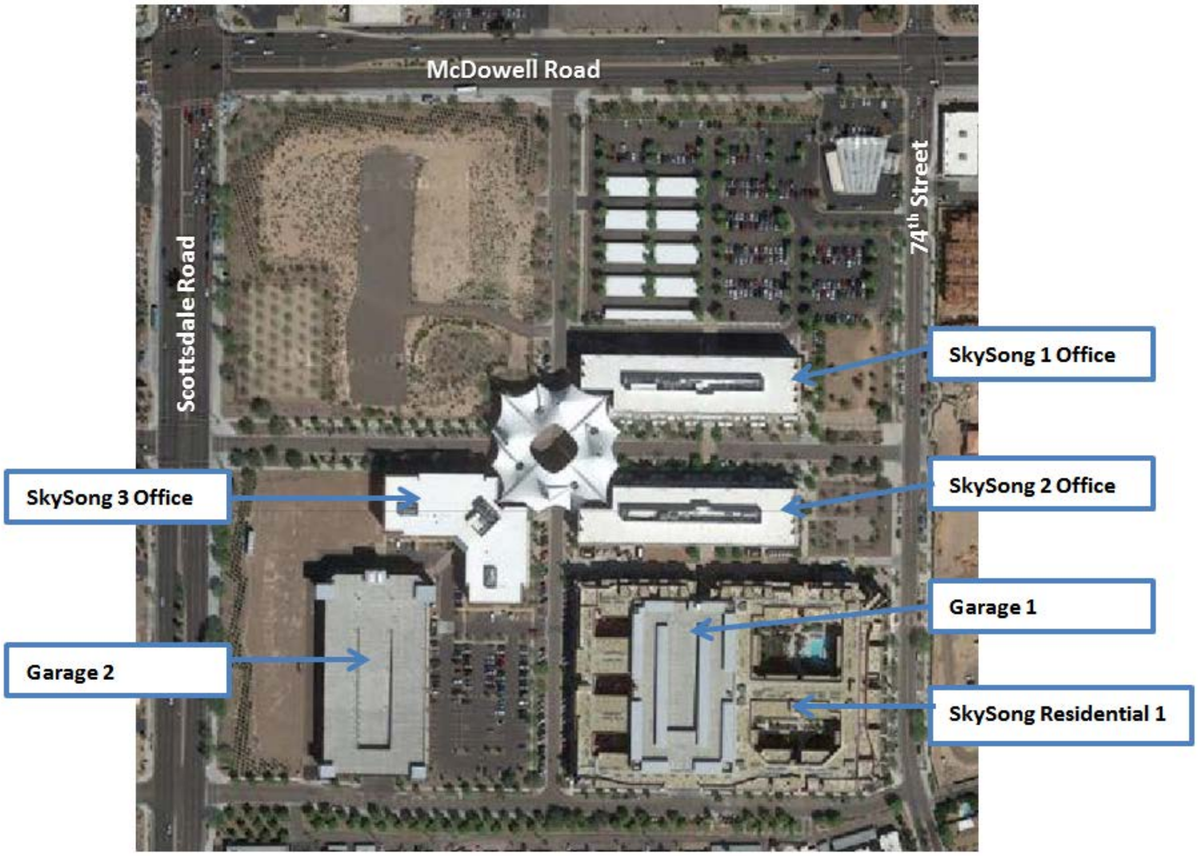
In June 2015, the building was sold to Mid-America Apartment Communities. Included in the sale was the residential parking garage, which was built in 2008 with the intent that it would be shared with SkySong 2 for commercial tenant parking. To complete the City's required capital contribution for infrastructure, the City paid $6 million towards the parking garage construction, in proportion to the projected SkySong 2 use. Even after the June 2015 sale, SkySong 2 retains the right to use approximately 486 parking spaces through an easement agreement. Garage maintenance costs are shared proportionate to the commercial and residential parking spaces.

SkySong Residential 1, LLC

In 2007, SkySong Residential 1, LLC, was formed by ASUF and LHP Scottsdale LLC for the purpose of developing and selling the residential property. LHP Scottsdale LLC provided construction financing and maintained the financial records. A separate property manager oversaw and maintained detailed transaction records for Apartment operations, and the summary financial information were uploaded by LHP into its records. In 2008, ASUF established a Ground Sublease agreement with SkySong Residential 1 LLC. In June 2015, upon sale of the Apartments, SkySong Residential 1 LLC assigned the Sublease to the Mid-America Apartment Communities.

[1] The residential rent was in addition to the original ground lease rent provision for the City and ASUF to share equally in SkySong's net operating income. Amendment 3 signed in 2012 revised the original commercial rent calculation to a fixed payment schedule over 75 years equaling repayment of the City's capital investment.

Figure 1. Aerial View of SkySong



SOURCE: City of Scottsdale Land Information System, 2014 Aerial view.

Residential Rent

There are two separate components to the residential rent calculation.

1. **Residential Completion Payment** – Upon completion of each residential unit, ASUF was to pay a one-time $9,200 per unit to the City. For 325 units, this totals to $2,990,000. However, the lease provided that some, or all, of this amount may be applied toward the City's infrastructure commitment if that had not been met by the time the residential building was completed.

   The 2012 Amendment 3 reduced the City's infrastructure cap to $41.4 million, effectively applying the $2.99 million Residential Completion Payment to reduce the infrastructure cap. The ground lease fixed payment schedule, intended to recover the City's infrastructure investment, was also adjusted for the Residential Completion Payment.

2. **Residential Net Revenue Payment** – This rent payment was also a one-time payment, due upon the first arm's-length sale of SkySong Residential. ASUF is to pay 50% of the net revenue from the residential sale after retaining the first $40,000 per unit, or $13 million. Table 1 on page 5 summarizes the contract definitions to be used in calculating net revenues.

Table 1. SkySong Residential Net Revenue Components

Component	Definition
+ Gross Revenue	All consideration, rent, fees, charges and payments of any kind relating to the occupancy of the Residential Component and proceeds in connection with the first sale of the Residential Component.
– Operating Expense	All expenses incurred by Tenant (ASUF) in connection with the operation and maintenance of the Residential Component.
– Actual Debt Service	Principal and interest repaid by Tenant in connection with funds borrowed to construct the Improvements.
– Annual Reserve	Amounts retained in a reserve or similar account in anticipation of tenant improvement costs.
– Residential Completion Payment	$9,200 per unit paid to the City or taken as a reduction to the City's infrastructure commitment upon the completion of the residential unit. This $2.99 million is deducted from Gross Revenues.
– Net Revenue Exclusion	ASUF retains the first $40,000 of Net Revenue per unit, or $13 million.
= Net Revenue	50% of Net Revenue is Residential Rent due to the City.

SOURCE: Auditor analysis of contract 2004-119-COS.

In July 2015, ASUF reported to the City that there were no net revenues subject to the rent provision and no Rent was due to the City upon the sale of SkySong Residential.

The Acting City Manager and the Director of Public Works requested that the City Auditor's Office audit ASUF's submitted Residential Rent calculation. At its August 2015 meeting, the Audit Committee approved adding this audit to the FY 2015/16 Audit Plan.

OBJECTIVES, SCOPE, AND METHODOLOGY

Upon approval of the Council's Audit Committee, an audit of *SkySong Residential Rent* was added to the City Council-approved fiscal year (FY) 2015/16 Audit Plan. The audit objective was to evaluate the accuracy of the SkySong Residential rent calculated due to the sale of the residential units.

To obtain an understanding of the Residential rent requirements, we reviewed the Ground Lease agreement (COS contract No. 2004-119-COS) and subsequent Amendments 1 through 6. We also reviewed a previous City Auditor audit of SkySong, *Audit No. 1212, SkySong Ground Lease Rent: Calendar Year 2010.*

We reviewed the rent calculation and supporting documents that ASUF submitted to the City's Real Estate Unit after the sale of SkySong Residential. These included loan payoff statements, construction loan agreements, promissory notes, builder's final invoice, construction budgets, and operating cost reports. We also interviewed the Real Estate staff to gain an understanding of lease terms and obtained copies of legal documents, such as parking easements and subleases.

To verify the reported revenue and expense amounts, we obtained the following records, which were provided by ASUF or its SkySong Residential partners:

- Detailed accounting reports of revenues and expenses going back to 2007
- Operating agreements between the entities involved in the project
- Construction loan funding schedules and interest calculations
- Selected vendor contracts and invoices
- Supporting documentation for selected adjustments
- Garage maintenance allocation reports and cost sharing agreements
- Purchase and Sale Agreement and Closing Statement

We analyzed the SkySong Residential transactions by vendor, category and payment description to evaluate compliance with lease terms. Based upon the amounts and apparent nature of transactions, we requested supporting contracts, invoices and other documents to determine the validity and purpose in relation to SkySong Residential construction and operation and the lease terms.

Additionally, we reviewed the City's accounting reports tracking the Infrastructure Cap and Capital Project Management's project spending reports to verify the SkySong Infrastructure spending to date.

Our audit found that some costs deducted in the Residential Rent calculation were duplicated and certain expense categories may not be deductible under the Ground Lease agreement. Additionally, further clarification is needed to determine allowability of other expenses.

We conducted this audit in accordance with generally accepted government auditing standards as required by Article III, Scottsdale Revised Code §2-117 et seq. 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. Audit work took place from September 2015 to January 2016.

FINDINGS AND ANALYSIS

1. Some operating costs were duplicated, and certain expense categories do not appear deductible under the Ground Lease agreement.

SkySong Residential Net Revenue was understated, with some costs being deducted as both Construction and Operating expenses. Additionally, other costs were included that were not related to apartment construction and operations.

A. Some costs were deducted twice and interest on funding for operating costs was included, as summarized in Table 2.

- From 2009 through early 2014, before apartment rental income was able to cover operating expenses, the cash flow for parking garage maintenance and apartment start-up costs was funded through the SkySong Residential construction loans and reported as a Construction cost. However, the actual expenditures had been recorded as operating costs and were also reported in Operating Expenses. These duplicated costs totaled about $840,000.

  The ground lease defines Actual Debt Service as principal and interest in connection with funds borrowed to *construct* the Improvements; therefore, interest on funds borrowed for operating cash flow should not be deducted. Given the loans' 7% and 10% interest rates over this 7-year period, the interest expense for these costs totaled almost $137,000.

- Additionally, the purchase of fitness equipment for the SkySong Residential gym was funded by the construction loan and included in Construction costs but also included as an Operating Expense. These duplicated costs totaled about $81,000.

- As well, about $23,000 in operating expenses for marketing services, though not duplicated in the Operating Expense deduction, was funded by the construction loans and included in Construction costs. The unallowable interest associated with this amount was about $4,300.

Table 2. Duplicated Costs and Unallowable Interest in Net Revenue Calculation

	Amount	Estimated Interest	Cost Classification
Start-up operating costs	$840,182	$136,927	Reported as both Construction Cost and Operating Expense; should be Operating Expense
Marketing costs	$23,177	$4,321	Reported as Construction Cost; should be Operating Expense
Gym equipment	$80,982	n/a	Reported as both Construction Cost and Operating Expense; should be Construction Cost

SOURCE: Auditor analysis of SkySong Residential accounting reports provided by ASUF.

B. Garage revenues and costs not associated with apartment operations were included.

The parking garage was used primarily by commercial tenants of the SkySong 2 office building during the five years prior to the Residential opening. However, ASUF included all of the garage's parking revenue and costs in the Residential rent calculation. According to the Ground Lease agreement, "Operating costs, including insurance premiums, reasonably allocated to the Residential Component in relation to its use of the parking structure" may be deducted as an Operating Expense. Since the parking structure was not used as part of apartment operations prior to the Residential opening in late 2013, these earlier costs and revenues should not be included. About $414,000 in operating revenue and $598,000 of operating expenses reported in the rent calculation were for garage operations prior to the apartments opening.

Additionally, we netted certain offsetting cost allocation entries for SkySong Residential's share of garage maintenance costs, and we excluded the allocated costs that occurred prior to apartment operations. These adjustments increased garage revenue by $99,800.

In total, $314,200 in garage-related revenues and $598,000 in garage operating expenses not related to Residential operations resulted in Net Revenues being understated by $283,800.

C. A $700,000 contribution, that was later reimbursed, was reported as a SkySong Residential construction cost.

One of the SkySong Holdings LLC members made an early financing contribution to determine SkySong Residential project feasibility and fund pre-development costs.[2] SkySong Residential 1 LLC reimbursed this amount in 2008 and recorded the reimbursement as a construction expense. However, ASUF could not provide documentation of the actual expenses to support their relevance to the Residential Rent calculation. Interest expense related to this payment was about $490,600.

Further, according to documentation provided by ASUF, it appears SkySong 1 LLC (a subsidiary of SkySong Holdings LLC) later returned this contribution to the investor during the dissolution of their partnership. A City audit of the 2010 Ground Lease rent noted that SkySong Holdings deducted this settlement cost as an operating expense from the 2010 Ground Lease rent calculation.[3]

D. Although ASUF deducted an Annual Reserve expense, an annual reserve account had not been established and no reserves were transferred with the sale.

ASUF deducted $81,250 as reserves for future tenant improvement costs, which the Ground Lease agreement allows. However, ASUF had not actually established such a reserve account. The Ground Lease defines Annual Reserve as "amounts retained in a reserve or similar account in anticipation of tenant improvement costs." As well, ASUF did not submit the proposed Annual Reserve amount to the City for review, as required by the Ground Lease. Further, no reserves were transferred to

[2] SkySong Holdings LLC was an organization formed by ASUF and affiliated partners to serve as a holding company for the multiple building development projects, which included SkySong 1 LLC, SkySong 2 LLC and SkySong 3 LLC. However, at the time of this audit, this organizational structure had changed.
[3] Audit No. 1212, *SkySong Ground Lease Rent: Calendar Year 2010,* issued November 2011.

the buyer with the Residential sale. According to City Real Estate staff, it is common practice for established reserve accounts to be transferred to the buyer.

E. Interest expense for the month of the sale was deducted both in the loan principal and interest expense, but interest expense did not include some earlier distributions.

   ASUF reported loan principal payments of $42,568,780 in its Residential Rent calculation. However, payoff statements and loan funding schedules show that the loan principal payments, excluding capitalized interest, totaled $42,507,760. The $61,020 difference equals the interest accrued for June 1 to June 11, 2015. However, this partial-month's interest is also included in interest expense, thereby duplicating the deduction. We deducted this amount in the loan principal adjustment in Table 3.

   Further, in reviewing the loan funding schedule, we noted that two additional distributions of accrued interest to investors but the amounts were not included in the reported interest expense, resulting in understated interest expense. These totaled about $514,000. We included this amount in the interest expense adjustment in Table 3.

F. Other expenses, totaling about $129,000, not within contract definitions for Operating Expense were reported.

   - SkySong Owner's Association costs prior to Residential operation—Association expenses, such as water fees, landscaping, and maintenance, and management fees, were included in SkySong Residential operating expenses. While Association membership dues paid after its opening represent a SkySong Residential operating expense, payments prior to this time could not relate to apartment operations. These prior costs totaled about $60,000.
   - Legal expenses—Legal fees not related to tenant leases or apartment management were included in SkySong Residential Operating Expenses. According to the Ground Lease, "attorney fees and other expenses incurred in connection with leasing space in the Residential Component or enforcing such leases" may be included in Operating Expenses. These non-lease legal fees totaled about $35,000.
   - Disposition costs—Legal fees, name trademarking, and survey costs in preparation of the apartment sale were included in SkySong Residential Operating Expenses. According to the Ground Lease agreement, Operating Expenses shall not include: "*Interest, amortization or other costs, including land trust and legal fees, transfer or recordation taxes and other charges in connection with the ownership of the Residential Component or the transfer thereof and any costs associated with any mortgage, loan or refinancing of the Residential Component."* These costs totaled about $34,000.

Recommendation:

Public Works staff should work with ASUF to obtain a revised Residential Rent calculation and associated payment that complies with Ground Lease definitions of Net Revenue.

Table 3. Summary of Finding 1 Adjustments

Residential Rent Components	Reported[1]	Errors Identified	Adjusted Amounts	Finding Sec.
5.5 Gross Revenue:				
Sale of Apartments	$ 67,750,000		67,750,000	
Leasing Operations	4,888,019		4,888,019	
Garage-Related Revenue	520,598	(314,660)	205,938	*1B*
Total Gross Revenue	**$73,158,617**		**$72,843,957**	
5.5 Cost of Sale	364,990		364,990	
5.6 Operating Expenses	3,480,389	(784,561)	2,695,828	*1A, 1B, 1F*
5.7 Actual Debt Service:				
Loan Principal for Design, Development, and Construction	42,568,780	(1,624,380)	40,944,400	*1A, 1C, 1E*
Interest	12,212,283	(117,726)	12,094,557	*1A, 1C, 1E*
5.8 Annual Reserve	81,250	(81,250)	-	*1D*
5.4.1.4 Residential Completion Payments	2,990,000	-	2,990,000	
5.3.1.2.1 Net Revenue Exclusion	13,000,000	-	13,000,000	
Total Deductions	**$74,697,692**		**$72,089,775**	
Net Revenue	**$(1,539,075)**			
Total Errors and Adjusted		**$ 2,293,257**	**$754,182**	
Residential Rent	**$ 0**		**$ 377,091**	

[1]Reclassified $520,598 from Operating Revenue to Garage-Related Revenue and $1,075,533 from Operating Expense to Actual Debt Service to more correctly reflect the nature of the Reported costs.

SOURCE: Auditor analysis of accounting reports and supporting documentation provided by ASUF.

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

In addition to the costs that were inconsistent with contract definitions for the rent calculation, we noted others that may impact the rent amount, but need further review or legal clarification.

A. Some legal fees do not appear directly related to the construction or management of the apartments.

While the Ground Lease specifies that only legal fees incurred in connection with leasing the apartments may be included in Operating Expense, the contract is less specific regarding construction costs. ASUF included significant legal expenses in the deducted construction costs. We reviewed 18 invoices representing more than a third of the reported legal expenses, which went back as far as 2007. All reviewed invoices included some charges that either did not appear directly related to the construction and operation of the Residential Apartments or had only vague descriptions. The described legal services included work on contractual agreements between the SkySong Residential 1 LLC members (each retaining their own legal counsel), negotiations regarding sharing the parking garage, negotiations regarding project financing, and meeting with City staff. While some legal expense is expected during the construction and development of apartment buildings, a significant portion of the reviewed legal costs appeared related to the organization and contractual relationships between the various project partners.

Based on the invoices we reviewed, determining the allowable amount of legal services directly associated with building and operating the Apartments would require a detailed review of each invoice. Table 4 summarizes the amounts deducted from SkySong Residential Gross Revenue for legal services, excluding about $3,700 paid by the property management company for lease-related legal expenses.

Table 4. Legal Expenses

Category	Expense
Funded by Construction Loan	$298,760
Plus: Associated Interest	$153,852
Reported in Operating Expense (in 1F on page 11)	$53,374
Total Legal Expenses	**$505,986**

SOURCE: Auditor analysis of SkySong Residential accounting reports and supporting invoices provided by ASUF.

B. ASUF received a $400,000 co-development fee that does not clearly meet the lease definitions.

The SkySong Residential 1 operating agreement between ASUF and LHP Scottsdale LLC provides that the ASUF and LHP shall be paid additional fees in amounts and at times determined by the Executive Committee. This provision is in addition to ASUF's reimbursable costs, which totaled $462,630, and an administrative fee equal to 1% of gross receipts. While the amount and purpose of this additional fee is not specified in the agreement, a budget attached to a 2012 contract amendment to the partners' agreement shows $800,000 budgeted for "ASUF/USAA Fee & reimbursables." ASUF confirmed that this documentation was the approval to pay the ASUF $400,000 co-development fee but USAA was not paid the other $400,000. Interest expense associated with this fee was about $136,000.

C. A fee paid from the construction loan of about $387,000 was not stipulated in the loan agreement. The loan agreement only specified a 1% commitment fee, which was also paid. Similar to the co-development fee, the SkySong Residential operating agreement provided for a "Guaranty Payment" but did not specify an amount or a basis for such payment. A budget attached to the 2012 operating agreement amendment showed the amount paid, which was 1.25% of the anticipated loan amount. The basis for this payment is unclear and the payee was not specified. Interest accrued on this amount totaled about $95,850.

Table 5. Summary of Finding 2 Questioned Costs

	Amount	Finding Section
Legal fees	$298,760	*2A*
Interest on Legal fees	$153,852	*2A*
ASUF Co-development fee	$400,000	*2B*
Interest on Co-development fee	$136,381	*2B*
Loan fee	$387,013	*2C*
Interest on Loan fee	$95,852	*2C*

SOURCE: Auditor analysis of accounting reports provided by ASUF.

Recommendations:

Public Works staff should work with ASUF to resolve these questioned costs and obtain a revised Residential Rent calculation and associated payment that complies with Ground Lease definitions of Net Revenue.

MANAGEMENT ACTION PLAN

1. Some operating costs were duplicated and certain expense categories may not be deductible under the Ground Lease agreement.

Recommendation:

Public Works staff should work with ASUF to obtain a revised Residential Rent calculation and associated payment that complies with Ground Lease definitions of Net Revenue.

MANAGEMENT RESPONSE: Agree

PROPOSED RESOLUTION: Ground Lease Contract Administrator, Audit staff, and Assistant City Attorney will work collaboratively and meet with ASUF to obtain a revised Residential Rent calculation consistent with the Ground Lease definitions/requirements.

RESPONSIBLE PARTY: Laurel Edgar

COMPLETED BY: 5/31/2016

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

Recommendation:

Public Works staff should work with ASUF to resolve these questioned costs and obtain a revised Residential Rent calculation and associated payment that complies with Ground Lease definitions of Net Revenue.

MANAGEMENT RESPONSE: Agree

PROPOSED RESOLUTION: Ground Lease Contract Administrator, Audit staff, and Assistant City Attorney will work collaboratively and meet with ASUF to resolve questioned costs, and obtain a revised Residential Rent calculation and associated payment that comply with the Ground Lease definition of Net Revenue.

RESPONSIBLE PARTY: Laurel Edgar

COMPLETED BY: 5/31/2016

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