









Los Angeles County

Weak Oversight of Its Lease With the Los Angeles County Fair Association Has Likely Cost Millions of Dollars in Revenue

Report 2016-106





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Elaine M. Howle State Auditor Doug Cordiner Chief Deputy

November 10, 2016

2016-106

The Governor of California President pro Tempore of the Senate Speaker of the Assembly State Capitol Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning Los Angeles County's (county) oversight of the Los Angeles County Fair Association (association). The county has a lease with the association that allows the association to operate the Los Angeles County Fair and conduct other activities on land largely owned by the county. Under the terms of this lease, the association must pay rent to the county based on a percentage of the revenue the association receives from its activities on this land.

This report concludes that the county has exercised weak oversight of its lease with the association. In our audit, we found that although the association owns a hotel that operates on county-owned land, the county allowed the association to exclude its hotel's revenue from its rent calculation for reasons that the county cannot adequately explain. Consequently, the county likely relinquished more than \$6 million in rent revenue from 2006 through 2015.

In addition, we found that the association provides its executives with significantly higher compensation than the executives in charge of other large fairs in California receive. For instance, in 2014 the association's former president received over \$1 million in total compensation, and many members of the association's executive management team earn more than the chief executives in charge of the State's other large fairs. However, as a nonprofit corporation that is not a public charity, the association is legally allowed to set its executive compensation at levels greater than those set by public entities. Finally, although the association received millions of dollars in public funding related to one of its recreational vehicle (RV) parks, the association failed to maintain the RV park, resulting in it being cited for numerous health and safety violations.

We recommend that to protect its interests and maximize its future revenue, the county should strongly consider ensuring that any potential amendment to the lease includes a revised rent calculation formula that factors in revenue from all of the association's activities, including revenue from its hotel.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE, CPA State Auditor

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SUMMARY

In 1988 Los Angeles County (county) entered into a Ground Lease and Operating Agreement (lease) with the Los Angeles County Fair Association (association) that allows the association to operate the Los Angeles County Fair (LA County Fair) and conduct other activities on land the county largely owns, commonly known as the Fairplex. The terms of the lease state that the association will pay the county rent based on the amount of revenue the association receives from its activities at the Fairplex. Since entering into the lease, the association—a private nonprofit mutual-benefit corporation—has developed the Fairplex by constructing a hotel and conference center. In addition, the association has established a number of other for-profit subsidiaries and nonprofit organizations that operate at the Fairplex. In this audit, we reviewed the county's oversight of the lease and the steps it has taken to ensure the association's compliance with the lease's terms. Based on our audit findings, we conclude the following:

The county's failure to actively monitor its lease with the association resulted in the loss of significant revenue.

Although the lease states that the association will pay rent based on a percentage of revenue it receives from activities at the Fairplex, for reasons the county cannot adequately explain, the county allowed the association to exclude from its rent calculation the revenue that its hotel received. As a result, the county likely relinquished more than \$6 million in rent related to the hotel's revenue from 2006 through 2015. Further, the county has never received rent related to the conference center, despite the association's representations to the contrary when the county provided it with a total of \$12 million in rent credits to help cover the costs of the conference center's construction.

The association's executives receive much higher compensation than executives that run other large fairs in California.

The association paid its former president total compensation of more than \$1 million in 2014, far more than the amount earned by the next highest-paid chief executive officer of a large fair. Although the county has no role in determining the association's executive compensation, its failure to collect all rent due under the terms of the lease allowed the association to retain revenue it otherwise would have owed the county and thus potentially contributed to the association's ability to pay its executives such high salaries. However, as a nonprofit corporation that is not a public charity, the association is legally allowed to set its executive compensation at levels greater than those of public entities. Page 13

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The association operated an RV park with numerous safety violations.

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Under a 2009 agreement, the Pomona Redevelopment Agency provided
\$3.3 million to the association in return for the association agreeing
to maintain 50 spaces for affordable housing at one of its RV parks.
Conditions at the RV park deteriorated until the Department of Housing
and Community Development (HCD) identified several violations,
including an imminent hazard to the health and safety of the residents at
several spaces at the RV park in March 2016. Although the association
took immediate steps to correct the imminent hazards at these spaces,
HCD only determined that the association had corrected all violations in
October 2016.

We have recommended that the county take the actions available to it to correct the problems we identified in this audit.

Summary of Recommendations

As soon as possible, the county should collect from the association all amounts presently owed under the lease as a result of the revenue generated by the conference center.

To protect its interests and maximize its future revenue, the county should strongly consider ensuring that any potential amendment to the lease includes a revised rent calculation formula that factors in revenue from all of the association's activities, including revenue from its hotel.

Agency Comments

The county generally agreed with our recommendations, although it indicated its ability to implement them may be dependent on cooperation from the association. Although we did not direct recommendations to the association, it submitted a written response asserting that our report is generally inaccurate and incomplete. However, the information the association provided did not change any factual statements in the report or any of our conclusions and recommendations.

INTRODUCTION

Background

Incorporated in 1940, the association is a private nonprofit mutual-benefit corporation that operates the LA County Fair and other year-round activities on property that the county largely owns. The association and its predecessor have operated the fair on this property— currently known as the Los Angeles County Fair, Hotel, and Exposition Complex (Fairplex)— almost every year since 1922, except when the federal government used the land for war defense activities during World War II. Figure 1 shows the Fairplex's current 543 acres.

Figure 1

Map of the Los Angeles County Fair, Hotel, and Exposition Complex Showing Los Angeles County's, the Los Angeles County Fair Association's, and Other Entities' Property Rights in the Land



Sources: Los Angeles County records, Los Angeles County Fair Association records, and Google Maps.

The association's mission is to promote the agricultural, horticultural, viticultural, industrial, and other interests of the county and the State. Its primary mission has remained the same since its founding, but its activities have evolved over time to keep up with the changing culture of the county. For instance, the association stated that it no longer conducts agricultural competitions at the LA County Fair because the county's agricultural activities have declined significantly, although it continues to have agricultural exhibits.

Lease to Operate on County-Owned Land

The association's predecessor ran the first LA County Fair in the city of Pomona in 1922. The county eventually acquired ownership of most of the 543-acre Fairplex located in Pomona, including land the association and its predecessor deeded to the county. Currently the county owns 502 acres, the association owns 36 acres, and other entities—including Southern California Edison and the Metropolitan Water District of Southern California—have various property rights in the remaining five acres.

The association eventually realized that to pay for the property's upkeep and the construction of new buildings, it needed a source of revenue in addition to the LA County Fair held annually in September. In 1948 the county entered into an agreement with

Some Key Provisions Allowing Early Termination of the Ground Lease and Operating Agreement

The Ground Lease and Operating Agreement (lease) automatically terminates if the Los Angeles County Fair ceases to be held on the Fairplex property, unless the cause is due to events beyond the control of the Los Angeles County Fair Association (association).

Los Angeles County (county) may terminate the lease under any of the following conditions:

- The association fails to maintain required insurance coverage.
- The association fails to pay rent or other monetary amounts due after 10 days' written notice from the county.
- The association becomes insolvent.
- · The association loses its nonprofit status.

Source: The 1988 lease between the county and the association.

the association under which the association paid an initial sum of \$66,412 to the county but did not pay any annual rent to the county for use of the land. In 1988, however, the county and the association entered into the current 56-year lease, which provides the association with the option to renew the lease for up to 10 additional years. The purposes of the lease included enabling the association to operate the LA County Fair; to develop the Fairplex, in part through the construction of a hotel and convention facilities; to increase the use of the Fairplex; and to provide additional revenue to the county.

Under the terms of the lease, the association must annually pay the county a percentage of the gross revenues it receives from the use of the Fairplex. In addition, any improvements the association makes on county-owned land at the Fairplex will become assets of the county upon termination of the lease. The county may terminate the lease early for the reasons presented in the text box. However, the county has oversight of the association's activities only to the extent laid out in the lease. Currently, the county's Chief Executive Office manages the lease.

The Association's Business Structure

The association's business structure has changed significantly since the county and the association entered into the lease in 1988. At that time, the association ran the annual LA County Fair and year-round events, operated two RV parks and a child development center, and owned a subsidiary whose purpose was to conduct harness racing. However, the association subsequently entered into other business activities and created additional subsidiaries that it owns and controls, as shown in Figure 2 on the following page. For example, the association's hotel, conference center, and two RV parks are owned by and constitute business activities of the association itself and are legally indistinguishable from the association. In addition, the association has a variety of subsidiaries, including an equestrian auction company, a food and beverage company that serves as the LA County Fair's master concessionaire, a party equipment rental company, and a storage company. The association also leases space at the Fairplex to unrelated organizations, such as the National Hot Rod Association, which operates the Auto Club Raceway at Pomona and a museum at the Fairplex.

Further, the association has three related nonprofit organizations that operate at the Fairplex—a child development center, an educational center, and an entity that supports the missions of the first two nonprofit organizations. The boards of these nonprofit organizations include association directors, association members, and association executive managers, as well as others not involved in the association's business operations. The association exercises influence but does not directly control these related nonprofit organizations. For instance, seven of the 15 individuals who served as directors of the Fairplex Child Development Center in 2014 were also involved in the association's former president, the association's chief financial officer, three association members, and two association directors.

According to its audited financial statements, the association is exempt from federal income and state franchise taxes under Internal Revenue Code section 501(c)5—which provides for the exemption from federal income tax of labor, agricultural, or horticultural organizations—and corresponding state provisions. As a result, the association does not pay taxes on business related to its tax-exempt purpose, which is to advance and promote the agricultural, horticultural, viticultural, industrial, and other interests of the county and the State. Consequently, it does not pay taxes related to conducting the LA County Fair. However, according to the association's audited financial statements, certain entities consolidated within it are subject to federal income and state franchise taxes.

Figure 2

The Business Structure of the Los Angeles County Fair Association and Its Related Organizations



Sources: The association's audited financial statements, website, and publicly available tax filings, and the Secretary of State's Office website.

- * The hotel opened in 1992 and the conference center opened in 2012. The association operates two RV parks—one that opened in the 1950s and one that opened in 1986.
- [†] The Fairplex Child Development Center opened in 1980 as a child care resource for Fairplex employees and was incorporated in its current form in 1997. It provides children and families with education and child care before the start of kindergarten.
- Fairplex Racing, Inc., was organized in 1986 for the purposes of conducting harness racing. It was renamed Fairplex Enterprises, Inc. (FEI), in 1998 and owns an interest in Barretts Equine Limited (Barretts).
- § Barretts was formed in 1990 and conducts equestrian auctions. The association controls Barretts through FEI and another subsidiary the association owns, Fairplex Esquire Sales, LLC, which was formed in 2002 to purchase the general partner interest in Barretts.
- I Cornucopia Foods, LLC, was formed in 2004 and serves as the master concessionaire for the fair and other events during the year.
- [#] Event Production Solutions, LLC, was formed in 2010 and rents event and party equipment.
- ** Fairplex RV and Boat Storage, LLC, was formed in 2010 and provides storage space for RVs and boats.
- ^{††} The association's related nonprofit organizations are overseen by boards that include a subset of the association's board members and executive management team, as well as others that are not involved with the association's operations.
- # Foundations at Fairplex was formed in 2004 to support and further the mission and programs of the Fairplex Child Development Center and The Learning Centers at Fairplex.
- ^{§§} The Learning Centers at Fairplex, formed in 1998 as the Fairplex Education Foundation, provides a wide spectrum of educational programs.

Differences Between the Association and Public Entities That Operate Other California Fairs

The California Department of Food and Agriculture (CDFA) provides fund administration and broad policy oversight to a group of fairs defined by state law as the Network of California Fairs. The Network of California Fairs currently includes 52 fairs that are run by state entities known as district agricultural associations (DAAs), whose primary purposes include holding fairs, expositions, and exhibitions; 19 fairs that are run by nonprofit organizations; six fairs that are run by county governments; and the California State Fair, which is operated by a state agency. The Fairs and Expositions Branch of CDFA oversees the Network of California Fairs, but has limited oversight of fairs that do not receive money from the state's Fair and Exposition Fund, such as the association. We describe some key differences between the association and the more common DAAs in Table 1.

Table 1

Key Differences Between District Agricultural Associations and the Los Angeles County Fair Association

DISTRICT AGRICULTURAL ASSOCIATIONS	LOS ANGELES COUNTY FAIR ASSOCIATION
District agricultural associations (DAAs) are state institutions.	The Los Angeles County Fair Association (association) is a nonprofit mutual-benefit corporation.
DAAs may be formed either for the purposes of holding fairs, expositions, and exhibitions to exhibit the industries and resources of the State, or for the purposes of constructing, maintaining, and operating recreational cultural facilities of general public interest.	A nonprofit mutual-benefit corporation can be formed for any lawful purpose. The association's primary mission is to promote the agricultural, horticultural, viticultural, industrial, and other interests of Los Angeles County and the State.
DAAs are required to meet certain standards prescribed by the California Department of Food and Agriculture (CDFA). CDFA also has oversight over California fairs receiving money from the Fair and Exposition Fund.	Currently, the Los Angeles County Fair does not receive money from the Fair and Exposition Fund. Therefore, CDFA has limited oversight of the Los Angeles County Fair run by the association.
DAAs may form an entity for the purpose of conducting fair horse racing and utilizing their racing facilities for such racing.	The association can carry on any other lawful business enterprise or activity that may seem connected to the association's purpose.
The Governor appoints DAA directors.	Under its bylaws, association directors are elected by the association's members or directors. Association directors must be regular members themselves.

Source: California State Auditor's analysis of state law and the association's articles of incorporation and bylaws.

The Association's Financial Situation

As Figure 3 on the following page shows, the association receives most of its revenue from its fair-related activities, its hotel and conference center, its food and beverage concessionaire, and its year-round events. The association receives relatively little public funding or other assistance from the State or from local governments. For instance, the only such assistance the association received in 2015 was an \$800,000 credit it applied against its annual rent payment to the county. We discuss this rent credit in greater detail in a subsequent section of the report. Of the \$15.3 million in total state and local government public funding and other assistance the association received between 2006 and 2015, \$9.1 million, or nearly 60 percent, directly related to the association's construction of the conference center—\$6.4 million in rent credits from the county and \$2.7 million in public funding from the Pomona Redevelopment Agency (Redevelopment Agency). Another \$3.3 million, or 22 percent, pertained to the Redevelopment Agency's purchase of affordable rental space covenants at one of the association's RV parks, which we describe later in this report. The remaining public funding was for other purposes, as described in Table 2.





Source: The association's audited financial statements for 2015.

- * Revenue from the LA County Fair held in September at the Fairplex.
- [†] Combined revenue from the association's hotel and conference center at the Fairplex.
- Revenue the association earns from activities conducted outside of the LA County Fair—including recreational vehicle (RV) shows, an annual Oktoberfest event, and sporting events—that are not represented in other categories in this figure.
- § Revenue from Cornucopia Foods, LLC, a for-profit entity wholly owned by the association that serves as its food and beverage master concessionaire.
- II Revenue from the association's other subsidiaries and business activities, including the RV and boat storage and party equipment rental companies that are wholly owned by the association.
- [#] Revenue from Barretts Equine Limited, the equestrian auction business that the the association wholly controls.

Table 2

State and Local Public Funding and Other Assistance the Los Angeles County Fair Association Received From 2006 Through 2015

PUBLIC FUNDING						
PUBLIC ENTITY	AMOUNT	DESCRIPTION				
Pomona Redevelopment Agency (Redevelopment Agency)	\$7,111,168	\$3.3 million —In 2009 the Redevelopment Agency agreed to provide \$3.3 million to the Los Angeles County Fair Association (association) in exchange for the association leasing at least 50 spaces in a recreational vehicle park it operates at the Fairplex to residents with low to moderate incomes for a period of 55 years. The Redevelopment Agency also understood the association would be using the funds to improve the Fairplex, including to help pay for a conference center the association was planning to build at the Fairplex.				
		\$2.7 million —In 2009 the Redevelopment Agency agreed to provide \$2.7 million to assist the association in building its conference center. The conference center opened in 2012.				
		\$675,093 —In 2005 the Redevelopment Agency's predecessor agreed to provide a rebate to the association—or a share of future tax increments—related to the renovation of its hotel. The Redevelopment Agency's predecessor based this rebate on the increased occupancy taxes it expected to receive. These rebates totaled \$675,093 for 2006 through 2010, when the term of the rebate expired.				
		\$436,075 —The Redevelopment Agency entered into a tax-sharing agreement with the association under which the Redevelopment Agency agreed to pay a share of the debt that the association incurred when it made investments in fairground facilities in 1989. The amount shown represents the Redevelopment Agency's total share for 2006 and 2007. The debt matured in 2007.				
California Department of Food and Agriculture (CDFA)	1,097,302	\$537,976 —State law at the time permitted CDFA to distribute Legislature-appropriated funds to pay toward unemployment insurance coverage for the Network of California Fairs. CDFA paid the association unemployment insurance subsidies from 2006 through 2010, when the Legislature discontinued authorization and funding for the program.				
		\$430,326 —According to CDFA staff, CDFA used revenue until 2011 to offer facility support to fairs that conducted horse racing. The association received \$179,055 in 2007 and \$251,241 in 2009.				
		\$90,000 —CDFA provided \$35,000 to the association in 2006, \$35,000 in 2007, and \$20,000 in 2011 to support the fair's general operations.				
		\$26,000 —CDFA provided money to fairs for projects to improve fairground accessibility and accommodations for the physically disabled under a program that was discontinued in 2007. CDFA provided \$26,000 to the association under this program in 2007.				
		\$13,000 —In 2011 CDFA provided the association funding for infrastructure purposes. The association stated that it used this money on its fair facilities.				
Los Angeles County (county)	668,516	\$450,000 —In 2006 the county provided funding to the association to help it refurbish an exhibition building at the Fairplex.				
		\$218,516 —In 2002 the county agreed to reimburse the association for capital improvements it made at the Fairplex to bring its facilities into compliance with the Americans with Disabilities Act. Within our audit period of 2006 through 2015, in February 2006 the county made only one payment to the association under this agreement.				
Total State and Local						

Public Funding \$8,876,986

OTHER ASSISTAN	CE	
County	\$6,400,000	\$800,000 per year from 2008 through 2015.
		The county agreed to provide the association an annual rent credit of \$800,000 for 15 years, beginning in 2008 and ending in 2022. The county provided this credit, which will total \$12 million, to help cover the costs of the conference center's construction.
Total State and Local Public Funding and Other Assistance	\$15,276,986	

Sources: Accounting records and other financial documents from the association, CDFA, the county, and the city of Pomona.

Although the association reported a net loss in five of the past six years in its audited financial statements, it reported positive income from its operations in every year throughout our audit period. According to the association, it evaluates its profitability based on its earnings before interest, depreciation, taxes, and amortization—presented as operating income in its audited financial statements-because the earnings reflect the actual cash the association has on hand to service debt and reinvest in capital. From 2006 to 2015, the association's operating income ranged from a low of \$4.9 million to a high of \$11.9 million; in 2015 it was \$6.8 million. As Table 3 shows, the net losses the association reported in its audited financial statements were mainly due to noncash amounts such as depreciation of its buildings and changes in the value of a bond-related transaction it entered into in order to keep its interest expenses predictable. In other words, its net losses were largely the result of accounting reporting requirements rather than inadequate revenue.

Table 3

The Los Angeles County Fair Association's Operating Income, Net Income, and Income After Excluding Significant Noncash Amounts From 2006 Through 2015

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Operating income	\$10,823,751	\$11,852,182	\$8,604,569	\$4,926,650	\$6,917,474	\$7,624,439	\$7,682,482	\$6,793,999	\$6,460,275	\$6,829,143
Total nonoperating revenues and expenses*	(1,432,456)	(5,998,751)	(7,160,936)	(4,480,587)	(10,646,696)	(16,108,581)	(7,959,570)	(2,553,540)	(14,901,398)	(10,320,112)
Net income (loss)	\$9,391,295	\$5,853,431	\$1,443,633	\$446,063	\$(3,729,222)	\$(8,484,142)	\$(277,088)	\$4,240,459	\$(8,441,123)	\$(3,490,969)

Calculation of revised income after adding significant noncash items back to net income †

Depreciation and amortization	\$3,378,004	\$4,398,744	\$5,039,536	\$5,909,311	\$5,896,730	\$5,595,551	\$6,040,994	\$6,366,572	\$6,568,631	\$6,117,983
Bond-related transaction [‡]	(637,040)	761,006	1,568,023	3,174,837	2,869,669	8,586,785	(270,631)	(7,228,772)	5,279,837	181,855
Noncash amounts included in net income	2,740,964	5,159,750	6,607,559	9,084,148	8,766,399	14,182,336	5,770,363	(862,200)	11,848,468	6,299,838
Income excluding significant noncash amounts [†]	\$12,132,259	\$11,013,181	\$8,051,192	\$9,530,211	\$5,037,177	\$5,698,194	\$5,493,275	\$3,378,259	\$3,407,345	\$2,808,869

Sources: The Los Angeles County Fair Association's (association) audited financial statements, accounting standards, and the California State Auditor's analysis.

- * According to the association's audited financial statements, its nonoperating revenue includes income it received from grants and contracts, investments, and gains on the value of a bond-related transaction described below. Its nonoperating expenses included interest expenses, losses on disposal of assets, depreciation and amortization, and losses on the value of the bond-related transaction. In every year presented, nonoperating expenses exceeded nonoperating revenue.
- To calculate the association's income excluding significant noncash items, we added to its net income total depreciation and amortization expenses. We also added losses and subtracted gains resulting from its bond-related transaction.
- The association entered into a transaction to allow it to pay a fixed interest rate on its variable rate bonds, thus keeping its cash expenses predictable. Changes in interest rates affect the gain or loss the association must report annually related to this transaction, but these changes do not affect the association's actual cash position or its operational revenues or expenses. ++

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The County's Failure to Actively Monitor Its Lease With the Association Resulted in the Loss of Significant Revenue

Key Points:

- The county's expectations of how much revenue the association would pay it in rent based on the operations of the association's hotel have changed considerably over time, and the county cannot adequately explain the timing or reasoning behind its decisions to lower its expectations. Had the county insisted that the association pay it rent as specified in the terms of the lease, the county would have received an additional \$6.2 million related to the hotel for the years 2006 through 2015 alone.
- The county has not ensured that the association paid it rent from the conference center, as the association represented it would when it asked the county for financial help with the conference center's construction costs. As a result, we estimate the county has failed to collect an additional \$350,000 in rent since 2012.
- The county does not collect rent on the millions of dollars that the association's subsidiaries earn at the Fairplex.

For Reasons It Cannot Fully Explain, the County Essentially Relinquished More Than \$6 Million in Rent Due From the Hotel's Operations

The county failed to actively monitor its lease with the association, potentially resulting in a loss of more than \$6 million in rent revenue related to the hotel alone during our 10-year audit period. As Figure 4 on the following page illustrates, the county entered into its current lease with the association in 1988 in part to enable the association to develop the Fairplex by constructing the hotel and other projects. The terms of the lease state that the association must annually pay the county a percentage of the gross revenue it receives from its use of the Fairplex. As the text box shows, while the lease explicitly omits certain limited revenue categories from the rent calculation, the definition of gross revenues includes revenue the association receives as a result of its own business activities, as well as any money the association receives from other activities on Fairplex property.

The Ground Lease and Operating Agreement's Definition of Gross Revenues

The Ground Lease and Operating Agreement (lease) defines *gross revenues* to encompass any and all money and cash receipts—without deduction for any overhead, cost or expense of operation—received by the association from use of the Fairplex, including but not limited to the following:

- Admissions.
- Gross charges.
- Sales.
- Rentals.
- Fees.
- Commissions.
- In-kind payments, assets, property or other things of value, made or received in lieu thereof.

The lease excludes the following from its definition of *gross revenues*:

- · Governmental grants for specific purposes.
- Taxes collected by the Los Angeles County Fair Association (association) for the benefit of a governmental body.
- Advertising or promotional considerations related to the operation of the fair.

The association must annually pay Los Angeles County (county) a percentage of the gross revenues it receives from its use of the Fairplex.

Source: The 1988 lease between the county and the association.

Figure 4

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Timeline of the Understanding of Rent to Be Paid to Los Angeles County From Operations of the Los Angeles County Fair Association's Hotel and Conference Center



Sources: California State Auditor's analysis of county records, the association's audited financial statements, the association's 1997 hotel management agreement, the association's 2004 hotel management agreement and 2009 amendment, and interviews with county and association staff.

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Revenue earned by the hotel—which the association opened in 1992 and which is currently known as the Sheraton Fairplex Hotel—falls under the lease's definition of gross revenues because the hotel is not a separate legal entity, but rather an asset owned by the association, a fact that the county appears to have understood around the time it entered into the lease. Specifically, in June 1990, as the association was in the planning phase of building its hotel, an assistant administrative officer with the county indicated in a letter to a county supervisor that the county would receive a percentage of the hotel's gross revenue. Additionally, in 1992 the same assistant administrative officer with the county sent a letter to a state agency that suggested the county expected the association to pay it a percentage of gross revenue generated from the hotel.

The terms of the lease related to the calculation of rent have remained unchanged since 1988, with the exception of certain assistance the county has agreed to provide to the association, as we discuss later in the report. Nonetheless, the county's expectations of how much rent it would collect from the hotel's operations each year have changed considerably over time, to the county's detriment. Specifically, we estimate that the association could have owed the county an additional \$6.2 million in rent from 2006 through 2015 alone based on the gross revenue from the operations of the association's hotel. Rather than collecting this amount, however, the county appears to have agreed that the revenue earned by the hotel did not meet the definition of gross revenues for reasons that it cannot adequately explain and that it did not adequately document. Instead, it allowed the association to include only fees and other payments it received from the hotel in its rent calculation. According to the association, it has never included any gross revenues generated by its hotel in its rent calculation. Table 4 on the following page shows the rents as calculated by the association, as well as additional rents we calculate that it should have owed, based on the lease. Table 4 also includes \$350,000 from the operations of the association's conference center, which opened in 2012. We discuss issues related to the conference center later in this report.

We estimate that the association could have owed the county an additional \$6.2 million in rent from 2006 through 2015 alone based on the gross revenue from the operations of the association's hotel. However, the county appears to have agreed that the revenue earned by the hotel did not meet the definition of gross revenues. This understanding severely limited the amount of rent the association owed the county related to the hotel's revenue. According to the association, it entered into an agreement with an outside party to manage its hotel in June 1991. Although the association was unable to provide the original agreement, a 1997 letter that the association sent to the county stated that the hotel management agreement required the hotel to pay the association \$50,000 per year in basic fees and another \$133,000 in additional fees. According to the understanding the county apparently reached with the association, the association would then pay a percentage only of this \$183,000 as rent, rather than a percentage of the hotel's gross revenue. We find this arrangement problematic, given that the hotel is not a legally separate entity and is part of the association itself. Further, if the county had determined that it was in its own best interest to collect a percentage only of these fees, we find it concerning that the county did not maintain adequate documentation to explain and support its reasoning.

Table 4

YEAR	RENT DUE*	LESS RENT CREDIT [†]	ACTUAL RENT PAID	POTENTIAL ADDITIONAL RENT BASED ON LOS ANGELES COUNTY FAIR ASSOCIATION'S HOTEL AND CONFERENCE CENTER'S OPERATIONS [‡]
2006	\$961,819	-	\$961,819	\$453,810
2007	1,003,211	-	1,003,211	489,010
2008	1,201,648	\$(800,000)	401,648	673,382
2009	998,898	(800,000)	198,898	493,409
2010	937,796	(800,000)	137,796	516,844
2011	869,057	(800,000)	69,057	600,639
2012	894,996	(800,000)	94,996	724,418
2013	955,941	(800,000)	155,941	804,815
2014	1,149,028	(800,000)	349,028	888,255
2015	1,062,002	(800,000)	262,002	867,945
Totals	\$10,034,396	\$(6,400,000)	\$3,634,396	\$6,512,527

A Comparison of the Rent Los Angeles County Collected From the Los Angeles County Fair Association to the Rent Its Lease Required From 2006 Through 2015

Sources: Los Angeles County's (county) financial documents, the California State Auditor's analysis of the Los Angeles County Fair Association's (association) audited financial statements, and the Ground Lease and Operating Agreement (lease) between the county and the association as amended.

- * The association calculates its rent based on a percentage of revenue it receives at the Fairplex. The association did not include rent related to its Sheraton Fairplex Hotel and Conference Center's operations in its calculation during the years identified. This column does not include any subsequent adjustments for overpayment or underpayment resulting from ensuing rent calculation reviews. The subsequent adjustments were minor and did not exceed a net total of \$15,000 in any lease year.
- [†] The county provided the association with an annual credit of \$800,000 against its rent due to the county since 2008 to support the association's financing of the development and construction of a conference center at the Fairplex. This rent credit will continue until 2022.
- [‡] The dollar amounts shown for the years 2006 through 2011 only include rent related to the hotel's gross revenue. For the years 2012 through 2015, gross revenue includes activities related not only to the hotel, but also to the conference center, which opened in 2012. Based on year-by-year projections the association provided to the county, we estimate that roughly \$350,000 of the total shown for the years 2012 through 2015 related to the conference center's operations. Consequently, we estimate that the county relinquished a total of \$6,162,527 from 2006 through 2015 by allowing the association to exclude its hotel's gross revenue from its rent calculation.

Moreover, in 1997 the association entered into a new hotel management agreement with a different hotel operator that further reduced the rent it owed the county. Specifically, the 1997 hotel management agreement fixed the annual fee that the hotel must pay the association at \$50,000, the fee amount that is still in effect. Consequently, the fee amount was reduced from \$183,000 to \$50,000. Adjusting for inflation, the association could hypothetically now owe the county less annually from the hotel's operations today than it did in 1992, when the hotel first opened.

Current county staff was unaware that the terms of the 1991 hotel management agreement changed in 1997 and reduced the hotel fees until we brought the issue to their attention. The lease requires the association to seek the county's approval for all subleases that exceed 10 years and also gives the county the right to request any of the association's subleases and other information relating to a proposed subtenant's identity, nature of business, and financial responsibilities. However, the association's hotel operating or management agreements are not considered subleases, and therefore this requirement does not apply. Although the association benefits by treating the hotel as a separate entity when calculating its rent, it does not have a sublease with the hotel because the hotel is one of its business activities. Therefore, the association does not have to obtain the county's approval before executing such agreements.

The amount of rent the association owed the county was also limited by the subordination of the hotel fees to payments on the debt that the association had incurred to finance the construction of the hotel. Specifically, in 1997 the association refinanced the debt it had incurred to build the hotel. As a condition of refinancing this debt, the association's lender required the county to recognize that any rent due to it from the hotel's operations was subordinate to the association's debt service on the hotel. In other words, the association would not owe the county even minimal rent from its hotel's operations until the subordination provisions of the bond documents were satisfied.

In connection with the debt refinancing, the county's Chief Executive Office confirmed the county's acquiescence to this subordination arrangement, though the county was not clear regarding whether it believed it would eventually receive rent based on the hotel's gross revenue or based on a percentage of the fees that the hotel transferred to the association. In a letter dated February 1997, in response to a request by the association, the county confirmed that it did not expect to receive rent related to the hotel until the subordination provisions of the bond documents were satisfied. However, the county also stated that pursuant to the lease, the association was required "to pay, as rent to the County, specified percentages of gross revenues from the Fair and gross receipts from Interim Events. The rent from

Interim Events at the Fairgrounds includes the development and operation of the hotel." It further stated that "it is the County's expectation that the unpaid required land rent on the hotel has been accruing, and that the County will receive all current and back due Interim Rents from the hotel development when the subordination provisions have been satisfied." The language used in this letter is inconsistent with the terms that define the rent calculation in the lease, and therefore does not clearly indicate whether the county still expected that it would eventually receive a percentage of the hotel's gross revenue upon satisfaction of the subordination provisions.

The association's subsequent actions and the county's poor management of the lease resulted in the continued delay of the association's payment of the back rent it owes, which the county will not receive until 2039 under the current situation. Although the county was aware of the association's 1997 refinancing of its debt, the association subsequently refinanced its debt multiple times without explicitly informing the county or seeking its approval. According to the county's deputy compliance officer, the county was unaware of the association's further debt refinancings in 2000 and 2009. Although the county should have learned about the association's refinancing of the debt when it reviewed the financial statements that the association generally provided to it on an annual basis, it appears the county did not observe that the refinancing had occurred. According to the association, it has never paid rent to the county based on the hotel's fees. This assertion aligns with our finding that the association excluded its hotel's annual fees from the rent calculation for our audit period from 2006 through 2015.

Although the county was aware of the association's 1997 refinancing of its debt, the county was unaware that the association subsequently refinanced its debt multiple times.

The county's deputy compliance officer stated that when the county agreed to the original debt refinancing in 1997, it did not anticipate that the association would continually refinance its debt. The county's legal counsel also stated that the 1997 letter related to the bond issuance in that same year did not contemplate future refinancing; therefore, he believed the association should have obtained further consent from the county when it subsequently refinanced the debt. He also stated that the county did not ensure compliance in this area because it was unaware of the association's actions until after the association had already refinanced its debt. According to the terms of the lease, the association is not required to give notice to the county when it refinances its debt. As it is, the association will be making payments on its debt through 2039, which is only four years before the lease term expires in 2043. Therefore, the county may not receive any rent related to the hotel's operations until near the end of the lease term.

In 2006 the county further exacerbated the problems created by its weak management of the lease when it apparently allowed the association to exclude its hotel's gross revenue from its rent calculation, and instead include only hotel fees and any other payments the association receives from the hotel. The county had contracted with an outside party to perform a review of the rent paid to the county by the association for the year ended December 31, 2004.¹ The reviewer's final report in June 2006 noted that the exclusion of the hotel's revenue from the rent calculation was consistent with previous years. However, the reviewer noted that the treatment of hotel revenue is unclear in the lease and that the county should issue a clarifying statement on the matter. Further, the reviewer stated that it was the opinion of the county that the association properly excluded the gross revenue earned by the hotel when preparing the rent calculation. Based on the definition of gross revenues in the lease, we do not understand how the county reached this conclusion, and the county could not provide a reasonable explanation as to why it agreed to this treatment. In response to the reviewer's recommendation, the county issued a letter in September 2006 that stated in part that revenue earned by the hotel did not meet the definition of gross revenues but that fees and other payments received by the association from the hotel are included in its rent calculation.

Because the hotel is one of the association's business activities, the association effectively received the hotel's revenue and thus should have been paying rent based on that revenue under the terms of the lease. When we questioned the association, it stated that the county has benefited from development of the hotel and the conference center we describe later in numerous ways. According to the association, these facilities not only substantially increased the value of the county's property, but also helped bring numerous conferences and events to the Fairplex, and with them, visitors and

¹ The term *audit* appears frequently in the county's internal communication and in references to this review, even though the type of engagement for which the county contracted was not an audit. Specifically, in an audit, the auditor independently develops the audit procedures. The reviewer and the county, on the other hand, agreed upon the procedures the reviewer would perform. As a result, the reviewer did not opine on the sufficiency of the procedures performed, but only made a conclusion based on his performance of the agreed-upon procedures.

spending in the region. However, we found little evidence that the county had made an informed decision about excluding the hotel's revenue based on these possible benefits.

Under the terms of the lease, the association should have been paying rent based on the hotel's revenue.

By not monitoring the lease, the county very likely relinquished approximately \$6.2 million in rent from 2006 through 2015. Instead, under the current arrangement, we calculated that the county is due only approximately \$70,000 in arrears in total rent related to the hotel fees since 1992.

Despite Providing the Association With \$12 Million in Rent Credits, the County Has Yet to Collect Rent Related to the Conference Center's Operations

Although the county expected to receive additional rent from the conference center the association built in part with assistance in the form of rent credits from the county, it has actually received no rent related to the conference center's operations. In 2007, as the association was attempting to obtain funding to help it build a conference center at the Fairplex, its president at the time asked the county to help finance the project and expressed that the county would receive a direct increase in rent from the conference center's operations and from the growth of complementary businesses on site. Ultimately, the county agreed to provide the association with \$12 million in the form of an \$800,000 annual credit (rent credit) that the association could apply against its rent due to the county for 15 years. When the county agreed to the rent credit, it indicated that it expected to receive an additional \$250,000 annually from the conference center's operations when the conference center was at full capacity. The county based this amount on the information the association provided to it, which suggested that the county would ultimately receive \$150,000 in increased rent revenue and \$100,000 in increased taxes.

However, the association subsequently took actions that resulted in it not paying rent to the county based on the conference center's revenue. Specifically, in 2009 the association amended its hotel management agreement so that its hotel operator would also operate the association's conference center in addition to operating the association's hotel. The association stated that it placed the conference center with the hotel's operations because the types of businesses were similar and many of the conference center's guests stay at the hotel. As a result, although the conference center opened in 2012, the county has received no additional rent from its operations, despite agreeing to provide the association with \$12 million in rent credits. The association's failure to pay rent related to the conference center appears to directly contradict its representations to the county when it was asking for help with financing the construction.

The county has received no additional rent from the conference center's operations, despite agreeing to provide the association with \$12 million in rent credits to help finance the project.

Based on year-by-year projections the association provided to the county three months before the county approved the rent credit, we estimate that the county has lost out on roughly \$350,000 in total rent revenue related to the conference center since it opened in 2012. According to the county's deputy compliance officer, the county never agreed to the exclusion of the conference center's revenue from the association's rent calculation, and it only recently discovered that it was not receiving rent from the conference center's activities. The county's auditor-controller uncovered this issue in early 2016 during the county's review of the association's rent calculation for the years 2012 through 2014. This review occurred four years after the conference center opened and seven years after the association amended its hotel management agreement to also include management of the conference center.

Had the county conducted timely reviews of the association's rent calculations, it likely would have uncovered this problem more quickly. Although the county or its contractor has conducted periodic reviews of the association's rent calculations that cover every year from at least 2006 through 2014, it has not always conducted these reviews in a timely manner. For example, as shown in the text box, at one point the county went longer than six years without conducting a review even though its informal goal was to conduct these reviews every three years. Although it then conducted a review that covered the previous five years, such long gaps between reviews could allow the

Reviews of the Los Angeles County Fair Association's Rent Calculations for the Years 2006 Through 2014

Year(s) Reviewed (Report Release Date)

2006 (December 2007)

2007 to 2011 (July 2014)

2012 to 2014 (Projected November 2016)

Source: Los Angeles County records.

association to improperly calculate the rent it owes the county for extended periods of time. As described above, the association excluded the conference center's revenue from its rent calculation for the four years following its opening. Had the county adhered to its goal to review the association's rent calculation every three years, it would have conducted reviews in 2010 and 2013. Because the 2013 review would have included the year in which the conference center began operations, the county likely would have discovered the association's exclusion of the conference center's revenue much earlier and been able to resolve the problem in a more timely manner.

The County Has Not Collected Rent Related to the Gross Revenues of the Association's Subsidiaries

In addition to the rent the county does not collect related to the association's hotel and conference center, it also does not collect rent based on the gross revenues of the association's subsidiaries. As previously discussed, the terms of the lease require the association to pay rent based on revenue it receives from the use of the Fairplex. Under its business structure at the inception of the lease in 1988, the association likely received almost all of the revenue generated from the use of the Fairplex. However, as Figure 2 on page 6 in the Introduction shows, the association has made significant changes to its business operations since 1988 by creating various for-profit subsidiaries, each of which it wholly controls. Unlike the hotel and conference center, these subsidiaries are legally separate entities. Consequently, the association itself does not directly receive these revenues and, under the terms of the lease, these amounts are not includable in the rent calculation. These revenues totaled roughly \$18 million in 2015.

Instead, the association must include in its rent calculation only the amounts its subsidiaries pay in fees to the association, as seen in Figure 5. However, because the association controls its subsidiaries, the amount of rent it pays to the county is driven by the amount of fees the association decides to charge its subsidiaries. In contrast, the Redevelopment Agency of Pomona had an agreement with the association that included the type of language that could have benefited the county in its lease with the association. In 1990 the association and the Redevelopment Agency entered into an agreement related to the hotel. This agreement entitled the Redevelopment Agency to receive a portion of the net profits generated by all the food and room service operations at the hotel. The agreement specifically applied to all entities "who directly or indirectly derive profits from the hotel's food and room service operations," including sublessees. Essentially, this agreement focused on the revenue generated by the use of the land instead of the revenue received by the association. Had the county chosen

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to use similar language in its lease, the association's rent would have been based on all of the association's and its subsidiaries' Fairplex-related revenue, regardless of any changes the association made to its business structure.

Figure 5

Structure of the Los Angeles County Fair Association's Rent Payments to Los Angeles County



Sources: 1988 Ground Lease and Operating Agreement between the association and Los Angeles County (county); the association's agreements with its hotel and conference center, subsidiaries, and outside parties; the association's audited financial statements; and county records.

* We define "fees" to mean any amounts the association receives from its hotel and conference center or under the terms of its subleases with its subsidiaries and outside parties for use of the Fairplex.

Further, the county could have benefited by including in the lease the type of renegotiation opportunities that it includes in its other agreements. For example, the county has an agreement with another entity that identifies specific renegotiation dates; on these dates, the annual rent percentages can be readjusted according to the fair market rental value. Because the county's lease agreement with the association does not include such a renegotiation provision, there was no automatic mechanism in place for the county to adjust the rent calculation as the association's business structure changed. Although the lease does specify incremental percentage increases in rent over time, it does not give the county the ability to renegotiate these percentages to ensure that it receives rent in an amount that reflects the property's rental value. The county's decision to enter into a long-term lease with no renegotiation provision suggests that it did not foresee that the association's activities and business structure would change in such a way that large portions of revenue generated at the Fairplex would be excluded from the rent calculation.

However, the county may have an opportunity to amend the lease to collect additional revenue from these subsidiaries, as well as to include language to clarify its share of the hotel's and conference center's revenues. Specifically, according to county records, the association has approached the county about a potential amendment to the lease in part because the association is considering additional developments at the Fairplex. In November 2015, the county's Board of Supervisors directed county staff to continue negotiations for a potential amendment to the lease, with the directive that they should structure any amendments to fully maximize the association's payments to the county. Because any amendments to the lease require the Board of Supervisors' approval, the county has leverage in its negotiations with the association and should take advantage of this opportunity to address the problems created, in part, by its weak lease management in the past.

Recommendations

By April 2017, the county should reach agreement with the association on the following issues:

- The date by which the association must pay the county for the rent in arrears related to the hotel.
- How much rent the association owes the county from the hotel's operations since 1992.

As soon as possible, the county should collect from the association all amounts presently owed under the lease as a result of the revenue generated by the conference center.

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To ensure that it recognizes and addresses in a timely manner areas of potential concern related to the association's rent, the county should create and adhere to a policy of reviewing the association's rent calculations at least every three years.

To protect its interests and maximize its future revenue, the county should strongly consider ensuring that any potential amendment to the lease includes the following:

- A revised rent calculation formula that factors in revenue from all of the association's activities, including its hotel and conference center, as well as revenue from its subsidiaries' activities at the Fairplex. This revised rent calculation formula should require the association either to pay the county an agreed-upon fixed amount, adjusted periodically for inflation, or to pay the county both a fixed amount every year and a percentage of the total gross revenue that the association earns at the Fairplex.
- Terms that define the circumstances or dates that require a renegotiation of the lease and the rent calculation formula.
- An agreement on the types of entities whose gross revenues the association must include in rent calculations. This agreement should cover any new businesses the association creates that operate at the Fairplex.
- Terms that require the association to provide the county with any subleases it wishes to enter, even those subleases that do not exceed 10 years. The terms should also require the association to provide the county with approval over other agreements that could affect the rent calculation, including the association's hotel management agreement and its amendments.
- Terms that require the association to provide the county with advance notice of any refinancing of the association's debt and what impact, if any, such transactions would have on the amount or timing of rent payments to the county.

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The Association's Executives Receive Much Higher Compensation Than Executives That Run Other Large Fairs in California

Key Points:

- The association provides its executives with significantly higher compensation than the executives of other large fairs receive.
- The association engaged outside contractors to perform compensation studies that it used to review its executives' salaries.

Perhaps in part because the county has not collected rent on some of the association's activities related to the use of the Fairplex, the association has been able to provide its executives with much higher compensation than the executives who are in charge of other large fairs in California have received. As we discuss in the previous section, the county has not received approximately \$6.5 million in total rent related to the hotel and conference center from 2006 through 2015. During roughly this same time period, the association consistently paid its then president total compensation greater than half a million dollars annually, according to its federal tax filings. Further, in 2014 it also paid many of its other executives more than the chief executives in charge of other large fairs earned.

During our audit period, the levels of compensation the association provided its executive management team varied as a result of the association's bonus-based compensation structure. Specifically, from 2006 to 2014, the association's former president's compensation ranged from a low of \$549,000 in 2009 to a high of \$1.2 million in 2007. His 2014 compensation totaled more than \$1 million—\$547,312 in base compensation, \$442,725 in bonus and incentive compensation, and \$55,051 in other compensation and benefits. Further, the association paid six of the seven members of its executive management team more than \$200,000 in 2014, as shown in Table 5 on the following page. The seven executives collectively earned a total of \$2.9 million in 2014. Moreover, the total reported compensation the association paid to its four highest-paid executives increased from 7 percent of its total salaries and employee benefits in 2006 to 13 percent in 2014.

According to the classification system the CDFA uses, the LA County Fair is one of only five Class VII fairs in the State, which are fairs with average operating revenues of more than \$10 million per year. Public entities operate three of these Class VII fairs. Specifically, DAAs operate the Orange County Fair and San Diego County Fair, while a state agency operates the California State Fair. The annual base salary for chief executive officers (CEOs) in charge of Class VII fairs at the two DAAs ranges from \$104,988 to \$128,808. In addition, these CEOs are also eligible to receive recruitment/retention pay differentials as well as car allowances, which can increase their total compensation. The annual base salary for the CEO in charge of the California State Fair currently ranges from \$149,916 to \$175,368.

Table 5 The Los Angeles County Fair Association Executive Compensation for 2014

TITLE	BASE COMPENSATION	BONUS AND INCENTIVE COMPENSATION	RETIREMENT AND OTHER DEFERRED COMPENSATION	NONTAXABLE BENEFITS	TOTAL COMPENSATION
President and chief executive officer	\$547,312	\$442,725	\$28,783	\$26,268	\$1,045,088
Vice president of finance and chief financial officer	244,450	176,069	28,783	5,514	454,816
Vice president of operations	189,191	149,586	28,783	13,463	381,023
Vice president of sales, marketing, and programs	210,901	185,586	28,783	13,204	438,474
Vice president of branding and product knowledge	161,445	113,305	28,288	9,596	312,634
Vice president of business management	179,575	21,449	5,833	19,536	226,393
Vice president*	NA	NA	NA	NA	86,869

Source: The Los Angeles County Fair Association's (association) publicly available 2014 Internal Revenue Service (IRS) tax filing.

* This individual was named to the position in August 2014. Because her reportable compensation—the total of her base compensation and bonus and incentive compensation amounts—was below \$150,000, the IRS instructions did not require the association to present a breakdown of her compensation in its IRS tax filing.

On the other hand, nonprofit organizations run the LA County Fair and the Alameda County Fair. Because these nonprofit organizations are corporations, they are not required to implement the same salary ranges that public entities must. Although we did not analyze the process the nonprofit organization that runs the Alameda County Fair uses to set its executive compensation, we noted that it is registered as a charitable organization. A charitable organization is subject to certain federal taxes if its executive compensation is excessive. The association, however, is not a charitable organization—rather, it is an agricultural organization and thus is not subject to these taxes. The association pays its executives a base salary, plus a bonus for meeting defined performance targets. Such targets may relate to revenue, operating income, and various strategic goals. The association's approach to determining compensation allowed it to provide its former president much higher compensation than the chief executives in charge of other Class VII fairs received in 2014, as seen in Figure 6. In fact, many of the association's top executives earned more than the CEOs of the organizations that operate the State's other Class VII fairs. The same individual served as the association's CEO throughout our audit period until he resigned in March 2016, and we found that his total reported compensation generally followed the trend of the association's revenue from 2006 through 2014. By comparison, we note that the San Diego County Fair generated revenue similar to that of the LA County Fair in 2014, yet its CEO received far less in total compensation.

Figure 6

Compensation Amounts in 2014 for Chief Executive Officers or Comparable Positions That Managed Class VII Fairs



Sources: The Los Angeles County Fair Association's 2014 audited financial statements and Internal Revenue Service Form 990, the Alameda Agricultural Association's 2014 Form 990, and information provided by the California Department of Food and Agriculture (CDFA).

Note: The CDFA defines Class VII fairs, the largest class of fair in the State, as those fairs with average annual operating revenue of more than \$10 million.

- * Compensation shown for the nonprofit executives includes base, bonus, and incentive compensation; it does not include retirement, other deferred compensation, or nontaxable benefits. Compensation shown for the executives of public entities includes base compensation and benefits such as recruitment/retention pay differentials and car allowances, as applicable.
- [†] The Los Angeles County Fair Association operates the LA County Fair.
- [‡] The Alameda Agricultural Fair Association operates the Alameda County Fair.
- § California Exposition and State Fair operates the California State Fair.
- II The 32nd District Agricultural Association operates the Orange County Fair.
- [#] The 22nd District Agricultural Association operates the San Diego County Fair.

We acknowledge that the association is legally allowed to set its executive compensation at levels greater than those set by public entities, and we recognize the association's desire to attract and maintain talent to manage a complex organization. During our audit period, the association commissioned executive compensation studies by two different consulting firms, which they completed in 2008 and 2011. In the studies, the consulting firms reviewed both for-profit and nonprofit organizations in industries such as hotels, recreation, fairs, and trade associations, as well as other market data. The studies found the association's executive compensation arrangement to be generally reasonable and competitive. According to the association, its executives manage more complex operations than do the executives of many Class VII fairs. For instance, the association stated that it oversees the hotel and conference center and the year-round operations at the Fairplex campus, which is in use throughout the year for hundreds of events large and small. Similarly, the association stated that it oversees various affiliated businesses such as its subsidiaries and its related nonprofit entities. We present some of the differences between the association and the other organizations that operate Class VII fairs in Table 6. Of particular note is that the association has significantly more employees than the other organizations do.

Table 6

A Comparison of the Los Angeles County Fair Association to Other Organizations Operating Class VII Fairs

ORGANIZATION AND FAIR	GOVERNMENTAL ENTITY	NONPROFIT ORGANIZATION	OPERATES A FAIR	NUMBER OF EMPLOYEES IN 2014
Los Angeles County Fair Association (Los Angeles County Fair)		✓	✓	1,711
Alameda County Agricultural Fair Association (Alameda County Fair)		✓	✓	744
California Exposition and State Fair (California State Fair)	✓		✓	215
32nd District Agricultural Association (Orange County Fair)	✓		✓	103
22nd District Agricultural Association (San Diego County Fair)	✓		✓	367

Sources: California State Auditor's analysis of the Class VII fairs' publicly available Internal Revenue Service tax filings, financial statements, and websites; California Department of Food and Agriculture records; and state law.
The Association Operated an RV Park With Numerous Safety Violations

Key Points:

- The Redevelopment Agency of Pomona provided the association with \$3.3 million in 2009. In exchange, the association agreed to provide affordable housing at one of its RV parks for more than five decades.
- The association allowed conditions at the RV park to deteriorate to such an extent that state inspectors discovered several health and safety violations.

Although the Redevelopment Agency² provided the association with millions of dollars related to an RV park at the Fairplex, the association failed to maintain the RV park, resulting in it being cited for numerous health and safety violations. In 2009 the Redevelopment Agency provided the association with \$3.3 million for the purchase of 50 affordable rental space covenants at the association's 160-space RV park. The terms of this purchase required the association to make the 50 spaces available for 55 years, or until 2064, to tenants whose income levels are very low to moderate.

State regulations require the owners of RV parks to safely maintain and operate all common areas; park-owned electrical, gas, and plumbing equipment; and park-owned permanent buildings or structures. Nonetheless, the association did not fully comply with these regulations. Specifically, in February 2015 a resident of the RV park submitted a complaint to HCD, which has enforcement authority over the RV park under state law. The resident reported a lack of handicapped access into restroom or shower buildings, a broken window in the men's shower, substandard electrical boxes, and excessive potholes in the roads. According to an administrator at HCD, the issues in the resident's complaint did not include what HCD considers to be immediate threats to the health and safety of the residents—gas leaks, exposed electrical wiring, or sewer leaks—and because the HCD inspectors had a backlog in their workloads, an HCD inspector did not visit the association's RV park until July 2015.

At her initial inspection of the RV park, the HCD inspector discovered several violations of the California Health and Safety Code, including broken restroom windows, mold, substandard flooring, and other issues, some of which are shown in Figure 7 on the following page. The inspector also noted that the association had begun repairs to the restrooms without obtaining proper work permits. She ordered the association to cease its repair work and to obtain the required work permits within 10 days.

At a subsequent inspection in January 2016, two HCD inspectors discovered that the association had been operating the RV park without the necessary permit for 29 years. In 1986 the association began operating a second RV park at the Fairplex. According

² In 2011 the Legislature enacted law to abolish redevelopment agencies. Pomona's Housing Authority is the successor agency to the low and moderate income housing functions of the former Redevelopment Agency.

Figure 7

Photos of Some Issues Noted at a Recreational Vehicle Park the Los Angeles County Fair Association Owns and Operates



Sources: The Department of Housing and Community Development's activity report for the recreational vehicle park dated July 13, 2015 (photos 1–4), and observations by the California State Auditor on April 27, 2016 (photos 5–6).

to the association, it operated the two parks as one business unit with the same business address; consequently, it believed the permit it obtained to operate the association's second RV park covered both parks. When HCD discovered the problem in January 2016, it ordered the association to apply for the permit within 15 days and to pay about \$42,500 in back fees and penalties. The association promptly paid the fees and obtained the permit to operate the RV park. Further, during a detailed inspection of the RV park in March 2016, an HCD inspector found more serious violations that were determined to be an imminent hazard to the health and safety of RV park residents. Specifically, in several spaces at the RV park, the park's electrical service equipment had been exposed or had easily accessible live electrical parts. The inspector instructed the association to fix these violations immediately, and the association took immediate steps to comply. HCD determined that the association had fully addressed these violations in May 2016.

However, the association took longer to correct other violations that the HCD inspectors identified during their March 2016 inspection. Specifically, of the 17 violations identified, the association had failed to resolve six—including accumulation of refuse and unapproved plumbing extensions—as of August 2016. As a result, HCD issued the association a notice of intent to suspend its permit to operate, giving the association 30 days to correct the violations. In September 2016 HCD determined that two spaces at the RV park still had an accumulation of refuse or other combustible material and ordered the association to abate the remaining violations or HCD could pursue further administrative measures. HCD conducted a reinspection in October 2016 and determined the RV park was in compliance with the applicable regulations. Blank page inserted for reproduction purposes only.

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OTHER AREAS WE REVIEWED

To address the audit objectives approved by the Joint Legislative Audit Committee (Audit Committee), we also reviewed the association's processes for selecting its members and electing its directors, its hiring and compensation practices, its financial and accounting practices, its nonprofit status, and its involvement in a lawsuit related to the collection of transient occupancy taxes at its RV parks. Table 7 shows the results of our review of these issues.

Table 7

Other Areas Reviewed as Part of This Audit

The Los Angeles County Fair Association's Selection of Members and Election of Directors

- Currently, the Los Angeles County Fair Association (association) is composed of up to 60 regular members, including an 11-member governing board of directors.
- The association's bylaws establish the process by which the association selects new members and elects new board members.
- When an opening for a new member occurs, current association members nominate potential members and refer them to the association's nominating committee for consideration and recommendation.
- Association directors are elected by the association's members or directors. Association directors must be members themselves.
- In the case of both potential new members and candidates for the board of directors, the bylaws state that the nominating committee should consider if a nominee has the ability to advocate the interests of the organization through fundraising and political influence; if the nominee has time to attend meetings; whether the nominee's views align with the purposes and goals of the association; and whether the nominee's age, gender, race, ethnicity, geographic base, and business background would add to or increase the diversity of the members.
- In our limited review of the selection of five new association members and the election
 of five new directors, we were unable to determine whether the association complied
 with its bylaws in all aspects related to the nominations and elections, or whether
 nepotism was a factor, because the association's board meeting minutes do not have
 sufficient information for our purposes. The association stated that it is unaware of
 any instance in which nepotism has been an issue with respect to the selection of
 association members or the election of its directors. The association also stated that
 although a few of its members are related through family connections, it selected these
 members based on their own merit and not because of their familial relationships.

The Association's Hiring and Compensation Policies

• We reviewed the association's hiring and compensation policies described in its employee handbook. We compared these policies against certain laws enforced by the Equal Employment Opportunity Commission, including laws related to discrimination on the basis of race, color, religion, national origin, or sex. We found that the association's hiring and compensation policies are in compliance with the laws we reviewed.

The Association's Financial and Accounting Practices

- The association's Ground Lease and Operating Agreement (lease) with Los Angeles County (county) requires the association to maintain its accounting records in accordance with generally accepted accounting principles and auditing practices.
- The association contracted with an external auditor to conduct an audit of its financial statements for every year within our audit period.
- We reviewed the association's audited financial statements for the years 2006 through 2015 and found that the auditor opined that the association had presented its financial statements in accordance with accounting principles generally accepted in the United States of America in each of these years.

The Association's Nonprofit Status

- Because the lease between the county and the association requires the association to maintain nonprofit status, we reviewed the association's audited financial statements dating back to 2006, as well as records from the Secretary of State's Office dating back to 2013, which were the earliest records available. We found that the association maintained its nonprofit status throughout our audit period.
- According to the Franchise Tax Board, the association has also maintained its state tax-exempt status throughout our audit period, although the lease does not require it to do so. Nonprofit and tax-exempt statuses are not the same: a tax-exempt organization is not required to pay taxes on the money it receives related to its exempt activities. The State grants tax-exempt status only after the Internal Revenue Service has made a determination that an organization is exempt from taxes for federal purposes.

The Association's Involvement in a Lawsuit Related to Its Collection of Transient Occupancy Taxes

- Under its city code, the city of Pomona imposes a transient occupancy tax on occupants of a hotel or similar accommodations, including recreational vehicle (RV) parks. The association, as an operator of two RV parks, is responsible for collecting the tax and remitting it to Pomona. Residents of the association's RV parks have filed a lawsuit against the association related to its collection of this tax.
- Under Pomona's city code, a resident, including an RV park resident, is not considered transient after residing at one of the association's RV parks for 30 days and should not be subject to the tax. According to a lawsuit filed by residents of the RV parks in September 2015, the association continued to collect this tax from residents who had resided at the RV parks for longer than 30 days. According to the lawsuit, the association ceased charging the tax in about April 2015.
- Pomona indicated that it settled claims by RV park residents by refunding one year's
 worth of transit occupancy taxes to residents who filed a claim for a refund, asserting that
 a city ordinance established a one-year statute of limitations on claims against the city.
- The residents are seeking a refund of 10 years' worth of this tax from the association, as well as other compensatory and punitive damages.
- As of October 2016 the outcome of this lawsuit was still pending. The association stated that it would not be proper for it to comment on pending litigation.

Source: California State Auditor's analysis of the records identified in this table.

SCOPE AND METHODOLOGY

The Audit Committee directed the California State Auditor (State Auditor) to review the county's oversight of the association. Table 8 lists the objectives that the Audit Committee approved and the methods we used to address them. As a private entity, the association is not under the same legal obligation to provide documentation or other information to the State Auditor as publicly created entities are. Nonetheless, we requested and received documents from the association in order to address certain audit objectives, such as its executive compensation studies, hiring policies, financial statements, bylaws, board minutes, hotel management agreements, and subleases. In addition, association staff met with members of the audit team to provide current and historical information on the association's operations. However, we agreed that we would not present certain confidential information about the association's operations.

Table 8

Audit Objectives and the Methods Used to Address Them

AUDIT OBJECTIVE		METHOD	
1	Review and evaluate the laws, rules, and regulations significant to the audit objectives.	Reviewed relevant state laws and regulations.	
2	Identify the public funding received by the Los Angeles County Fair Association (association) over the past 10 years and the major categories of expenditures of those funds, including the extent to which public funds were used for staff and executive compensation.	 Obtained accounting records from Los Angeles County (county), the association, the city of Pomona, and the California Department of Food and Agriculture (CDFA). Analyzed the terms and requirements related to the largest state and local government public funding amounts and other assistance the association received. Obtained documentation and interviewed staff at the governmental entities that provided the association with public funding and other assistance to determine whether those entities exercised any oversight of the funds. Interviewed association staff to determine the purposes for which the association used any public funds and other assistance. Identified the purposes of any public funding in Table 2 on page 9 of the Introduction. We did not become aware of any specific instances where the association used these funds for staff or executive compensation. 	
3	Compare the association's executive compensation with executive compensation of organizations of similar size.	 Determined that comparable organizations include Class VII fairs under the CDFA's classification system. Obtained the compensation amounts for the chief executive officer (CEO) or other similar positions at each of the Class VII fairs for 2014, the most recent year for which data were available for all fairs. Compared the association's 2014 compensation for its CEO with compensation for the CEO or other similar positions at the other Class VII fairs. Compared the association's revenue with its CEO's compensation for 2006 through 2014. Determined the association's process for setting its executives' compensation. 	

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	AUDIT OBJECTIVE	METHOD	
4	To the extent possible, evaluate whether the association's hiring and compensation practices comply with laws, rules, policies, and generally accepted practices.	 Obtained the association's employee handbook. Evaluated the association's hiring and compensation practices, as outlined in its employee handbook, against certain laws enforced by the Equal Opportunity Employment Commission. 	
5	Determine whether the association's financial and accounting practices comply with generally accepted accounting or industry standards.	 Obtained and reviewed the association's independent auditors' reports for the years 2006 through 2015. We noted that the independent auditor is licensed and has no complaints on file. 	
6	Determine for each of the past 10 years whether the association has been operating at a loss and, if so, to the extent possible, determine what factors are contributing to this condition.	 Obtained the association's independent auditors' reports for 2006 through 2015, as well as its publicly available Internal Revenue Service filings. Determined whether the association had an operating loss or net loss for any of the years in question. Determined the extent to which any net losses were due to noncash items. 	
7	Evaluate whether the association's activities are promoting its mission and whether its operations are within the parameters outlined in Government Code section 25900, et seq., which authorizes a county board of supervisors to participate in the affairs of an agricultural fair association and expend certain state funds for those purposes.	 Compared the association's current mission with the mission stated in its articles of incorporation and determined the extent to which its mission has changed. Reviewed the county's Ground Lease and Operating Agreement (lease) with the association. Evaluated the association's organizational structure and the nature of its activities. Determined the terms of the lease related to the calculation of the rent that the association must pay the county annually. Obtained other documentation related to the association's annual rent calculation. Reviewed key county decisions that relate to the lease requirements. Interviewed county staff to determine what policies and procedures the county has established for overseeing the county's lease with the association. Compared the county's lease with the association to two of the county's agreements with other developers and to two of the county's agreements with other nonprofit organizations. 	
8	Examine whether the association's status and filings related to its nonprofit status are in compliance with applicable requirements.	 Determined the requirements to obtain and maintain nonprofit status. Determined the requirements to obtain and maintain tax-exempt status. Obtained documentation from the Secretary of State's Office and the Franchise Tax Board to determine whether the association made the necessary filings to maintain these statuses. 	
9	To the extent possible, examine the extent to which the association is complying with laws, rules, or policies related to the selection of its members and election of its board of directors. Determine whether this process is fair, reasonable, and avoids nepotism or the appearance of nepotism.	 Obtained the association's bylaws, which set the process for selecting association members and electing directors. Reviewed the selection of five new association members and five new board directors elected during our audit period. Obtained board minutes from the association to determine whether it followed the process established in its bylaws for our selection of members and directors. Reviewed the association's bylaws and interviewed association staff to determine whether the association has any prohibitions against nepotism. 	
10	Review and assess any other issues that are significant to the audit.	 Obtained documentation related to issues noted at the association's recreational vehicle (RV) park. Interviewed staff at the Department of Housing and Community Development (HCD) and the association related to the safety violations identified by HCD inspectors at the RV park. Interviewed staff at the association to determine why the association operated the RV park without the required permit for 29 years. 	

Sources: California State Auditor's analysis of the Joint Legislative Audit Committee's audit request number 2016-106, as well as information and documentation identified in the column titled *Method*.

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Assessment of Data Reliability

The U.S. Government Accountability Office, whose standards we are statutorily required to follow, requires us to assess the sufficiency and appropriateness of the computer-processed information that we use to materially support our findings, conclusions, or recommendations. In performing this audit, we relied upon financial information provided to us from the association's, the county's, CDFA's, and Pomona's information systems to determine the amount of state and local public funding and other assistance provided to the association from 2006 through 2015. We compared the association's records against the public entities' records, as well as comparing CDFA's records against the county's records. We found that the records generally matched each other with only minor discrepancies. Therefore, we determined that the financial information was sufficient for our purposes and that a data reliability assessment was not required.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to 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 specified in the Scope and Methodology section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE, CPA State Auditor

Date: November 10, 2016

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Legal Counsel: Heather Kendrick, Sr. Staff Counsel

For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255. Blank page inserted for reproduction purposes only.



November 2016

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Board of Supervisors HILDA L. SOLIS First District

MARK RIDLEY-THOMAS Second District

SHEILA KUEHL Third District

DON KNABE Fourth District

MICHAEL D. ANTONOVICH Fifth District

Elaine M. Howle, State Auditor* State of California 621 Capitol Mall, Suite 1200 Sacramento, CA 95814

Dear Ms. Howle,

October 20, 2016

Thank you for the opportunity to review the draft report of your audit of the Los Angeles County Fair Association. At this time, we do not have specific comments on the report or its recommendations. We will not have an opportunity to review the Fair Association's portion of the report until it is issued. We look forward to reviewing the entire report when it becomes available.

County of Los Angeles CHIEF EXECUTIVE OFFICE Kenneth Hahn Hall of Administration 500 West Temple Street, Room 713, Los Angeles, California 90012 (213) 974-1101 http://ceo.lacounty.gov

While, we generally agree with the recommendations based on what we have seen thus far, as you understand, our ability to implement them may be dependent on cooperation from the Los Angeles County Fair Association. We look forward to working with the Fair Association with the intent of implementing these recommendations; and we will also consider any observations or recommendations your report may make pertaining to the Fair Association.

If you have any questions, please contact me at (213) 893-2477.

Sincerely,

ALPHE

DAVID P. HOWARD Assistant Chief Executive Officer Asset Management Branch

SAH:JJ:DPH:BB FC:LG:mda

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SACHI A. HAMAI Chief Executive Officer

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Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE COUNTY OF LOS ANGELES

To provide clarity and perspective, we are commenting on the response to our audit report from the county. The numbers below correspond to the numbers we placed in the margin of the county's response.

We provided the county with a redacted draft report that contained only those portions relevant to the county. We provided enough information and context to support our recommendations to the county.

While we recognize that the county will require the association's cooperation to implement our recommendations related to any potential amendment to the lease or to resolve issues related to rent due from the hotel's and conference center's operations, we note that the county has the ability to implement certain recommendations on its own. For instance, the county can create and adhere to a policy of reviewing the association's rent calculations at least every three years.

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Victor De la Cruz Manatt, Phelps & Phillips, LLP Direct Dial: (310) 312-4305 E-mail: VDelaCruz@Manatt.com



November 4, 2016

BY E-MAIL ELAINEH@AUDITOR.CA.GOV

Ms. Elaine M. Howle^{*} California State Auditor 621 Capitol Mall, Suite 1200 Sacramento, California 95814

Re: Audit No. 2016-106 – Preliminary Response of the Los Angeles County Fair Association

Dear Ms. Howle:

Thank you for providing the Los Angeles County Fair Association ("LACFA") an opportunity to comment on a portion of the forthcoming audit of the County of Los Angeles' ("County") oversight of its lease with LACFA. We welcome the opportunity to collaborate with your office to ensure that the facts and analysis in the State Auditor's report are accurate. LACFA also appreciates that your audit has found that:

- 1) LACFA has "reported positive income from its operations in every year throughout [the] audit period." Tax filings seldom represent the financial health of any organization, particularly non-profits, yet, as your audit report notes, net operating income through the audit period averaged several millions every year during the audit period.
- 2) LACFA receives "relatively little public funding or other assistance from the State or from local governments." Moreover, LACFA has not received any direct public funding since 2011, and in fact, has not received direct funding from the County for a decade.
- During the audit period, LACFA had the highest revenues of any fair organization in the State and employed more workers than every major fair combined.
- 4) LACFA has continuously maintained its non-profit status.

Questions about these issues led to the audit in the first place, and we are pleased that the State Auditor's report has clarified these facts.

11355 West Olympic Boulevard, Los Angeles, California 90064-1614 Telephone: 310.312.4000 Fax: 310.312.4224 Albany | Chicago | Los Angeles | New York | Orange County | Palo Alto | Sacramento | San Francisco | Washington, D.C.

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^{*} California State Auditor's comments begin on page 63.



We also appreciate that you have supplied, if not full, at least some context and history so that LACFA's current position can be placed in better perspective. Your audit report notes that LACFA is not an agency of the State or County, but a private non-profit that has existed in some form or another since 1922, and you correctly noted that LACFA deeded much of the 543-acre Fairplex to the County. Having given so much valuable land to the County, for many years LACFA did not pay any annual rent for use of the land, although in 1988 the County and LACFA entered into the current 56-year lease (the "Lease"), which was geared at generating revenues to the County while still allowing LACFA to continue providing significant community benefits to the east San Gabriel Valley. This history is critical to an understanding of the Lease, and should have informed much of the analysis in the State Audit. *See* GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS at § 6.13 (stating that auditors should obtain an understanding of "[a] program's strategic plan and objectives; and the external factors that could directly affect the program").

Not many tenants give away their land to a landlord, and perhaps to the casual observer this does not make sense. However, LACFA's primary mission has always been to serve the County and its residents, and for decades, the County and LACFA have worked hand-in-hand in this same spirit of cooperation to further the public interest. That should have been the starting point to the State Audit report, but unfortunately, it appears that the historic relationship was not put in its full context.

In an e-mail from Mr. Joe Meyer of your office on August 2, 2016, LACFA was informed that it would be presented with a "final draft" of the audit. We did not expect to receive a highly redacted draft and thus we may provide additional comments once the full report is released to LACFA and the public. However, based on the material that LACFA has been allowed to review, it is apparent that the State Auditor's report is premised on a fundamental misunderstanding of LACFA and this longstanding relationship with the County—a relationship that recognizes LACFA's role as a major economic engine for the east San Gabriel Valley, and perhaps most importantly, values the non-profit programming that have made the Fairplex a hub for community building and education for tens of thousands of County families.

Much of the State Auditor's report is based on an erroneous Lease interpretation that defies decades of practice, prior independent audit reports, a 2006 confirmation by then-Chief Administrative Officer ("CAO") David Jannsen, and critically, the whole foundation upon which LACFA's partnership with the County is based. Largely relying on correspondence drafted by a single employee which dates back 25 years ago, has no official independent status, and is itself flawed on its face (for example, it provides an illogical hotel gross revenue number that is smaller than even the debt service for the hotel's construction, so it cannot possibly be referring to gross revenues), the State Auditor's report still takes the position that the County should have interpreted the Lease to require the payment of rent based on the hotel's gross revenues. This rewriting of history and re-interpretation of the Lease, which was entered into decades ago

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before the County even corresponded via e-mail, is particularly twisted and defies logic. For one, the State Auditor's interpretation would have never allowed a hotel to be financed and constructed during California's crippling recession of the early 1990s, which is why—*from day one*—the Lease has been interpreted in a consistent fashion by LACFA *and the County* that excludes the hotel's gross revenue.

While the report implies that there may be a different interpretation, in re-construing the Lease, the State Auditor's report violates Generally Accepted Government Auditing Standards, which specify that "[a]uditors must *obtain sufficient, appropriate evidence* to provide a reasonable basis for their findings and conclusions." *See* GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS at § 6.56 (emphasis added). Similarly, "[e]vidence is *not sufficient when* ... using the evidence carries an unacceptably high risk that it could lead the auditor to reach an incorrect or improper conclusion "Id. at § 6.71(b) (emphasis added). Unfortunately, the State Auditor's report appears to be premised on a guessing game as to what should have been intended by LACFA and the County when the Lease was drafted, rather than the County's own interpretation or a deeper analysis of the LACFA-County relationship and the economic environment of the early 1990s.

If the County and LACFA had only viewed their partnership through the narrow prism of rent, or if LACFA was only interesting in maximizing its own revenues, then LACFA certainly would not have deeded away the Fairplex land to the County so that it could serve the public interest in perpetuity, or provided millions in non-profit programming to County residents, none of which is required by the Lease. For decades, LACFA and the County have been partners working to foster educational opportunities for youth throughout the east San Gabriel Valley and have worked to develop the Fairplex with an eye toward creating community-building and economic growth for the region. The State Auditor report's failure to discuss these matters in depth and to instead view the LACFA-County relationship as a traditional landlord-lessee relationship, does a disservice to the public.

Throughout all areas of the audit report, the State Auditor provides an incomplete picture and this necessitates significant revisions to the document. Furthermore, several conclusions in the report lack accurate facts or sound analysis. The comments below address important revisions that the State Auditor should make in order to provide a more balanced final report.

I. BACKGROUND AND HISTORY OF THE LOS ANGELES COUNTY FAIR ASSOCIATION AND ITS RELATIONSHIP WITH THE COUNTY

Over the last seven decades, the County and LACFA have shared a mission to promote agriculture, horticulture, forestry and viniculture in the region. Through the years, the County has experienced social change, economic change, and political change, yet the relationship between the County and LACFA has endured—and in fact, thrived.

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This sense of community is at the heart of the unique partnership between the County and LACFA. The Los Angeles County Fair began in 1922. Nearly a century later, the Fair is one of the most prominent fairs in the United States, entertaining and educating millions. The Fairplex property has also changed. In the 1940s, LACFA deeded much of the Los Angeles Fairgrounds to the County. The Fairplex is now one of the most valuable properties in the County's real estate portfolio, and houses a museum, hotel, and conference and trade center, among other assets. Although the County supported these endeavors, LACFA financed most of this development without County support. Today, the facilities at the Fairplex are worth over \$60 million, but cognizant of its longstanding commitment to community investment, LACFA will eventually transfer ownership of these facilities to the County, just as it did with the land. Unfortunately, the draft report only makes passing reference to these facts and fails to connect them to the Lease.

The remarkable growth of the Fairplex exemplifies what LACFA can do when aligned with the County. LACFA employs nearly 1,500 workers annually to support the Fair. With the construction of the hotel and conference center, over 160 full time equivalent jobs poured into the County, providing a direct impact in the lives of County residents. These jobs provide income and spur additional economic growth in Pomona. Parents can support their families and afford housing. Businesses have more customers. Residents pay their taxes. By extension, the County and LACFA are able to realize their goal of enriching the lives of others. None of this happens without LACFA and the County working together, yet the connection between the Lease and job creation is not drawn in the State Auditor's report.

Moreover, LACFA's work goes beyond hosting a fair, building a hotel, and creating jobs. Supported by the development of the Fairplex, LACFA supports several affiliated non-profit organizations and community programs. For instance, LACFA operates and maintains a yearround 5-acre educational farm at the Fairplex (known as "The Farm"). LACFA invites over 175,000 students to the Farm annually to learn about agriculture, horticulture, forestry and viniculture. LACFA also oversees numerous programs such as (1) The Learning Centers, (2) the Career and Technical Education Center, (3) Junior Fair Board, (4) Millard Sheets Art Center, and (5) the Alex Xydias Center for Automotive Arts, among others. These programs provide vocational training in auto mechanics, arts, landscaping, and other skills. Finally, LACFA administers The Child Development Center, which offers early education for 250 children ages 8 weeks to 6 years, approximately half of whom are from low-income families. The State Auditor reduces a discussion of this important work to a handful of footnotes.

LACFA also continues to make a tremendous impact in the community. In 2016, over 1.3 million people visited the Fairplex, an increase of 3.18% from the prior year. LACFA also paid millions in taxes and other fees to the County and the City of Pomona. Furthermore, LACFA promotes numerous community events. This includes hosting of annual competitions for craft beer, extra virgin olive oil and dairy products, hosting the 48th District Agricultural Association Schools' Agriculture and Nutrition Fair, hosting AGDAY LA, hosting the SoCal College Fair, and overseeing the Upland Lemon Festival and the Los Angeles Oktoberfest, just to name a few. Again, the State Auditor overlooks these facts.

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II. COMMENTS TO DRAFT REPORT

A. CALCULATION OF RENT

In 1948 and 1988, the County and LACFA established long-term ground leases and operating agreements. The current Lease expires on December 31, 2043. The Ground Lease is performance-based; the County receives payments based on certain percentages of the gross revenue from Fair and non-Fair events. In this way, the Lease is community-focused; if more people come to the Fair and visit the Fairplex, the County receives more rent. Thus, the County encourages LACFA to find ways to bring people together at the Fairplex. However, the State Auditor ignores that the Lease is ultimately a device used to achieve the greatest community benefit for the County and its residents—the Lease does not exist to simply make money.

The State Auditor finds that hotel and affiliate revenue should be included in the Lease's definition of "Gross Revenue." However, requiring LACFA to pay a share of Gross Revenues to the County on the businesses that it operates is inconsistent with the performance-based nature of the Lease. As discussed below, charging rent based on Gross Revenue: a) creates a disincentive and unfair disadvantage for LACFA to develop new business on the property compared to the economic arrangement that third parties have, b) discourages LACFA from trying profitable businesses that could better utilize the Fairplex property and pay rent to the County, c) discourages LACFA from looking for ways to diversify income streams and generate net income, and d) ultimately allows for fewer dollars for reinvestment back into the County's asset.

The Lease does not contain any provision that would expressly require the inclusion of hotel or affiliate revenue in the rent. Section 3.01 of the Lease states "For each Lease Year, Fair Association shall pay as Rent to County the percentages of *gross revenues* derived from the use of the Property and *received by Fair Association* during such Lease Year as hereinafter set forth." (Emphasis added.) Similarly, Section 3.07(a) of the Lease defines "Gross Revenue" to include "any and all money and cash receipts ... *received by Fair Association* from use of the Property ..." (Emphasis added.) Accordingly, the Lease makes three things clear:

- 1. Rent is calculated based on "Gross Revenue,"
- 2. "Gross Revenue" is a term-of-art under the Lease, and
- 3. Under the Lease, Gross Revenue—and therefore Rent—is solely calculated based upon items of value (such as cash or money) "received by Fair Association."

The obvious implication is that if monies are *not* received by LACFA, monies are *not* included as part of Gross Revenue and are therefore excluded from Rent. This view of Rent under the Lease—adopted and put into practice by the parties for over 25 years—is not adequately addressed in the report. In fact, the State Auditor comes to a contrary conclusion.

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Both the County and LACFA agree that revenues "received by" LACFA are included in the Rent, but revenues "earned by" LACFA are not. In a letter provided by the County Chief Administration Officer dated September 11, 2006 (cited in the report but buried in small font provided at Figure 4), the County stated as follows:

We [the County] agree that revenues earned by [LACFA's separately owned affiliates] and the Hotel do not meet the definition of Gross Revenue and as such shall not be included in the County lease calculation.

Id. County Counsel affirmed this interpretation of the Lease, and the Board of Supervisors received notice of the same. See infra (citing 2005 Independent Auditor Report). The report fails to quote this language and completely ignores County Counsel's affirmation.

The State Audit report goes on to state that "[r]evenues earned by the hotel . . . falls under the lease's definition of gross revenues because the hotel is not a separate legal entity, but rather an asset owned by the association." *See* Report at 15. The existence of a separate legal entity is irrelevant. LACFA earns money from the hotel (and LACFA affiliates) in the same way it earns money from every company doing business with LACFA. A third party (Sheraton) operates the hotel under a management agreement. When customers visit the hotel and pay for rooms, events, etc., *the Sheraton—not LACFA—receives cash* coming into the hotel. LACFA earns amounts set forth pursuant to the management agreement.

Third parties, affiliate companies, the hotel—in fact, every company or vendor doing business at LACFA—receive cash from customers but pay negotiated rents or fees to LACFA. The negotiated rents or fees are monies "received by" LACFA. LACFA adds these amounts to the Gross Revenue as defined under the Lease and calculates the Rent. The County does not receive gross revenues from third party or affiliate companies so it makes little sense to treat the hotel differently, especially when the monies at issue here are "received by" Sheraton. The State Auditor should accurately report the way by which LACFA earns monies from the hotel. Money "earned by" LACFA is not included in Rent. The State Auditor should make this point clear and prominent in its report.

Since the early 1990s, LACFA and the County have excluded hotel and affiliate revenues from rent. Several independent audit firms conducting County-requested reviews, dating back as far as 2000 (beyond the scope of the audit), demonstrate that the payment of rent consistently excluded hotel and affiliate revenues from the definition of "Gross Revenue." Every available audit report is addressed to the County Board of Supervisors with courtesy copies to the Boardappointed Audit Committee. The independent auditors confirm (1) the historic treatment of hotel revenue as excluded from rent under the Lease, (2) the consistent practice between the parties, (3) the CAO's interpretation of the Lease, and (4) County Counsel's review and approval of the same.

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The State Auditor ignores the following:

Report	itent	
2000 Auditor: Williams & Tucker Accountancy Corp. Addressed to Los Angeles County Board of Supervisors	 The independent auditor conducted "a review of the Association's compliance with the Operating Lease Agreement and related amendments regarding rent payable to the County for the lease year 2000." The independent auditor concluded "[w]e believe the Los Angeles County Fair Association has <i>complied with the Ground Lease and Operation Agreement in all material respects</i>." Additionally, the independent auditor stated that it "verified the Association's schedule of rent payable to the County, including gross revenues, and schedule of rent credit allowable." The independent auditor concluded "[i]n our opinion, the attached schedule of Year to Date County <i>Lease Calculation fairly reflects the rents due to the County of Los Angeles</i> in a manner consistent with terms of the ground lease and operating agreement." 	
2001 Auditor: Conrad and Associates, LLP Addressed to Los Angeles County Board of Supervisors	1. The independent auditor reports that "[t]he difference between amounts reported on the lease calculation schedule <i>excluded hotel</i> <i>revenues and interest income which are not required to be</i> <i>included in the lease calculation per lease</i> and amendment to lease agreement."	
2003 Auditor: Conrad and Associates, LLP Addressed to Los Angeles County Board of Supervisors	 The independent auditor acknowledges that differences between total revenues stated in LACFA's audited financial statements and its lease calculation schedules result from the inclusion of hotel revenue (among other revenue streams) in the audited financial statements but not in the lease calculation schedules. The independent auditor states "[t]he reconciling items noted above <i>appear to be in accordance</i> <i>with the Lease Agreement.</i>" 	
2004 Auditor: Conrad and	1. The independent auditor states that " <i>[c]ertain revenue earned by the Fair Association were not considered to meet the definition of </i> <i>'gross revenues'</i> as defined in the lease agreement, and were accordingly not included as part of the County Lease	



Associates, LLP	Calculation." Hotel revenue is specifically identified as one of the
Addressed to Los Angeles County Board of Supervisors	 assets excluded from the definition of gross revenues. The independent auditor also states "[t]he treatment of subsidiary revenue and Hotel revenue is unclear in the lease agreement. It is the opinion of the Chief Administrative Officer (CAO) that the Fair properly excluded the gross revenues earned by the Hotel "
	3. The independent auditor states that "gross revenues earned by the Hotel are not included as part of the County Lease Calculation. This treatment is consistent with prior years."
	4. Approximately one and a half months after the independent auditor published the 2004 audit report, <i>the CAO issued a letter clarifying that Hotel revenue was excluded from the definition of "Gross Revenues" under the Ground Lease.</i> The CAO reasoned that even though hotel revenues are "earned by" LACFA, these revenues are not "received by" LACFA. <i>As noted below, County Counsel approved the CAO's interpretation.</i>
2005 Auditor: Mayer Hoffman McCann, P.C. Addressed to Los Angeles County Board of Supervisors	 The independent auditor repeated the analysis provided in the 2004 audit. However, the independent auditor provided an update explaining "[w]e had previously recommended that the County consider amending the lease agreement (or at a minimum prepare a letter of correspondence) to clarify the definition of gross revenues to specifically address the inclusion or exclusion of the gross revenues earned by [the hotel] Subsequent to June 9, 2006, <u>the County Counsel reviewed and approved the CAO's letter of understanding which clarifies the definition of 'Gross Revenues' per the Agreement</u>."
2006 Auditor: Mayer Hoffman McCann, P.C. Addressed to Los Angeles County Board of Supervisors	1. The independent auditor states that "Gross Revenues earned by the Hotel are not included as part of the County Lease Calculation, which is consistent with the letter of understanding from the County Chief Administrative Office dated September 11, 2006."
2007-11	 The independent auditor states "[v]ariances between revenues report[ed] in the Lease Calculation Schedule and those reported in



Auditor: Vasquez & Company, LLP	2.	the Association's audited financial statements were due to elimination of intercompany transactions and other Association revenues not subject to the County lease."
Addressed to Los Angeles County Board of Supervisors		Schedule VI of the report excludes "Hotel revenues" as part of its "Revenue Reconciliation."

As a matter of law, the State Auditor's refusal to give adequate weight and deference to the interpretation of the Lease ascribed by the County and LACFA (and validated by the independent auditors and County Counsel) is unprecedented. Courts routinely find that the conduct of the parties is the "most reliable evidence" of what a written agreement means. California case law explains:

[A] construction given to [a contract] by *the acts and conduct of the parties* with knowledge of its terms, before any controversy has arisen as to its meaning, *is entitled to great weight, and will, when reasonable, be adopted* and enforced by the court.

* * *

The *conduct of the parties* after execution of the contract and before any controversy has arisen as to its effect *affords the most reliable evidence* of the parties' intentions. This rule of practical construction is *predicated on the common sense concept that 'actions speak louder than words.'* Words are frequently but an imperfect medium to convey thought and intention. *When the parties to a contract perform under it and demonstrate by their conduct that they knew what they were talking about* the courts should enforce that intent.

Employers Reinsurance Co. v. Superior Court (2008) 161 Cal.App.4th 906, 921 (citations omitted) (emphasis added).

The State Auditor ignores that the longstanding interpretation of the County and LACFA "is entitled to great weight" and "affords the most reliable evidence" of how rent under the Lease should be calculated—not some interpretation recently conceived by the State Auditor. The County and LACFA have treated hotel rent in a consistent manner since the opening of the hotel 26 years ago. There is no basis for the State Auditor's contrary opinion, and this error should be corrected in the report. Moreover, there is a formal writing supporting the historic treatment of hotel revenues under the Lease.

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The report only cites two documents to support its interpretation of the Lease. First, the report cites to a document drafted by an Assistant Administrative Officer dated June 1990 (approximately two years before the hotel was constructed), which supposedly "indicates" that hotel revenue would be included in the Lease.¹ See Report at 15. Second, the report cites a 1992 letter by the same Assistant Administrative Officer to an unidentified state agency that apparently "suggested" the same. *Id.* As evidenced by the equivocal language used by the State Auditor in the report, neither document comes to any conclusion regarding rent. It should be obvious that this material cannot evidence an agreement or understanding *between* the parties.

Moreover, the cited letter takes a position that is inconsistent with the County's Chief Administrative Officer. It is also unclear whether the State Auditor actually interviewed the author of this correspondence, particularly when it so clearly contradicts the historic practice of the parties. "Indications" or "suggestions" should not take precedence over "the most reliable evidence" of how rent should be calculated—the conduct of the parties, their documented course of performance, numerous independent reports, and correspondence confirming that hotel (and affiliate) revenue is not included in the Rent.

By relying on the 1990 and 1992 correspondence, the State Auditor's report is inconsistent with Generally Accepted Government Auditing Standards. Under those standards, "[a]uditors must *obtain sufficient, appropriate evidence* to provide a reasonable basis for their findings and conclusions." *See* GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS at § 6.56 (emphasis added). Similarly, "[e]vidence is *not sufficient when*... *using the evidence carries an unacceptably high risk* that it could lead the auditor to reach an incorrect or improper conclusion...." *Id.* at § 6.71(b) (emphasis added). No audit report, financial record, or document between the parties permits the State Auditor to conclude that hotel or affiliate revenues were ever included as part of rent. Compared against the conduct of the parties and express writings interpreting the Lease, the 1990 and 1992 correspondence carries an "unacceptably high risk" that it will lead to an incorrect or improper conclusion.

As a practical matter, the exclusion of hotel revenues from rent is consistent with the spirit of the Lease. Under the Lease, ownership of the hotel eventually vests in the County, not LACFA. The County did not finance the development of the hotel, nor does the County pay for maintenance or building upgrades, yet at the end of the Lease, the County will receive a fully functional asset worth several millions of dollars. This connection between hotel revenue and the Lease should be made when discussing rent in the Report.

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¹ From what we understand, the 1990 letter from the Assistant Administrative Officer "indicates" that the County expected to receive 3.5% of \$1.1 million in revenues from the hotel. While we are not sure where the \$1.1 million number comes from, it is clearly not Gross Revenues – hotel revenues from 1992 to 1995 were approximately \$2.3 million (half-year), \$5.4 million, \$5.95 million, and \$6.4 million, respectively. For perspective, the debt service alone on the hotel was around \$1.8 million.



Additionally, the hotel allows LACFA to host more events and bring more people to the Fairgrounds, which in turn increases the Rent paid to the County. Affiliate revenue also allows LACFA to continue with its non-profit mission. The report states that "[t]he association receives relatively little public funding or other assistance from local governments." *See* Draft at 7. As it follows, additional revenues allow LACFA to make a greater impact in the community. The report provides no detail on how these revenues are used or how they benefit the County. The State Auditor should at least add the following facts to its discussion concerning the use of hotel and affiliate revenue:

- Hotel and affiliate revenue help pay for the FairKids Field Trip Program, inviting over 150,000 students to the Farm annually to learn about agriculture, horticulture, forestry and viniculture.
- The revenues also support programs such as The Learning Centers, the Career and Technical Education Center, Junior Fair Board, Millard Sheets Art Center, the Alex Xydias Center for Automotive Arts, the Ambassador Program, and Adopt a School program. These programs provide vocational training in auto mechanics, arts, landscaping, leadership, and other skills.
- Finally, operating profits are used to administer The Child Development Center, which offers early education for 250 children ages 8 weeks to 6 years, approximately half of who are from low-income families.

The State Auditor also fails to consider that the hotel generates millions in tax revenue. Since the completion of the hotel, the City of Pomona has received more than \$13 million in transient occupancy tax. The hotel has also generated millions more in other fees and taxes and is one of the largest employers in Pomona, providing approximately 160 full-time equivalent jobs to local residents. LACFA provides a substantial economic impact to Los Angeles County. According to the last report done on the Los Angeles County Fair's economic impact by the Los Angeles Economic Development Corporation in 2003, LACFA's impact exceeded \$300 million. Adjusted for inflation, that figure could be as much as \$400 million or more today.

Having not been involved in the negotiation or administration of the Lease, the State Auditor does not appreciate how the hotel and LACFA's affiliates fit within the overall relationship between the County and LACFA. Under Generally Accepted Government Auditing Standards, the State Auditor should have obtained an understanding of "[a] program's strategic plan and objectives; and the external factors that could directly affect the program." *See* GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS at § 6.13. Instead, the State Auditor has its own interpretation of the Lease, disregards the interpretation of the parties, ignores the parties' course of performance, and gives no weight to the opinions of several independent auditors. This reveals serious errors in the State Auditor's analysis. 55



B. <u>EXECUTIVE COMPENSATION</u>

The State Auditor's review of executive compensation speculates that "[p]erhaps because the county has not collected rents, the LA Fair was able to provide executives much higher compensation than executives of other large fairs in California." *See* Report at 27. There is no basis for this statement—it is unfair and unfounded, especially in light of other conclusions in the report. As discussed below, the State Auditor acknowledges that LACFA is a non-profit, and not required to implement compensation at levels that public entities must implement. This explains differences in compensation. Similarly, the report acknowledges that the Los Angeles County Fair employs more people than every fair cited in the report *combined* and that LACFA generates more revenue than any fair. This also explains the differences in compensation.

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Comparing the Los Angeles County Fair to other, smaller fairs in California run by public entities departs from what the State Auditor promised to investigate. The State Auditor's January 13, 2016 "Analysis of Audit Request" states that it would "[c]ompare the association's executive compensation with executive compensation of *organizations of similar size*." State Auditor Howle testified before the Joint Legislative Audit Committee that "[Assemblymember Freddie Rodriguez] is interested in having us compare the executive compensation for individuals at the Association with executive compensation of *organizations of similar size*." *See* Joint Legislative Audit Committee Testimony, January 13, 2016 at Min. 16:50-58. Audit Objective No. 3 in the report confirms that the State Auditor was to "[c]ompare the association's executive compensation with executive compensation of *organizations of similar size*." Despite these instructions, every fair cited by the State Auditor bears absolutely no resemblance to the Los Angeles County Fair Association, which operates much more than a fair.

As the report explains, LACFA receives "relatively little" public funding and does not receive funds from the State's Fairs and Exposition Fund. However, the State Auditor compares LACFA to public entities and those provided with state funding. LACFA is not subject to the same oversight as state-affiliated fairs. Likewise, the state-affiliated fairs exclusively follow state-mandated salary structures regardless of size, attendance, or revenue. *See e.g.* State of California Exempt Pay Scale as of August 31, 2016 at p. 51 ("NA00" salary classification exclusive of retirement and health costs). State employees also enjoy long-term retirement benefits as part of their employment with the State, whereas LACFA employees do not enjoy this opportunity for continued benefits after retirement. The State Auditor should note these discrepancies in its report on executive compensation as well as in its table of "Key Differences" between District Agricultural Associations and LACFA. *See* Report at 7 (Table 1); Report at 27-30.

The State Auditor only cites four fairs—the report does not consider non-profit organizations in similar industries, review other non-profit or for-profit organizations in Los Angeles, or study fairs of comparable size. Two of the fairs cited in the report, CalExpo (Sacramento Fair) and Alameda County, have revenues of approximately 1/3 of the Los Angeles

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County Fair. See Report at 29 (Figure 2). A third fair, the Orange County Fair, has revenues of approximately 1/2 of LACFA. Id. The State Auditor never explains why it believes these fairs are of "similar size" to Los Angeles. All three are substantially smaller. And obviously, none run a Hotel and Conference Center, or oversee multiple year-round businesses and activities on an almost 500-acre campus. At a minimum, the State Auditor should identify and discuss these differences in the report.

Of the fairs cited by the State Auditor, the San Diego County Fair is closest to the Los Angeles County Fair by revenue, but the revenues in San Diego are below those generated by LACFA. This is quite an accomplishment for LACFA given the practical limitations it deals with compared to San Diego. LACFA does not have a world-class turf club, which contributes to more than half of all the organization's revenue streams, nor is it located in a very affluent seaside community with great year-round weather. LACFA is away from major tourist destinations and in a location where high summer temperatures can create fair attendance issues. Still, LACFA's operations do tremendously well financially and are outstanding community resources. In fact, LACFA's gross revenue numbers under its prior CEO more than doubled.

The State Auditor's citation to the San Diego County Fair highlights the flaws in the State Auditor's report. The report states "we note that the San Diego County Fair generated revenue similar to that of the LA County Fair in 2014, yet its CEO received far less total compensation." *See* Report at 28. This statement is misleading. The state-affiliated 22nd District Agricultural Association ("DAA") shares the administration of the Del Mar Fairgrounds with a separately managed entity, the Del Mar Thoroughbred Club ("DMTC"). The State Auditor never mentions the shared responsibility in San Diego, but this is central to understanding the executive compensation and management in San Diego. The combined executive compensation of the administrative units in San Diego, excluding employee benefits and insurance, is approximately \$3.7 million—several hundred thousand dollars more than the combined compensation of LACFA executives.² The DMTC should be addressed in the report.

The State Auditor also ignores that San Diego privatized many of its operations through the DMTC. According to the 2016 DMTC media guide, the DMTC hosted the following notable events: (1) Friday concert series following horse races, (2) a State BBQ Championship, (3) Food Truck Festival & Craft Beer Fest, (4) Reggae Festival, (5) Western Regional Chili Cookoff, (6) various weekend concerts, and (7) Del Mar Pizza & Beer Fest. The DAA is responsible for other programing. By comparison, LACFA is responsible for providing, arranging, or overseeing all programming. It hosts the Los Angeles County Fair and the numerous non-fair events. Some of these events have included competitions for craft beer, extra virgin olive oil and dairy products, the

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² See <u>http://www.delmarfairgrounds.com/pdf/2016/board/2016_01_12_DMF-packet.pdf</u> at p. 42 (reporting combined projected annual combined salaries of \$3,683,500 *excluding* employee benefits and insurance) (last accessed October 31, 2016).



48th District Agricultural Association Schools' Agriculture and Nutrition Fair, AGDAY LA, the Upland Lemon Festival, Oktoberfest, as well as programming for numerous community programs and affiliated non-profits. LACFA does significantly more with less than San Diego.

Furthermore, the State Auditor does not cite executive compensation studies prepared by the 22nd District DAA (or any other fair), even though it apparently considers San Diego to be relevant. On or around August 2015, the Del Mar fairgrounds commissioned a study on executive compensation and it showed that its executives were "woefully undercompensated" and that the agency went on record saying the following: "*We at the [San Diego] DAA have not kept up with the times in terms of compensating senior executives* in line with the responsibilities they have . . . If we had to go through the market for replacement of senior staff . . . we wouldn't be able to offer a competitive package. And that's a concern of the board." (Emphasis added.)³

While the report overlooks the revenue and administrative differences between Los Angeles and other fairs, the State Auditor states, "[o]f particular note is that the association has significantly more employees than the other organizations do." *See* Report at 30. However, this is just a part of the difference between the job responsibilities for executives at LACFA from those at San Diego, Alameda County, Orange County, Sacramento/Cal Expo, or any other fair in this state. As noted above, LACFA employs more people than the San Diego, Alameda County, Orange County, Sacramento/Cal Expo fairs combined. Additionally, LACFA is a community-based organization in ways that San Diego, Alameda County, Orange County, and Sacramento/Cal Expo are not. The State Auditor briefly reports that LACFA supports certain non-profits, but fails to provide details, thereby providing inadequate context concerning LACFA's operations.

LACFA serves more than 150,000 students with hands-on, educational programming each year through its FairKids program. In addition, more than 1,000 students benefit from LACFA's year-round educational programs each month. The majority of these students come from socioeconomically challenged communities and benefit from programs that complement the education they receive through the public education system and help prepare them for success in further education and careers. With the exception of about 50% of LACFA's tuition-paying Child Development Center students, these participants benefit from these programs at no cost. LACFA's community and educational programming are substantial and significantly exceed the programming of other fairs. LACFA's CEO and its executive staff lead these efforts. Their compensation is also, in part, recognition of this effort.

Furthermore, the State Auditor renders conclusions without the expertise of compensation experts or a market study supported by competent evidence. In a December 22,

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³ See <u>http://www.delmartimes.net/news/local-news/del-mar/sddmt-del-mar-fairgrounds-pay-study-2015aug20-story.html</u> (last accessed October 31, 2016).



2011 letter from independent compensation experts to the LACFA Board of Directors' Finance Committee, experts opined:

Based on our evaluation of Fairplex's executive compensation program, we find overall a competitive program, appropriate for an organization of Fairplex's size, scope of operations, and taxexempt status, and we find no problematic or excessive pay practices. On that basis, we have issued our <u>unqualified</u> opinion on the reasonableness of Fairplex's compensation program . . ."

(Emphasis added.) While the State Auditor notes that independent experts reviewed the reasonableness of LACFA's compensation, the State Auditor fails to address the fact that the experts made an "unqualified opinion" as to the reasonableness of that compensation. At a minimum, the State Auditor should reference the third party "unqualified opinion" in its report.

For its review of LACFA, the State Auditor only looks at state compensation schedules. According to the expert opinions in the 2011 Fredric W. Cook Compensation Report (Fredric W. Cook also provides compensation review for the California Attorney General), there are multiple Los Angeles-area non-profits where executive compensation is similar—or exceeds—that of LACFA's executives. This trend is also evidenced at fairs outside of California. For example, the State Fair of Texas reported annual revenue of less than half of LACFA, yet the salary of LACFA's CEO is on par with the CEO of the Texas State Fair. State Auditor should also include this information in its report.

Whether it is overseeing unparalleled community programming, more than doubling revenue, making the Los Angeles County Fair once again a safe, enjoyable, and educational experience, or running the hotel and conference center, a lot has happened under LACFA's executive compensation scheme and under the stewardship of its former CEO. We urge the State Auditor to be balanced in its comparisons. A proper comparison should include organizations of similar size regardless of whether those organizations hosted fairs. Moreover, if other fairs are considered, the State Auditor should also consider executive compensation at fair organizations of similar size, regardless of whether they are based in California.

C. <u>RV PARK</u>

The Joint Legislative and Audit Committee did not ask the State Auditor to review the RV Park. Audit objective No. 10 states that the auditor is to "Review and assess other issues that are significant to this audit." The RV Park represents a minor part of the revenue stream for the County. The report acknowledges that LACFA promptly paid HCD fees, corrected safety issues and is in full compliance with applicable law. Moreover, the State Auditor does not reference or discuss the numerous types of inspections LACFA passes each year, ranging from public health

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inspections, CalOSHA reviews, and other inspections from other regulatory agencies. Accordingly, it is unclear how the State Auditor can consider the RV Park "significant."

Without any explanation of why the report even addresses the RV Park, the State Auditor dedicates three pages to alleged violations, only to state at the very end that HCD "determined that the RV Park was in compliance with the applicable regulations." *See* Report at 33. An alternative, more objective analysis would have removed this section of the report in its entirety, or at least started by explaining that LACFA is currently in compliance with applicable law. As drafted, the report leaves the impression that LACFA was somehow dilatory in remedying issues at the RV Park.

When HCD discovered issues at the RV Park, LACFA took immediate steps to remedy the situation. The report discusses problems at the RV Park communal bathrooms. However, the report does not mention that LACFA immediately and completely refurbished the communal bathrooms shortly following the HCD inspections. Similarly, the State Auditor provides pictures of violations but fails to include pictures of the repaired facilities. These refurbishments included new windows, mold removal, new shower curtains, new soap dispensers, and new plumbing, among other work. At a minimum, the State Auditor should provide context to the citations by discussing and graphically depicting LACFA's remedial efforts.

Similarly, the report discusses electrical service issues and "other violations" at the RV Park. The report points out that LACFA took "immediate steps" to upgrade the electrical system, and also reports that the "other violations" were remedied, but fails to provide context as to how these issues arose, and why in some cases, additional time was needed to correct problems. These issues, especially those that remained after May 2016, were caused by tenant improvements. LACFA informed HCD of these problems. In response, LACFA hosted meetings with individual tenants, HCD, and LACFA's construction contractor to fix outstanding issues. However, remediation was not as simple as fixing a hole or even renovating communal bathrooms. The State Auditor should address this in the report.

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D. <u>ADDITIONAL ERRORS AND OMISSIONS IN THE REPORT</u>

There are a handful of additional issues in the report where a more balanced approach is appropriate. These issues are addressed below.

First, the report notes that there is approximately \$70,000 in accrued hotel rent due to financing agreements with lenders, which require the payment of construction debt prior to the payment of hotel usage fees to the County. The State Auditor raises concerns as to when and whether LACFA will pay this amount. LACFA has never denied an obligation to pay. More importantly, despite criticizing the agreed-to arrangement for rent abatement, the State Auditor omits several important facts. For instance, LACFA built the hotel in the early 1990s, at a time

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when interest rates were higher than they are today. Over the last 25-plus years, LACFA refinances debt to secure the best interest rates available. Through these efforts, LACFA has reduced its loan financing rates from 10% to a blended rate of 3.6%—saving an amount that far exceeds \$70,000. Reducing LACFA's debt obligations benefits the County. LACFA's debt refinancing is a sound business practice that should be addressed the report.

Second, the report concludes the County "has lost out on roughly \$350,000 in total rent revenue related to the conference center since it opened in 2012." *See* Report at 21. However, the State Auditor ignores that rent for the Conference Center assumed LACFA would manage the Conference Center. Prior to opening, LACFA assigned management to Sheraton. Because of this change, rather than rent, LACFA paid approximately \$300,000 in possessory interest tax to the County. Furthermore, the County rent credit financed the Conference Center. The County provided \$12 million in credits for a facility that cost approximately \$30 million to construct. Ultimately, the County will have saved \$18 million on a project where it did not have to advance any funds and which will be completely owned by the County in the future. The County also gets free or below market access to the Conference Center. The State Auditor should add these facts in its discussion of the Conference Center.

III. <u>CONCLUSION</u>

LACFA and the County have had a fruitful partnership that has served the local community for several decades. LACFA plays a vital role that is both complementary to the County, and as a completely separate organization, provides services different from what the County traditionally offers its residents. However, the report fails to take this into full account by misinterpreting the Lease, providing a flawed analysis of executive compensation, and providing a slanted or misleading view of important facts. The report is correctable, but as it stands, many of its central conclusions are neither accurate nor helpful.

Thank you for your time and attention to this matter. LACFA looks forward to discussing these issues further.

Very truly yours. Victor De la Cruz

cc: Mr. Joe Meyer, State Auditor
 Mr. Nicholas Kolitsos, State Auditor
 Heather Kendrick, Esq., Senior Staff Counsel, State Auditor
 George Kieffer, Esq., Manatt, Phelps & Phillips, LLP

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Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE LOS ANGELES COUNTY FAIR ASSOCIATION

The Audit Committee asked us to audit the county's oversight of the association, not the association itself. As a result, we audited the county's oversight of its lease with the association. As a courtesy to the association, we provided it with a redacted draft copy of the audit report to allow the association an opportunity to review it and raise any concerns regarding the accuracy of information in the report. Despite the association's many disagreements with our analysis and conclusions that it expressed in its 17-page response, the information the association provided did not cause us to change any factual statements in the report or any of our conclusions and recommendations.

To provide clarity and perspective, we are commenting on the response to our audit report from the association. The numbers below correspond to the numbers we placed in the margin of the association's response.

While the association may not have received direct funding from the county since 2006, the association has received other assistance from the county. As we point out in Table 2 on page 9, the association received a total of \$6.4 million in other assistance from the county for the years 2008 through 2015 in the form of a rent credit to help cover the costs of the conference center's construction.

We only compared the association's revenue and number of employees against those of other Class VII fairs for 2014, as shown in Figure 6 on page 29 and Table 6 on page 30. We did not analyze this information for the other years in our audit period.

We conducted this audit in accordance with generally accepted government auditing standards and the California State Auditor's thorough quality control process. In following audit standards, we are required to obtain sufficient and appropriate audit evidence to support our conclusions and recommendations. As is our standard practice, we engaged in extensive research and analysis for this audit to ensure that we could present a thorough and accurate representation of the facts. Furthermore, we note that the association's response does not indicate any factual errors in our draft report, but rather a different interpretation of the same facts. 1

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- We present limited historical information on pages 3 and 4. In our report we present the results of our audit of the county's oversight of the association's activities, not a history of the relationship between the association and the county. Nonetheless, according to the association's website, between 1941 and 1952 the association deeded a total 421 acres of the land it owned to the county, and in return the association received a long-term ground lease. This action occurred long before the association and the county entered into the current lease, long before the association made significant changes to its business structure—such as establishing its for-profit subsidiaries—and long before the association built its hotel and conference center.
- (5) The association did not, as it asserts, receive a "highly redacted draft." The association received a draft with certain portions of the report redacted. The association did not see text which summarized text provided to the association, text which pertained solely to entities unrelated to the association, and recommendations we made to the county. In addition, we met with the association in September 2016 for the purpose of holding a confidential exit conference at which we distributed excerpts of the draft report pertaining to the association so that the association could provide feedback and perspective to us, which is an important step in our quality control process. During this meeting we also noted that because we have no recommendations for the association, we would not be seeking a response from the association. However, we subsequently agreed as a courtesy to provide the association with a final redacted draft so it could provide any comments or concerns it might have had about the draft report.
- (6) We stand behind the analyses, conclusions, and recommendations included in our report. In several areas of its response the association makes certain claims about information that the association believes we should have included in our report but that we note is outside the scope of our audit. We have provided enough background information in our report to support the conclusions we reached.
- The association is misrepresenting the timeline related to the county's understanding of the rent due from the hotel's operations. We acknowledge that the county confirmed in 2006 that revenue earned by the hotel did not meet the definition of *gross revenues* but that fees and other payments received by the association from the hotel are included in the calculation. However, this only supports our finding that the county's expectation of the rent it would receive from the hotel's operations has changed since the hotel opened in 1992.

We note that the "single employee" the association so easily dismisses was acting in his official capacity as an assistant administrative officer when he represented the county's position to external parties, including the association, in his 1992 correspondence. We further note that although this "single employee" signed the correspondence, it was sent under the name of the county's then-Chief Administrative Officer. Finally, it is worth noting that the 2006 confirmation the association refers to was sent under the name of the county's then-Chief Administrative Officer, but was actually signed by an assistant administrative officer within the county.

The association misstates our conclusion. We state that the county's expectations of how much revenue the association would pay it in rent based on the hotel's operations changed considerably over time and that the county was unable to provide evidence as to why it allowed the association to exclude the hotel's revenue from the rent calculation. We note on pages 13 and 15 that revenue earned by the hotel falls under the lease's definition of gross revenue because gross revenue includes any and all money and cash receipts received by the association for its use of the Fairplex and, as the hotel is not a separate legal entity from the association, the association receives the hotel's revenue. In addition, we state on page 19 that the association should have been paying rent based on the hotel's revenue under the terms of the lease. As we point out on Figure 4 on page 14 and in the text on page 15, the county appears to have had a similar understanding around the time it entered into the lease. On pages 19 and 20 we provide the association's perspective on some of the benefits the hotel provides to the region before noting that we found little evidence that the county had considered these possible benefits and made an informed decision when it allowed the association to exclude the hotel's revenue from the rent calculation.

Contrary to the association's assertion, we are hardly engaging in a "guessing game." On pages 13 and 15 of the report we note that revenue earned by the hotel falls under the lease's definition of gross revenue because gross revenue includes any and all money and cash receipts received by the association for its use of the Fairplex and, as the hotel is not a separate legal entity from the association, the association receives the hotel's revenue. Notably, the association includes the hotel's revenue in its financial statements and tax returns. In addition, we state on page 19 that the association should have been paying rent based on the hotel's revenue under the terms of the lease. The association has not provided any evidence to contradict this fact. Instead, the association asks us to perform deeper analysis of the association-county relationship and the economic environment of the early 1990s. What the association fails to point out is that the county and the association entered into the current lease in 1988 in part, as we note on page 4, to allow the

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association to construct a hotel. In addition, we show in Figure 4 on page 14 and in the text on page 15 that, based on correspondence in 1990 and again in 1992 from an assistant administrative officer with the county, it appears the county expected the association to pay a percentage of gross revenue generated from the hotel to the association. We further note that the assistant administrative officer sent a copy of the 1992 letter to both the association's president and its chief financial officer.

- (1) We cannot speak to the association's intentions at the time it deeded land to the county, but it appears the association is currently interested in maximizing its own revenue; otherwise it would not have started engaging in other business activities. In addition, if the association were not interested in maximizing its revenue, it would not include revenue as one of its performance targets in determining its executives' bonus and incentive compensation, as we note on page 28.
- (12) On pages 19 and 20 we provide the association's perspective on some of the benefits the hotel provides to the region before noting that we found little evidence that the county had considered these possible benefits and made an informed decision when it allowed the association to exclude the hotel's revenue from the rent calculation. In addition, the fact that any improvements the association makes on county-owned land at the Fairplex will become assets of the county upon termination of the lease is in addition to the county receiving rent from the association's gross revenue, not in lieu of the county receiving rent.
- We never stated that the lease exists solely to make money, as the association asserts. On page 4 we note multiple purposes of the lease, which included enabling the association to operate the LA County Fair, to develop the Fairplex, and to provide additional revenue to the county.
- On page 13 we note that lease's definition of gross revenue includes any and all money and cash receipts received by the association for its use of the Fairplex. As we make clear on page 22, unlike the hotel and conference center, these subsidiaries are legally separate entities. Therefore, their revenues are not includable in the rent calculation according to the terms of the lease.
- ⁽¹⁵⁾ Our understanding of the lease is based on a reading of the lease itself. In addition, as noted in Figure 4 on page 14, we reviewed documents from multiple sources to arrive at our conclusions as to how the understanding of the rent to be paid to the county from the operations of the association's hotel and conference center has changed over time.

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The association argues that it doesn't directly "receive" hotel revenue and, as a result, it is improper to include such revenue in the calculation of rent. The association's perspective defies common sense. As described on pages 16 and 17 of the report, the association contracted with an outside company to manage and operate its hotel. This management company is an agent of the association that acts on behalf of the association. This relationship does not change the association's ownership of the hotel or change the fact that the hotel's revenue belongs to the association as evidenced by the fact that the hotel's revenue is included in the association's financial statements and tax returns. According to the association's logic, the association could continue to hire external agents to manage even more of its operations to the point where it is no longer "directly" receiving any gross revenues, thereby unilaterally controlling the amount of rent due to the county. It defies common sense that a rental agreement would allow a tenant to unilaterally dictate the amount of rent owed.

Contrary to the association's assertion, we did not bury this information in small font in Figure 4. In addition to including it in Figure 4, we provide the relevant information in the text on page 19 where we note that "...the county issued a letter in September 2006 that stated in part, that revenue earned by the hotel did not meet the definition of *gross revenue* but that fees and other payments received by the association from the hotel are included in the calculation."

The association fails to mention that in the 2005 review, the reviewer also noted that, "Upon reading the definition of gross revenue per the Lease Agreement, it appears that revenues earned by Cornucopia, the Hotel, and Barretts may satisfy the definition of gross revenue as outlined in the Lease Agreement." Although the county issued a letter in September 2006 that stated in part, that revenue earned by the hotel did not meet the definition of gross revenue but that fees and other payments received by the association from the hotel are included in the calculation, we note on page 19 that the county could not provide a reasonable explanation as to why it agreed to this treatment.

Contrary to the association's claim, the fact that the hotel is not a separate legal entity from the association itself is very relevant. As we note on page 13, the terms of the lease state that the association must annually pay the county a percentage of the gross revenue it receives from its use of the Fairplex. In addition, we note on page 5 that the association's hotel constitutes a business activity of the association itself and is legally indistinguishable from the association. Therefore, as we state on page 19, under the terms of the lease the association should have been paying rent based on the hotel's revenue.

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- We state on page 19 that the reviewer of the 2004 rent calculation noted that the exclusion of the hotel's revenue from the rent calculation was consistent with previous years. We are not disputing the historical treatment of the hotel's revenue in the rent calculation. Rather, as we point out on page 16, we find it concerning that the county did not maintain adequate documentation to explain and support the exclusion of the hotel's revenue from the rent calculation.
- (21) The association presumes that the county shares its perspective. However, our audit of the county found that the county's expectation with respect to the collection of rent on the hotel's revenue has changed over time. Further, because the amount of rent related to the hotel has been subordinate to the association's bond debt since the 1990s, the county could not collect any rent related to the hotel's operations, and thus we are unable to evaluate the county's conduct with respect to collecting rent.
- 2 Contrary to the association's assertion, our understanding of the lease is based on a reading of the lease itself. In addition, as noted in Figure 4 on page 14, we reviewed documents from multiple sources to arrive at our conclusions as to how the understanding of the rent to be paid to the county from the operations of the association's hotel and conference center have changed over time. In addition, we further note that the assistant administrative officer sent a copy of the 1992 letter to both the association's president and its chief financial officer.
- The assistant administrative officer wrote this letter in 1990, approximately two years prior to the opening of the association's hotel. While the association may take issue with the \$1.1 million referenced in the letter, the county's expectation at the time was clearly that it would receive far more than just a percentage of the hotel fees due to the association, which are currently \$50,000 annually.
- We disagree with the association's comment that there is no basis for our statement. As we indicate on page 28 of the report, the association pays its executives a base salary, plus a bonus for meeting defined performance targets. Such targets may relate to revenue, operating income, and various strategic goals. When the county does not collect all rent due under the terms of the lease, the association retains additional revenue, which potentially contributes to the association's ability to pay its executives high salaries.
- We disagree with the association's assertion that we did not compare the association's executive compensation with organizations of similar size. In fact, we compared the association's executive

compensation with organizations of similar size in two ways. Firstly, we compared the association's executive compensation against that of other organizations that run Class VII fairs, the largest class of fairs in California, and provided the reasons on pages 28 and 30 of why its executive compensation is higher. Secondly, we note on page 30 that the association had commissioned two executive compensation studies during our audit period and that the consulting firms that performed the studies reviewed both for-profit and nonprofit organizations in a variety of industries. We also point out that both of these studies concluded that the association's executive compensation was generally reasonable. However, we were unable to provide additional context about these studies in our report because the association considers these studies confidential and we agreed that we would not present certain confidential information about the association's operations.

We were asked by the Audit Committee to compare the association's executive compensation with executive compensation of organizations of similar size. In Figure 6 on page 29 we show that the association's chief executive officer earned much higher compensation than executives in charge of organizations that run other large fairs in California in 2014 without including retirement and deferred compensation or other nontaxable benefits.

It appears the association means to refer to Figure 6 on page 29.

The information the association is providing does not alter our conclusions. When we compared the Class VII fairs, we considered various factors that impact the differences in executive compensation, including revenue, type of organization, and number of employees. Our analysis is not misleading. For example, although we noted that the 22nd District Agricultural Association responsible for operating the San Diego County Fair had similar revenue to the association in 2014, we also noted on page 27 that it is a public entity with set salary ranges, and we note in Table 6 on page 30 that it has fewer employees than the association. We also present a full-page graphic illustrating the association's business structure in Figure 2 on page 6, which provides adequate context concerning its operations.

We reviewed the Del Mar Thoroughbred Club's (DMTC) 2016 operating budget at the link the association provided and were unable to reach the same conclusion the association did. The \$3.7 million figure the association cites comes from a line titled "Salaries—annual administration and expense." There is no indication in the operating budget or in the accompanying narrative that this \$3.7 million contains only San Deigo's combined executive compensation, as the association claims it does. 26

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We are confused as to what point the association is trying to make when it states that we rendered conclusions not supported by competent evidence. We noted on page 30 that the association commissioned executive compensation studies by two different consulting firms, which they completed in 2008 and 2011. We reviewed these studies and presented an overall conclusion that these studies—which comprise the totality of the compensation studies completed during our audit period—found the association's executive compensation arrangement to be generally reasonable. In addition, we gathered sufficient evidence and did not need to engage compensation experts or perform a market study to conclude that the association's executives receive much higher compensation than the executives that run the other Class VII fairs in California.

(3) The association seems to have overlooked the fact that the Audit Committee asked us to identify the public funding received by the association over the past 10 years and the major categories of expenditures of those funds. As we note on page 8, in Table 2 on page 9, and on page 31, the Redevelopment Agency of Pomona provided the association with \$3.3 million in 2009 for the purchase of 50 affordable rental space covenants at the RV park. This represents a significant source of public funding to the association in our audit period. As we noted on page 31, although the association received millions of dollars related to the RV park, the RV park was cited for numerous health and safety violations after a tenant filed a complaint with the Department of Housing and Community Development (HCD).

32 It is worth noting that the association's response does not dispute the facts presented in our report. Regardless of why it took the association an extended period of time to ensure all the violations at the RV park were rectified, the fact is that the association took so long that in August 2016 HCD determined it needed to issue the association a notice of intent to suspend its permit to operate if the association did not correct the remaining violations within 30 days.

We do not understand the association's point. We did not take issue in our report with the association's refinancing of its debt. We simply noted on pages 18 and 19 that as a result of these refinancings, the association would not owe any rent to the county from the hotel's operations until 2039 under the current structure. We also noted on pages 18 and 19 that although the association refinanced its debt multiple times without explicitly informing the county or seeking its approval, the association is not required to give notice to the county when it refinances its debt according to the terms of the lease.

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Notwithstanding any amounts the association may have paid to the county in taxes, as we note on page 20, the association provided information to the county that suggested it would receive \$150,000 annually in increased rent revenue from the conference center's operations once the conference center was at full capacity, but the county has actually received no rent related to the conference center's operations.

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