



**GARLAND**  

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**INTERNAL AUDIT**

# Concrete Recycling Facility Lease Agreement

*March 20, 2018*

*Report 201803*

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## Overall Conclusion

The City of Garland (COG) currently leases its Concrete Recycling Facility to Strata Materials, LLC (Strata). According to the lease agreement, The City is entitled to the following:

- Receive 50,000 tons of crushed concrete annually as consideration (“In-Kind Base Rent”) for use of the Leased Premises.
- The lessee will pay royalties at 2.5% of billed sales on a monthly basis over and above \$150,000.
- The lessee will pay \$2,700/month (effective date June 15, 2015) to pay-off the purchase of the “Crusher” equipment. The initial amount of the secured claim was \$207,000.
- The lessee will pay dump fees at a rate of \$5.00 per dump for all dumps made by trucks others than those operated by the City or its contractors. This will only apply if the lessee charges and collects dump fees from its customers.

The Street Department maintains a good working relationship with Strata. This audit revealed that Strata has consistently made payments for royalties, Crusher equipment, and provides the required annual concrete tonnage. Due to current market conditions, Strata is currently paying customers \$5.00 or \$10.00 for dumps based on truck size. Therefore, the City is not currently being paid dump fees.

However, Internal Audit (IA) identified the following opportunities for improvement:

- The City should take full advantage of the arrangement with Strata by utilizing all of the crushed concrete tonnage designated for the City. Based on IA’s review, the City on average, only uses approximately 27,000 tons of crushed concrete annually. The remaining 23,000 tons is valued at approximately \$218,000 annually.
- The Street Department should obtain Strata’s insurance coverage on an annual basis and verify for adequate coverage.
- The City should monitor the crushing hours to ensure Strata is in compliance with the lease agreement, or evaluate the circumstances to see if it is appropriate to modify the contract to allow Strata to crush concrete beginning at 7AM.

Management was also provided with an additional opportunity for improvement regarding the review of royalty calculations. This was not considered significant to the objectives of the audit, but warrant the attention of management. Consequently, they do not appear in this report.

## Authorization

We have conducted an audit of the Concrete Recycling Facility Lease Agreement. This audit was conducted under the authority of Article VII, Section 5 of the Garland City Charter and in accordance with the Annual Audit Plan approved by the Garland City Council.

## Objective(s)

Objective A: Verify if the City receives In-Kind Base Rent, supplemental rent, and pre-existing default payments in accordance with the terms and conditions of the lease agreement.

Objective B: Determine if minimum insurance coverage is maintained and hours of operation are limited as required by the lease agreement.

## Scope and Methodology

IA 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.

The scope of this audit is from June 15, 2015 to September 30, 2017. However, the scope was expanded to include calculating the City's concrete usage as of December 31, 2017 and reviewing the pay-off of the Crusher on January 12, 2018.

To adequately address the audit objectives and to describe the scope of our work on internal controls, IA performed the following:

- Conduct meetings with Street, Water, Firewheel Golf Park, Garland Power & Light and Parks to evaluate their tracking and use of recycled concrete obtained from the lessee (Obj A);
- Review lessee payments, including supplemental rent (royalties and dump fees) and pre-existing defaults, to ensure funds are collected in accordance to the lease agreement (Obj A);
- Reconcile lessee's reporting of retail sales and dumps, with supporting evidence such as sales and dump tickets, to determine the accuracy of supplemental rent (royalties and dump fees) paid to the City (Obj A);
- Review insurance certificates to determine if coverage is adequate (Obj B);
- Conduct site visits and review lessee's records to determine if crushing operations are limited as required by the lease agreement (Obj B).

To assess data reliability of Strata's Sales/Misc. Inquiry Reports, several sources of information were compared including Strata's sales reconciliations, sales reports, sales/dump tickets, the City's accounts receivables, check copies, and bank statements. IA also conducted interviews with Strata and various City departments. As a result of our testing, IA determined that the data was sufficiently reliable for the purposes of this report.

Based on the audit work performed, any deficiencies in internal control that are significant within the context of the audit objectives are stated in the Opportunities for Improvement section starting on page 6.

## Background

The Street Department's mission is to provide high quality service to the citizens of Garland by maintaining, repairing and replacing streets, alleys, and other related infrastructure. A safe road system is provided through proper maintenance, rehabilitation, and replacement of deteriorated segments of pavement and other related infrastructure <sup>(1)</sup>.

The Street Department maintains a Concrete Recycling Facility, located at 3637 Castle Drive, in Garland, TX where concrete pavement is crushed to make base material for construction projects. Persons who reside within the City of Garland and contractors performing work for the City of Garland may dump concrete rubble at the concrete recycling center free of charge <sup>(1)</sup>. The facility is currently leased to Strata Materials, LLC (Formerly known as Congress Materials LLC). The commercial lease agreement expires in September 2022, with an optional renewal of the Lease Term for five additional years subject to the City's (Lessor) reasonable satisfaction with Strata's (Lessee) performance <sup>(2)</sup>.

Congress Materials (original lessee - contract dated September 19, 2007) filed a voluntary petition for relief under Chapter 11 Bankruptcy Code in July 2014 <sup>(2)</sup>. In February 2016, Congress Materials changed its name to Strata Materials to represent a fresh beginning along with new ownership and a new management team <sup>(3)</sup>.

The bankruptcy plan, as approved by the bankruptcy court resulted in several amendments to satisfy all pre-existing defaults on the Lease <sup>(2)</sup>. Those requirements include:

- The lessee to pay the City a \$207,000 secured claim for the purchase of the Crusher used in connection with the lease. The lessee will pay the City \$87,000 in partial satisfaction of the secured claim on the Crusher. Monthly payments of \$2,700 shall be made to cure the remaining \$120,000 balance until it is paid in full.

*Note: On January 12, 2018, Strata Materials paid the remaining balance of \$52,500 in full <sup>(4)</sup>.*

- The lessee owed the City \$87,000 in unpaid royalties for concrete recycling operations at the Leased Premises.

*Note: According to the City Attorney's office, the bankruptcy court discharged this debt. The City did not object to the final bankruptcy plan, in part because the value of the crushed concrete was believed to exceed the benefit of the ongoing royalty payments.*

- The lessee to pay the City for the Leased Premises In-Kind Base Rent of 50,000 tons of recycled concrete annually.

*Note: The 2017 average selling price for materials sold at the Garland Facility was \$11.78 per ton <sup>(3)</sup>. Based on this average selling price, the value of the 50,000 tons approximates a \$589,000 annual value for the City.*

- The City is also entitled to two types of supplemental rent:
  - 1) Royalty payments are calculated at a rate of 2.5% of actual billed retail sales shipped by Strata across its scales at the Facility on a monthly basis over and above \$150,000.

*Note: During the scope of this audit, from June 2015 through September 2017, the City has received \$84,710 in royalties.*

- 2) Dump fees are calculated at a rate of \$5.00 per dump for all dumps made by trucks other than those operated by the City or its contractors. Dump fees are only payable if Strata charges and collects a dump fee from customers.

*Note: Due to current market conditions, Strata is currently paying customers \$10.00 for 20 yard trucks and \$5.00 for tandem trucks for concrete dumps.*

The lessee is also required to maintain several insurance policies on the Leased Premises <sup>(2)</sup>. Those policies cover:

- Commercial general liability against claims for bodily injury, death or property damage
- Automobile liability on all motor vehicles owned and/or operated by Lessee or its employees.
- Property and casualty liability on improvements constructed on the property whether owned by Lessee or Lessor.

The Texas Commission on Environment Quality (TCEQ) authorizes the operation of Strata's Rock Crushing Plant. Strata is required to maintain various permits, including an Air Quality Permit. The Air Quality Permit allows the Crusher to operate up to 10 hours per day <sup>(5)</sup>.

There are 4 types of materials that are most commonly purchased from the Concrete Recycling Facility. Those include <sup>(3 & 6)</sup>:

1. 1.5" TxDOT Flex Base



2. 1" Crushed Concrete



3. 5" Oversize



4. Recycled Asphalt (RAP)



Sources:

- 1) City of Garland Street Management
- 2) Commercial Lease Agreement
- 3) Strata Materials, LLC and Finance Records
- 4) Finance System and City's Bank Statement
- 5) TCEQ Air Quality Permit #83866L001
- 6) IA's Site Visit

## Management Accomplishments\*

The current management of Strata Materials took over operations of the concrete recycling facility located at 3637 Castle Drive in June 2015. Since that time, they have fulfilled all the stipulations of the reorganization plan developed under the bankruptcy agreement. They paid the \$87,000 that was a partial satisfaction of the secured claim on the concrete crusher on the schedule required, they have paid the monthly payments on the crusher on schedule and they have made royalty payments on time each month. They also paid several back royalty payments that were not required in the reorganization plan and they have already paid off the lien on the crusher, well ahead of schedule.

In addition to satisfying all financial requirements of the lease and the reorganization plan, Strata Materials has also made substantial improvements to the leased facility. They have invested a significant amount of money in purchasing new equipment and constructing a new scale and office facility on the site. Recently, they replaced the chain link fence along the front of the property. The site is also very well organized. The material piles are separated and there are safe vehicle circulation paths around the site.

The Street Department is very pleased with the lease operations of Strata Materials. They are meeting the obligations of the lease, and they are always willing to work with us when requested. We will certainly recommend extension of the lease agreement for an additional five year period when it expires on September 19, 2022, as is allowed in the first amendment of the lease agreement.

\*Please note that "Management Accomplishments" are written by the audited entity and that IA did not audit or verify its accuracy.

# Opportunities for Improvement

During our audit we identified certain areas for improvement. Our audit was not designed or intended to be a detailed study of every relevant system, procedure, and transaction. Accordingly, the Opportunities for Improvement section presented in this report may not be all-inclusive of areas where improvement might be needed.

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## FINDING # 1 – TAKING FULL BENEFIT OF IN-KIND BASE RENT (Obj. A)

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**CONDITION  
(THE WAY IT IS)**

The Commercial Lease Agreement between the City and Strata requires Strata to pay the City In-Kind Base Rent of 50,000 tons of recycled concrete annually. IA’s review of various City departments’ concrete tracking schedules, and Strata’s Annual Production Reports identified that the City is not taking full advantage of the 50,000 tons of crushed concrete available for use:

Year	Annual Available Tons	COG* Usage	Difference (Unused)	Average Selling Price** Per Ton	Est. Market Value of Unused Concrete
2015	50,000	27,197	22,803	\$ 8.50	\$ 193,826
2016	50,000	25,125	24,875	\$ 9.04	\$ 224,870
2017	50,000	30,027	19,973	\$ 11.78	\$ 235,282

Upon further inquiry with the Street and the Water Departments, and review of departmental projects such as, Water’s Forest Lane Water Replacement, and Street’s Annual Utility Contract, IA identified that the City did not take into consideration for its 3<sup>rd</sup> party contractors to obtain crushed concrete from the City’s designated stockpile. Instead, these 3<sup>rd</sup> party contractors were buying crushed concrete from the same facility and charging the City for the costs.

*\*COG Usage obtained from Strata’s Annual Production Reports.  
 \*\*The Average Selling Price (ASP) is a blended rate derived from all materials picked up at the facility during the year, and the list prices per ton for each product picked up. The ASP for each calendar year was obtained directly from Strata Materials, LLC.*

**CRITERIA  
(THE WAY IT SHOULD BE)**

The Commercial Lease Agreement between the City of Garland and Strata Materials, LLC Exhibit A, Article III, Section 3.01 states: “In Kind Base Rent. Lessee agrees to pay Lessor rent for the Leased Premises in kind 50,000 tons of recycled concrete annually (“In Kind Base Rent”).

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	The United States Government Accountability Office states in the Objectives of an Entity, section OV2.19, "Effective operations produce the intended results from operational processes, while efficient operations do so in a manner that minimizes the waste of resources." As such, the City should be operating as efficiently as possible to minimize costs and utilize resources effectively to the extent of the lease agreement.
<b>CAUSE (DIFFERENCE BETWEEN CONDITION &amp; CRITERIA)</b>	<p>Consideration was not made to require the City's 3<sup>rd</sup> party contractors to utilize the City's designated stockpile from the Concrete Recycling Facility.</p> <p>Also, each City department tracks concrete usage independently, and therefore a centralized tracking mechanism was not in place to determine the City's annual usage nor remaining availability of crushed concrete.</p>
<b>EFFECT (SO WHAT?)</b>	Based on the estimated market value (as noted above), the value of the unused concrete averages approximately \$218,000 per year.
<b>RECOMMENDATION</b>	<p>The Street Department should:</p> <ul style="list-style-type: none"> <li>• Amend the City's agreements with contractors that utilize crushed concrete for the City's projects in order to ensure they obtain crushed concrete from the City's available stockpile as the first source.</li> <li>• Coordinate with other departments to track their crushed concrete usage across the City in order to track and maintain accurate records of use.</li> </ul>
<b>MANAGEMENT RESPONSE</b>	Concur
<b>ACTION PLAN</b>	<ol style="list-style-type: none"> <li>1. The Street Department has contacted Strata Materials about potentially assigning pickup of in-kind crushed concrete to outside contractors to allow the City to maximize utilization of the in-kind materials. They will work with us, but this will require developing some type of identification method to avoid potential fraud. This will also require rewriting future City construction contracts to permit contractors to acquire base material for free as part of their contract.</li> <li>2. The Street Department will coordinate with other departments to develop a method to track citywide use of crushed concrete in a centralized database.</li> </ol>
<b>IMPLEMENTATION DATE</b>	<ol style="list-style-type: none"> <li>1. Immediate and ongoing</li> <li>2. Immediate</li> </ol>

**FINDING #2 – INSURANCE CERTIFICATE (Obj. B)**

<p align="center"><b>CONDITION (THE WAY IT IS)</b></p>	<p>Valid insurance and adequate coverage is in place for Strata’s operations. However, IA observed that the Street Department did not have Strata’s current insurance certificate on hand, nor do they verify the certificate is active as well as ensures adequate coverage is in place in accordance with the lease agreement.</p>
<p align="center"><b>CRITERIA (THE WAY IT SHOULD BE)</b></p>	<p>The Commercial Lease agreement between the City of Garland and Strata in Exhibit A, Article V, Section 5.01 states, “<u>Lessee’s Minimum Insurance Amounts</u>. Lessee shall obtain and maintain continuously in effect at all times during the Lease Term, at Lessee’s sole expense, at least the following minimum insurance with a carrier or carriers licensed to do business in the state of Texas and satisfactory to the Lessor:”</p> <ul style="list-style-type: none"> <li>a) Commercial General Liability insurance against claims for bodily injury.</li> <li>b) Automobile Liability Coverage on all motor vehicles owned and/or operated by Lessee or its employees on the Leased Premises.</li> <li>c) Property and Casualty insurance on improvements constructed on the property, whether owned by Lessee or Lessor.</li> </ul> <p>The Street Department should be familiar with the insurance certificate to ensure Strata’s policy meets the City’s minimum standards and the lease agreement standards.</p>
<p align="center"><b>CAUSE DIFFERENCE BETWEEN CONDITION &amp; CRITERIA)</b></p>	<p>The Street Department did not have a process in place to ensure that they have Strata’s most recent insurance certificate, and to verify its validity and coverage adequacy in a timely manner.</p>
<p align="center"><b>EFFECT (SO WHAT?)</b></p>	<p>If an active insurance policy is not in place, nor adequate coverage then the City would be liable for various claims such as, bodily injury, automobile accidents on the premises, and property damage.</p>
<p align="center"><b>RECOMMENDATION</b></p>	<p>The Street Department should develop a process to obtain and review Strata’s insurance certificate in order to verify that the policy is active and coverage is adequate (per the lease agreement). Also, Street Department should work with Risk Management if questions arise regarding the policy and/or coverage.</p>
<p align="center"><b>MANAGEMENT RESPONSE</b></p>	<p>Concur</p>

<b>ACTION PLAN</b>	The Street Department will implement a system to ensure that we obtain the most recent insurance certificate from Strata Materials and verify coverage is adequate.
<b>IMPLEMENTATION DATE</b>	Complete - the Street Department has obtained Strata Materials' current insurance certificate. We have also set up a reminder system to contact Strata Materials to provide us a new certificate when coverage expires and verify coverage is adequate.

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**FINDING # 3 – CONCRETE CRUSHING HOURS (Obj. B)**

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<b>CONDITION (THE WAY IT IS)</b>	IA reviewed Strata’s Daily Production Sales and Inventory Reports and identified inconsistencies where Strata crushed concrete prior to 8AM, as well as witnessed Strata crushing concrete before 8AM.
<b>CRITERIA (THE WAY IT SHOULD BE)</b>	The Commercial Lease agreement between the City of Garland and Strata in Exhibit A, Article IV, Section 4.02 (c) states: “ <u>Prohibited Uses and Activities</u> . Lessee agrees not to engage in Crushing Operations between the hours of 6:00 PM and 8:00 AM.”
<b>CAUSE (DIFFERENCE BETWEEN CONDITION &amp; CRITERIA)</b>	The initial TCEQ Air Quality permit (dated 5/16/08) allowed Strata to crush concrete starting at 7AM, yet the City’s Lease Agreement did not allow crushing until 8AM, thus creating confusion.
<b>EFFECT (SO WHAT?)</b>	There is a potential concern that nearby residents could complain about the noise level from the yard crushing concrete before 8AM.
<b>RECOMMENDATION</b>	The Street Department should: <ul style="list-style-type: none"><li>• Monitor the crushing hours to ensure that Strata is in compliance with the lease agreement, OR</li><li>• Evaluate the circumstances to see if it is appropriate to modify the contract in order to allow Strata to crush concrete beginning at 7AM.</li></ul>
<b>MANAGEMENT RESPONSE</b>	Concur
<b>ACTION PLAN</b>	Strata was notified during the audit that their crushing operation was occurring outside the hours permitted in the lease. Strata immediately modified the hours they crushed concrete to comply with the lease. The Street Department contacted Strata to determine whether they wanted to pursue a lease amendment to change the hours of the crushing operation, but they have chosen not to modify those hours at this time.
<b>IMPLEMENTATION DATE</b>	Complete – no further action required.

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