Commercial Real Estate Advisers:
101 Best Practices

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Introduction and Acknowledgment

These 101 best practices were gathered from independent reviews of control systems performed at prominent real estate advisers. The fieldwork to develop this information included identifying objectives of control, discussions with personnel at each adviser, obtaining and documenting our understanding of the control system in place at each adviser and testing key aspects of the systems for compliance. This work is similar to that described in Statement of Auditing Standards #70, Reports on the Processing of Transactions by Service Organizations.[1]

This paper focuses on management practices of real estate advisers managing separate accounts for institutional investors. The investors are most often public or private pension funds, insurance companies and public or private REITs, although investment may also be made by way of pooled funds, commercial mortgage backed securities, mortgages, co-lending, and co-mingled equity. No matter what form the investment may take, skilled property management is required. Investors need to assess the risks of investing, including management risk.

Gathering best practices for reducing risk involved hundreds of hours of work in the field at some of the largest real estate advisory firms in the U.S. The compilation of best practices presented here does not represent all of the firms that do this type of advisement. The reader is encouraged to accept these results as management practices from some of the most sophisticated firms in the business which have the resources to devote to ensure the adequacy of their internal control and risk management systems. Professional judgment has been applied to cull the best of the lot. Not every best practice is presumed to be reported (you may know of others), yet the work presented is complete enough to provide internal auditors, investors, advisers, and others with a valuable reference tool for bench marking the control environments they are responsible for reviewing or managing. The views presented herein are those of the author and are not intended to represent any other persons, offices, or organizations. The author acknowledges the contributions to this paper of Robert Kosky, CPA and Richard Panza, CPA.

Background

Real estate advisers play an extremely important and increasingly valuable role in the investment in real estate by the world's pension funds. According to a *Pensions & Investments* survey, the top 25 advisers collectively manage approximately $108 billion in tax exempt assets.[2] The advisers that were a source for these best practices collectively manage approximately $53 billion and all of them are in the top 25.

With purses bulging, the huge pension funds and trusts are shopping the markets in hopes of diversifying their portfolios against disproportionate weighting in the equity and fixed income markets. With suggested allocations in real estate of anywhere between 5% and 20%, these enormous funds are having great difficulty even approaching their targets while staying prudent investors. The New York State Common Retirement Fund (NYSCRF) is a perfect example, having a targeted allocation of 10% in real estate, they are struggling to get to just 5% of their $90 billion fund by the year 2000. In 1995 and 1996, the NYSCRF completed the hiring of seven commercial real estate advisers to help them move toward their targeted allocation. They are not alone. The amount of money waiting to be invested in commercial real estate is simply staggering.

The Art after the Deal

Much media emphasis has been placed on the art of deal making. There is little doubt that this is due to the excitement of the negotiations surrounding huge sums of money, the long-term impact of the property on people and communities, and the exhilarating and ultimately satisfying pride of ownership. Much less media emphasis has been on properly managing property after the deal making is over. It is here in the somewhat more mundane day-to-day world where we believe that good deals are made, bad deals can be salvaged, and good deals gone sour can be made sweet again. This is the art after the deal.

Donald Trump relates this story of a proposed cost cutting initiative at Trump Tower. The initiative was put forth by someone from his partner, Equitable. Resisting the proposed cuts, he remarked, "When you set the highest possible standards, they're expensive to maintain." The representative from Equitable wished to proceed with the cuts anyway. Trump said, "That was probably the end of my partnership with Equitable."[3] This is “The Donald” at his inimitable best.

The Trump anecdote says much about how a real estate investment relationship should not be run. Where in Trump’s story are the normal budgetary controls that would address expenses? Where are the operating projections that would have included the costs in question? What is the ramification in legal and other professional fees of forcing a partner to withdraw over a relatively trivial issue (frequency of polishing the brass)? Yes, Mr. Trump may have written the book on the art OF the deal, but what about the art AFTER the deal?

Listed on the following pages, after a brief discussion on value erosion factors and establishing objectives of control, are the policies, procedures, methods, and techniques that are being used now with great success at the top real estate advisers. These are the best practices. Glitzy they’re not, but they comprise the art after the deal.

Value Erosion Factors

Of all investment vehicles perhaps real estate has exposure to more sources of value erosion than any other. That is not to say that real estate is the riskiest investment type. It simply has more opportunities for loss in value than most investments. At the same time, there is no question that the right real estate investments have provided enormous strength against inflation, added great diversification to portfolios, and provided above average returns. The investor must understand these potential value erosion factors (VEF). The table below shows some of the many VEFs affecting real estate.

Value Erosion Factor	**Potential negative effect**[4]
General illiquidity	Due to lack of a continuous market, the investor may make price concessions at disposition.
Inflation rate	Income from the property does not increase as general purchasing power decreases. This reduces the value.
Interest rate changes	To the extent that there is a trend to shorter holding periods, property values will be more affected by interest rate changes.
Debt on property	To the extent that lenders have claims to the property, income and proceeds are at risk in liquidation.
Governmental regulation	Changes in governmental rules and regulations, whether foreseen or unforeseen, create added expense and/or losses in revenue with resultant reduction in value.
Management skill	Management operates inefficiently, lacks adequate control systems, does not respond appropriately to competition, and is not innovative. Value decreases as a result.

Obviously, not all VEFs can be controlled. For example, it is difficult and costly, if not impossible, to influence governmental regulation in the way one would wish. Rent controls are a perfect example. The same is true for interest rate changes and many other VEFs. The remainder of this paper focuses on management skill which is controllable to a great degree.

Establishing Objectives

The following presentation of best practices focuses on 15 objectives of control established to measure management skill. By implementing best practices designed to achieve these objectives, real estate advisers can prevent value erosion caused by lack of management skill.

In real estate separate accounts usually all aspects of management are delegated to the adviser or to persons or firms under the adviser's direction. With the advisory agreement in place and certain parameters established, the investor may only become involved on those infrequent occasions when events occurring outside the established parameters require input. Short of this, the investor may receive only limited and periodic reporting of events and transactions of the property.

The investor must be extremely confident that the real estate adviser is managing skillfully. Measurement of their skill is achieved through the establishment of objectives related to separate account advisement which includes acquisition, ongoing management, and disposition. The objectives listed on the following pages were designed to identify those areas of adviser responsibility that were deemed most important by investor accounting and investment management.[5]

Best Practices - Acquisition

OBJECTIVE A1 - Property Selection

To ensure that sufficient research, reviews and approvals by management are performed prior to properties being recommended for acquisition and that properties meet stipulated criteria for investment.

Best Practices:

A1.1) Potential deals are pro-actively sourced. For example, an Investment Criteria Sheet is prepared and distributed to brokers, developers, owners and financial institutions.

A1.2) Advisers use the expertise of acquisition personnel in field offices to source deals.

A1.3) Weekly deal status meetings are held. Deal status meetings outline the current status of proposed properties, existing properties, and properties being sold. Proposed properties are matched to investor requirements and pre-qualified at these meetings.

A1.4) Prior to Investor contact, the Investment Committee approves the decision to recommend a property. The Investment Committee will approve the allocation decision, if applicable. The Investment Committee typically consists of the President, Senior Officers and all Portfolio Managers.

A1.5) A detailed analysis of the property is performed prior to sending the preliminary investment package and executed letter of intent (LOI) to the investor for approval.

A1.6) A thorough due diligence process begins only after the Investor approves the preliminary investment package.

Best Practices - Acquisition

OBJECTIVE A2 - Due Diligence

To ensure that proper due diligence steps are performed throughout the acquisition process.

<u>Best Practices:</u>

A2.1) A comprehensive due diligence is performed and a detailed closing checklist is completed and maintained. Checklist steps are initialed by the individual(s) that performed the related work.

A2.2) A predetermined response format is developed by the Adviser's Engineering Department for environmental and engineering reviews. The contractors are required to report their study results in a predetermined format (to ensure consistency).

A2.3) Any significant changes to deal terms and conditions (pricing, timing, etc.) require Investor approval prior to closing.

Best Practices - Management

OBJECTIVE M1 - General Control Environment

To ensure that the Adviser's organization structure, personnel policies, and business environment are conducive to adequate job training, proper segregation of duties, proper supervisory hierarchies, responsive remedial action, ethical business conduct, and a lack of conflict of interests.

<u>Best Practices:</u>

M1.1) Adviser organization is segregated by function with sufficient staffing levels. See an organization chart, page 22.

M1.2) Adviser staff receives paid internal and external training.

M1.3) Continuing education is encouraged. Tuition reimbursement programs are in place.

M1.4) Detailed procedures outlining responsive remedial action are in place. Procedures are included in the Employee Handbook.

M1.5) Extensive background checks are performed prior to hiring. They include drug tests, credit checks, criminal background checks and employment history verification.

M1.6) Employee orientation periods are established (usually 90 to 120 days) on an employment at will basis.

M1.7) Ongoing employee feedback is provided. Employees are formally evaluated periodically.

M1.8) Key adviser staff have appropriate professional designations. Examples include Member - Appraisal Institute (MAI), Certified Public Accountant (CPA), Certified Property Manager (CPM), and Certified Apartment Manager (CAM).

M1.9) Key adviser staff are active members or officers in Professional Organizations. Examples include the Urban Land Institute (ULI), the Institute of Real Estate Management (IREM), the Building Owner and Managers Association (BOMA), and the National Association of Real Estate Investment Managers (NAREIM).

M1.10) Ethics:

- Detailed ethics and conflict of interest policies are in place.
- These policies are reevaluated periodically and updates are made when appropriate.
- These policies are acknowledged (through signature) upon hiring and periodically thereafter.
- Ethics and conflict of interest statements are posted in Adviser’s offices

Best Practices - Management

OBJECTIVE M2 - Computer and Data Security

To ensure that, for any computer automation used, proper safeguards are in place to protect the Investor's data and related processing.

<u>Best Practices:</u>

M2.1) Access authorization is granted to users on a need to know basis.

M2.2) Passwords are used and must be changed every thirty days.

M2.3) All user access rights are reviewed for accuracy and appropriateness periodically.

M2.4) Attempted security violations are tracked and monitored.

M2.5) Virus Protection:

- All personal computer and file servers utilize virus protection software to detect and prevent the spread of computer viruses.
- Anti-virus software is used to scan files as they are written to the server or to a personal computer hard disk.
- A scan of each personal computer hard disk is performed routinely.
- All files obtained from sources outside the organization are scanned before they are saved to the system.

M2.6) Backups:

- Personal computer data is backed up continually. File server data is backed up daily.
- Weekly backups are stored offsite.

M2.7) Confidential material is disposed of in a secure manner.

M2.8) Personal computers are secured and a custody listing is established and maintained.

M2.9) Portable computers remain in the employee's possession when traveling and they are not left unattended.

M2.10) Employment termination (when initiated by the employee or the adviser) is immediately communicated to the appropriate security group to ensure that access rights are deactivated prior to the employee's departure.

M2.11) The EDP internal audit department reviews new systems and existing systems.

M2.12) Computer room is locked. Access is granted only to authorized individuals. The computer room has environmental controls.

Best Practices - Management

OBJECTIVE M3 - Adviser Fees

To ensure that Adviser's fees billed to Investor (or the property) are accurate in accordance with the terms of the Adviser contract.

Best Practices:

M3.1) The Adviser Agreement (including the fee schedule) is abstracted and distributed to all key employees.

M3.2) Fee schedules are prepared based on the adviser agreement.

M3.3) Fee schedules are reviewed and approved by the Accounting Controller and the Portfolio Manager prior to investor distribution.

Best Practices - Management

OBJECTIVE M4 - Contract Requirements

To ensure that the Adviser complies with Investor's requirements as delineated in the contract and other policy directives.

Best Practices:

M4.1) The Investment Committee, consisting of all key Adviser personnel, is established. The Committee meets when an investor is obtained and periodically thereafter.

M4.2) Contract requirements (and any changes) are reviewed in detail and abstracted by the Investor Committee.

M4.3) Contract requirements (and any changes) are distributed to the appropriate adviser personnel promptly.

M4.4) The Portfolio Manager is accountable for ensuring that all requirements are satisfied.

Best Practices - Management

OBJECTIVE M5 - Budget and Cash Flow
To ensure that the property budget provides an adequate estimate of expected cash flows and overruns are identified in a timely manner.

<u>Best Practices:</u>

M5.1) A current year budget should be prepared in monthly detail. Future years' budgets should also be prepared.

M5.2) The Asset Manager reviews all budget assumptions with the Property Manager. Assumptions are reviewed for reasonableness in light of the competitive market.

M5.3) The Accounting Department reviews the reasonableness of certain budget items with the Property Manager and the Asset Manager. For example, Accounting reviews account coding, budgeted capital expenditures and budgeted cash flow.

M5.4) The Asset Manager reviews the budget with the Portfolio Manager. The Portfolio Manager formally approves (signs) the budget.

M5.5) The Property Manager prepares periodic budget forecasts using the same format and accounts as the original budget.

M5.6) The Asset Manager reviews forecasts with the Property Manager. All material changes from the original budget are reviewed for accuracy and reasonableness by the Asset Manager and the Portfolio Manager.

M5.7) The Property Manager prepares monthly budget variance reports and provides explanations for pre-specified variances (e.g., 5% and $1,000). The Accounting Controller and the Asset Manager review explanations.

M5.8) The Asset Manager reviews material variances with the Portfolio Manager.

M5.9) Unbudgeted expenses and those significantly over budget need Asset Manager and Investor approval.

M5.10) The Adviser maintains a budget tracking system in which cumulative expenses are tracked against budget prior to payment.

Best Practices - Management

OBJECTIVE M6 - Revenues
To ensure that all property revenue is properly billed, collected and deposited.

<u>Best Practices:</u>

M6.1) Detailed tenant credit checks are performed prior to executing lease agreements.

M6.2) Leases are executed by the Asset or Portfolio Manager.

M6.3) Rent roll information should be periodically verified for accuracy.

M6.4) Monthly rent roll totals should be reconciled to accounts receivable postings periodically.

M6.5) Upon occupancy, the tenant is sent a letter that summarizes the lease terms. The letter should state that rental payments are due without the receipt of an invoice.

M6.6) A/R balances are monitored closely. Specific procedures are in place to handle delinquent accounts receivable.

M6.7) All A/R write-offs must be approved by the Asset or Portfolio Manager (in writing).

Best Practices - Management

OBJECTIVE M7 - Cash Management

To ensure that excess property cash is invested properly and timely in order to maximize investment returns at acceptable risks.

<u>Best Practices:</u>

M7.1) Lockbox bank accounts are established close to the property if mail float will be minimized.

M7.2) All excess investor cash is swept nightly into secured overnight investments.

M7.3) Payments are made using zero-balance accounts.

M7.4) A cash distribution worksheet is prepared periodically to ensure that excess cash is distributed to the Investor promptly.

Best Practices - Management

OBJECTIVE M8 - Cash Safeguarding

To ensure that property cash and investments are properly safeguarded.

<u>Best Practices:</u>

M8.1) Lockbox accounts are used whenever feasible.

M8.2) Transfers between bank accounts are properly authorized.

- Recurring Automated Clearing House (ACH) transfers are controlled via secured templates. No person should have the authority to both setup and approve an ACH template.
- No person should have the ability to initiate and approve a single cash transfer.
- Individuals that are authorized to setup or approve templates are not authorized to initiate or approve transfers.

M8.3) All bank accounts and authorized signers are established according to investor requirements. All checks must be signed by at least two signatories.

M8.4) All check stock and insignia are safeguarded.

M8.5) Reconciliations are prepared and approved by someone independent of the cash receipts and disbursements functions.

- Cash (bank to book)
- Cash receipts (bank to cash receipts journal)
- Cash disbursements (bank to check register)

Best Practices - Management

OBJECTIVE M9 - Disbursements

To ensure that all property cash disbursements are for valid and approved expenditures.

<u>Best Practices:</u>

M9.1) All expenses are paid through the A/P system by the Accounts Payable Department.

M9.2) Accounting reviews disbursements for proper approval, accuracy, adequate supporting documentation, and proper classification.

M9.3) All expenses are approved prior to payment as follows:

- Budgeted expenses are approved by the Property Manager, the Asset Manager or the Portfolio Manager based on the disbursement nature and amount.
- Unbudgeted or over budget expenses are approved by the Asset Manager, the Portfolio Manager and the Investor.

M9.4) Cumulative expenses are compared to budget prior to payment.

M9.5) The Engineering Department will analyze all significant proposed capital expenditures.

M9.6) The A/P Vendor Master file is properly controlled.

Best Practices - Management

OBJECTIVE M10 - Reporting

To ensure that financial and management reports useful to both the Adviser's management and to the investor are prepared accurately and timely.

Best Practices:

M10.1) Periodically, a reporting schedule is distributed to all relevant Adviser personnel.

M10.2) All key Adviser Departments are involved in preparing reports.

M10.3) All reports are reviewed by the Accounting Controller, the Asset Manager and the Portfolio Manager prior to distribution.

Best Practices - Management

OBJECTIVE M11 - Valuation

To ensure that property market values are estimated properly and timely.

<u>Best Practices:</u>

M11.1) Market valuations consider the three approaches to value. They include:
- Replacement cost
- Market/Sales comparison
- Discounted cash flow

M11.2) Internal valuations are prepared by a MAI (Member, Appraisal Institute) in accordance with the Uniform Standards of Appraisal Practice. External valuations are obtained periodically.

M11.3) Valuation assumptions are provided by an experienced Asset Manager. Research Department information is utilized.

M11.4) The Head of the Appraisal Department reviews all valuations.

M11.5) All valuations are reviewed by top management.

Best Practices - Management

OBJECTIVE M12 - General Management

To ensure consistent monitoring of the property's physical condition, the on-site management and all related property issues.

<u>Best Practices:</u>

M12.1) Adviser personnel perform periodic property site visits.

M12.2) Property tax assessments are continually monitored to determine whether abatement should be applied for. The appeal may be made by internal staff or by a third party real estate tax consultant.

M12.3) A tenant retention program is in place.

M12.4) Tenant surveys are performed periodically.

M12.5) Emergency procedures are developed by the adviser and distributed to all properties (to ensure consistency). The Property Manager must acknowledge (in writing) that they have received the procedures.

M12.6) Environmental policies and procedures are developed by the adviser and distributed to all properties (to ensure consistency).

M12.7) All legal issues are communicated to the Asset Manager promptly.

M12.8) A detailed tenant complaint log is maintained by the Property Manager and reviewed by the Asset Manager. This log includes the complaint date and the resolution date.

M12.9) Apartments: Professional shoppers are hired to shop the property.

M12.10) Property Managers and leasing agents are evaluated periodically.

M12.11) The Risk Management Department, in-house Counsel and some third party insurance consultant review insurance policies periodically. They review coverage levels, deductibility limits, carrier ratings and other policy provisions.

M12.12) Market studies are performed periodically by the Research Department.

M12.13) Retail properties: Tenant Sales audits are performed periodically.

M12.14) Engineering reviews are performed periodically by the Engineering Department.

M12.15) Prime contractors for construction contracts are bonded.

M12.16) Contracts have 30 day cancellation clauses.

M12.17) The Internal Auditing Department performs periodic audits of all key aspects of real estate investment management.

Best Practices - Disposition

OBJECTIVE D1 - Disposition

To ensure that research is periodically performed to determine when properties should be recommended for disposition, and that property sales price is maximized at disposition.

<u>Best Practices:</u>

D1.1) A Hold / Sell Analysis is prepared annually and included in the Annual Business Plan.

D1.2) The property's performance is monitored closely. The performance is continually compared to the original investment objectives. Research Department information is utilized.

D1.3) The Disposition Department, the Portfolio Manager and the Asset Manager work closely throughout the disposition process.

D1.4) The investor approves all major decisions regarding the disposition process.

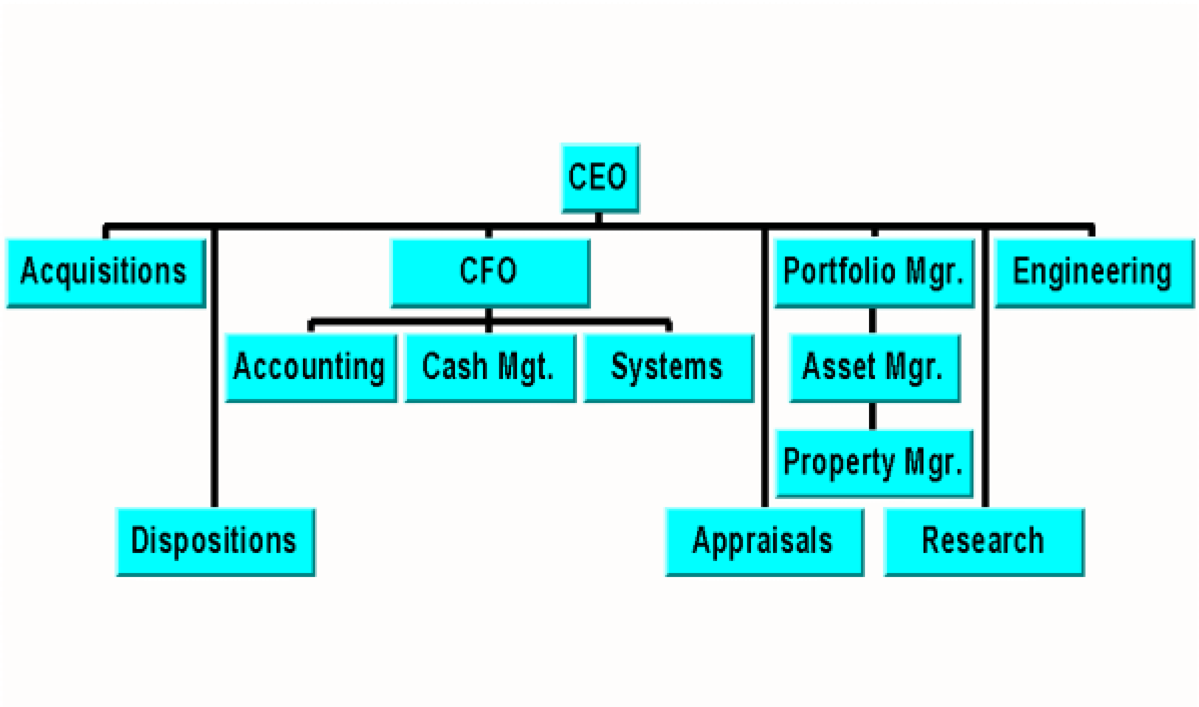
D1.5) A thorough due diligence is completed.

D1.6) The Disposition Department identifies target markets and formulates an investment disposition strategy.

Model Adviser Organization Chart

The chart below depicts the best practice model for organization of the real estate adviser. It was chosen primarily because it included separate departments for all significant functions. It is rare to have all functions in separate departments but it serves as a good model.

Of course, as with any management control, the cost must be considered. It is possible that the above organization would be too costly to implement for the smaller advisers. Therefore, it would not be practical in all cases.



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***P2E* CONSULTING GROUP, LLC**

Steve Harding has thirty years of experience in financial services, and is nationally recognized as an expert on risk management in public pension funds. Until forming P2E Consulting Group, LLC, Steve directed the fiduciary audit and operational review practice of Independent Fiduciary Services. He worked for IFS for twelve years and provided consulting services to more than 60 public and private pension funds during that time.

From 1990 to 1999 Steve worked in the Office of the New York State Comptroller where he managed financial, compliance and operational audits of the $100+ billion New York State and Local Employees' Retirement System. He last served as Assistant Director of Internal Audit.

In 1990 Steve formed a steering group that founded the Association of Public Pension Fund Auditors, Inc. He served as APPFA's first President from 1991 to 1994. Steve incorporated the Association, obtained its tax exempt 501(c) status, and drafted the first Constitution and By-laws. He served as a director until 1999.

From 1982 to 1985, Steve worked for Coopers & Lybrand. He became a Certified Public Accountant in 1984. He then worked in the securities industry from 1985 to 1988 as Internal Auditor for First Albany Corporation, a publicly held broker-dealer where he earned the Series 7 and 63 licenses. From 1985 to 1990 he was a member of the New York State Society of CPAs Stockbrokerage Committee and served as Chairman his last year. From 1988 to 1990 he worked for a regional CPA firm.

Steve taught for ten years as an adjunct accounting instructor at the graduate School of Business of the University at Albany. He also graduated from UAlbany in 1981 with a B.S. in Accounting, *cum laude*.

Steve is author of *Auditing External Real Estate Advisors: 101 Best Practices*. He recently authored the textbook chapter "*Pension Funds"* in Institutional Money Management: Objectives, Constraints, and Strategies published in 2011 by John Wiley & Sons, Inc. (Robert Kolb Finance Series).

Steve served as board member of the Foundation for Fiduciary Studies from 2003 to 2006. He also served as a consultant to the Texas Municipal Retirement System Audit Committee and to CalPERS' Ad Hoc Risk Management Committee enterprise risk management initiative. He is a member of the American Institute of Certified Public Accountants and the Institute of Internal Auditors.

Notes

1. *Statement on Auditing Standards #70, Reports on the Processing of Transactions by Service Organizations*. American Institute of Certified Public Accountants. New York. 1992

2. Top 50 Real Estate Advisers. Pensions & Investments. 1997. Available from http://www.pionline.com/research/top50.html. INTERNET.

3. Trump, Donald. *Trump: The Art of the Deal*. Random House. New York. 1987

4. Brueggeman, William B., Fisher, Jeffrey D., and Stone, Leo D. *Real Estate Finance*. Eighth edition. Richard D. Irwin. Homewood, Illinois. 1989.

5. I have not included any objectives related to the measurement of ROI. ROI measurements are important in the evaluation of any adviser.