

ABERDEEN CITY COUNCIL

COMMITTEE	Audit, Risk and Scrutiny Committee
DATE	24 February 2021
EXEMPT	No
CONFIDENTIAL	No
REPORT TITLE	Internal Audit Report AC2017 – Industrial & Commercial Property - Rental Income and Void Control
REPORT NUMBER	IA/AC2017
DIRECTOR	N/A
REPORT AUTHOR	Colin Harvey
TERMS OF REFERENCE	2.2

1. PURPOSE OF REPORT

- 1.1 The purpose of this report is to present the planned Internal Audit report on Industrial & Commercial Property - Rental Income and Void Control.

2. RECOMMENDATION

- 2.1 It is recommended that the Committee review, discuss and comment on the issues raised within this report and the attached appendix.

3. BACKGROUND / MAIN ISSUES

- 3.1 Internal Audit has completed the attached report which relates to an audit of Industrial & Commercial Property - Rental Income and Void Control.

4. FINANCIAL IMPLICATIONS

- 4.1 There are no direct financial implications arising from the recommendations of this report.

5. LEGAL IMPLICATIONS

- 5.1 There are no direct legal implications arising from the recommendations of this report.

6. MANAGEMENT OF RISK

- 6.1 The Internal Audit process considers risks involved in the areas subject to review. Any risk implications identified through the Internal Audit process are as detailed in the attached appendix.

7. OUTCOMES

- 7.1 There are no direct impacts, as a result of this report, in relation to the Council Delivery Plan, or the Local Outcome Improvement Plan Themes of Prosperous Economy, People or Place.
- 7.2 However, Internal Audit plays a key role in providing assurance over, and helping to improve, the Council's framework of governance, risk management and control. These arrangements, put in place by the Council, help ensure that the Council achieves its strategic objectives in a well-managed and controlled environment.

8. IMPACT ASSESSMENTS

Assessment	Outcome
Impact Assessment	An assessment is not required because the reason for this report is for Committee to review, discuss and comment on the outcome of an internal audit. As a result, there will be no differential impact, as a result of the proposals in this report, on people with protected characteristics.
Privacy Impact Assessment	Not required

9. APPENDICES

- 9.1 Internal Audit report AC2017 – Industrial & Commercial Property - Rental Income and Void Control.

10. REPORT AUTHOR DETAILS

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Internal Audit Report

Resources

Industrial & Commercial Property

Rental Income and Void Control

Issued to:

Steven Whyte, Director of Resources
Andy MacDonald, Director of Customer Services
Stephen Booth, Chief Officer – Corporate Landlord
Jonathan Belford, Chief Officer – Finance
Jacqui McKenzie, Chief Officer – Customer
Fraser Bell, Chief Officer – Governance
External Audit

EXECUTIVE SUMMARY

Aberdeen City Council has around 800 assets in its Tenant Non-Residential Property portfolio (TNRP) (the Investment Portfolio). These non-operational assets within the Council's asset register are commonly referred to as Commercial Investment Property and are leased to individuals, commercial organisations, charities and voluntary groups.

The portfolio largely comprises of retail, office and industrial units across Aberdeen and surrounding areas. Whilst recent additions to the Council's assets include the Marischal Square hotel, office and retail complex in the City centre and two hotels situated at TECA, these are operated through separate contractual and management arrangements.

In addition to the socio-economic benefits which investment properties may offer, the lease income which the portfolio generates makes an important contribution towards the cost of funding Council services. In December 2019, income from the portfolio was forecast to be £21,565,000 for the 2019/20 financial year. It is accounted for in a separate Trading Account managed by the Corporate Landlord section within Resources.

The objective of this audit was to provide assurance over the processes in place for letting, recovering rental income, and managing voids for industrial and commercial premises.

At the time audit work was completed (January 2020), written guidance was not all up to date, records and approvals were not held consistently, and Key Performance Indicators were limited to income targets. The Service has stated that procedures have since been updated, records have been consolidated and approval processes clarified, performance standards are being reviewed as part of the Council's performance management framework, and further review of the efficiency of leasing administration is in progress.

The Council last approved a Property Asset Management Framework and Strategy in 2016. A Property Estates Strategy is currently being developed which will inform a review of the commercial estate. The Service plans to wait until there is greater stability in the market before concluding this review. In the interim, in response to Internal Audit's findings, the Service has stated that it has implemented quarterly reviews in respect of surplus property, revised processes in respect of void property recording and monitoring, and it will be reviewing further aspects of service design as part of the budget setting process.

Debt collection is managed corporately rather than within the Service. At the time audited, the Service had limited access to regular information on tenant arrears to direct intervention where appropriate. The Service has stated that this information is now available, and a debt review process has been proposed between responsible Services.

1. INTRODUCTION

- 1.1 Aberdeen City Council has around 800 assets in its Tenant Non-Residential Property portfolio (TNRP) (the Investment Portfolio). These non-operational assets within the Council's asset register are commonly referred to as Commercial Investment Property which can be leased to individuals, commercial organisations, charities and voluntary groups.
- 1.2 The portfolio largely comprises of retail, office and industrial units across Aberdeen and surrounding areas, as well as smaller assets such as garage lockups and pieces of land which are, for example, leased as car parking spaces or telecommunications mast sites. More recent additions to the portfolio include the Marischal Square hotel, office and retail complex in the City centre and two hotels situated at TECA. Whilst part of the portfolio, these are operated through separate contractual and management arrangements.
- 1.3 In addition to the socio-economic benefits which investment properties may offer, the lease income which the portfolio generates makes an important contribution towards the cost of funding Council services. As at December 2019, income from the portfolio was forecast to be £21,565,000 for the 2019/20 financial year. It is accounted for in a separate Trading Account managed by the Corporate Landlord section within Resources.
- 1.4 The objective of this audit was to provide assurance over the processes in place for letting, recovering rental income, and managing voids for industrial and commercial premises. This was obtained through enquiry and a walk through of relevant documentation and system data in respect of a sample of assets and lease arrangements.
- 1.5 The factual accuracy of this report and action to be taken with regard to the recommendations made have been agreed with Stephen Booth, Chief Officer – Corporate Landlord.

2. FINDINGS AND RECOMMENDATIONS

2.1 Written Procedures

- 2.1.1 Comprehensive written procedures which are easily accessible by all members of staff can reduce the risk of errors and inconsistency. They are beneficial for the training of current and new employees and provide management with assurance that correct and consistent instructions are available to staff. This is important in the event of an experienced employee being absent or leaving, and they have increased importance where new systems or procedures are being introduced.
- 2.1.2 Written procedures are available for staff in a shared drive and range from detailed system operation instructions to an indexed property management manual. However, the impact of changes in the Service management and staffing structure, which had resulted in revised reporting lines and practice, had not yet been reflected in procedures.

Recommendation

The Service should ensure that written guidance relating to investment property letting and void property management reflects current governance arrangements and practice.

Service Response / Action

Agreed. The service was in the process of being redesigned and procedures were in the process of being updated and made consistent across different service areas. The procedures have now been consolidated and updated and will be subject to annual review.

Implementation Date

Implemented

Responsible Officer

Chief Officer (Corporate Landlord)

Grading

Significant within audited area

2.2 Strategy

- 2.2.1 In 2016, the Council approved its 2016-2018 Property Asset Management Framework and Strategy which stated 'Property...income must be maximised and additional income streams should be identified [since] this income helps support service delivery.' This involves 'investing to increase or maintain revenue income, disposing of poorly performing investment assets, [and] identifying new sources of revenue from assets.' Key planning objectives for the Council's property portfolio include having 'the right assets, at the right time, in the right place', maximising value from non-operational assets and increasing the income they generate.
- 2.2.2 The Strategy had not been updated to consider whether these objectives remain relevant in 2020 and to confirm whether these were still the focus of Corporate Landlord's approach to the Investment Portfolio.

Recommendation

The Service should update the Property Estates Strategy.

Service Response / Action

Agreed. A Property Estates Strategy is currently being updated/ developed which will lead to a review of the commercial estate later in 2021 . A soft market testing exercise was undertaken with regard to the TNRP and then aborted due to market changes around Covid. A review is proposed but will not be reported until there is greater stability in the market.

Implementation Date

Responsible Officer

Grading

Estates Strategy – April 2021	Chief Officer (Corporate Landlord)	Significant within audited area
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- 2.2.3 The Service had no Key Performance Indicators to demonstrate how efficiently the portfolio is operating. This could limit opportunities to determine performance across each property type in terms of income, meeting the City’s property related socio-economic needs, and delivering the Property Asset Management Strategic aims efficiently.

<u>Recommendation</u>		
The Service should put in place Key Performance Indicators which will inform management’s strategic development of the Investment Portfolio.		
<u>Service Response / Action</u>		
Agreed. The portfolio has been managed to meet the income targets set within the budget process and maximise income. This key performance criteria has been met.		
KPI’s will be reviewed as part of reviewing Service Standards in late 2020.		
<u>Implementation Date</u>	<u>Responsible Officer</u>	<u>Grading</u>
April 2021	Chief Officer (Corporate Landlord)	Significant within audited area

- 2.2.4 As part of the Council’s commitment to Shaping Aberdeen and to improve the use of its resources, in 2016 the Service committed to reviewing the investment portfolio to identify where investment and dis-investment was required. The Framework’s Asset Management Methodology involves a review of assets including the ‘Commercial Investment Portfolio’. In 2016 the status of this action was recorded as ‘To be drafted’.

- 2.2.5 As at November 2019, the portfolio included 797 assets, 742 of which had live leases in place. It included industrial and commercial properties such as shops, offices, industrial units, telecommunications mast sites, wayleaves, temporary occupation agreements etc. for which rental income is received. It also included properties generally being used for recreational or charitable purposes which are leased for a nominal sum.

- 2.2.6 In March 2019 the Council’s budget report identified asset rationalisation and a review of its portfolio as contributions from the Service towards managing the Council’s funding gap. Although consideration is given to individual elements of the portfolio content as leasing arrangements change, there has been no specific exercise to review the whole portfolio, therefore opportunities to meet or improve the budget position may not have been achieved.

- 2.2.7 Where properties have no lease in place or generate little rental income, the cost of managing the leases and maintaining the properties can outweigh their benefit to the Council, hence the need for a regular Portfolio review. There is often good reason for properties being held vacant or land not being leased, e.g. where land areas are earmarked for road improvements. However, the reasons and assumptions are not consistently recorded, or subject to periodic review to ensure they remain valid. Opportunities to divest, or obtain income in the short term, may not be realised.

<u>Recommendation</u>		
The Service should periodically review the Investment Portfolio to ensure that assets remain strategically relevant and add value to the Council.		
The Service should ensure sufficient data is available to support periodic review.		
<u>Service Response / Action</u>		

Agreed. Reviews have been established and consistency in recording all surplus property types and designations have been agreed including commercial property, which will be reviewed on a quarterly basis.

<u>Implementation Date</u>	<u>Responsible Officer</u>	<u>Grading</u>
Implemented	Chief Officer (Corporate Landlord)	Significant within audited area

- 2.2.8 The cost of void properties can be significant for the Council in terms of Business Rates, utility payments and maintenance. The risk of vandalism, theft and fire-raising also increases when properties are vacant, resulting in additional potential costs.
- 2.2.9 While there was evidence of some property checks being undertaken (some of which are daily), the necessity, adequacy and regularity of checks across the portfolio had not been set out.
- 2.2.10 Given the number of properties in the Investment Portfolio and the limited resources available, a clearer and more strategic risk-based approach to property monitoring could provide greater assurance in terms of the management of void properties. To ensure that the extent and regularity of monitoring is commensurate with risk, consideration should be given to the types of property, their history and location, and any current factors which may increase the risk.

Recommendation

The Service should ensure that it can demonstrate a clear, risk-based approach towards the monitoring of properties in the Investment Portfolio.

Service Response / Action

Agreed. A revised process has been agreed and is now in place.

<u>Implementation Date</u>	<u>Responsible Officer</u>	<u>Grading</u>
Implemented	Chief Officer (Corporate Landlord)	Significant within audited area

- 2.2.11 Major investment projects and new income streams such as TECA and Marischal Square have increased income to the Council. These projects include reliance on external partners, to varying extents in respect of property and tenancy management including letting, recovering rental income, and managing voids.
- 2.2.12 Although the Service provided verbal assurance of the arrangements in place, evidence was not available to demonstrate the agreements with those involved which detail the roles of each organisation and the lines of responsibility in relation to letting, income recovery and void management; or of regular meetings and supporting records between the Council and the property management agents to discuss letting, income and void management.

Recommendation

The Service should retain agreements, evidence of meetings and monitoring reports associated with property management arrangements at TECA and Marischal Square.

Service Response / Action

Agreed. All information in relation to letting meetings and property management meetings are recorded in an electronic file for MSQ. A shared site has also been established for the TECA development albeit this is still in a handover phase between the capital delivery team and ongoing management.

<u>Implementation Date</u>	<u>Responsible Officer</u>	<u>Grading</u>
Implemented	Chief Officer (Corporate Landlord)	Significant within audited area

- 2.2.13 The Service had not programmed a review of the merits and efficiency of these arrangements which commenced in 2017-18 for Marischal Square and 2019-20 for TECA. It would be prudent to identify a suitable point in the future when the impact of the new property management arrangements can be reviewed and reported.

<u>Recommendation</u> The Service should programme formal reviews to report on the effectiveness and efficiency of the property management arrangements associated with the TECA site and Marischal Square.		
<u>Service Response / Action</u> Agreed. The Service will establish a regular review process of management arrangements. This will form part of the annual service design and budget setting process.		
<u>Implementation Date</u>	<u>Responsible Officer</u>	<u>Grading</u>
March 2021	Chief Officer (Corporate Landlord)	Important within audited area

- 2.2.14 As the Investment Portfolio includes assets which are managed for non-commercial reasons, and the scale of these income streams (in comparison to the above) may result in limited commercial interest, the more traditional elements continue to be managed internally. There may however be options or elements of practice which could be implemented to parts of the Investment Portfolio to enhance the efficiency and effectiveness with which the Service delivers its objectives.

<u>Recommendation</u> The Service should consider whether different approaches to property management could be applied across parts of the Investment Portfolio which might increase Portfolio income and deliver Portfolio objectives more efficiently and effectively.		
<u>Service Response / Action</u> Agreed. This will be considered as part of the service design process on an annual basis.		
<u>Implementation Date</u>	<u>Responsible Officer</u>	<u>Grading</u>
April 2021	Chief Officer (Corporate Landlord)	Important within audited area

2.3 Leasing Process

- 2.3.1 Robust systems and processes are needed for letting, income recovery and the management of void properties within the Investment Portfolio to ensure appropriate records are maintained, that rent invoices are accurate and timeously raised and that income from the Investment Portfolio is maximised where possible. The Service utilises a property management system to record property valuations, lease and tenant information.
- 2.3.2 The leasing process for Investment Property is overseen by the Corporate Landlord and involves the following stages:

- 2.3.3 Rental valuation – Property rental values are determined from surveys performed in accordance with Royal Institute of Chartered Surveyors (RICS) guidelines by RICS-qualified Surveyors. Depending on staff availability, surveys may be undertaken in-house or by an external provider.
- 2.3.4 Property advertising – Marketing details which incorporate an ‘asking rent’ are drafted by Corporate Landlord and are then advertised on the Council’s website and / or via a letting agent.
- 2.3.5 Lease negotiation – where a potential tenant is identified, the general terms of the lease (Heads of Terms) are agreed between Corporate Landlord and the prospective tenant. The Legal team (Governance) are instructed to prepare the lease document.
- 2.3.6 Lease finalisation – Following the agreement of all parties, the lease is signed by the tenant and the Council, and details are passed to Central Administration (Customer) to ensure the property management system is updated with the current lease terms and tenancy details. Tenants’ records are cross referenced to the Debtors system for invoicing.
- 2.3.7 Tenant invoicing – Investment property rent invoices are raised in accordance with the terms of the lease, through a monthly interface file which is downloaded from the property management system and transferred following manual adjustments to the financial system. Checks are in place to confirm that invoice data is uploaded correctly.
- 2.3.8 Thereafter, Lease Extensions, Lease Terminations, Rental Revaluations and other tenancy changes are administered using the same systems and staff within the Council.
- 2.3.9 For the purposes of property letting, income recovery and void management, the Service retains documents relating to rental valuations, marketing, lease agreements and property checks in electronic files which have a Case Number for each property. This Case Number is detailed in the Property’s record within the property management system.
- 2.3.10 While the leasing process provides reasonable control over letting and income, and segregation of duties is such that the risk of fraud is reduced, the process could be made more efficient. The Property Details Amendment Form (PDAF) is a key control form on which Case Officers record changes to tenancy and lease details which impact on invoicing. PDAF’s must be authorised by the Estates Manager before being passed to the Central Administration Team for processing to the property management system.
- 2.3.11 Similar information is passed in other formats for different purposes to and from other parties involved, including the Legal team and the tenant. Forms which were noted included the Heads of Terms, the Lease Summary, the Property Transaction (PT) Form, and a Concluded Missives Advice in addition to the PDAF. If these forms can be combined, or embedded in the system with sufficient authorisation and review controls, the processes could be more efficient and reduce the risk of error inherent in duplicating and transferring data.

Recommendation

The Service should review the efficiency of the leasing administration process.

Service Response / Action

Agreed. Minor amendments have been made with the introduction of SharePoint and Teams systems, although further review work is required.

Implementation Date

December 2021

Responsible Officer

Chief Officer (Corporate

Grading

Important within audited

2.4 Rent Reviews

- 2.4.1 Rental valuations are undertaken as required by rent review terms in a lease, when a property is to be advertised for let, a new lease is established, or at the end of a lease when an assessment for dilapidations may be required.

- 2.4.2 Leases in excess of one year typically include a clause setting out the frequency of rent reviews. Leases are set up in the property management system with dates when, in accordance with the lease, a rent review is due and a surveyor’s assessment of the rental value required. The system alerts the Service when rent reviews fall due, and evidence of them being completed is retained in the electronic case file with details being fed into the property management system. Reviews can be delayed, pending completion of surveys and negotiation with tenants, though the standard position is that they are back-dated to the date on which they should have been completed. The revised rent agreed with the tenant is detailed on a Property Details Amendment Form (PDAF) which is signed off by the Estates Manager.

- 2.4.3 There was no set guidance on the level of variation from Surveyor’s rental valuation which may be accepted, and documentation of reasons for reducing rents is not consistent. Setting thresholds, delegated levels of authority, and evidentiary / documentary requirements would improve efficiency and assurance over the process.

- 2.4.4 A substantial element of the portfolio (201 properties / 25% in November 2019) was subject to Tacit Relocation – i.e. leases had been extended year on year under the same conditions and rent levels, indicating the Service has not taken action to serve notice on tenants to end the tenancy or formally re-let and apply a rent review. This may be an appropriate option for assets which could prove difficult to re-let or which are anticipated to result in a lower market rent being determined. However, the Service did not retain consistent evidence in support of these decisions.

<u>Recommendation</u>		
The Service should retain consistent evidence in support of decision making.		
<u>Service Response / Action</u>		
Agreed. The rent review valuation and reporting system has been altered to give clear parameters for negotiation. The market has however seen reduction in rental levels in a number of areas in recent years.		
A process has been introduced by the service to support the process and any decision for a property to be on tacit relocation. This is signed off by the Team leader or Service Manager.		
<u>Implementation Date</u>	<u>Responsible Officer</u>	<u>Grading</u>
Implemented	Chief Officer (Corporate Landlord)	Significant within audited area

2.5 Lease Terminations

- 2.5.1 Where a lease terminates, the Service must ensure that staff check the property and issue a PDAF form to the Central Administration team in order that the status of the vacant property is revised in the property management system.

- 2.5.2 There are various actions which should take place at the end of a lease including end of lease property checks, meter readings and disconnections, the update of system records

and recovery of any final income due, e.g. for dilapidations caused by the tenant, and consideration of application for business rates relief. Whilst there was some evidence of these actions taking place, records were not always consistent. A checklist could provide further assurance over completion.

<u>Recommendation</u>		
The Service should develop and implement checklists for relevant lease stages.		
<u>Service Response / Action</u>		
Agreed. A checklist is now being completed for all new terminations.		
<u>Implementation Date</u>	<u>Responsible Officer</u>	<u>Grading</u>
Implemented	Chief Officer (Corporate Landlord)	Important within audited area

2.5.3 Where a property becomes available for let it should be advertised on the Council's website as soon as possible to increase occupancy and maximise income from the portfolio.

2.5.4 A list of properties identified as vacant and available for let in the property management system was checked to the Council's website and 31 of 56 vacant properties were not advertised at that time. This could suggest that property classifications within the system need to be reviewed to provide greater assurance that there is a legitimate reason for vacant properties not being marketed. Otherwise, marketable properties could be overlooked, potential income lost and the risk of unauthorised and fraudulent use of properties could increase.

<u>Recommendation</u>		
The Service should ensure that vacant properties are clearly classified in the property management system to ensure that all which are available for lease are promptly re-advertised.		
<u>Service Response / Action</u>		
Agreed. A review process to reclassify vacant assets correctly across all accounts has been introduced and is reviewed on quarterly basis. A number of properties were identified which are of little or no value or held for other purposes.		
<u>Implementation Date</u>	<u>Responsible Officer</u>	<u>Grading</u>
Implemented	Chief Officer (Corporate Landlord)	Significant within audited area

2.6 Rent Arrears

2.6.1 In 2018, responsibility for income recovery for all services, including Corporate Landlord, was transferred to the Service Income Team within the Customer Service. A lack of resource in both the Customer and Resources Services was limiting the ability to be proactive in addressing rent debt in line with the Corporate Debt Recovery and Service Income Policies approved by City Growth and Resources Committee in November 2018.

2.6.2 Although Finance provided an overdue invoices report for budget holders, it was still being developed to meet budget holder needs. Finance intended to provide guidance on their use by the end of 2019/20 and was developing training. On 18 November 2019 this report indicated £2,682,000 of outstanding debt, of which over £1,000,000 was more than six months overdue.

- 2.6.3 While income targets can be monitored in the Trading Account, the Service was not provided with regular reports of where rent invoices had not been paid and the resource to manage this did not sit within the Service. This limited the Service's ability to support income recovery action through early intervention in a bid to prevent tenants' outstanding debts from escalating, nor assist in negotiating debt repayment plans in a fair and sensitive manner.
- 2.6.4 The delegated authority and arrangements to write off uncollectable debt is detailed in the Corporate Debt Recovery Policy. Schedules should be kept of debt write-offs which include the tenant or debtor details, debt value, reason for write off and the approval of the same. Debt write-offs above £25,000 should be reported annually to the City Growth and Resources Committee and amounts below this figure require reporting to the Chief Officer (Finance) and the Chief Officer (Customer) more frequently.
- 2.6.5 Reports of debt write-offs relating to uncollected Industrial & Commercial rents were requested from the Chief Officer (Customer), however Corporate Landlord has not written off any uncollected rent since the new Policy was introduced. This could mean that the Council is carrying aged debts which are unlikely to be recovered which may mean that actual income is being misrepresented in the Trading Account. Further, it means that the Service is not well-positioned to establish lessons which can be learned from each case and understand where strategies which involve earlier intervention can improve outcomes for both the Council and the tenant.

Recommendation

The Service should ensure that tenants' outstanding industrial and commercial rent debt is regularly reviewed and that uncollectable debts are considered for write-off and reported in accordance with the Corporate Debt Recovery and Service Income Policies.

Service Response / Action

Agreed. Debt collection is managed corporately rather than within the Service. The Service does now however have access to regular information on tenant arrears. These are cross checked around lease events and any tenant requests. A debt review process has been proposed between responsible Services.

Implementation Date

March 2021

Responsible Officer

Chief Officer (Corporate Landlord)

Grading

Significant within audited area

AUDITORS: D Hughes
C Harvey
P Smith

Appendix 1 – Grading of Recommendations

GRADE	DEFINITION
Major at a Corporate Level	The absence of, or failure to comply with, an appropriate internal control which could result in, for example, a material financial loss, or loss of reputation, to the Council.
Major at a Service Level	<p>The absence of, or failure to comply with, an appropriate internal control which could result in, for example, a material financial loss to the Service/area audited.</p> <p>Financial Regulations have been consistently breached.</p>
Significant within audited area	<p>Addressing this issue will enhance internal controls.</p> <p>An element of control is missing or only partial in nature.</p> <p>The existence of the weakness identified has an impact on a system's adequacy and effectiveness.</p> <p>Financial Regulations have been breached.</p>
Important within audited area	Although the element of internal control is satisfactory, a control weakness was identified, the existence of the weakness, taken independently or with other findings does not impair the overall system of internal control.