COUNTY OF LOS ANGELES
DEPARTMENT OF AUDITOR-CONTROLLER

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December 7, 2010

TO: Supervisor Michael D. Antonovich, Mayor
Supervisor Gloria Molina
Supervisor Mark Ridley-Thomas
Supervisor Zev Yaroslavsky
Supervisor Don Knabe

FROM: Wendy L. Watanabe
Auditor-Controller

SUBJECT: **TARZANA TREATMENT CENTER – FOLLOW-UP REVIEW (BOARD AGENDA ITEM #35, JUNE 16, 2009)**

This follow-up report is our assessment of Tarzana Treatment Centers' (Tarzana or Agency) rent charges to County programs for Fiscal Year (FY) 2008-09 for the six related party properties noted in our August 19, 2009 report, and an additional property that Tarzana subsequently disclosed as also leased from an Agency executive.

On August 19, 2009 we issued a report to your Board on our review of Tarzana's County contracts. In that report, we noted that Tarzana charged rent expense to its County and non-County programs based on the fair market rent of $2.6 million, rather than the actual property rent-related cost of $1.1 million. This resulted in an excess (i.e., overstating costs) amount of $1.5 million.

We reported that Tarzana applied this methodology to six properties owned by Tarzana executives/Tarzana Board members (landlords) and leased to Tarzana for its business uses, including operating County and non-County programs. Tarzana's contract with the County limits the amount that can be charged for related party leases (i.e., less than an arm's length transaction) to the lower of property rent-related cost or fair market rent. According to the Federal Office of Management and Budget (OMB) Circular A-122, a less than an arm's length lease is one under which one party to the lease agreement is able to control or substantially influence the actions of the other.

We also reported that because Tarzana operates County and non-County programs, we recommended that Tarzana determine the appropriate amount of rent allocable to its County programs and report the applicable amount to the Auditor-Controller for review.

We worked with County Counsel, the Assessor, Children and Family Services (DCFS), Health Services (DHS), Mental Health (DMH), Probation, Public Health (DPH) and Public and Social Services (DPSS) to determine (1) the County's authority to recover questioned costs for all 33 contracts with Tarzana, (2) allowable cost, and (3) the appropriateness of Tarzana's fair market rent appraisals.

Results of Review

We determined that, subsequent to our August 2009 report, Tarzana's management made the necessary adjustments to ensure compliance with all relevant requirements and regulations. Tarzana submitted its final cost reports to the County, which properly charged the lower rent expense amount, thereby resolving this issue.

The following chart compares our prior (August 2009) and current findings:

Summary of Fair Market Rent and Actual Property Rent-Related Cost		
	A-C's August 2009 Report	**A-C's Current Findings**
County and Non-County Programs:		
Fair Market Rent	**$2.6 million (A)**	$3.1 million
Actual Rent-Related Cost	**$1.1 million (B)**	**$2.2 million * (D)**
Overstating the Cost	**$1.5 million (C)**	N/A
Rent-Related Cost Allocation by Tarzana:		
County Programs	*N/A*	***$1.3 million (E)***
Non-County Programs	*N/A*	*$0.9 million*
Total Actual Rent-Related Cost	*N/A*	***$2.2 million (D)***

On August 19, 2009, we issued a report to your Board on our review of Tarzana's County contracts. In that report, we noted that Tarzana charged rent expense to its County and non-County programs based on the fair market rent of $2.6 million (see (A) above), rather than the actual property rent-related cost of $1.1 million (see (B) above.) This resulted in an excess (i.e., overstating costs) amount of $1.5 million (see (C) above).

* Attachment I shows that for each of the seven leased properties, the total actual property rent-related cost charged to the County was lower than the fair market rent.

During the follow-up review, we confirmed that Tarzana adjusted the rent charges to its County and non-County programs from $2.6 million to $2.2 million (see Ⓓ above) in FY 2008-09. Of the $2.2 million, Tarzana allocated $1.3 million (see Ⓔ above) as rent costs to County programs. This is the appropriate County amount based on the actual property rent-related cost, which is lower than fair market rent, as required under OMB Circular A-122.

Additionally, during our review, we noted a lack of uniformity in County contract provisions for recovering disallowed or questioned program costs. We asked County Counsel to review Tarzana's 33 County contracts and provide uniform contract language for recovery of disallowed or questioned program costs.

Further, we found that Tarzana's appraisals of fair market rent for five properties did not accurately reflect the fair market rent of comparable properties located in the same area. We recommend new property rental appraisals on all related party properties.

Lastly, Service Employees International Union (SEIU or Union) Local 721, concurrent with the issuance of our August 2009 report, conducted its own analyses and reported that Tarzana overstated its fair market rents charged to the County. We asked the County Assessor to review the Union's analyses. The Assessor concluded that SEIU did not use a methodology that is totally consistent with industry standards.

Details of our review are discussed below.

Tarzana's Adjusted Rent Calculation/Allocation

We reviewed documentation subsequently submitted by Tarzana showing its calculation of FY 2008-09 rents allocable to County contracts for seven leased properties. We validated the actual rent paid to the landlords and determined the actual adjusted property rent-related cost for each property.

On August 19, 2009 we issued a report to your Board on our review of Tarzana's County contracts. In that report, we noted that Tarzana charged rent expense to its County and non-County programs based on the fair market rent of $2.6 million, rather than the actual property rent-related cost of $1.1 million. This resulted in an excess (i.e., overstating costs) amount of $1.5 million.

Tarzana's contract with the County limits the amount that can be charged for related party leases (i.e., less than an arm's length transaction) to the lower of property rent-related cost or fair market rent. When we issued our report in August 2009, Tarzana had not submitted its final cost reports to the County. Such reports are typically required as part of the year-end settlement process to document actual program expenditures. As such, the County required Tarzana to submit a final cost report for 26 of is 33 contracts in FY 2008-09.

We subsequently reviewed additional documentation submitted by Tarzana supporting its FY 2008-09 final cost reports. We also validated the methodology used by Tarzana to allocate rent for the seven leased properties and conducted interviews with Tarzana management. We confirmed that, although the fair market rent paid by Tarzana to its landlords were $3.1 million, Tarzana appropriately allocated the lower actual property rent-related cost totaling $2.2 million ($1.3 million to its County programs and $.9 million to its non-County programs) for its seven leased properties (see Attachment I and II). Per OMB Circular A-122, depreciation, maintenance, property taxes, insurance, interest and utilities are permissible in establishing property rent-related cost.

Recommendation

None.

Subsequent Years' Rent Allocation

Our review only covered the FY 2008-09 rental costs. However, Tarzana management indicated that it allocated rent based on the lower of property rent-related cost or fair market rent, as required, in FY 2009-10 and will continue to do so in subsequent fiscal years. Tarzana is also no longer charging rent expense for one of the seven lease properties (see Attachment I, Property 7) beginning July 1, 2009 in an effort to be more compliant with the established rules and regulations. Therefore, County Departments that contract with Tarzana should review the Agency's subsequent years' rent (e.g., during the year-end settlement process, as part of their contract monitoring reviews, etc.), beginning with FY 2009-10, to ensure that Tarzana is charging/allocating only the allowable rent to its County programs.

Recommendation

1. **County Departments that contract with Tarzana should review the Agency's subsequent years' rent (e.g., during the year-end "settlement process", as part of each Department's contract monitoring reviews, etc.), beginning with FY 2009-10, to ensure that Tarzana is charging/allocating only the allowable rent to its County programs.**

Additional Findings

Contract Review

Tarzana maintains various contract types (i.e., cost reimbursement, Fee-for-Service and a combination thereof) with the County. Under a cost reimbursement contract, providers are paid by the County based on actual program expenditures. Whereas, under a Fee-for-Service contract, providers are paid a pre-approved flat rate by the County for the unit of service provided (e.g., per clinic visit, per application completed, etc.).

We asked County Counsel to review all 33 contracts with Tarzana to ensure that the County had the authority to recover the excess rents charged to the County, preliminarily identified in our August 2009 report, from both cost reimbursement and Fee-for-Service contracts.

Based on County Counsel's review, while the cost reimbursement contracts appear to include the appropriate contract provision that allow for recovery of disallowed or questioned costs, not all Fee-for-Service contracts do. We recommend that County Counsel work with various Departments to develop contract provisions for Fee-for-Service contracts that allow for the adequate recovery of disallowed or questioned program costs. Also, County Departments should incorporate the contract provisions in Fee-for-Service contracts, as applicable, to ensure the County has authority to recover disallowed or questioned program costs (e.g., excess rent, etc.).

Recommendations

2. **County Counsel work with various Departments to develop contract provisions for Fee-for-Service contracts that allow for the adequate recovery of disallowed or questioned program costs (e.g., excess rent, etc.).**

3. **County Departments incorporate the contract provisions in Fee-for-Service contracts, as applicable, to ensure the County has authority to recover disallowed or questioned program costs (e.g., excess rent, etc.).**

Related Party Transactions

According to OMB Circular A-122, a less than an arm's length lease (i.e., related party lease) is one under which one party to the lease agreement is able to control or substantially influence the actions of the other. Such leases included, but are not limited to, those between an organization and a director, trustee, officer, or key employee of the organization or his immediate family either directly or through corporations, trusts, or similar arrangements in which they hold a controlling interest.

The Chief Executive Office (CEO), County Counsel and various County Departments (i.e., DCFS, DMH, DHS, Probation, DPH and DPSS) that contracted with Tarzana during FY 2008-09 concur that all County contracts should be consistently reviewed for all related party transactions, including leases. Based on our discussions with these County Departments, we recommend that County Counsel develop solicitation documents and contract provisions regarding related party transactions. The solicitation documents and contract provisions should require prospective and current contractors to disclose related party transactions at the beginning of the contracting process and at anytime whenever such an event occurs during the contract term. Disclosure would enable County Departments to appropriately review contractors' related party program

costs. We also recommend that County Departments incorporate the related party disclosure requirement into all applicable County contracts.

Recommendations

4. **County Counsel develop solicitation document and contract provisions that require prospective and current contractors to disclose related party transactions at the beginning of the contracting process and at anytime whenever such an event occurs during the contract term. Disclosure would enable County Departments to appropriately review contractors' related party program costs.**

5. **County Departments incorporate the related party disclosure requirement into all applicable County contracts.**

Status: The CEO, County Counsel, DCFS, DHS, DMH, Probation, DPH and DPSS agree with these recommendations. County Counsel is currently working on the necessary contract provisions.

Property Appraisal Evaluation

Tarzana hired a licensed appraiser and submitted appraisals, for five of its seven related party properties below, containing the fair market rents (FMR) used in billing its County programs (see Attachment I for a listing of all seven properties):

Property 1 - 44447 N. 10th Street West, Lancaster
Property 3 - 8330 Reseda Blvd., Los Angeles
Property 4 - 7101 Baird Avenue, Los Angeles
Property 5 - 18646 Oxnard Street, Tarzana
Property 6 - 18700 Oxnard Street, Tarzana

For the other two properties, Property 2 and 7, Tarzana did not submit appraisals. According to Tarzana management, the rent for one property (Property 2), located at 907 Lancaster Boulevard, Lancaster, is based on the FMR appraisal for one of its other facilities located in the same area that is of similar size and use (e.g., alcohol and drug outpatient program, etc.). The second property (Property 7), located at 38744 Cortina Way, Palmdale, is a residential property and its rent is based on Tarzana's own assessment of rents of similar properties in the same area.

At our request, County Assessor appraisers reviewed the appraisal reports for Tarzana's five related party properties to determine: 1) whether Tarzana's FMR appraisals complied with industry standards, and 2) the reasonableness of Tarzana's reported FMR. The County Assessor concluded that:

- Tarzana's appraiser used appropriate methodology to estimate the market rents[1] for three of the five properties (Properties 3, 4 and 6). However, Tarzana's appraiser made upward adjustments to the market rents for tenant improvements on the properties which may have resulted in above-market rental appraisals. The use of above-market rent to bill the County could result in excess rent charges to County programs.

- For the remaining properties (Properties 1 and 5), the County Assessor concluded that although Tarzana's appraiser used a reasonable methodology to estimate FMR, the appraiser's risk rate[2] assumptions were not supported by market data. Therefore, the appraised FMR for these properties may not be reliable.

Since Tarzana appropriately charged/allocated the lower of cost or FMR, these appraisals did not affect our review and confirmation of rent allocation. However, in the future, Tarzana should consider obtaining new property rental appraisals on all related party properties at the time the Agency renegotiates its leases.

Recommendation

6. Tarzana consider obtaining new property rental appraisals on all related party properties, at the time the Agency renegotiates its leases.

Status: Throughout the review, Tarzana management expressed a willingness to comply with all established guidelines and requirements. Tarzana management indicated that it will consider obtaining new property rental appraisals when the related leases expire.

SEIU Local 721 Analyses

Concurrent with the issuance of our August 19, 2009 report, SEIU Local 721's Center for Public Accountability conducted its own analyses of the fair market rent for three (Properties 3, 4 and 6) of Tarzana's seven leased properties. SEIU concluded that Tarzana overstated its fair market rents charged to the County.

To address the Union's concerns, we asked the County Assessor to review the Union's analyses of Tarzana's FMR for the three properties. According to the County Assessor, SEIU did not use a methodology that is totally consistent with industry standards. SEIU's analyses estimated Tarzana's FMR by multiplying a market capitalization rate (i.e., the ratio used to determine the value of income producing property) by the reported purchase price of the three properties and did not include a market rent survey

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[1] Market rent is the rental income a property would probably command in the open market.

[2] The appraiser assigned a risk rate to the land and improvements. The land and improvement values are multiplied by the assigned risk rate to arrive at an estimate fair market rent.

of comparable facilities within the same area. According to the County Assessor, an appropriate methodology for estimating FMR utilizes comparable market rent data when it is available. Consequently, the Union's conclusion may not be reliable.

Recommendation

None.

Acknowledgments

On August 13, 2010, we met with Tarzana management to discuss the results of our follow-up review. We also met with representatives from the CEO, County Counsel, Assessor, DCFS, DHS, DMH, Probation, DPH and DPSS on August 18, 2010 to present the results of our review. All parties generally agree with all the findings and recommendations contained in the report.

Attached is Tarzana management's response to Recommendation #6 indicating agreement with obtaining new appraisals for its related party properties. The CEO and County Counsel are currently working with County Departments to implement the remaining recommendations and will provide a detailed response to your Board upon completion.

We thank Tarzana management and staff for their cooperation and assistance throughout our review. In addition, we thank County Counsel and County Assessor's staff for their expert assistance and the other six County departments, DCFS, DHS, DMH, Probation, DPH and DPSS for their support.

If you have any questions, please call me or your staff may contact Jackie Guevarra at (213) 974-8309.

WLW:MMO:JTG
Tarzana Board Order Follow-up Report

Attachment

c: William T Fujioka, Chief Executive Officer
Andrea Sheridan Ordin, County Counsel
Patricia S. Ploehn, Director, Department of Children and Family Services
John F. Schunhoff, Interim Director, Department of Health Services
Marvin J. Southard, Director, Department of Mental Health
Donald H. Blevins, Chief Probation Officer
Jonathan E. Fielding, Director and Health Officer, Department of Public Health
Philip L. Browning, Director, Department of Public Social Services
John R. Noguez, Assessor
Scott Taylor, President/Chief Executive Officer, Tarzana Treatment Centers
Public Information Office
Audit Committee

ATTACHMENT I

Tarzana Treatment Center
Summary of Rent Charged/Allocated to County Contracts
Fiscal Year 2008-09

				Follow-up Review		
	Facilities Owned (2)	Lessor	Related Party Ownership	Actual Rent Paid to the Landlords (FMR) (3)	Total Property Rent-Related Costs by Facility (4)	Actual Rent Charged/Allocated to County Programs
1	44447 N. 10th Street West, Lancaster, CA	10th Street West LLC	100%	$ 1,001,487	$ 563,602	$ 503,101
2	907 Lancaster Blvd., Lancaster, CA	Lancaster Health Center LLC	100%	$ 142,806	$ 62,001	$ 29,824
3	8330 Reseda Blvd., Los Angeles, CA	Reseda Medical Center LLC	100%	$ 352,452	$ 403,464	$ 226,369
4	7101 Baird Avenue, Los Angeles, CA	Baird Enterprises LLC	100%	$ 392,040	$ 241,760	$ 91,516
5	18646 Oxnard Street, Tarzana, CA	Oxnard Property LTD	50%	$ 728,871	$ 643,126	$ 232,713
6	18700 Oxnard Street, Tarzana, CA	Yolanda Equity Partners LLC	100%	$ 402,792	$ 308,776	$ 234,974
			Subtotal	**$ 3,020,447**	**$ 2,222,728**	**$ 1,318,497**
7	38744 Cortina Way Palmdale, CA (5)	Senella Family Revocable Trust	100%	$ 36,000	$ 17,193	$ 11,254
			Total	**$ 3,056,447**	**$ 2,239,920**	**$ 1,329,751** (1)

Amount Charged/Allocated to Non-County Programs **$ 910,169** (1)
Total Charged to Tarzana's County and Non-County Programs **$ 2,239,920** (1)

FMR = Fair Market Rent

(1) *Based on total property rent-related cost of $2.2 million - which is lower than the total fair market rent of $3.1 million - Tarzana appropriately charged/allocated a total of $1.3 million to its County programs (see Attachment II for details). Tarzana allocated the difference of $900,000 ($2.2 million - $1.3 million) to its non-County programs.*

(2) *Tarzana management identified these seven properties as owned by Tarzana officers, Board Members and/or family members. OMB Circular A-122 defines a related party lease as those between an organization and a director, officer, or key employee of the organization and his immediate family either directly or through organizations, trusts or similar arrangements in which they hold a controlling interest.*

(3) *This represents the actual rent paid by Tarzana Treatment Center to its landlords. In August 2009, we reported rent based on Tarzana's lease agreements. During the follow-up review, we validated actual rent of $3.1 million paid by Tarzana to the landlords.*

(4) *Per OMB Circular A-122, maintenance, property taxes, depreciation, interest, and utilities are permissible property rent-related costs. In August 2009, we reported a total of $1.1 million in property rent-related costs. During the follow-up review, we validated additional property rent-related expenses for the seven properties listed above. As a result, the total increased from $1.1 million (August 2009) to $2.2 million.*

(5) *This property was not included in our August 19, 2009 report. Tarzana disclosed ownership of this property during our follow-up review.*

ATTACHMENT II

Tarzana Treatment Center
Rent Allocation by County Contract (1)

	Dept		Contract Name	Contract No.	44447 N. 10th Sreet	907 W. Lancaster	8330 Reseda	7101 Baird	18646 Oxnard	18700 Oxnard	38744 Cortina	Totals
1	DCFS	TTC	Wraparound	04-011-32	$ 22,188	$ -	$ -	$ -	$ -	$ -	$ -	$ 22,188
2	DHS	TTC	PPP	H703152	-	-	-	-	-	-	-	$ -
3	DHS	TTC	PPP	H703410	-	18,994	225,569	-	-	-	-	$ 244,563
4	DMH	TTC	EPSDT	MH120266	-	-	-	-	-	-	-	$ -
5	DMH	TTC	EPSDT	MH040072	-	-	-	-	11,764	98,071	-	$ 109,835
6	Probation	TTC	Home Based	64007116	-	-	-	15,432	-	-	-	$ 15,432
7	DPH	TTC	CASC	H-702189	24,737	-	-	-	-	-	-	$ 24,737
8	DPH	TTC	GR & Drug Court	H-702192	32,787	395	-	-	18,868	-	-	$ 52,050
9	DPH	TTC	Youth	H-702231	54,974	768	-	-	23,229	136,903	11,254	$ 227,128
10	DPH	TTC	Reg County	H-702267	121,857	-	-	-	67,607	-	-	$ 189,464
11	DPH	TTC	Prop 36	PH-000164	102,948	3,296	-	8,507	44,944	-	-	$ 159,695
12	DPH	TTC	TANF	PH-000397	124,898	-	-	-	37,856	-	-	$ 162,754
13	DPH	TTC	DCFS	PH-000400	9,021	691	-	-	2,556	-	-	$ 12,268
14	DPH	TTC	DMC	PH-000402	1,161	-	-	-	576	-	-	$ 1,737
15	DPH	TTC	Fam Dep DC	PH-000404	8,530	-	-	-	2,301	-	-	$ 10,831
16	DPH	TTC	Non Med	PH-000408	-	5,680	-	-	-	-	-	$ 5,680
17	DPH	TTC	PPNP	PH-000410	-	-	-	-	1,910	-	-	$ 1,910
18	DPH	TTC	Outreach Initiative	H-300271-2	-	-	-	21,333	-	-	-	$ 21,333
19	DPH	TTC	Needle Exchange	PH000231-1	-	-	-	6,974	-	-	-	$ 6,974
20	DPH	TTC	Mental Health	H-210794-4	-	-	-	3,505	-	-	-	$ 3,505
21	DPH	TTC	NOCHAA	H-210795-17	-	-	-	9,450	-	-	-	$ 9,450
22	DPH	TTC	Jail	H-300127-7	-	-	-	8,554	-	-	-	$ 8,554
23	DPH	TTC	Self Help	H-700268-2	-	-	-	2,970	-	-	-	$ 2,970
24	DPH	TTC	HERR	H-700887 17-20	-	-	-	8,851	-	-	-	$ 8,851
25	DPH	TTC	MTU	H-700890 7-8	-	-	-	-	-	-	-	$ -
26	DPH	TTC	HIV Trans Hse	H-700979-4	-	-	-	-	-	-	-	$ -
27	DPH	TTC	HIV Res	H-700982-2	-	-	-	-	11,227	-	-	$ 11,227
28	DPH	TTC	HIV Detox	H-700983-4	-	-	-	-	5,868	-	-	$ 5,868
29	DPH	TTC	HIV Trans Hse	H-701004-6	-	-	-	-	-	-	-	$ -
30	DPH	TTC	CNA	H204608-15	-	-	-	5,940	-	-	-	$ 5,940
31	DPH	TTC	HIV Med O/P	H209018-10	-	-	800	-	-	-	-	$ 800
32	DPH	TTC	Treatment Advocacy	H209078-14	-	-	-	-	4,007	-	-	$ 4,007
33	DPSS	TTC	FS Application	FSA07019	-	-	-	-	-	-	-	$ -
Rent Charged/Allocated to COUNTY Programs					**$ 503,101**	**$ 29,824**	**$ 226,369**	**$ 91,516**	**$ 232,713**	**$ 234,974**	**$ 11,254**	**$ 1,329,751** (2)

(1) Tarzana prepared the rent allocation schedule by County contract. We validated the rent amounts and confirmed the reasonableness of the allocation methodology used.

(2) Tarzana charged/allocated $1.3 million in rent to its County programs for FY 2008-09.

ATTACHMENT III

CORPORATE OFFICERS

Scott Taylor

Albert M. Senella

Bobbi Sloan, Ph.D

Silvia Cadena

TARZANA TREATMENT CENTERS

Integrated Healthcare

Substance Use • Mental Health • Primary Care • HIV/AIDS

www.TarzanaTC.org

September 10, 2010

Ms. Wendy L. Watanabe
County of Los Angeles
Department of Auditor-Controller
500 West Temple Street, Room 525
Los Angeles, CA 90012-3873

Dear Ms. Watanabe:

Pursuant to your review, we are responding to the findings and one of the recommendations contained in the *Tarzana Treatment Center – Follow-up Review (Board Agenda Item #35, June 16, 2009)* audit report. Specifically, the following is Tarzana Treatment Centers' (TTC) response to Recommendation #6 regarding property appraisals:

Recommendation 6

Tarzana consider obtaining new property appraisals on all related party properties, at the time the Agency renegotiates its leases.

Response:

We concur. In the event that TTC Board of Directors opt to renew related party leases, as current leases expire, TTC will obtain new independent appraisals on each related party property. However, in doing so, TTC is not agreeing or disagreeing with the County Assessor's opinion in the report that the risk factors or allowance for tenant improvements is or is not appropriate. The TTC Board of Directors reasonably relied upon the fair market rents provided by an independent appraiser to establish rent for its leased properties at that time. In general, the TTC Board of Directors rely on independent expert advice, as appropriate, to make decisions relevant to TTC operations and will continue to do so in the future.

TTC management wishes to express their appreciation for the professionalism shown by your audit staff and other County officials throughout this lengthy process. Their relentless pursuit of the facts, to fully understand the issues, is commendable. As always, TTC will continue to fully cooperate until this matter is fully resolved.

Respectfully,

Albert M Senella
President/Chief Operating Officer