



Auditor General's comments on ABOR's response

We appreciate ABOR's response. However, ABOR has included certain statements in its response that necessitate the following comments and clarifications.

1. ABOR makes the following statement related to Finding 1 (see ABOR's response, page 1):

"The Auditor General has determined that additional written guidance is warranted to implement ABOR's real estate policies and that a lack of such guidance increases the risk of inappropriate use of public resources leased to private parties. However, as the Auditor General acknowledges, no lease transactions have been submitted to ABOR since its policies have been updated to address commercial real estate transactions. The policies as revised became effective in December 2018. Thus, this finding is based on speculation regarding how effectively ABOR will exercise its governance responsibilities in the future when implementing the recently revised policies. The revised policies include requirements that will allow ABOR to obtain the information necessary for it to make decisions regarding specific commercial real estate transactions and ensure appropriate governance."

Although it is accurate that, as of March 2019, no lease transactions have been submitted to ABOR for its review since it revised its leasing policy, our review of ABOR's real estate policies, including its revised leasing policy, identified internal control deficiencies that could jeopardize ABOR's consistent application and implementation of these policies. Specifically, Finding 1 describes 4 areas of internal control risk we identified related to ABOR's implementation of its real estate policies that increase its risk of not ensuring the appropriate use of public resources leased to private parties. Absent additional procedures and/or written guidance to help ensure the consistent application and implementation of ABOR's real estate policies, those risks would continue to exist. Thus, the finding is not speculative but forward-looking because it includes recommendations that address these risks, strengthen ABOR's controls around its real estate policies and practices, and help ensure the appropriate use of public resources leased to private parties (see Finding 1, recommendations 1 through 5, pages 12 through 14).

2. ABOR makes the following statement related to Finding 1 (see ABOR's response page 2):

"Because the Auditor General could not identify a policy structure specific to higher education against which to compare ABOR's policies, the Auditor General instead adopted model policies articulated by the Government Finance Officers Association (GFOA) and the Pew Charitable Trusts designed for state and local governments engaged in economic development activities. The title of the cited GFOA policy is "Establishing an Economic Development Incentive Policy." The Auditor General's reliance on this standard is misplaced.

The inappropriate application of the selected standard creates two main flaws in the report. First, the report equates granting a tax benefit to private entities in exchange for an undefined benefit, such as economic development, with generating additional lease revenue by monetizing the university tax status. Economic development outcomes, such as new jobs, are difficult to track and source. The recommendations outlined in the report, such as clear performance standards and tracking mechanisms, are designed for municipalities engaged in economic development to help them better track the economic performance of tax incentive programs. ABOR engages in no such programs. Thus, the recommendations do not directly apply to ABOR leases, which are simple to track and enforce.

Second, the GFOA and Pew guidelines assume economic growth is the objective of land development. ABOR's stated objective for commercial land development is to "optimize the value of the property to the university and enhance the institutional mission of the university" (ABOR policy 7-207 B.1.A). Recommendations that apply to land development for economic growth, such as clearly defined guidelines on how to calculate economic benefits, will not necessarily apply to all ABOR leases."

- a. Although we did not identify a higher education real estate policy structure against which to compare ABOR's real estate policies, the GFOA and Pew criteria cited in the report is relevant to ABOR's commercial real estate activities because it provides useful and applicable guidance for ensuring the appropriate use of public resources for private benefit. ABOR's use of its tax-exempt status to attract private entities to develop its property for the purpose of generating additional revenue for the universities constitutes a use of public resources to incentivize private development for the universities' benefit and is similar to government entities using their taxing authorities and other public resources to incentivize private economic development. Thus, the GFOA and Pew criteria apply to ABOR's activities. According to GFOA, there is often a substantial risk with the use of such incentives. GFOA recommends that public entities develop policies guiding their use of incentives to help mitigate the risk of incentives' misuse and to help ensure that public resources are directed to the highest and best use.¹ Therefore, we recommended that ABOR develop written guidance for its leasing policy that aligns with the GFOA guidance.

Additionally, although ABOR states that the GFOA and Pew criteria do not apply to its practice of generating additional lease revenue by monetizing its tax-exempt status, the criteria are applicable to ABOR's activities because they include guidance on assessing the impacts of using tax incentives on other taxing jurisdictions. Specifically, as discussed in Finding 1 on pages 7 through 8, ABOR has approved commercial lease agreements that convey ownership of privately constructed improvements from the lessee to ABOR to ensure that the improvements are exempt from property tax. This conveyance of property ownership uses ABOR's tax-exempt status to provide a benefit to a private entity. Although these commercial lease agreements benefit ABOR by requiring the lessees to make additional payments to the universities, the agreements may present a cost to the local taxing jurisdictions that would have collected property tax on the lessee's improvements had the lessee retained ownership of the improvements under the lease agreement. ABOR has revised its leasing policy to require a review of the property tax impacts on other taxing jurisdictions for commercial lease agreements, and the GFOA and Pew criteria provide guidance on conducting this type of assessment. Therefore, it would be prudent for ABOR to align its practices with the guidance issued by GFOA and Pew to help ensure that the use of its property and its tax-exempt status through commercial lease agreements to provide incentives for private development is the highest and best use of public resources for the State.

Finally, ABOR states that our recommendations are "designed for municipalities engaged in economic development" and thus do not apply to it because it does not engage in economic development activities. However, as discussed in Finding 1 (see page 9), the universities have in some cases included statements about proposed lease agreements' expected economic benefits in their public proposals to ABOR for its review and approval, but they have not assessed, evaluated, or tracked these expected outcomes. For example, during ABOR's review of the proposed lease agreement for Marina Heights, ASU reported that the development would provide revenue to the State and local municipalities and employment opportunities for students. However, ASU did not provide ABOR an economic benefits analysis to support this statement. In addition, ABOR's revised leasing policy requires the universities to document each proposed commercial lease agreement's economic benefits to the universities and the State (see below for more information). Therefore, despite ABOR's assertion, the GFOA and Pew guidance related to evaluating and tracking economic benefits is applicable to ABOR's activities.

¹ Government Finance Officers Association (GFOA). (2017a). *Establishing an economic development incentive policy*. Retrieved 5/6/2019 from <https://gfoa.org/establishing-economic-development-incentive-policy>.

b. ABOR indicates in its response that recommendations that apply to land development for economic growth, such as clearly defined guidelines on how to calculate economic benefits, will not necessarily apply to all ABOR leases. However, ABOR's revised leasing policy requires the universities to document the economic benefits to the universities and the State for all proposed commercial lease agreements. Therefore, ABOR's statement in its response contradicts its own policy requirement. In addition, despite this policy requirement, ABOR has not issued written guidance that the universities must follow for documenting the economic benefits, which may lead to ABOR receiving inconsistent or insufficient information for its consideration (see Finding 1, page 10).

3. ABOR makes the following statement related to Finding 1 (see ABOR's response page 2):

"Finally, recommendation 1a requires the inclusion of specific performance standards in each lease agreement and remedies should these standards not be met. ABOR lease agreements include performance standards and remedies. This recommendation is once again based on GFOA guidance to local municipalities providing tax incentives for economic development. Recommendations that are generally not applicable to ABOR transactions."

As discussed in Finding 1 on page 11, GFOA recommends that for each development project agreement, public entities establish measurable performance standards related to defined objectives for using tax incentives, including a process through which the public entity can take action if the performance standards are not met. Although ABOR's commercial lease agreements include typical contractual provisions that require the lessee to make rent and/or additional payments to the universities, the agreements do not include other measurable performance standards related to ABOR's objective to use commercial lease agreements to optimize the value of the property to the university and to enhance the institutional mission of the university. For example, as reported in Finding 1 on page 9, during ABOR's public review of the Marina Heights development, ASU reported that the development would provide employment opportunities for students. The inclusion of this information in ASU's proposal is consistent with ABOR's current policy requirement to demonstrate how lease agreements will enhance the institutional mission of the university. However, the Marina Heights lease agreement does not include a measurable performance standard regarding ASU student employment opportunities, nor does it include any actions ABOR could take if this performance standard was not met. ABOR policy requires that commercial lease agreements optimize the value of ABOR property to the university and enhance the institutional mission of the university. Therefore, we recommended that ABOR develop and implement written guidance for the universities to follow that requires each agreement to include measurable performance standards related to its policy objective for entering the agreement and a process through which ABOR may take action if a private entity receiving a benefit through an agreement does not meet the performance standards (see Finding 1, page 12).

4. In its explanation to Finding 1, recommendation 1a, ABOR indicated the following (see ABOR's response page 4):

"Finding 1 and the related recommendations (recommendations 1-5), ask the Arizona Board of Regents (ABOR) to add clarifying guidance to its recently established commercial real estate policies. While the ABOR will implement the recommendations, please see the general concerns about the audit approach outlined in the agency cover letter. Please also note, the Auditor General found no examples of inappropriate use of public resources leased to private parties. The report only suggests additional guidance will strengthen the already robust governance structure."

a. A robust governance structure should be capable of functioning without failure under a wide range of conditions. However, as reported in Finding 1, pages 7 through 14, we identified several internal control deficiencies that indicate ABOR's governance structure for commercial real estate development is not as robust as it should be and could jeopardize ABOR's consistent application and implementation of its real estate policies, including its revised leasing policy. These deficiencies and the absence of procedures and/or written guidance to mitigate the risk these deficiencies pose actually serve to weaken ABOR's governance in this area. As such, we made several recommendations to strengthen

ABOR's controls over its real estate activities (see Finding 1, recommendations 1 through 5, pages 12 through 14).

- b. It is misleading to state that we found no examples of inappropriate use of public resources leased to private parties. Specifically, as reported in Finding 1 on page 9, as of March 2019, none of the universities had presented a long-term, commercial lease agreement proposal to ABOR for its review and approval since it revised its leasing policy. Thus, there were no agreements executed under ABOR's revised leasing policy for us to review.
5. In its explanation to Finding 1, recommendation 4, ABOR indicated the following (see ABOR's response page 5):

"ABOR currently has approval and reporting processes in place, including the following: ABOR Policy 2-207 (A) states that "All lease agreements and amendments of lease agreements of real property. . . shall be reviewed by the Finance, Capital and Resources Committee and approved by the board before becoming effective" except for those leases exempted under the policy because they fall under certain thresholds established by the policy. ABOR Policy 2-207(B)(3) requires the universities to report at least annually "on the status of all executed long-term leases subject to subsection B, and the performance of such long-term leases. The report shall include timelines and financial information relative to the terms of executed agreements, the intended use of any revenue received by the university, and other information as coordinated with the executive director of the board." ABOR Policy 2-207(C) requires that "All leases entered into shall be reported to the board office annually in accordance with procedure developed by the executive director."

Although ABOR has established ongoing reporting and approval requirements as stated above, it does not have a process in place to help it ensure that the universities comply with ongoing approval, reporting, or assessment requirements for approved lease agreements, including any lease amendments. Instead, as reported in Finding 1 on page 10, ABOR has relied on informal communication between ABOR staff and the universities to ensure the universities comply with these requirements and has not ensured that the universities consistently complied with these requirements. For example, ABOR could not provide evidence that it had reviewed and approved all the subsequent amendments for 2 of the 5 lease agreements we reviewed. Therefore, we recommended that ABOR develop and implement a process to help track and monitor ongoing approval and reporting requirements in order to provide continued oversight of its lease agreements (see Finding 1, recommendation 4, page 13).