

GENERAL SERVICES ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

**Audit of PBS's Tenant
Improvement Process
Report Number A050063/P/R/R06005**

March 31, 2006



U.S. GENERAL SERVICES ADMINISTRATION
Office of Inspector General

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Reply to Deputy Assistant Inspector General
Attn of: for Real Property Audits (JA-R)

Subject: Audit of PBS's Tenant Improvement Process
Report Number A050063/P/R/R06005

To: David L. Winstead
Commissioner, Public Buildings Service (P)

This report presents the results of our audit of the Public Buildings Service's (PBS) actions to effectively manage the tenant improvement (TI) process in leased space. **Primarily, the audit assessed the basis for price reasonableness, as well the project and financial management.** Our audit disclosed that improvements could be made to ensure PBS customers **receive the best value** for their tenant improvement dollars. PBS could do this by **strengthening the support for the determination that the prices paid for the tenant improvements are reasonable, by reinforcing active project management of the tenant build-out process, and by improving tracking and reconciling tenant improvement cost.** Additionally, adherence to all **applicable procedures** for identifying leases as either an operating or capital lease could be improved.

If you have any questions regarding this report, please contact me or Regina O'Brien, Deputy Assistant Inspector General for Real Property Audits, on (202) 219-0088.

Susan P. Hall
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EXECUTIVE SUMMARY

Purpose

The audit objective was to assess whether PBS effectively manages the tenant improvement (TI) build-out process in leased space. This encompassed an examination of the basis for price reasonableness, as well as a review of project and financial management.

Background

Tenant improvements (TI) are the finishes and fixtures that raise space from a base building (or "shell") to a finished, usable condition. The Public Buildings Service (PBS) is responsible for managing and overseeing the build-out of tenant improvements for agency customers. PBS provides customers with a monetary TI allowance, which the tenant can use to take the space to a "vanilla" office space and cover the special items necessary to meet the agency's unique needs. The funding source for the TI allowance is the lessor in leased space.

PBS acts as the Federal Government's representative, and negotiates with the lessor to ensure the best value for the Government. Throughout the build-out, PBS monitors the progress of the construction. The tenant improvement costs are recaptured from the tenant either as part of the monthly rental rate or a lump sum Reimbursable Work Authorization (RWA). In FY Year 2004, PBS billed agency tenants almost \$139 million for tenant improvements in leased space.

Results-in-Brief

Improvements are needed in the oversight of the tenant improvement process in leased space. PBS's management of the TI process varied considerably based on the level of involvement by PBS associates or contractors, as well as the degree of influence from the tenant agency. The majority of the sampled projects in two of the three regions lacked strong support for the price reasonableness of the tenant improvements. In several instances, we could not verify that all TI costs were captured and passed on to the tenant. Additionally, many times there was limited documentation illustrating active project management during the build-out process, especially in one region. As a consequence, PBS may not always have obtained the best value for the tenant agency's tenant improvement dollars. Further, some files did not indicate all applicable procedures for identifying the lease as an operating or capital lease (scoring) were followed. Adherence to internal PBS policy, guidance, and training related to the TI process would have prevented many of the deficiencies identified in our review.

Recommendations

We recommend that the Commissioner of the Public Buildings Service take steps to:

- a. Ensure PBS associates follow established guidance for: (1) assessing cost reasonableness; (2) processing RWAs; and (3) scoring leases.
- b. Initiate a standardized methodology for tracking and reconciling TI costs.
- c. Provide guidance and training related to Construction Specifications Institute formatted cost proposals.
- d. Ensure that either the responsible PBS associate, or contracted project management actively manages TI projects.

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INTRODUCTION

Background

Tenant improvements (TI) are the finishes and fixtures that raise space from a base building (or "shell") to a finished, usable condition. As the Federal Government's landlord, the Public Buildings Service (PBS) is responsible for managing and overseeing the build-out of tenant improvements for agency customers. PBS provides most customers with a monetary TI allowance, which is composed of: (1) a general component, which takes the space to a "vanilla" office space; and (2) a customization allowance to cover special items necessary to customize the space for a particular agency. The general allowance is currently \$31.92 (based on Washington D. C. as the index city) and has been static since fiscal year (FY) 2000. It is set nationally and adjusted to local construction costs, which are reviewed annually. Based on a preliminary FY 2005¹ study performed by the Office of the Chief Architect, there will be a slight increase (less than \$1.00 per square foot) in the TI General Allowance Rate in FY 2006. The customization allowance is based on a series of customization tiers, which are equal to one tenth of the value of the general allowance and each agency and bureau has an assigned tier. The customization allowances are not adjusted since they are a percentage of the general allowance. The funding source for the TI allowance is the building owner, which is the lessor in the leased space, and PBS in Federally owned space. PBS does not use tier allowances for prospectus level projects, or projects where PBS has developed extensive program requirements. In these projects, the tenant improvement allowance is based on benchmarks or cost estimates.

In leased space, which is the focus of this audit, PBS acts as the Federal Government's representative, and negotiates with the lessor to ensure the best value for the Government. For most projects, the tenant improvement process begins after PBS has negotiated the overall space requirements and rent rate with the successful lessor. The lessor, working with PBS and the agency tenants, prepares working/construction drawings for the improvements per Government requirements. Based on these drawings, the lessor must provide the PBS Contracting Officer (CO) with a pricing proposal for the tenant improvements. This proposal can be based on detailed cost or pricing data or evidence of price competition. After the CO determines price reasonableness, the lessor is given a notice to proceed with the build-out of the tenant improvements. Throughout the build-out, PBS monitors the progress of the construction. After the Government

¹ This study will be finalized in August 2006, at which time the TI General Allowance rate will be revised. Please see Management's Comments in Appendix A-1 for additional details.

determines that the space is substantially complete, and accepts the space, rent payments commence.

The tenant improvement costs are recaptured from the tenant either as part of the monthly rental rate and/or a lump sum Reimbursable Work Authorization (RWA). There is an upper limit on the amount that can be amortized in the rent, which is the point at which TI pushes the total rent beyond the top end of the market. In FY 2004, PBS billed agency tenants almost \$139 million for tenant improvements in leased space.

Objective, Scope, and Methodology

The audit objective was to assess whether PBS effectively manages the TI build out process in leased space, which is the focus of this audit. PBS acts as the Federal Government's representative, and negotiates with the lessor to ensure the best value for the Government. This encompassed an examination of the basis for price reasonableness, as well as a review of project and financial management. We performed audit work in the National Office and three Regions: National Capital (Region 11), Southeast Sunbelt (Region 4), and Mid-Atlantic (Region 3). We reviewed:

- Initial lease offers to determine the extent of competition;
- TI price proposals for sufficient detail to assess price reasonableness;
- Evidence of PBS review/negotiations related to the TI proposal;
- TI and shell definitions in the Solicitation for Offers (SFO);
- The extent of tier adjustments;
- Methodologies for tracking TI and reconciling costs from the initial SFO proposal to the final billed amount;
- Payment, scoring, and RWA issues related to TI;
- Amounts billed the tenant as compared to the Occupancy Agreements GSA has with the tenant;
- The OA Tool with regard to ensuring TI related data was accurate, complete, and reflected lease information; and,
- Evidence of project related correspondence, status meetings, progress inspections, GSA/Agency input, punch lists, and open items reconciliation.

To accomplish our objective, we spoke with cognizant Regional and National Office associates regarding tenant improvements, and methodologies related to awarding and administering the build-out. We also reviewed applicable PBS policies and desk guides, Federal Acquisition Regulations (FAR), Office of Management and Budget (OMB) guidance, as well as stated regional business practices. Our sample was selected from leases where TI build-out was completed and space acceptance and billing occurred in fiscal year 2004. A total of 20 large to small dollar leases were selected: five from the National Capital Region (NCR), seven from Region 4, and eight from Region 3. The sampled leases varied greatly in both size and dollar value of the tenant improvement

costs. Square footages ranged from roughly 4,900 rentable square feet (RSF) to 127,000 RSF. The sample's total square footage was about 783,000 RSF. According to PBS's database, the TI costs for the leases in our sample ranged from about \$358,000 to \$7,000,000, with the sample's total TI value approximating \$34,000,000, including the TI for four prospectus level projects. For sampled leases, we reviewed lease and project management files for evidence of competition/negotiation/evaluation efforts made toward ensuring the Government received the best value for its tenant improvement dollars. We also assessed aspects of the TI process related to financial management of build-out costs, as well as on-site project management.

Fieldwork was conducted between May and October 2005. The audit was performed in accordance with generally accepted Government auditing standards.

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RESULTS OF AUDIT

Improvements are needed in the oversight of the tenant improvement process in leased space. PBS's management of the TI process varied considerably based on the level of involvement by PBS associates or contractors, as well as the degree of influence from the tenant agency. The majority of the sampled projects in two of the three regions lacked strong support for price reasonableness. In several instances, we could not verify that all TI costs were captured and passed on to the tenant. Additionally, many times there was limited documentation illustrating active project management during the build-out process, especially in one region. As a consequence, PBS may not always have obtained the best value for the tenant agency. Further, some files did not indicate all applicable procedures for identifying the lease as an operating or capital lease (scoring) were followed. Adherence with internal PBS policy, guidance, and training related to the TI process would have prevented many of the deficiencies identified in our review.

PRICE REASONABLENESS

While many projects exhibited only limited documentation to support the basis for the price reasonableness of the lessor's TI proposal, there was usually some evidence to indicate PBS's efforts to obtain fair and reasonable prices for the Government. Support in this area was especially strong for the five projects in the National Capital Region. However, improvements in this area are needed to provide PBS's customers with the full benefit of their tenant improvement allowances.

The FAR requires contracting officers to obtain sufficient information to determine price reasonableness. PBS leases, which incorporate FAR references, require the lessor to provide detailed cost or pricing data as a basis for entering into negotiations to determine a final cost for the tenant improvements. In lieu of cost or pricing data, the lessor can submit a price based on the results of a competitive process, if several conditions are met. They include: (1) inviting a minimum of three qualified contractors to participate; (2) no building shell items are included in the competitive proposal; and (3) the proposal contains specifics on overhead, profit, and fees, so that such costs can be negotiated. If the contracting officer (CO) does not feel that the lessor's submission provides sufficient information to determine price reasonableness, the CO can request an Independent Government Estimate (IGE) as a point of comparison. We reviewed PBS lease and project management files to evaluate the COs' basis for their determination that the TI costs were fair and reasonable. Specifically, we assessed whether the files contained: (1) cost or pricing data, (2) competition in lieu of cost or pricing data; (3) Independent Government Estimates; (4) detailed evaluation of proposals; and

(5) evidence of negotiation. Five of the 20 files we reviewed did not contain evidence of any of these.² Ten files contained some evidence of competition as a basis for the proposed TI costs. The remaining five included some combination of an IGE, record of negotiations, or evaluation of proposed costs.

We noted that a positive contributing factor in the extensive negotiations evidenced in the NCR files was the involvement of contract Project Managers. Conversely, the majority of Realty Specialists also acted as Project Managers in the instances where we found limited evidence of evaluation and negotiation of the proposed TI costs.

According to PBS, its Leased Cost Relative to Market Performance Measure is based on the entire lease rent rate paid to the lessor. PBS performance measure data for FY 2004 notes that the weighted average rental rate for PBS leases in the three regions we reviewed were from 3.91 to 10.7 percent below market comparable rates. While we did not perform a detailed analysis of the overall rental rates negotiated by PBS for the total leased space, we did review the market analysis information contained in the lease files. Eight of the files in our sample did not contain such information. Of the twelve which did, one contained a memorandum requesting permission from the Realty Services Division to award a lease with a rental rate above market comparable rates, based on the tenants unique space needs.

Limited Evidence of Detailed Cost or Pricing Data, or Competition for TI Work

Whether providing cost or pricing data or competing the work, the lessor must provide sufficient proposal detail to allow the contracting officer to perform a thorough analysis. None of the files for the 20 leases in our sample contained detailed cost or pricing data. Ten of the 20 had evidence that the lessor submitted a price based on competitive bids. Two of these ten projects were competed at the general contractor level³. Eight projects had evidence showing that competitive bids were sought from the sub-contractors doing the trades work such as carpentry, plumbing, electrical work, etc. Of these, only one had multiple bids for all subcontract work. The remaining seven only received multiple bids for a portion of the subcontract work.

Negotiation and Evaluation of TI Proposals Not Always Performed

² While the PBS associates responsible for two of these five stated they made a good faith effort to obtain fair and reasonable prices, they could not provide documentation to substantiate these statements.

³ Documentation of these competitions consisted of memos from the lessor's representative. No copies of the actual contractor bids were included in the file.

PBS regional training stresses the importance of reviewing and negotiating the lessor's TI proposals. We assessed the files for evidence that the TI proposals in our sample were evaluated for inclusion of shell items and the price reasonableness of specific proposed costs. Evidence of PBS's actions in negotiating changes to the proposed costs was also examined. Eleven files contained verification that the lessor's proposal was evaluated and used as a basis for negotiations. Six files, predominately in the NCR, contained considerable documentation supporting the Government's efforts. These efforts included the removal of shell items from the lessor's proposed TI costs. In contrast, nine of the projects contained minimal evidence of active TI price negotiation or substantive evaluation of TI proposals prior to project award. This may result from TI proposals not being presented in sufficient detail to allow effective evaluation and negotiation. Several of the TI price proposals in our sample were limited to one page, broad-based breakdowns by general construction element (i.e., plumbing, electrical, painting, etc.) with no details to be evaluated.

Another mechanism available to the Government to assist in evaluating price reasonableness is an IGE. Seven of the twenty leases reviewed included IGEs specific to the TI build-out. Five of the IGEs were associated with projects in NCR. While three of these IGEs were significantly less than the lessor's proposals, the Project Managers stated the information was still useful for negotiations.

Thirteen SFOs (in two of the regions reviewed) required that contractor proposals be submitted in Construction Specifications Institute (CSI), or compatible format. TI training in these two regions also emphasized obtaining TI proposals in CSI format. This layout breaks down construction elements to a point where PBS associates can readily determine whether shell items are included in TI and facilitates comparing different offers. Only two projects from our sample actually received TI proposals with detailed construction element breakouts. When queried, PBS associates in the regions stressing the use of CSI formatted proposals stated that they did not understand what actually constitutes CSI format, the status of its implementation, or the required analysis of the submitted product. It does not appear that the requirement for CSI formatted proposals is actively enforced. Additionally, PBS does not have nationwide guidance regarding CSI requirements or format. If it is PBS's intent that lease proposals be in CSI format (as evidenced by the language in the standard SFO), then PBS needs to develop clear guidance in this area. In a related matter, while SFOs clearly state shell items are not to be included in the TI costs, some SFOs in our sample did not differentiate shell and TI in sufficient detail to allow meaningful guidance to the lessor, although the PBS standard SFO contains detailed language outlining what is TI versus what is shell. This omission could be especially troublesome to smaller lessors who may not be as familiar with Government contracting. PBS should require that proposals meet FAR and SFO requirements and aggressively negotiate and evaluate the TI proposals to ensure the Government receives fair and reasonable pricing throughout the TI build-out process.

FINANCIAL MANAGEMENT

Financial management of the TI process varied significantly among projects reviewed. Due to wide variances in cost tracking efforts by PBS associates we were not always able to determine whether all TI costs were captured and passed on to the tenant agency. Even in instances where we could verify costs, we encountered unique payment issues. These included: TI being amortized beyond the firm term of the lease; lease terms extended without competition to keep rent rates under market; and lessor's being paid for tenant improvements months before the build-out work began. As a result, GSA, in accommodating tenants, may have taken actions that were in violation of policy. We also encountered examples where RWA monies were moved among projects without evidence of an amended RWA. Finally, there were omissions in data related to the OA Tool, which is used to generate the Occupancy Agreements (OA) for the tenant, and the tenant's rent bill.

TI Cost Tracking and Reconciliation Not Always Done

The TI cost tracking effort varied significantly among GSA associates. We were able to easily reconcile TI costs for eight of the projects in our sample, primarily because the responsible PBS associate/contractor employed a rational cost tracking methodology. Usually this was in the form of project cost summaries, as well as instructions detailing how the lessor would be compensated for TI costs (amortized in the rent or by a lump sum payment) in a Supplemental Lease Agreement (SLA). For a number of projects, however, costs were not tracked at all or were tracked informally. To illustrate, some tracking was limited to written notations on various file documents. This made reconciliation difficult, and sometimes impossible. The CO for three projects where TI costs could not be reconciled inherited the projects after the original PBS associate left the region. This new CO was also unable to recreate final TI project costs, or determine whether all TI costs were passed on to the tenant. Under these circumstances, if a tenant requested a full accounting of their TI costs, PBS would have difficulty reconstructing the TI charges.

In another project, the SLA formalizing the final TI amount to be amortized in the rent showed the rental rate as being adjusted downward \$2.39 per usable square foot in the first five years of the lease because the tenant did not use the entire TI allowance. While the SLA referenced the total TI allowance it did not clearly state the actual TI amount to be amortized in the rent. Nor did the SLA break out the rent rate into its basic components--shell, TI and operating costs. The SLA did show the reduced rent rate in effect in five years, when the TI amortization period was over. Subsequently, when PBS prepared the final OAs, and corresponding rent bills for the tenant, they subtracted the \$2.39 from the shell rental rate, not the TI portion of the rent rate. Potentially, this could result in PBS overcharging the tenant for unpaid amortized TI if the tenant vacates the space early. Or, if the tenant stays in the space more than five years, PBS will be under billing the tenant by charging insufficient rent to cover the lessor's remaining rent costs.

RWAs Used for Other Than Intended Purposes

As part of our cost reconciliation of the TI projects, we assessed if PBS obtained the appropriate RWAs for those TI costs that were not amortized in the rent. According to PBS policy, such RWAs must contain a sufficiently detailed scope of work, including the location and the type of work to be performed. Our assessment disclosed RWAs used for projects and purposes other than initially intended without the requisite authorization. This is counter to RWA National Policy Guidance, which requires an amended RWA from the tenant agency if funds are to be used for purposes other than originally intended. Ten RWAs, from six leases in our sample, intended for a particular scope of work were also used for purposes/buildings other than those designated on the RWA. For example, a sample lease was assigned an RWA for \$200,388, designated for above standard alterations. This same RWA had \$125,967 obligated against another building. In another instance, a \$540,000 RWA designated for above standard alterations for a project in West Palm Beach Florida, had almost \$105,000 charged against the RWA for work in a Tallahassee, Florida building. In these, and other instances, there was no record of an amended RWA in either the lease files or the PBS RWA databases. In May 2005, PBS issued a Reimbursable Work Authorization National Policy Document to consolidate PBS's RWA guidance and to foster consistency across the regions regarding the RWA program.

Unique Payment Issues

Our review disclosed some novel payment arrangements related to TI amortization. One lease showed TI being amortized for a period (17 years), which significantly exceeds the firm term of the lease (10 years). PBS pricing policy states the amortization period is usually the firm term of the lease. According to a PBS associate, this was done at the request of the tenant, who wanted a lower annual rent. He believes GSA is protected from potential monetary penalties because of a verbal agreement with the lessor. The agreement reputedly maintains that if the tenant agency leaves after the ten-year firm term of the lease, and does not make payment on the outstanding TI, the lessor will absorb the remaining costs. This agreement is not reflected in any lease file documents. The written OA and the Rider to the lease both state the firm term of the lease is 10 years but that the TI amortization term is 17 years. Neither document explains how remaining TI costs are to be paid if the lease term is not extended. This lease also has a \$225,248 rent credit (for an unpaid commission on the base building) that is being amortized at a lower interest rate than the TI over a 25-year period. This rent credit not only exceeds the firm term of the lease, it also exceeds GSA's 20-year leasing authority. PBS was flexible with amortization and lease terms in order to satisfy customer and lessor needs; however, PBS may have left itself vulnerable to potential financial ramifications.

In another instance, one lease's unique tenant requirements necessitated TI costs that were \$17.20 per usable square foot more than the tenant's TI

allowance. The lessor agreed to a 5-year lease extension in order to amortize the entire TI amount over fifteen years versus the originally intended ten. This lease was extended without competition. The Contracting Officer's Justification for Other Than Full and Open Competition notes that to award to other than the incumbent lessor at the time of the lease extension would result in substantial costs to the Government. These examples illustrate how higher TI requirements can impact GSA leasing actions.

Payment Methods Conflict with Good Business Practices

During the course of this review we found at least two instances where payment methods conflict with good business practices. In these instances, PBS began paying the lessors for alteration work far in advance of the work being received. First, in a succeeding lease, amortized payments to the lessor for TI in the amount of \$312,222 (17 months x \$18,366 per month) were made almost a year and a half before the start of the TI build-out. As a consequence, the lessor was effectively paid in advance (17 months) for TI alterations. The tenant wanted to be billed from the lease commencement date in April 2004 to spread the cost of tenant improvements over a longer timeframe. The TI build-out did not begin until June of 2005, with an estimated completion date of August 2005. The actual value of the TI alterations as of July 2005 (\$361,897) was only 16 percent of the total TI allowance (\$2,204,242) for which the tenant agency is being billed and the lessor is being paid. The project's Realty Specialist did not consider the timing of the TI payments, and billing for this project unusual, noting that the Government would receive a rent credit for any unused TI amount. Other PBS associates advised us that, optimally, the lessor should be paid using incremental rent rates. At the initial lease commencement, the lessor would be paid the new rent rates, except for the TI costs. Upon the completion of the TI build-out, a SLA would be prepared to incorporate the final TI costs into the rent rates.

On another project, the final total TI allowance for the lease included more than \$408,000 that was reserved for future TI for 13,000 square feet on the building's third floor. PBS's tenant required the entire leased space even though the tenant did not have a specific organization designated for this 13,000 square feet at the time of lease commencement. These reserved funds were amortized into the final total TI figure and passed through the rent bills at lease commencement (first rent bill to tenant and payment to lessor in June 2004). A tenant was eventually found for the majority of the reserved space. TI for this space was scheduled for completion in September/October 2005. As a result, at the time of this review, TI had been prepaid for more than a year while awaiting a prospective tenant. The Realty Specialist did not view this situation as unusual, explaining that a future tenant would likely be found, and that a rent credit would be issued if the TI allowance was not fully spent in the future.

These types of arrangements reduce the lessor's incentive to negotiate TI prices and complete the TI build-out in accordance with agreed upon time schedules. The lessor's diminished incentive to actively fulfill his contractual obligations may

also impact resolution of TI open items. Further, such arrangements necessitate careful oversight and cost reconciliation, two areas we found lacking in several projects in our sample.

OA Tool TI Related Data Often Unavailable

The OA is a record of understanding between GSA and a client agency, including financial terms and conditions. The OA Tool is a web-based application that enables users to create OA's for client agencies, including the assignment of TI costs. It also provides the capability to select and run reports containing financial and clause information, and to preview various rate calculations before creating the OA. During our review of TI related data in the OA Tool, we found that information was incorrect or unavailable as the result of manually performed calculations and unpopulated fields.

To illustrate, in one region the Data Accuracy Group manually calculates the TI rates and inputs the information into the OA Tool. This can lead to math errors that result in incorrect CBR information being entered into the OA Tool, which occurred in one of our sample projects. This task could be better, and more accurately, accomplished through use of the calculation function incorporated into the OA Tool. Entering required information into appropriate OA Tool Cost Screens allows accurate calculation of TI costs, and their automatic distribution to required OA Tool fields.

Additionally, in many instances, fields related to TI expenditures and payment methods, especially RWA costs, were not populated. Discussions indicate that PBS associates do not always feel it necessary to capture the entire TI amount in the OA Tool. Since TI costs are not always documented in official lease files, it is important that all OA Tool related fields be correctly completed.

PROJECT MANAGEMENT

For six projects, evidence of active project management was generally absent leading us to question whether PBS aggressively managed the build-out to ensure that costs were controlled and tenant needs were met.⁴ Four of the six projects were located in the same region. In this particular region, the Realty Specialist usually also served as Project Manager. In the other two regions, where the majority of projects exhibited evidence of strong project oversight, PBS usually contracted out the project management function.

Additionally, in all three regions, PBS utilized neither competition nor IGEs for most change order work, and the files contained minimal evidence of negotiation or evaluation of change order costs. For some change orders, invoices or quotes

⁴ While PBS considers a lessor's past performance prior to awarding a lease, even projects awarded to reliable performers require sufficient project management oversight to ensure the customer expeditiously receives quality tenant improvements.

were provided as cost support. For the most part, it appears change order costs were accepted as proposed.

To assess the extent of project management we reviewed information on status meetings, inspections, general correspondence, and change order evaluation. We also discussed projects with the GSA associate or contractor who oversaw the build-out. For projects with limited project oversight we found the following:

- In one project, with TI of approximately \$1.2 million, there were three Project Managers working on the building simultaneously, which caused confusion as to orders and record keeping. The lead Project Manager used the lessor's cost tracking spreadsheet as the lease's official cost tracking mechanism. The spreadsheet showed higher costs than we were able to substantiate given the lease and project files. PBS began billing the tenant, and paying the lessor even though the space was not substantially complete and the tenants had limited use of the space. Punchlist items were not resolved until eight months after the billing for the entire TI amount had already begun. The tenant agency has lodged a complaint against GSA citing poor project management.
- The lessor began the approximately \$368,000 in TI build out without submitting a TI proposal and receiving a notice to proceed. TI costs are still being negotiated more than a year and a half after the effective date of the lease. The effective date of this lease was December 2003, and negotiations regarding final TI costs and the amount due lump sum (RWA) from the tenant were ongoing as of August 2005.
- The lessor never provided a TI proposal for the approximately \$691,000 in costs; instead he informally sent in TI price quotes via email, which did not provide sufficient detail for a thorough analysis of the costs. He also began TI build out without a Notice to Proceed (NTP) from GSA. Further, TI open items were not resolved until several months after the effective date of the lease. These files also contained correspondence reflecting tenant dissatisfaction with timeliness of open items resolution. The lessor and the Realty Specialist disagreed about TI reimbursements due the lessor for months after the effective date of the lease.
- There was little evidence (i.e. correspondence, inspections, change order negotiations, status meetings, etc.) of active GSA project management for three of the TI projects which had approximate TI costs ranging from \$368,000 to \$1.3 million. It appears oversight of the build-out was essentially turned over to the lessor. It should be noted, however, that the files contained no indication of claims or customer dissatisfaction.

Based on the above, it appears that lack of oversight may have, in some instances, contributed to the Government not receiving the best value. Claims and customer dissatisfaction may also have resulted.

SCORING NOT COMPLETED PER PRESCRIBED POLICY

Part of GSA's responsibility when entering into leases for its customers is to ensure that the leases are appropriately identified as capital or operating leases in accordance with OMB scoring requirements. In this regard, our review identified issues related to the OMB scoring process. We found three instances where leases approaching capital lease status were not rescored even when TI costs exceeded the estimates in the initial scoring analysis. Budget scoring (scoring) is the method by which the Federal government distinguishes between capital expenditures and operating expenditures. Capital expenditures are those expenditures that are equivalent to the purchase of an asset. If a lease is designated a capital lease, GSA must allocate budget authority in the initial year of the lease that equals the present value of the triple net lease payments over the full term of the lease plus the cost of the associated annual real estate taxes. An operating lease's obligations are limited to the lease payments due to the lessor each year. Since GSA has fiscal year budget limitations on its rental of space authority, PBS must ensure that lease actions do not cause PBS to exceed this authority. Of the seven criteria that must be met for a lease to be characterized as an operating lease, the one posing the biggest challenge to PBS is the requirement that the present value of the minimum lease payments over the term of the lease do not exceed 90 percent of the fair market value of the asset at the inception of the lease.

National PBS guidance suggests that scoring may be required three times in the lease process: (1) when the space requirement is first identified; (2) at the solicitation stage and prior to award (using projected TI costs); and (3) if changes occur in the minimum rent or the discount rate. For our sample it appears most leases were initially scored, however, there was little indication that they were rescored in instances where TI costs surpassed the TI costs evaluated as part of the award process. While most of the leases in our sample were significantly under the 90 percent referenced above, three leases initially scored in the high 80's (one at 89.99 percent). There was no indication that these leases were rescored after TI build-out, even when amortized TI costs increased. Since the actual TI costs raised the rent rates, these properties could possibly have attained capital lease status. Additionally, the full service rent rate for the 89.99 percent lease was calculated incorrectly. The TI for this lease was to be amortized in the first five years of the lease term. Therefore, the second five years of the lease had a much lower rental rate. This requires the rental costs to be levelized by a net present value of the rent stream. In the case in our sample, the person who prepared the scoring documents simply averaged the two rent rates. Levelizing the rent, as opposed to simply averaging the rent would have probably resulted in a higher rent rate, since greater weight is given to the rent rates earlier in the lease term.

Another lease, with a score of 68.39 percent, did not include all applicable TI rent in the initial scoring document. The lease contained the option to amortize additional TI for an increase of \$1.59 in the rent rate (which the Government

exercised). However, the person who prepared the scoring documents only used the lower TI amount in the full service rent rate. We were advised by a PBS Capital Investment Officer, that the preparer should score such leases using the different possible lease scenarios to determine the impact changes in the lease rate would have on the scoring ratio. While the Region did not include the option amount in the initial scoring performed in the early stages of the project, the Region did include the option amount in a revised scoring performed after tenant build out.

In many instances, leases may not have been scored at all. The lease files for eight leases (six in one region) contained no evidence of scoring. A PBS associate responsible for one of these leases commented he did not realize scoring was required for “small” leases. Since fiscal year 1999, Regions have been required to maintain records showing a scoring analysis for every lease.

Given the serious budget and accounting consequences of entering into a capital lease, it is imperative that PBS associates preparing scoring documents adhere to all scoring guidelines and appropriately test all scoring scenarios.

CONCLUSION

PBS’s responsibility in obtaining quality space for agency clients extends beyond obtaining competitively procured leased space. After lease award, PBS associates must ensure that the space is built out in accordance with the agencies needs, while pursuing the best value for the Government. PBS has provided policy, guidance and training to PBS associates to assist in optimally performing these tasks. Many of the conditions cited in our report, including minimal evidence of efforts to obtain price reasonableness, limited indications of thorough financial management, inadequate project management, and insufficient scoring of leases, could have been avoided by consistent implementation of PBS policy.

RECOMMENDATIONS

We recommend that the Commissioner of the Public Buildings Service take steps to:

- a) Ensure PBS associates follow established guidance for: (1) assessing cost reasonableness; (2) processing RWAs; and (3) scoring leases.
- b) Initiate a standardized methodology for tracking and reconciling TI costs.
- c) Provide guidance and training related to CSI formatted cost proposals.
- d) Ensure that either the responsible PBS associate or contracted project management actively manages TI projects.

MANAGEMENT COMMENTS

The PBS Commissioner has provided comments to this report, which we have included in their entirety as Appendix A. Management's response indicates concurrence with the report conclusions and recommendations. Changes were made to this report to incorporate points made in Management's comments.

MANAGEMENT CONTROLS

As discussed in the Objective, Scope and Methodology section of this report, the audit focused on aspects of the TI process. Related management control issues are discussed in the context of the audit findings and addressed by the recommendations provided above.

APPENDICES

APPENDIX A

Audit of PBS's Tenant Improvement Process Report Number A050063/P/R/R06005

Management's Response to Draft Report



MAR 30 2006

GSA Public Buildings Service

MEMORANDUM FOR REGINA O'BRIEN
DEPUTY ASSISTANT INSPECTOR GENERAL
FOR REAL PROPERTY AUDITS (JA-R)

FROM:

DAVID L. WINSTEAD
COMMISSIONER (P)

SUBJECT:

Review of PBS's Tenant Improvement Process
Draft Report Dated March 9, 2006
Number: A050063

The Public Buildings Service (PBS) concurs with the essence of the Office of the Inspector General's (OIG's) conclusions and recommendations. We are confident that the current direction of the program, driven by our eLease transaction management tool, upcoming issuance of a joint Realty Services Letter addressing scoring, and anticipated training for cost reasonableness will enable us to address the issues raised, not only by OIG, but by our internal reviews as well.

We have identified two areas in the report that we feel do not properly present our policies and request that OIG revise the report accordingly:

1. Page 1 (Background section) – Clarification to the footnote. The new rate will be loaded into the OA Tool upon receipt and will be available for use for new projects. Additionally a notice will be sent to the Realty Specialist indicating the TI rate has been changed and asking if the OA should be revised to reflect the new rate. The Realty Specialist will have the opportunity to incorporate the new rate on a case-by-case basis.
2. Page 2 (Background section) – Amend the first sentence in the first full paragraph. The tenant improvement costs are recaptured from the tenant either as part of the monthly rental rate and/or a lump sum Reimbursable Work Authorization (RWA).

Throughout the audit report, there are instances noted where RWAs were not properly administered either because "... RWA monies were moved among projects without evidence of an amended RWA" or RWAs were "... used for projects and purposes other than initially intended without the requisite authorization." We are concerned about these findings and believe we have some opportunities this fiscal year to work closely with the regions to improve these particular areas of our reimbursable program.

U.S. General Services Administration
1800 F Street, NW
Washington, DC 20405-0002
www.gsa.gov

APPENDIX A

Audit of PBS's Tenant Improvement Process Report Number A050063/P/R/R06005

Management's Response to Draft Report

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As noted in the audit report, we have issued the RWA National Policy Document that describes our business policies regarding RWAs. We believe this will help our associates consistently implement our reimbursable program to our customers, nationwide. We have also initiated several reviews this fiscal year where we plan to evaluate the validity of a significant number of PBS open non-recurring RWAs. We have already developed several areas to analyze and will also include a review to: (1) determine that the RWA file has a detailed scope of work (i.e., location, site address, building number, etc.); and (2) support that the actual services rendered or goods procured by GSA are for the purposes as stated in the description of work on the RWA (GSA Form 2957). We will identify the errors and provide corrective action as necessary. The results of these reviews will provide us areas where further training is required in our regional and/or field offices and where additional clarification of our policies is needed.

We agree that the National Office should play a more strategic role than it has in the past few years. While guidance exists for several of the topics raised in the report, practical training tools to more consistently implement the guidance has lagged behind. Thus, in fiscal year 2006, we will begin preparing training to address cost reasonableness, processing RWAs, and reviews of lease scoring. This will include guidance and training related to Construction Specifications Institute (CSI) formatted cost proposals.

We also plan to develop standardized methods to track and reconcile project costs and identify required project management resources. Based on project size and complexity, we plan to develop parameters for determining the level of resources needed for active project management, and we will develop template letters/memoranda to be used in eLease to ensure these communications take place.

In January 2006, we re-implemented the regional peer reviews of lease files so that we can proactively identify areas where trends indicate guidance is not being followed consistently, and we will take appropriate steps to provide training as needed. We have reviewed three regions to date, and reviews of the remaining regions are planned and will be conducted through November 2006.

We appreciate the opportunity to comment on the draft audit report for the Tenant Improvement Process. If you have any questions, please contact Mr. Anthony E. Costa, Deputy Commissioner, Public Buildings Service, at (202) 501-1100.

APPENDIX B

Audit of PBS's Tenant Improvement Process Report Number A050063/P/R/R06005

Report Distribution

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