



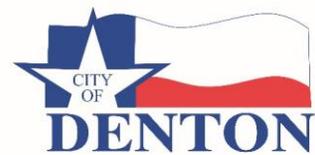
# AUDIT OF CAPITAL PROJECTS ADMINISTRATION

Property Acquisition

## ABSTRACT

The Real Estate Division's acquisition procedures are generally adequate. Improvement in controls over acquisition activities will improve the effectiveness of transactions.

City Auditor's Office



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## Executive Summary

Honorable Mayor and members of the City Council,

The City Auditor's Office has completed a performance audit of the Real Estate Division's property acquisition process for capital projects. The City of Denton's Real Estate Division (Division) acts as a service division for other departments and provides real estate services, including property acquisition, property valuation, relocation, and other property related services. The Division also acquires rights of way for City departments constructing capital projects, and as part of those services.

The following are our salient findings:

- The Real Estate Division's records were missing in a few tested samples as presented in Table 3, which bears the risk of hindering management verification of accuracy and appropriateness of transactions. Any abuses of the process may not be identified if relevant documentation is missing. That being said, the acquisitions were properly recorded in the County's records transferring title to the City.
- Current acquisition procedures do not specify a negotiation authority level for Real Estate Specialists. Such a delegation of authority would typically set a certain limit or percentage over the appraisal value of the property that the Specialist can offer without further documentation. In the absence of proper formal documentation recording the negotiation proceedings and justification for outcome, effectiveness of the negotiation efforts during the selected acquisitions could not be verified. Due to this reason, it is not clear if the agreed final settlement price was justified. This condition may lead to abuses. No formal document was available that could provide justification for the agreed settlement prices for 18 out of 20 parcels that were acquired above appraised value.

Management has concurred with 5 of 5 recommendations made in this report. Management responses are attached to this report in Appendix A. We appreciate staff's cooperation during the audit. Please contact the City Auditor if you have any questions or need more information.

Sincerely,

Umesh Dalal, City Auditor

## Introduction

The City Auditor is responsible for providing: (a) an independent appraisal<sup>1</sup> of City operations to ensure policies and procedures are in place and complied with, inclusive of purchasing and contracting; (b) information that is accurate and reliable; (c) assurance that assets are properly recorded and safeguarded; (d) assurance that risks are identified and minimized; and (e) assurance that resources are used economically and efficiently and that the City's objectives are being achieved.

The City Auditor's Office has completed a performance audit of the real estate acquisition process of the Real Estate Division as part of the Capital Projects audit. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## Management Responsibility

City management is responsible for ensuring: resources are managed properly and used in compliance with laws and regulations; programs are achieving their objectives; and services are being provided efficiently, effectively, and economically.

## Audit Objectives, Scope, and Methodology

This report is intended to provide assurance about economic and efficient use of the City's resources by evaluating the effectiveness of controls over the Real Estate Division's property acquisition process for capital projects.

Audit fieldwork was conducted during September and October of 2019. The scope of review varied depending on the procedure being performed. The following list summarizes major procedures performed during this time:

- Reviewed documentation including industry standards, best practices, policies, and procedures;
- Developed a process narrative and flow chart to identify current control activities, which was certified by the Capital Projects Deputy Director of Real Estate;
- Reviewed a sample of 30 right of way acquisitions (41 parcels) out of a population of 77 property parcels valued around \$2.7 million acquired by The Real Estate Division for Capital Projects during 2018 and 2019. The acquisitions completed during this period consist of different parcel types, viz. fee simple<sup>2</sup> (11), permanent easement<sup>3</sup> (23), temporary easement (40) and right of way<sup>4</sup> (3). To review the property acquisition activities of the Real Estate Division relating to capital projects, 30 acquisitions samples (41 parcels) out of a population of 64 acquisitions (77 parcels) were selected. These consisted of fee simple (10), permanent easement (16), temporary easement (13) and right of way (2). Since the selected sample spread over two administrations, Table 1 provides context to our observations:

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<sup>1</sup> The City of Denton Internal Auditor's Office is considered structurally independent as defined by generally accepted government auditing standard 3.56.

<sup>2</sup> Land owned in fee simple is owned completely, without any limitations or conditions.

<sup>3</sup> An easement is a legal right to use another's land for a specific limited purpose.

<sup>4</sup> A right of way (ROW) is a right to make a way over a piece of land, usually to and from another piece of land.

**Table 1:** Sample Parcels Completed prior to / during or after February 2017

Administration	Acquisition Began	Parcels Acquired
Prior Administration*	Prior to February 2017	14
Current Administration*	During or After February 2017	27
Total:		41

*\*Prior Administration and Current Administration have been referred to the previous City Manager’s and current City Manager’s administration respectively.*

The City acquires real estate through purchase, eminent domain, exchange or by donation. The acquisition samples selected for audit represent all kinds of acquisitions as presented in Table 2.

**Table 2:** Selected Samples’ Mode of Acquisition

Mode of Acquisition	No. of Parcels
Purchase	26
Eminent Domain <sup>5</sup>	11 <sup>6</sup>
Donation	3
Exchange	1
Total:	41

- Compared the Real Estate Division’s acquisition procedures to the Texas Property Code, Texas Local Government Code and other laws as applicable, and
- Interviewed Real Estate Division staff to better understand the acquisition process and activities undertaken

<sup>5</sup> Eminent domain is the government's power to take private land for public use under certain circumstances.

<sup>6</sup> 11 parcels were acquired from 2 property owners.

## What Works Well

The City of Denton’s Real Estate Division (Division) acts as a service division for other departments and provides real estate services, including property acquisition, property valuation, relocation, and other property related services. The Division also acquires rights of way for City departments constructing capital projects, and as part of those services, performs the following activities:

- Work closely with real estate consultants, title companies and appraisers;
- Order title reports and property appraisals;
- Meet with property owners;
- Present offers; and
- Negotiate property sales transactions, including requesting City Council’s approval for real estate transactions, whenever required.

## Real Estate’s Current Acquisition Procedures Align with Applicable Laws

The auditors reviewed the existing procedures followed by the Real Estate Division for acquisition of properties and found that:

- The current acquisition procedures followed by Real Estate has been established in compliance with the Texas Property Code (Chapter 21) and the Texas Local Government Code (Chapters 251 & 252.051), wherever applicable.
  - Established procedures require an appraisal to be ordered whenever the acquisition of any property is initiated.
  - The timelines and documentary requirements of the established procedures have been framed in accordance with the requirements of aforementioned laws.
- In case of all acquisitions, wherever the power of eminent domain was used, the condemnation process was properly administered and completed under applicable provisions of the Texas Property Code (Chapter 21) and the Texas Local Government Code (Chapters 251 & 252.051) with appropriate approval of City Council.
- The requirement for Uniform Relocation Assistance (Texas Property Code § 21.046) and assessment under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 are duly incorporated in the acquisition procedures checklist.

## Management Reporting and Tracking Procedures have Improved

A construction project’s timeline depends upon the timely acquisition of the relevant properties identified during the design phase. Though the time taken in acquisitions may depend on various factors such as negotiations, re-designing, funding, re-prioritizations, occupant relocations, discovery of additional interests, and staffing shortages, proper tracking helps to improve the efficiency of staff and control of management over the overall process. Additionally, two-way communication between the Real Estate Staff and Project Managers is required to ensure that project delays are avoided as much as possible. Without timely communication of delays and real-time status updates, Project Managers may not be able to adequately plan for the completion of their projects.

Therefore, it is critical that periodically Project Managers receive acquisition tracking and status reports. The auditors found the following:

- No formalized procedure existed prior to February 2019 for sharing parcel acquisition tracking and status reports with Capital Project’s Project Managers.
- However, as a result of new Real Estate management’s observations and actions, tools are being implemented to improve and standardize the tracking and reporting of Real Estate acquisition activities, including:
  - Real Estate maintains a “Monthly Status Tracking Report” to track the status of open acquisition cases in EXCEL. While the report is required to be updated on a real-time basis by Real Estate staff, it does not currently contain information on all historical projects; however, Real Estate is working on inputting all historical project information into this database in an effort to streamline reporting procedures.
  - Real Estate has implemented a new spreadsheet-based “Progress Report” for milestones tracking with Project Managers.
  - Finally, Real Estate staff and Project Managers communicate frequently via email and telephone as the acquisition progresses or when there is a potential delay.

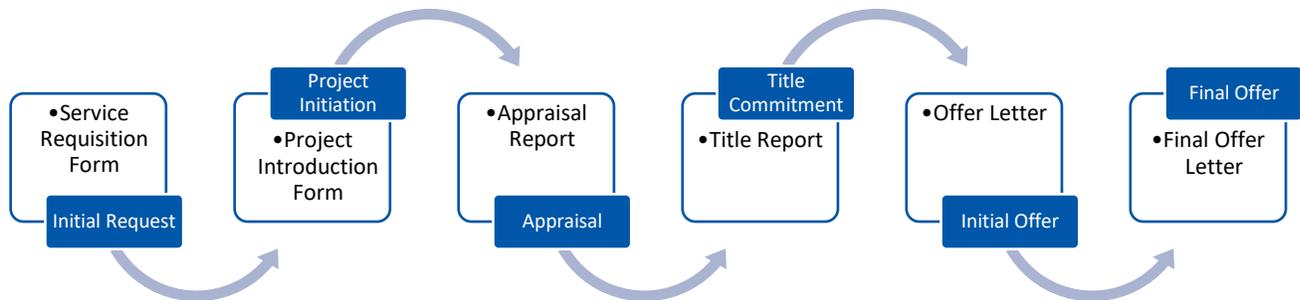
## Opportunities for Improvement

Acquisition activities of the Real Estate Division of the City of Denton are governed by the Texas Property Code, Texas Local Government Code and City Ordinances as applicable. The City must have adequate evidence of compliance with the statutory provisions.

### Acquisition Process Documentation Needs to be Improved

Formally adopted policy documents help eliminate common misunderstandings by recognizing job responsibilities, establishing limitations for the job holders and achieving a common business objective. The steps of the real estate acquisition process were established in February 2019 and their associated documentation are depicted in Figure 1:

Figure 1: Real Estate Acquisition Process



### What We Found?

Based on the testing of the selected parcels, we found that the required documents were not properly maintained or executed as follows in Table 3:

Table 3: Missing Documents

Documents	Missing Documents			
	Prior Administration (14 parcels)		Current Administration (27 parcels)	
	# of Parcels	%	# of Parcels	%
Services Requisition Form <sup>7</sup>	NA	NA	3*	75.0%
Project Introduction Letter <sup>8</sup>	NA	NA	4*	100.0%
Appraisal Report	2	14.3%	3	11.1%
Title Commitment	0	-	1	3.7%
Initial Offer Letter	0	-	1	3.7%
Final Offer Letter/ Letter of Understanding (LOU)	0	-	2	7.4%

\*Only 4 acquisitions were started and completed after Feb 2019.

- In two (2) cases, the initial offer letters were signed by Real Estate staff and not by the City Manager; Real Estate staff did not have authority to sign offer letters at that time.

<sup>7</sup> Introduced in the February 2019 formal procedures.

<sup>8</sup> Introduced in the February 2019 formal procedures.

- Deputy Director of Real Estate has been authorized by City Manager to make offer and negotiate the real estate property acquisition up to a value of \$50,000 effective July 31, 2019.
- We were able to verify that:
  - The selected acquisitions were properly recorded with the Denton Central Appraisal office and recorded instruments were available. All selected final acquisitions were completed with the appropriate authority of City Manager and City Council approval whenever required and ordinances were properly passed.
  - Other requirements of the Texas Property Code, the Texas Local Government Code, the Uniform Relocation Assistance (Texas Property Code § 21.046) and the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 have been duly complied with, wherever applicable.
- Auditors also recognized that Real Estate acquisition procedures have improved under current Real Estate management’s guidance and leadership. Real Estate is in the process of implementing Standard Operating Procedures (SOP) as a guidance to other functions to understand and follow the requirements while requesting any property acquisition.

### Why Does It Matter?

The Real Estate Division’s records were missing in a few tested samples as presented in Table 3, which bears the risk of hindering management verification of accuracy and appropriateness of transactions. Any abuses of the process may not be identified if relevant documentation is missing. That being said, the acquisitions were properly recorded in the County’s records transferring title to the City. The following are the implications of the above observations:

- In the absence of Services Requisition Forms, it is difficult to verify the timeliness of an acquisition request as well as the exact details of parcels and properties requested for acquisition. According to the Deputy Director of Real Estate, an acquisition request should ideally be received from Project Managers when about 30% of project design is completed and parcels are identified for acquisition. This timeframe typically provides adequate opportunity to complete the acquisition process, however, if project redesigns occur, it may cause delays to the construction project. In addition, it may be difficult to prioritize acquisition projects without tracking which department has authorized and for what reason a project was initiated.
- Acquisition activities start with sending a Project Introduction Letter to the owners of the properties to be acquired. This requirement aligns with the industry’s best practices. This letter is sent to inform property owners in advance about public projects before the initiation of acquisition activities. Absence of advance project intimation could surprise the property owners and may or may not impact their willingness to work with the City. These events may delay the acquisition process.
- Missing appraisal reports may result in non-compliance with Chapter 252.051 of Texas Local Government Code. In addition, the City may not know the actual worth of the property to be acquired and could end up in paying higher settlement price of the property even after negotiation.

- Title commitments indicate if the property has clear title or defects to the title. Without these documents, it may not be possible to determine if the City will receive free and clear title to the property being acquired.
- Documents such as initial and final offer letters represent the City’s terms of acquisition of the property. When an initial offer letter results in further negotiation, a final offer letter or a letter of understanding should be executed to document the agreed upon terms for proper recording of the transaction.
- Unauthorized execution of documents by City staff on the City’s behalf bears an inherent risk of abuse and fraud, though none was identified.

**Recommendations:**

1. Require Real Estate Staff to execute and maintain all required documents properly for acquisition of real estate properties in line with implemented real estate acquisition process.

*Real Estate Comments:* Direction to execute and maintain documents had previously been given prior to audit. Steps have been implemented to check/confirm compliance monthly.

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### Negotiation Process is not Formalized

Real Estate makes offers to property owners for acquisition of real estate properties and parcels. In cases where negotiations with the property owners do not work out, condemnation proceedings typically follow as shown in Figure 3. While project plans, surveys, and construction have relatively finite timelines, condemnation proceedings often make property acquisition last longer than expected or desired.<sup>9</sup> A streamlined, and formalized negotiation process would help Real Estate staff steer negotiation activities in a systematic manner.

**Figure 3:** Negotiation and Eminent Domain Process



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<sup>9</sup> National Cooperative Highway Research Program (NCHRP) Study 2000.

## What We Found?

- As per current procedures, a Real Estate Specialist negotiates with the property owner in good faith to reach an agreed price through correspondence, calls, and potentially visit unresponsive property owners whenever necessary.
- Current acquisition procedures do not specify a negotiation authority level for Real Estate Specialists. Such a delegation of authority would typically set a certain limit or percentage over the appraisal value of the property that the Specialist can offer without further documentation.
- Current acquisitions procedures do not prescribe any form for documenting the justification and agreement on the final settlement price over and above the appraisal value.
  - No formal document was available that could provide justification for the agreed settlement prices for 18 out of 20 parcels (20 parcels were acquired at a settlement price over the appraisal value, which constitute 49% of total parcels reviewed).

## Why Does It Matter?

Negotiation is a vital phase in the overall right of way acquisition process. If not administered properly through a formal process, negotiation proceedings may increase acquisition cost and delay the overall project as well. Best practices in the “TxDOT Guidebook for Right-of-Way Valuations and Negotiations” affirm that successful negotiations can benefit the City by reflecting fair market prices, building a good rapport with landowners, and reducing project duration and cost. Negotiation outcomes can be made more effective by having in-depth interviews with the property owner regarding the project and property.

In the absence of proper formal documentation recording the negotiation proceedings and justification for outcome, effectiveness of the negotiation efforts during the selected acquisitions could not be verified. Due to this reason, it is not clear if the agreed final settlement price was justified. In addition, current procedures authorize Real Estate Specialists to negotiate with the property owner whenever required without involvement of senior Real Estate personnel. There is no limitation established on the ability of a Real Estate Specialist to independently negotiate acquisition price. Unrestricted powers of negotiations for Real Estate Specialists may lead to a closure of negotiation proceedings at higher settlement prices and may increase acquisition cost. In addition, this condition may lead to abuses.

## Recommendations:

2. Adopt a formalized negotiation process incorporating the following key requirements:
  - a) Criteria and steps of negotiation with the property owner including a requirement to perform in-depth interviews with property owners to discuss issues such as the impact of the project, property usage by the owner and estimated value of the property;
  - b) Real Estate staff to get approval of the Deputy Director on a formal document recording the agreement on settlement price along with the justification for accepting the price over and above the appraisal value; and
  - c) Limitation on the power of Real Estate Specialists to independently negotiate up to a certain percentage of appraised value and involvement of senior officials beyond that limit.

**Real Estate Comments:** Processes for each recommendation were in place at time of audit. Formal adoption has been completed through the department’s SOP process.

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## Information about Donated Properties is not Communicated to Accounting

Statement 34 of the Governmental Accounting Standards Board states that “donated capital assets should be reported at their estimated fair value at the time of acquisition.” Capital assets include permanent easements.

### What We Found?

- Real Estate does not have an established process for reporting donated properties and parcels to the Accounting Division for recordkeeping.
- Of the 41 parcels reviewed, 3 permanent easement parcels were donated to the City. These parcels were not reported to the Accounting Division and were not documented in the City’s financial records.

### Why Does It Matter?

Capital asset value in the City’s financial statements is understated at least by \$71,591 (the appraised value for one parcel is not known, hence excluded from this amount).

### Recommendations:

3. Jointly develop a process with the Accounting Division for timely reporting of donated real estate assets to improve recordkeeping.

*Real Estate Comments:* Process has been implemented and monthly reporting has been established.

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## Real Estate Policy Changes Should be Made to Align with Best Practices

Auditors found that the following best practices recommended in the “TxDOT Guidebook for Right-of-Way Valuations and Negotiations” can improve current real estate acquisition process.

- Appraisers hired must be state-certified or licensed by the Texas Appraiser Licensing and Certification Board.
- Real Estate Division staff should periodically attend training courses to ensure their understanding of laws and procedures relating to acquisitions.

These practices were developed and compiled by Center for Transportation Research Department of University of Texas, Austin based on review of statutes and analysis of surveys and interviews of property owners and TxDOT personnel.

### What We Found?

- Current Acquisition procedures followed by the Real Estate Division do not prescribe any qualification for appraisers to be hired. However, we found the following practices:
  - State Certified Appraisers were hired in all sample cases where appraisal reports were available.<sup>10</sup> Additionally, 22, appointed appraisers were also a Member of Appraisal Institute (MAI).

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<sup>10</sup> Appraisal reports were not available in 5 sample parcels.

- Auditors were informed that Member of Appraisal Institute (MAI) are hired as appraisers when possible.
- Current acquisition procedures followed by the Real Estate Division do not prescribe any staff training requirements.
  - Auditors were informed during the interview with Real Estate Division’s staff that training, and seminars organized by the International Right of Way Association are attended by some staff members of the Real Estate Division to maintain Continued Professional Education (CPE) requirements of their licenses.

### Why Does It Matter?

According to the TxDOT, professionally qualified appraisers will have significant experience in applying the generally recognized valuation methods and techniques. These appraisers are bound to follow the code of ethics of their institution and are expected to generate unbiased, independent and objective appraisal reports. Auditors recognize the best practices followed by Real Estate by appointing state-certified appraisers, though the requirement is not codified in the current procedures. Codifying this requirement would further obligate the current and future staff to follow the practice.

Requiring Real Estate staff to undergo periodic training would improve overall staff expertise. It would provide assurance for completing the title commitment, appraisal and uniform relocation assistance activities in a proper manner in conformance with updated laws. One NCHRP study (NCHRP, 2000) reported that inadequately trained staff presents one of the biggest challenges to reducing the project delivery time.

### Recommendations:

4. Define qualification criteria in policies and procedures for hiring and engaging appraisers  
*Real Estate Comments: Currently advertising RFQ to define and establish criteria.*
5. Codify Real Estate Specialist training requirements to provide greater assurance that staff is constantly abreast of updated laws and procedures relating to acquisitions.  
*Real Estate Comments: Licensed Real Estate Specialists have required continuing education to maintain licensure. Additionally, industry training is offered, recommended and required as appropriate, when applicable to legal updates impacting eminent domain acquisition processes.*

Appendix A: Management Response Matrix

The following summarizes the recommendations issued throughout this report. The auditors found that staff and the Division was receptive and willing to make improvements to controls where needed. Management has provided their response to each recommendation.

1	<i>Require Real Estate Staff to execute and maintain all required documents properly for acquisition of real estate properties in line with implemented real estate acquisition process</i>	<b>Concur</b>	Expected Completion: <b>Complete</b>
Comments: Direction to execute and maintain documents had previously been given prior to audit. Steps have been implemented to check/confirm compliance monthly.			<b>Responsibility:</b> Dep. Dir. Of CP-RE/RE Prog. Mgr.
2	<i>Adopt a formalized negotiation process incorporating the following key requirements: a) Criteria and steps of negotiation with the property owner including a requirement to perform in-depth interviews with property owners to discuss issues such as the impact of the project, property usage by the owner and estimated value of the property; b) Real Estate staff to get approval of the Deputy Director on a formal document recording the agreement on settlement price along with the justification for accepting the price over and above the appraisal value; and c) Limitation on the power of Real Estate Specialists to independently negotiate up to a certain percentage of appraised value and involvement of senior officials beyond that limit.</i>	<b>Concur</b>	Expected Completion: <b>Complete</b>
Comments: Processes for each recommendation were in place at time of audit. Formal adoption has been completed through the department’s SOP process.			<b>Responsibility:</b> Dep. Dir. CP-RE
3	<i>Jointly develop a process with the Accounting Division for timely reporting of donated real estate assets to improve recordkeeping.</i>	<b>Concur</b>	Expected Completion: <b>Complete</b>
Comments: Process has been implemented and monthly reporting has been established.			<b>Responsibility:</b> RE Prog. Mgr.
4	<i>Define qualification criteria in policies and procedures for hiring and engaging appraisers</i>	<b>Concur</b>	Expected Completion: <b>Complete</b>
Comments: Currently advertising RFQ to define and establish criteria.			<b>Responsibility:</b> RE Prog. Mgr.

5	<i>Codify Real Estate Specialist training requirements to provide greater assurance that staff is constantly abreast of updated laws and procedures relating to acquisitions.</i>	<b>Concur</b>	Expected Completion: <b>Complete</b>
Comments: Licensed RE Specialists have required continuing education to maintain licensure. Additionally, industry training is offered, recommended and required as appropriate, when applicable to legal updates impacting eminent domain acquisition processes.			<b>Responsibility:</b> Dep. Dir. CP- RE