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**2007-719**

**Final Report**

**Audit of Lease Escalations**

**Office of Audit and Evaluation**

**December 18, 2008**



Public Works and  
Government Services  
Canada

Travaux publics et  
Services gouvernementaux  
Canada

**Canada**

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## MAIN POINTS

The Main Points section is not a stand-alone document and must be read in conjunction with the body of this report.

### What was examined

- i. Public Works and Government Services Canada (PWGSC) has a mandate to provide office accommodation to the federal government through Crown-owned and leased buildings. The Department manages approximately 6.9 million square metres of rentable space, of which 3.3 million m<sup>2</sup> (48%) is leased space; 0.5 million m<sup>2</sup> (7%) is lease-purchased space and 3.1 million m<sup>2</sup> (45%) is Crown-owned space. PWGSC provides leased space through approximately 2,000 lease contracts.
- ii. Where negotiated, a lease escalation is an amount paid by the tenant to cover part of the landlord's operating and tax expense increases.
- iii. The purpose of this audit was to determine whether the internal controls over the establishment and payment of lease escalations were adequate and whether they were functioning as intended.

### Why it is important

- iv. Lease escalation payments are one of many elements that influence the cost of accommodation. Adequate internal controls are needed to ensure that lease escalation payments are accurate. In addition, due to the complexity of some lease agreements and the method of calculating lease escalations, controls are required to ensure that payments are made in accordance with lease clauses. These controls need to mitigate the risk of large overpayments over a long period of time and limit claims disputes between parties. During 2007-2008, annual rental payments for leased offices represented \$920M, of which approximately \$67M was for lease escalation.

### What was found

- v. Overall, we observed that internal controls over the establishment, calculation and payment of lease escalations are adequate and functioning as intended. However, improvements could be made in the areas of monitoring, policies/guidance, and training to improve consistency between regions.
- vi. More specifically, although the process varies between regions, we found that lease escalation processes, which include calculation and payment, are being followed and controls are being applied. We observed that the roles and responsibilities are understood by the staff involved in the escalation processes. We also noted that in the absence of up-to-date national guidelines and training, regions developed their own procedures and

these are being followed. However, the absence of national guidelines has contributed to some process inconsistencies between regions.

- vii. In addition, although required by a departmental directive, we noted that no lease escalation “audits” were recently conducted. Finally, we found that, generally, lease escalation files contained all supporting documents.

## Management Response

- viii. The Real Property Branch (RPB) considers the results of the audit accurately and fairly reflect the state of the lease escalation process within RPB. The Branch intends to act on the two recommendations of the audit by implementing a Management Action Plan, detailed as follows.

- ix. We recommend that the Assistant Deputy Minister, Real Property Branch:

1. Update the lease escalation policies and procedures; ensure that they are appropriately communicated; and ensure that they are implemented and consistently applied both in headquarters and across all regions.

**RPB’s response.** RPB agree with this recommendation. RPB is updating and developing lease escalation policies and procedures that will be implemented both in headquarters and all regions.

- 1.1. Develop a work plan with deliverables and milestones for the key policies and procedures to be updated.
  - 1.2. Develop roles and responsibilities of the lease escalation process document to ensure consistency across all regions.
  - 1.3. Update lease escalation policies and procedures documents such as:
    - “*The Ins and Outs of Lease Escalation*” document;
    - The Departmental Directive (#15/78) entitled “Lease Escalation Audit”; and
    - The lease escalation methodology and workflow.
  - 1.4. Table updated lease escalation policies and procedures at the RPB Policy and Planning Steering Committee.
  - 1.5. Formally communicate and provide training, as part of the Lease Administration Course, on updated lease escalation policies and procedures to PWGSC staff involved in the lease escalation process in headquarters and in regional offices to ensure consistency across all regions.
2. Update the lease escalation monitoring process and utilize it to review lease escalation transactions using a risk-based approach to ensure that lease escalation procedures are consistently applied and to reduce the risk of overpayments.

**RPB's response.** RPB agree with this recommendation. RPB will update the escalation monitoring process both in headquarters and all regions to ensure that procedures developed are applied consistently to reduce the risk of overpayment.

- 2.1 Develop a national monthly monitoring process for lease escalation transactions using a risk-based approach.
- 2.2 Carry out quarterly monitoring of a suitable sample size of lease escalation transactions from headquarters and regions.
- 2.3 Report results of quarterly monitoring to relevant RPB and Regional staff

## INTRODUCTION

1. The objective of this internal audit was to assess the adequacy of the internal controls over the establishment, calculation and payment of lease escalations and the degree to which the controls are functioning as intended.

## BACKGROUND

2. Public Works and Government Services Canada (PWGSC) has a mandate to provide office accommodation to the federal government. The Department manages approximately 6.9 million m<sup>2</sup> of rentable space, of which 3.3 million m<sup>2</sup> (48%) is leased space; 0.5 million m<sup>2</sup> (7%) is lease-purchased space and 3.1 million m<sup>2</sup> (45%) is Crown-owned space. PWGSC provides leased space through approximately 2,000 lease contracts. During 2007-2008, annual rental payments for leased offices represented \$920M, of which approximately \$67M was for lease escalation.
3. Where negotiated, a lease escalation is an amount paid by the tenant to cover part of the landlord's increase in operating and tax expenses. An escalation payment is therefore issued as a result of an increase of an eligible item of operating costs or taxes. Lease escalations can also include reimbursements in situations where eligible expenses decreased. The fluctuation (or cost adjustment) is calculated using the difference between the base year (first year) amount and any subsequent year of the term of the lease. Each lease specifies the method for calculating lease escalation payments for both operating costs and taxes.
4. PWGSC uses approximately 10 different types of operating lease escalations. An example of a commonly used lease escalation method of calculation is the "Operating and Taxes Costs Based on Actual Costs" method. With this method, the calculation of the escalation amount is based on the variance between actual costs and the expenses identified in the lease document for the base (first) year. The allocation of eligible expenses between tenants and the lessor is identified in the lease. This allocation is generally proportionate to the percentage of space rented over the total rentable space of the building. Actual costs are normally supported by an audited operating cost statement (or claim) with supporting invoices for each year. Tenants pay their proportionate share of the increase, or conversely, the lessor refunds the proportionate share of the decrease.
5. Another method frequently used to calculate lease escalation is called "Operating Costs Based on Consumer Price Index (CPI)." For escalation based on CPI, a ratio between the current year CPI index (for the month established in the lease) and the CPI index of the base year (for the same month) is calculated. The Real Property Branch (RPB) uses this ratio to determine the "current operating and maintenance costs." Once calculated, these costs are compared to the operating and maintenance costs of the base year, and PWGSC pays the difference or receives a credit to be used to pay rent or any outstanding balance of the tenant.

## FOCUS OF THE AUDIT

6. The audit focused on the lease escalation process as part of lease contracts for both capital and operating leases managed by PWGSC for other federal departments and agencies. The audit included lease escalations for leases located in the National Capital Area (NCA), and Ontario and Western Regions. Combined, these three regions represented, on a national basis, more than 85% of the total escalation costs in 2006-2007. More information on the objectives, scope, approach and criteria can be found in the “About the Audit” section.

## OBSERVATIONS

### **1) Processes and controls are being applied but some improvements are needed.**

7. A process is a series of actions, tasks or functions designed to produce a particular result or goal. Processes are normally supported by controls intended to manage risk and increase the likelihood that established objectives and goals will be achieved. Lease escalation payments are one of many elements that influence the cost of accommodation. Adequate internal controls are needed to ensure that these payments are accurate. In addition, due to the complexity of some lease agreements and the method of calculating lease escalations, documented processes and controls are required to ensure that payments are calculated consistently and made in accordance with lease clauses. These controls are necessary to mitigate the risk of large overpayments over a long period of time and to limit claims disputes between parties.
8. We expected that a comprehensive process to establish, calculate and pay lease escalations was in place and that it included adequate controls such as procedures/guidelines, policy and defined roles and responsibilities. We also expected that the process and controls were consistently applied.

***In the absence of national guidelines, regional procedures were developed but these vary between regions.***

9. We obtained several guideline documents from NCA. However, these documents were dated from 1979 to 1991 and were not used by staff in their day-to-day activities. Although these documents could still apply today, there would be value for RPB to review and update these documents to reflect the current processes and roles and responsibilities, including a detailed flowchart of the lease escalation process.
10. In the absence of up-to-date guidelines, we observed that some regions developed their own desk procedures. Further, we noted that the lease escalation process varies between regions. This includes differences in the role of staff in similar positions. We also found that the regions use different supporting documents during the lease escalation process. In the Western Region, the documents used in support of lease escalation calculations and payments even vary between some of its regional offices. The lack of consistency between the regions and sometimes between regional offices within the same region

could lead to process inefficiencies and potential inconsistencies in the calculation of lease escalation amounts.

11. By developing more up-to-date and consistent policies and national guidelines, RPB would ensure greater consistency between regions and limit the risk of error and overpayment. These policies and national guidelines could also serve as a valuable training instrument.

*No formal training is offered to staff on the lease escalation process.*

12. We found no evidence that formal training is offered to staff on the lease escalation process. In the absence of formal training, senior officers or other colleagues normally provide on-the-job training to new lease escalation employees. The Western Region indicated that its employees had received training in November 2001 through the Lease Administration Course, which is part of the PWGSC Real Property Professional Accreditation Program. The NCA indicated that this course, dated 2002, is currently being revised. However, through our review of the course outline we found no evidence that the lease escalation process is covered. RPB expects to offer an updated course during fiscal year 2008-2009.
13. Although RPB considers the lease escalation process to be a “straightforward” activity, it would be beneficial for staff to include information specific to lease escalation in the revised leasing training material.

*Access to financial information for lease escalation payment is limited to the financial units.*

14. Lease escalation payment information is maintained by units other than those responsible for establishing and calculating lease escalation amounts. In the NCA, RPB’s Business Operations Services maintains and has access to the payment information. In the regions, staff from Finance Branch maintains and has access to this financial information. To compensate for the lack of access to financial information for lease escalation payments, we noted that NCA developed and maintains a detailed log (spreadsheet) of all taxes and operating and maintenance escalation payments for each lease. However, we found instances where the log was not updated to reflect claims adjustments. As a result, the financial information contained in this log was not always accurate.
15. Although the lease escalation units can request the payment information from RPB’s Business Operating Services or from Finance Branch staff, it would be valuable for the lease escalation units to have direct access to the payment report / system. This information would allow lease escalation staff to validate the actual payments with their own files and to perform a year-end reconciliation with actual payments made to ensure the accuracy of their files. It would also allow RPB to perform trends analysis, conduct reconciliations if required, and respond to ad-hoc information requests or claims disputes.



*A lease escalation process is being followed and controls are applied.*

16. Although the process varies between regions, we found that each region follows its own lease escalation process, which includes calculation and payment of escalation.
17. We found that controls over the lease escalation process exist and are adequate. These controls exist through the entire process, including the establishment, calculation and payments of lease escalation. We found that a series of documents are produced during the lease escalation processes, such as spreadsheets, memorandum and payment requisitions. These documents are used to initiate and process lease escalation payments.
18. We also noted that, for the regions examined, roles and responsibilities are generally clearly understood. We also noted that key lease escalation activities are included in each region's desk procedures and in job descriptions of NCA employees involved in the lease escalation process.

**2) Overall, lease escalation calculations and payments are accurate and made in accordance with the lease.**

19. The requirement and method of calculating lease escalation payments are detailed in lease clauses. It is important that lease escalation be accurately calculated to avoid situations of overpayment or claims disputes with landlords. We expected that lease escalation payments were accurately calculated and made in accordance with the requirements of the lease.
20. Through the review of our sampled transactions, we found that, in general, the amounts paid are accurate and made in accordance with the leases. We found six cases of overpayments where errors had not been detected by RPB; one in the NCA; one in the Ontario Region; and four in the Western Region. However, these overpayments are not considered material as they represented less than 1% (and in some cases less than 0.5%) of the total lease escalation amounts paid during the year. For instance, the most significant lease escalation overpayment found on a lease was approximately \$8,000 over a total annual escalation cost of \$877,000. The other overpayments found ranged between less than \$100 to roughly \$1,200 over a one-year period.
21. We also found a few instances where errors in calculation and overpayments occurred but were later identified and corrected by RPB. The most significant of these errors was found in the Ontario Region where an overpayment of \$360,000 was made in fiscal year 2006-2007. This error was discovered by RPB in January 2008 and resolved in July 2008. Overall, we noted that the existing preventive and detective controls have contributed to reducing the risk of overpayments.
22. We also observed that, as another control, Finance Branch conducts post-payment account verification using a risk-based approach. As a result, a sample of financial transactions is reviewed, which may or may not include lease escalation payments.

23. Another risk-mitigation factor is that the majority of leases are with major real estate corporations. In cases of overpayment of escalation, the risk, or the inability to recover the funds, is considered low given the size of the organizations and the frequency of payments. In these cases, PWGSC can either reduce subsequent payments or request a refund.
24. Overall, we found that the lease escalation amounts are calculated and paid accurately, and in accordance with the terms of the leases.

### **3) Lease escalation “audits” are not being conducted.**

25. Government and departmental policies or directives provide specific guidelines that public servants should follow when they carry out their work. Public Works Canada (PWC) or Supply Services Canada (SSC) issued a departmental directive (dated July 12, 1978) before the amalgamation of these two departments into PWGSC in 1993. According to PWGSC’s website, “the policies are still valid and will remain in effect until the sponsoring organization rewrites or cancels them.” The web site also indicates that this directive “remains valid, but it is in the process of being reviewed and updated.”
26. The departmental directive requires that RPB employees, under certain conditions, conduct lease escalation “audits.” This review is essentially an internal monitoring process conducted by RPB employees to provide RPB senior management with assurance on lease escalation payments.
27. We expected that lease escalation “audits” were conducted by RPB as required by the departmental directive. We found no evidence that “audits” were conducted on the lease escalation files included in our sample. When asked, staff in the NCA, Ontario and Western Regions were not aware of any recent lease escalation “audits” having taken place.
28. Although no significant issues of overpayments were found in our sample of lease escalation files, there is always a residual risk of overpayment and non-compliance with lease clauses. By not conducting “lease escalation audits,” RPB is not complying with the directive. A rigorous and risk-based monitoring process applied across all regions would allow RPB to mitigate even more the risk of non-compliance with lease clauses, and further limit the risk of overpayments and potential disputes with landlords.

### **4) Lease escalation files generally contained all supporting documents.**

29. A lease escalation file needs to include all the documents required to support each payment. Proper files enable employees involved in the process to demonstrate due diligence by documenting their decisions and ensuring payments are appropriately supported. We expected that appropriate file(s) exist, are complete and are maintained for each lease escalation.

30. Although each region uses different documents during its process, we found that, overall, lease escalation files for the three regions examined contained appropriate and complete information to support the lease escalation payments.

## CONCLUSIONS

31. Based on the work conducted, we have determined that the controls over the establishment, calculation and payment of lease escalations are adequate. We also established that these controls are normally functioning as intended.
32. We also concluded that a lease escalation process, which includes calculation and payment of escalation, is being followed. In addition, we observed that overall escalation payments are accurate and made in accordance with the lease clauses. We also found that, generally, escalation files audited for the three regions contain all relevant information to support the lease escalation payments. However, we noted that improvements should be made in the area of monitoring, policies/guidance and training in order to improve consistency between regions.

## MANAGEMENT RESPONSE

33. The Real Property Branch (RPB) considers the results of the audit accurately and fairly reflect the state of the lease escalation process within RPB. The Branch intends to act on the two recommendations of the audit by implementing a Management Action Plan, detailed as follows.

## RECOMMENDATIONS

34. We recommend that the Assistant Deputy Minister, Real Property Branch:
1. Update the lease escalation policies and procedures; ensure that they are appropriately communicated; and ensure that they are implemented and consistently applied both in headquarters and across all regions.  
  
**RPB's response.** RPB agree with this recommendation. RPB is updating and developing lease escalation policies and procedures that will be implemented both in headquarters and all regions.
    - 1.1. Develop a work plan with deliverables and milestones for the key policies and procedures to be updated.
    - 1.2. Develop roles and responsibilities of the lease escalation process document to ensure consistency across all regions
    - 1.3. Update lease escalation policies and procedures documents such as:
      - *“The Ins and Outs of Lease Escalation”* document;
      - The Departmental Directive (#15/78) entitled “Lease Escalation Audit”; and
      - The lease escalation methodology and workflow.

- 1.4. Table updated lease escalation policies and procedures at the RPB Policy and Planning Steering Committee.
  - 1.5. Formally communicate and provide training, as part of the Lease Administration Course, on updated lease escalation policies and procedures to PWGSC staff involved in the lease escalation process in headquarters and in regional offices to ensure consistency across all regions.
2. Update the lease escalation monitoring process and utilize it to review lease escalation transactions using a risk-based approach to ensure that lease escalation procedures are consistently applied and to reduce the risk of overpayments.

**RPB's response.** RPB agree with this recommendation. RPB will update the escalation monitoring process both in headquarters and all regions to ensure that procedures developed are applied consistently to reduce the risk of overpayment.

- 2.1. Develop a national monthly monitoring process for lease escalation transactions using a risk-based approach.
- 2.2. Carry out quarterly monitoring of a suitable sample size of lease escalation transactions from headquarters and regions.
- 2.3. Report results of quarterly monitoring to relevant RPB and Regional staff

## **ABOUT THE AUDIT**

### **Objective**

35. The objective of this internal audit was to determine whether the internal controls over the establishment and payment of lease escalations were adequate and whether they were functioning as intended.

### **Scope and Approach**

36. This audit was conducted from January 2008 to August 2008.
37. The audit focused on the lease escalation process as part of lease contracts for both capital and operating leases managed by PWGSC for all federal departments and agencies. The audit covered lease escalation payments made from 2004 to 2007. The audit included lease escalations for leases located in the National Capital Area, Ontario and Western Regions. Combined, they represent more than 85% of total national escalation costs made in 2006-2007.
38. The audit was conducted in accordance with the Treasury Board Policy on Internal Audit and the Internal Auditing Standards for the Government of Canada.
39. Interviews were conducted with personnel in the three regions. Relevant processes and documents were examined.
40. From the complete lists of leases in the NCA, Ontario and Western Regions with lease escalations payments, we sampled a total of 51 lease files (32 from the NCA, 12 from Ontario and 7 from Western Regions). The sample was selected on a judgmental basis taking into consideration the dollar value of the lease escalation payments made by each region and, to a lesser extent, the number of leases with lease escalation clauses.
41. The selected sample covered over 67% of the total lease escalation payments made by these three regions between 2004 and 2007, and roughly 5% of these regions' leases with escalation clauses. Our sample included lease escalation payments using different calculation methods such as Actual, Additional Net, Proportionate Share Above Base on the actual (PSAB) and CPI.
42. Based on analysis of the information and evidence collected, the audit team prepared audit findings and conclusions, which were validated with the appropriate managers, prior to tabling of the Draft Final Report at the PWGSC Audit and Evaluation Committee.

## **Criteria**

43. The criteria for this audit were based primarily on departmental policies and procedures.
44. The audit criteria were as follows:
1. A comprehensive process and adequate controls to establish, calculate and pay lease escalations are in place and consistently applied;
  2. Lease escalation payments are accurate and in accordance with the requirements of the lease;
  3. Lease escalation “audits” are conducted where required;
  4. Appropriate files for each lease escalation exist, are complete and are maintained for each lease escalation.

## **Audit Work Completed**

45. Audit fieldwork for this audit was substantially completed on August 4, 2008.

## **Audit Team**

46. The audit was conducted by members of the Office of Audit and Evaluation, overseen by the Director, Internal Audit, under the overall direction of the Chief Audit Executive, Office of Audit and Evaluation.