



CITY OF  
Santa Fe

City of Santa Fe

Leases Internal Audit

April 2020

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# **City of Santa Fe Lease Administration Internal Audit Report**

City of Santa Fe  
Audit Committee and Management

## **INTRODUCTION**

We performed the internal audit consulting services described below to assist City of Santa Fe in evaluating lease administration. Our internal audit focused on evaluating City of Santa Fe’s processes and controls over lease administration to determine if the City was utilizing best practices and sound internal controls. In addition, we evaluated the current processes in place to ensure compliance with the upcoming changes to the lease implementation standard. To gain an understanding of the processes and controls in place we interviewed key personnel. These interviews indicated significant opportunities for improvement in the existing control structure so detailed testing was not considered beneficial at this time.

Our services were performed in accordance with the terms of our Professional Services Agreement and engagement letter for internal audit services and the applicable Standards for Consulting Services prescribed by the American Institute of Certified Public Accountants. Although we have included management’s responses in our report, we do not take responsibility for the sufficiency of these responses or the effective implementation of any corrective action.

## **PURPOSE AND OBJECTIVES**

In June 2017, the Governmental Accounting Standards Board (GASB) published a single model for lease accounting in order to assist with improving the comparability and decision-making information provided on a government’s financial statements. This change fundamentally alters the way leases were previously accounted for on a government’s books by shifting the way leases are recognized, measured and disclosed. Major changes include:

- Lease classifications into “short-term”, “contracts that transfer ownership” and “all other”;
- Leases longer than 12 months will have balance sheet impact on both the lessee and lessor; and
- Financial statement disclosures and schedules will be required for contracts that transfer ownership and non-short-term leases.

The City of Santa Fe is required to implement GASB 87 by July 1, 2021, for its fiscal year 2022. The City of Santa Fe currently has a lease portfolio consisting of primarily real estate and equipment leases in which the City serves as both the lessee and lessor. Many leases in the portfolio will be subject to the GASB 87 rules therefore, it is critical for the City of Santa Fe to develop an implementation plan and work towards ensuring compliance with the new standard prior to the deadline.

Our internal audit focused on evaluating the City of Santa Fe's controls and processes around lease administration and oversight with an emphasis on measures taken to achieve compliance with GASB 87 by the required implementation date. The primary objectives were to assist management in determining whether processes surrounding the initiation, recording and tracking of leases provided adequate safeguards and reflected best practices to ensure leases were accounted for.

## **SCOPE AND PROCEDURES PERFORMED**

In order to gain an understanding of the processes and operations, we interviewed the following personnel:

- Mary McCoy, Finance Director
- Debra Harris-Garmendia, Accounting Officer
- Clayton Pelletier, Interim Treasury Officer
- Patrick Lucero, Finance Project Manager
- Fran Dunaway, Chief Purchasing Officer
- Jarel LaPan Hill, City Manager
- Brad Fluetch, CFA, Investment and Planning Officer
- Kevin Kellog, Asset Development Manager
- Rich Brown, Economic Development Director
- Lauren Lucero, Economic Development Associate
- Erin McSherry, City Attorney
- Marcos Martinez, Assistant City Attorney
- Irene Romero, Office Manager
- Andrea Salazar, Assistant City Attorney

We inquired whether there are any documented policies and procedures related to lease initiation and management; however, it was communicated that any written documentation was either unavailable or outdated and inconsistent with current practices.

Based on the results of these conversations, significant issues were identified in the existing control structure that the City was already aware of. REDW determined testing the current processes would provide no additional benefit, as it is clear what the issues were and testing

would likely not identify any new insights. REDW worked closely with City of Santa Fe staff to assess which areas should be addressed first and provided recommendations for key considerations as suggested by GASB and the Government Finance Officers Association (GFOA).

## **OBSERVATIONS, RECOMMENDATIONS AND MANAGEMENT RESPONSE**

We identified the following weaknesses in lessee/lessor internal controls:

### ***1) LEASE MANAGEMENT***

The new rules surrounding GASB 87 will require significant recordkeeping for all leases in place with City of Santa Fe. GASB 87 defines a lease as “a contract that conveys control of the right to use another entity’s nonfinancial asset as specified in the contract for a period of time in an exchange or exchange like transaction”. The new standard must be applied retroactively by restating financial statements for all prior periods presented.

The City of Santa Fe has no centralized repository for executed leases, nor any written policies and procedures regarding lease management for when the City is either the lessee or lessor. The Clerk’s Office files all executed contracts, including leases; however, there is no process in place to easily identify lease contracts and/or monitor key dates or other relevant compliance aspects. Further, it was unclear whether the information maintained at the Clerk’s Office was complete and/or accurate. Many lease contracts are old and may lack necessary details that will be necessary to comply with GASB 87.

The existing control structure only provides some oversight for leases in which the City is the Lessee. Lessor type leases are typically older, the contracts lack detail and there is no individual/department responsible for ensuring revenues earned are being collected timely.

**Potential Risk:** *High* – The City of Santa Fe has no mechanism in place to 1) easily identify its portfolio of leases as both the lessee and lessor 2) track and monitor key dates, payments, or other compliance aspects of each individual lease; and, 3) ensure compliance with financial reporting guidelines and upcoming GASB 87 implementation thus elevating this risk to high.

### **Recommendations**

#### GASB 87 Implementation Plan

In accordance with key considerations provided by the GFOA, the City of Santa Fe should consider developing an implementation plan for GASB 87. While the City of Santa Fe has taken some proactive steps to get prepared, such as beginning work on developing a complete lease database and upgrading the MUNIS Financials system, there are several other steps that must be performed to ensure compliance with implementation rules. Below are several recommendations listed in order of suggested implementation that synchronize GASB and GFOA key considerations with the current structure at City of Santa Fe.

#### Lease Aggregation and Portfolio Development

City of Santa Fe should work closely with the Clerk’s Office, departments, and the Assessor’s Office to develop a lease portfolio as well as establish who maintains the information on each lease. City management must first determine how far back accounting and other recordkeeping documents should be examined to maximize the completeness of the portfolio population while

also being mindful of time and resources available. Consideration should be placed on any potentially substantial real estate leases that may have been executed long ago but still represent a significant revenue/expense to the City. In these instances, it may be practical to define different timeframes for each type of lease population. This time frames should be well documented and communicated to all participants working on the project. The portfolio should comprise all leases (both lessee and lessor) and provide a standardized method for differentiation. The City's lease population should be assessed at a) a lower-volume/higher-dollar value arrangement for real estate and property and b) a higher-volume/lower-dollar value arrangements for equipment. The City should then allocate time and resources based on the differing needs and risks of these populations. Also, the City needs to consider maintaining the following for each lease at a minimum:

- The tracking numbers used by various departments (i.e. Clerk's Office and Finance). Each lease should contain all these unique identifiers to more easily communicate with the various departments.
- Department Lease is assigned.
- Contact details of department employee assigned to oversee.
- Lease Terms
  - Lease commencement date; and
  - Lease end date (including end-of-lease options that are reasonably assured/certain).
- Payment Terms
  - Lease incentives;
  - Contractual minimum lease payments;
  - Residual value guarantee, including the amount of guarantee;
  - Bargain purchase options likely to be exercised, including the amount of the option; and
  - Any payments made prior to the start of the lease term.
- Lease Classifications
  - Economic lives of related assets;
  - Fair values of underlying assets; and
  - Interest rate (or incremental borrowing rate).

If existing lease agreements do not contain necessary information and/or are ambiguous, the City should work to revise or amend these contracts and explore whether a standard lease contract template could be used, where practicable. The City's Legal department should work in tandem with the employees tasked with lease aggregation to help facilitate any lease amendments or revisions that are necessary such that each agreement contains enough detail to comply with GASB 87.

#### Identify GASB 87 Leases

Once a complete portfolio of leases has been developed with key details, all leases should be assessed to determine what components must be disclosed under the GASB 87 rules. Per the GFOA, the following steps should be taken during the review of each lease contract:

- If the contract has both lease and non-lease components (i.e. maintenance agreements), separate the lease components from the non-lease components, and treat as separate contracts.

- If the contract has multiple underlying assets with different lease terms:
  - Treat each underlying asset as a separate component (lessor and lessee) and allocate the contract price to each component based on professional judgment and reasonableness.
    - Use the price for each component in the contract, or
    - Stand-alone prices for similar assets.
    - If unable to determine an allocation, treat as a single-lease unit.
- Determine the interest rate charged by the lessor in the agreement, if known (it may be implicit in the lease). Otherwise, an estimate of the interest rate the lessee would be charged to finance the lease is acceptable.

### Lease Tracking Software

The City of Santa Fe will upgrade the MUNIS Financial system which will enable lease tracking. The City should ensure this software will meet the needs for GASB 87 compliance, prior to entering leases into the system. After all relevant GASB 87 leases have been identified, the City of Santa Fe must then perform calculations to determine what must be reported on the financial statements under the new standard. Under GASB 87, the City will be responsible for expanded financial reporting disclosures, both as lessee and lessor. The City should work to input all GASB 87 leases into the MUNIS Financials system and ensure appropriate review controls are in place over the calculations to ensure their accuracy.

### Monitoring

The City needs to define how leases, from the lessee and lessor perspective, will be monitored. Once a portfolio of leases is developed, each lease should be assigned to a designated employee and/or department who will be responsible for ensuring compliance with lease terms.

### Policy and Procedures

Once a lease repository has been developed and a lease tracking software implemented, management should develop policies and procedures around the newly developed processes. Policies are critical documents used to reinforce and clarify the standards expected of employees and will help the City manage staff more effectively as it defines what is acceptable, and creates consistency throughout all departments. Documented procedures are just as important to provide guidance on how activities should be performed and provides safeguards for maintaining institutional knowledge, in the event of employee departures. These new policies and procedures should document both the tracking and reporting components of a lease from both the lessee and lessor side. Items to consider adding are:

- Policies surrounding adequate documentation of lease terms, options, payment provisions;
- Controls to ensure Accounting is aware of new leases and changes to existing leases to ensure proper financial reporting; and
- Capitalization policies on intangible assets.

The City of Santa Fe should consider implementing standardized forms to assist in tracking this information. Policies and procedures should be developed and implemented prior to the effective implementation date of GASB 87.

### Other Considerations

As discussed previously, the GASB 87 standard will significantly change the way governments report leases. As the City of Santa Fe works to implement the changes, other items of consideration include:

- Perform a review of state and local laws and agreements to determine impact with compliance on debit limitations and bond covenants; and
- Utilize the City’s auditors (either external or internal) to work with staff who will be part of the lease process to provide training on implementation and monitoring on leases.

**Management Response:** Management agrees with this observation.

As GASB 87 establishes a single model for lease accounting based on the principle that leases are financings of the right to use an asset, the City will begin training and preparing in FY21 to be in compliance with GASB 87, effective for fiscal year 2022.

City staff has already started the process to create an inventory of existing leases and contracts. This is a time consuming process, as lease contracts are spread across the organization in different departments, divisions, and locations. As part of developing a complete portfolio, staff is gathering and maintaining information specific to GASB 87 compliance, (ex: lease term, extensions, termination options, and payment provisions) for leases, including buildings, land, and equipment as well as subscription-based information technology arrangements.

Staff is reviewing all agreements as agreements may meet the definition of a lease under GASB 87 even if the word “lease” is not in the agreement. As the City creates the inventory of existing leases and contracts, staff is also determining which agreements meet the GASB 87 definition of a lease and which can be excluded as not all leases will meet the definition of a lease under GASB 87. Although only leases that exceed the capitalization threshold of \$500,000 in total lease payments (or \$500,000 in remaining lease payments if the lease has already begun) must be recorded under GASB 87 accounting rules. However, the City is requiring that all leases be tracked and departments will be able to use MUNIS Financials to track all leases, regardless of dollar value.

Currently, policies and procedures along with a business process are being developed that will take into consideration internal controls and compliance with GASB 87 standards so that lessees will recognize a lease liability and an intangible right-to-use asset, and lessors will recognize a lease receivable and a deferred inflow of resources.

Within its MUNIS Financial System upgrade, beginning in FY21 the City has taken steps to ensure the system will be in compliance with GASB 87.

The system will have the following functionality: a central repository of leases, the ability to track City-owned and leased land and leases of other assets such as equipment and vehicles, and software subscriptions; billing for payments, track receivable leases (City is lessor) for land and other assets, and for facilities leased to a non-City entity; record lease accounting transactions, including lease payments, produce reports for reconciliation and financial statement disclosures. By using a single system for multiple business purposes, the City will reduce data entry and increase data accuracy.

As part of future trainings, a list of the data fields that will be required in MUNIS for each type of lease will be provided to Department staff. MUNIS system fields and reports are currently scheduled to be completed in the Spring of 2021 so that staff can start using the new system to maintain additional lease information in preparation for the FY22 effective date of GASB 87.

If existing lease agreements do not contain necessary information and/or are ambiguous, the City should work to revise or amend these contracts and explore whether a standard lease contract template could be used, where practicable.

## **2) LESSOR PAYMENTS**

The City of Santa Fe currently is the lessee and lessor for various types of leases with differing payment requirements (i.e. annual, semi-annual, monthly, etc.). The City of Santa Fe uses an antiquated in-person payment method for lessor payments and there is no mechanism in place to ensure all lessors have been paying the correct amounts on a timely basis. City management communicated to REDW that given the antiquated payment method many lessor payments could have been uncollected for decades. In addition, there is minimal information requested when payments are made therefore, there is no process in place to ensure lease payments are appropriately applied to the correct receivable and revenue accounts. Lastly, there is no database to track lease payments and evaluate delinquencies thus the City is unable to accurately quantify current receivables and pursue collections if necessary. Due to the lack of controls, REDW was unable to quantify a range of potential uncollected revenues. The City of Santa Fe provided an analysis for one department (Economic Development) that attempted to quantify lessor revenues over the period of July 2015 through June 2019. This analysis resulted in total revenues of approximately \$803,000. REDW did not audit this schedule, nor is aware of its completeness, but it may provide some insight into the total magnitude of dollars related to lessor activity. This information was provided only for illustrative purposes as other departments may have fewer, or no, lessor type agreements.

**Potential Risk:** *High* – Failure for the City to adequately account for and monitor lease payments could result in lost revenue. In addition, failure for the City to adequately track lease payments and ensure lease revenues are posted to appropriate accounts could result in skewed financial data which ultimately could affect the decision making process when it comes to lease operations.

### **Recommendations**

We recognize the City has already taken proactive steps towards addressing some of the issues discussed above such as hiring an individual to build a module in the MUNIS system that will allow the City to send invoices to lessees in accordance with lease provisions and also allow payments to be made electronically. In addition, steps are being taken to build a complete lease database in MUNIS Financials to ensure all leases can be tracked and lease receivables are being assessed on each lease to determine where issues may be. As progress continues in this area, we recommend the following items (in order of suggested implementation) be considered:

#### Cash Window Payments

Since not all payments will be electronic, it is critical for controls to be implemented at the City Hall payment window to ensure lease payments received are able to be recorded timely and accurately. The City should consider developing a form with all necessary information such as lessee number, lessee name, property address etc. for the lessee to fill out when making a

payment to assist the City in identifying which payments belong to which leases when they are submitted. In addition, as the City moves towards a paperless environment, it would be beneficial to add all relevant information to the individual invoice so when a customer brings in payment, the Cashier can reference the invoice for assistance in applying the payment to the correct account.

Cashiers who will be processing lease payments should be required to attend trainings regarding how lease payments should be accounted for to ensure the process is consistent. In addition, policies and procedures should be developed over the process for Cashiers to reference when processing payments.

#### Lease Receivables Tracking

Once a database of leases has been developed, the City should implement procedures to review outstanding receivables on a monthly basis to determine if collection efforts need to begin. The City Legal department should be involved in the process and made aware when a lessee becomes delinquent so they can process the collections in accordance with relevant laws and regulations.

**Management Response:** Management agrees with this observation.

In order to maximize revenue collection especially during the budget shortfalls resulting from COVID19, the City has already taken steps to address the issues identified by REDW such as creating an inventory and reviewing terms and collections monthly, ensuring lease revenues are posted to appropriate accounts, starting to upgrade the MUNIS Financial System that will allow the City to send invoices to lessees in accordance with lease provisions and also allow payments to be made electronically.

Within its MUNIS Financial System upgrade, the City of Santa Fe will implement an electronic payment system consisting of the modules General Billing and Vendor Self-Service. This will allow the City's lessees to submit electronic payments that are monitored and tracked in the Project Accounting and Accounts Receivable modules. Regarding the terms and compensation of each individual City lease, policies and procedures, along with a business process are currently being developed that will take into consideration internal controls and compliance with GASB 87 Standards.

City staff has already started the process to create an inventory of existing leases and contracts to ensure all leases can be tracked and lease receivables are being assessed. This is a time consuming process, as lease contracts are spread across the organization in different departments, divisions, and locations. Staff is gathering and maintaining information specific to GASB 87 compliance, (ex: lease term, extensions, termination options, and payment provisions) for leases, including buildings, land, and equipment as well as subscription-based information technology arrangements.

The City has developed a form with all necessary information such as lessee number, lessee name, property address etc. for the lessee to fill out when making a payment to assist the City in identifying which payments belong to which leases when they are submitted. This will create controls at the City's Cashier's Office to ensure lease payments received are able to be recorded timely and accurately. Cashiers processing lease payments have been trained on how lease payments should be accounted for to ensure the process is consistent and the Treasury Officer is developing policies and procedures for Cashiers to reference when processing payments.

Finally, in FY21 the Treasury Officer will implement procedures to review outstanding receivables on a monthly basis to determine if collection efforts need to begin and work with the City Attorney's Office when a lessee becomes delinquent so they can process the collections.

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This report is intended solely for the information and use of City of Santa Fe's management, Audit Committee and City Council members. If additional procedures had been performed, other matters might have come to our attention that would have been reported to you.

We received excellent cooperation and assistance from City of Santa Fe personnel during the course of our testing. We very much appreciate the courtesy and cooperation extended to our personnel. We would be pleased to meet with you to discuss our findings and answer any questions.

REDW LLC

Albuquerque, New Mexico  
August 26, 2020