



Smithsonian
Institution

Audit of the Management of Leased Office Space

Smithsonian Needs to Finalize Its Cost-Benefit Analysis to Inform Real Estate Decisions

**Office of the Inspector General
Report Number A-13-12
July 3, 2014**



In Brief

Smithsonian Needs to Finalize Its Cost-Benefit Analysis to Inform Real Estate Decisions *Report Number A-13-12, July 3, 2014*

Why We Did This Audit

The Smithsonian houses its staff in buildings that it either owns or leases.

The objectives of this audit were to evaluate the Smithsonian's short- and long-term plans for managing its leased office portfolio, and also to assess management's strategies for identifying opportunities to reduce costs relating to leased office space.

Background

The Smithsonian has 15 office leases in 5 locations, totaling 642,705 square feet, with an annual lease cost of approximately \$29 million.

The Smithsonian, like other federal entities, continues to lease rather than purchase office space, partly due to the Office of Management and Budget's (OMB) budget scoring procedures. These procedures, set forth in OMB Circular A-11, appear to favor leasing instead of purchasing because many entities fail to develop a cost benefit analysis.

What We Found

We found that the Smithsonian has developed and implemented short- and long-term plans to reduce leased office space, as well as long-term plans to synchronize the expiration dates of Washington, D.C. area office leases in anticipation of purchasing office space in 2021. Management has employed some effective strategies for identifying opportunities to reduce its leased space costs. By monitoring Smithsonian's use of leased office spaces, the Division successfully consolidated some spaces to reduce costs where possible. However, management had not finalized a cost-benefit analysis to support its plans to purchase a building.

What We Recommended

To present a more informed position to stakeholders regarding the purchase or lease of office space, we recommended that management: continue to refine and complete a cost-benefit analysis for use in the decision making process and include this analysis in the Smithsonian's federal budget proposal.

Management concurred with our finding and recommendation and plans to complete its cost-benefit analysis by or before September 30, 2015. We will continue to monitor management's progress towards completion of this recommendation.

For additional information or a copy of the full report, contact the Office of the Inspector General at (202) 633-7050 or visit <http://www.si.edu/oig>.



Smithsonian Institution

Office of the Inspector General

Date July 3, 2014

To Walter Ennaco, Acting Director, Office of Planning Design and Construction,
Debra Nauta-Rodriguez, Deputy Director, Office of Planning, Design and
Construction
Edward Rynne, Associate Director, Real Estate Division

cc Albert Horvath, Under Secretary for Finance and Administration/
Chief Financial Officer
John Lapiana, Deputy Under Secretary for Finance and Administration
Nancy Bechtol, Director, Office of Facilities Engineering and Operations
Porter N. Wilkinson, Chief of Staff, Board of Regents
Patricia Bartlett, Chief of Staff, Office of the Secretary
Judith Leonard, General Counsel
James Douglas, Director, Office of Human Resources
David Voyles, Director, Office of Planning Management and Budget
Cindy Zarate, Executive Officer, Office of the Under Secretary for Finance
and Administration/Chief Financial Officer
Stone Kelly, Program and Budget Analyst, Office of Planning,
Management and Budget

From Epin Christensen, Acting Inspector General

A handwritten signature in black ink, appearing to read "Epin Christensen".

Subject Audit Report on the Management of Leased Office Space, A-13-12

Attached please find a copy of our final report titled *Smithsonian Needs to Finalize Its Cost-Benefit Analysis to Inform Real Estate Decisions*.

We made one recommendation to improve the management of leased office space. Specifically, we recommended that management continue to refine and complete a cost-benefit analysis for use in the decision making process and include this analysis in the Smithsonian's federal budget proposal.

We appreciate the courtesy and cooperation of all Smithsonian staff during this review.

Please call me or Joan Mockeridge, Acting Assistant Inspector General for Audits, at 202.633.7050 if you have any questions.

INTRODUCTION

The Smithsonian houses its staff in buildings that it either owns or leases. The Smithsonian has 15 office leases in 5 locations, totaling 642,705 square feet, with an annual lease cost of approximately \$29 million:

| Square Feet | Locations |
|----------------|--------------------------|
| 397,673 | Washington D.C. |
| 159,131 | Cambridge, Massachusetts |
| 51,481 | Arlington, Virginia |
| 23,406 | New York City, New York |
| <u>11,014</u> | Herndon, Virginia |
| <u>642,705</u> | |

The objectives of this audit were to evaluate the Smithsonian's short- and long-term plans for managing its leased office portfolio, and also to assess management's strategies for identifying opportunities to reduce costs relating to leased office space.

A detailed description of our objectives, scope, and methodology is included in Appendix A.

Management concurred with our finding and recommendation and has planned corrective actions to address the recommendation. Please refer to Appendix B for management's complete response.

BACKGROUND

The Smithsonian, like other federal entities, continues to lease rather than purchase office space, partly due to the Office of Management and Budget's (OMB) budget scoring procedures. These procedures, set forth in OMB Circular A-11, appear to favor leasing instead of purchasing because many entities fail to develop a cost benefit analysis. Without this analysis, OMB scoring procedures for operating leases¹ compares the cost of one year's lease payment to the entire purchase price of a building in the year of purchase. Therefore, when applying OPM scoring procedures, inevitably a one-year lease payment will appear less costly than the entire purchase price of a building.

¹ An operating lease is a contract that allows the use of an asset, but does not convey rights of ownership of the asset. Lessees account for operating leases as a rental expense and do not classify them as an asset on their financial statements.

Smithsonian Directive (SD) 416, *Real Estate Asset Management*, states that the Office of Facilities Engineering and Operations (OFEO) is responsible for the accounting, reviewing, acquiring, and disposing of real property. The Real Estate Division (Division), an office within OFEO, is responsible for managing office leases in accordance with *The Real Estate Manual*, a guide for implementing SD 416. This manual provides procedures, technical guidance, and information on how the Smithsonian acquires, disposes of, and manages real estate.

According to the Smithsonian's *Real Estate Manual*:

The Division provides real estate expertise, oversight, technical consultation, counsel, and coordination with all Smithsonian units regarding implementation of SD 416 *Real Estate Asset Management*. It is also responsible for recommending and implementing best practices for all Smithsonian-related real estate assignments (owned and leased), as well as maintenance of real property records and documentation.

In addition, the Division provides facilities-related budget information for inclusion in the Smithsonian's annual budget submission to OMB.

RESULTS OF AUDIT

We found that the Smithsonian has developed and implemented short- and long-term plans to reduce leased office space, as well as long-term plans to synchronize the expiration dates of Washington, D.C. area office leases in anticipation of purchasing office space in 2021. Management has employed some effective strategies for identifying opportunities to reduce its leased space costs. By monitoring Smithsonian's use of leased office spaces, the Division successfully consolidated some spaces to reduce costs where possible. However, management had not finalized a cost-benefit analysis to support its plans to purchase a building.

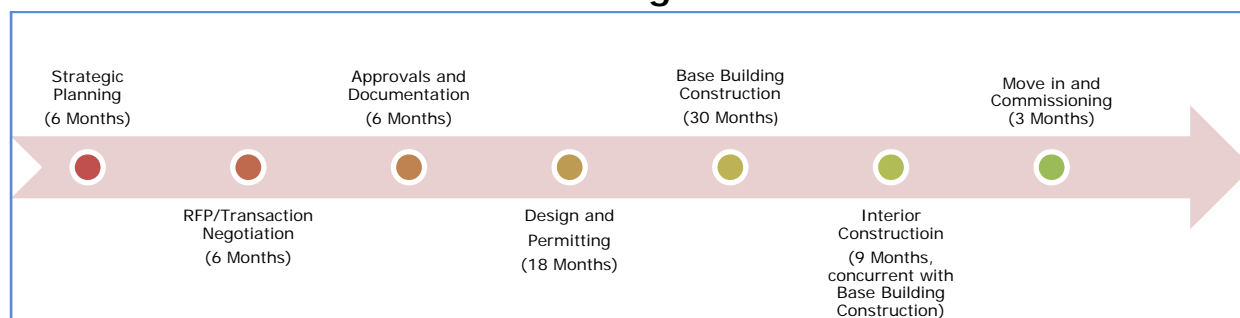
The Smithsonian Needs to Develop an Office Space Cost-Benefit Analysis

The Smithsonian has consolidated and synchronized the expiration of current leases around the Washington, D.C. area in an effort to strategically position the Smithsonian to explore an owned building alternative to house administrative offices. However, according to a real estate study, prepared jointly by the Division and a commercial real estate consultant, the Smithsonian should begin its planning process to purchase a building. This process needs to begin now since there will be fewer options available the closer it gets to the end of the lease terms, which may put the Smithsonian in a disadvantaged negotiating position resulting in a higher

purchase price. Moreover, management said the existence of historically low interest rates presents an opportunity for the Smithsonian, and adds to the sense of urgency to move forward with this initiative expeditiously.

This study suggests that, should the Smithsonian pursue a Built-to-Suit alternative, it will take approximately 69 months (5 years and 9 months) to complete planning through full occupancy. See diagram below for details.

Time Line for a Built-to-Suit Building



This same study advises that the least costly scenario requires prompt action, while the most expensive scenario is to do nothing. According to the Smithsonian's Office of Planning Management and Budget (OPMB), preparing a cost-benefit analysis will help the Smithsonian persuade decision makers, including OMB and Congress, to determine whether the purchase of a new building is in the best interest of the Smithsonian. In fact, Smithsonian management has completed a draft cost-benefit analysis and continues to refine it as more specific market information becomes available; it expects to finalize this analysis by the end of fiscal year 2016.

Likewise, Smithsonian policy and OMB guidance discuss the importance of, and need for, such analyses in making real property acquisitions. SD 416 states that:

- Facility investments are made based upon objective performance criteria, fulfillment of the intended mission and life-cycle cost-benefits analysis.
- Lease versus ownership decisions are based upon the mission-critical need for the requirement, financial cost to the Institution in the short- and long-terms, maintenance costs, and the degree of control of the physical plant desired by the Smithsonian.

Further, OMB Circular A-94 (1992), *Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs*, outlines how to analyze lease versus purchase decisions.

In addition to the above guidance, the Government Accountability Office (GAO) has issued reports on government real estate leasing practices for many years.² These reports state that the government uses too many costly operating leases when in the long-term it would be less expensive to purchase an office building. The auditee, General Services Administration (GSA), agreed with the findings, but noted that the OMB budget scoring procedures constrains federal agencies to select operating leases in lieu of purchasing a building. These constraints, which compares a one-year operating lease amount to the entire purchase amount of a new building, ultimately favors the lower one-year lease cost.

Moreover, we found Congressional testimony³, where the Congressional Budget Office stated that both GAO and GSA have reached the same conclusions that operating leases make sense for a short or uncertain period; however, purchasing a building to meet long-term needs would result in significant savings.

If the Smithsonian continues to lease office space, it will likely pay higher-than-necessary costs compared with owning a building outright. According to the real estate study mentioned above, if the Smithsonian purchased a building of approximately 550,000 square feet, it could save about \$107 million over a 15-year period. The study explained that if the Smithsonian continued to lease during that period, it would cost a total of \$386 million; however, if the Smithsonian purchased a building the estimated cost would be \$279 million. According to the study, if the Smithsonian owned the building, it would continue to save funds over the useful life of the building, with a total savings of \$445 million over a 40-year period.

Ultimately, Congress makes federal budget decisions, and federal budget realities may not support a decision to purchase an office building. Nevertheless, by completing a cost-benefit analysis, the Smithsonian will be better prepared to argue the benefits of their proposal—to own or lease—to stakeholders.

² In a 1989 report, the GAO stated that, for 43 operating leases reviewed, the GSA could have saved \$12 billion through ownership of the assets over 30 years. A 1995 GAO report found that, for 55 of 73 GSA operating leases examined, the total lease cost was \$700 million more than it would have cost GSA to construct new buildings. A more recent GAO report issued in 2008 found that, for 4 of 7 leases analyzed, operating leases were more costly by \$83 million over 30 years.

³ Blum, James L. Statement to the House, Subcommittee on Legislation and National Security Committee on Government Operations. *Statement of James L. Blum, Deputy Director, Congressional Budget Office on the Lease-Purchase Scorekeeping Rule*, hearing, September 20, 1994. Available at <https://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/49xx/doc4909/doc77.pdf>

Recommendation

To present a more informed position to stakeholders regarding the purchase or lease of office space, we recommend that the Associate Director, Real Estate Division:

1. Continue to refine and complete a cost-benefit analysis for use in the decision making process and include this analysis in the Smithsonian's federal budget proposal.

Appendix A**OBJECTIVES, SCOPE, AND METHODOLOGY**

The objectives of this audit were to evaluate the Smithsonian's short- and long-term plans for managing its leased office portfolio, and also to assess management's strategies for identifying opportunities to reduce costs relating to leased office space.

To accomplish our objectives we reviewed federal policies regarding leasing of real property and guidance from the OMB contained in Circular A-11, *Preparation, Submission, and Execution of the Budget*, and Circular A-94, *Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs*. These circulars discuss OMB budget scoring of leases and purchases of capital items. We reviewed internal Smithsonian directives and manuals. We also reviewed audit reports from various offices of inspectors general and the GAO. In addition, we reviewed government and private industry best practices for the leasing of real property.

To obtain an understanding of the Smithsonian's management of its lease portfolio, we met with personnel from the Real Estate Division and other OFEO groups.

We reviewed the minutes of the Board of Regents' Facilities Committee meetings during the period January 4, 2008 through February 28, 2013, to determine whether the Committee discussed the Division's real estate plans during its meetings.

To gather information about telework and other opportunities to reduce leased office space at the Smithsonian, we met with staff from the Smithsonian's OHR. We also met with the Director of OPMB and members of his staff to discuss the Smithsonian's budget process.

In order to assess the accuracy of the Division's real estate database for office space we compared data in the database to the original leases for all the leased office space. This included 15 current office leases in 5 locations, totaling 642,705 square feet with an annual lease cost of approximately \$29 million.

Appendix A**OBJECTIVES, SCOPE, AND METHODOLOGY (Continued)**

We conducted this performance audit in Washington, D.C. from August 2013 through June 2014, 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 we obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix B

MANAGEMENT'S RESPONSE



Smithsonian Institution

Memo

Office of Facilities Engineering and Operations
Office of Planning, Design and Construction

Date June 27, 2014

From Walter R. Ennaco, P.E., Acting Director, Office of Planning, Design and Construction

cc Ed Rynne, Associate Director, Real Estate
Debra Nauta-Rodriguez, Deputy Director, OPDC
Nancy Bechtol, Director, OFEO
Sheri Vucci, Director, OBATS
Rick Haas, Associate Director, FAM

To Office of Inspector General

Subject Report A-13-12

In response to the Inspector General Report A-13-12, Formal Draft Report on the Audit of the Management of Leased Office Space, the following responses are submitted to the recommendations therein:

Recommendation: To present a more informed position to stakeholders regarding the purchase or lease of office space, we recommend that the Associate Director, Real Estate Division:

1. Continue to refine and complete a cost-benefit analysis for use in the decision making process and include this analysis in the Smithsonian's federal budget proposal.

Comment: Concur

Planned Actions: OPDC Real Estate Division is continuing to work on the refinement of the preliminary analysis, which has already been briefed to the USF&A. If authorization is received from USF&A, we will proceed with an RFP process soliciting specific responses from the commercial real estate market in the National Capital Area.

Target Date of Completion: If authorization is received within the next 30 days, we feel confident that the completed analysis can be completed by or before **September 30, 2015**.

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Appendix C

MAJOR CONTRIBUTORS TO THIS REPORT

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