INTRODUCTION TO LEASE AUDITING

Lease Audit: The systematic and analytical process by which an individual, the auditor, verifies that the landlord and the tenant are both in compliance with their respective contractual rights and obligations as set out in the lease that binds them.

Unlike a financial statement audit which may be governed by prescribed protocols, and standards, such as generally accepted audit standards ("GAAS") and generally accepted accounting principles ("GAAP"), lease auditing is not currently governed by any generally accepted standards. As such the landlord and tenant work with each other to determine the appropriate processes, requirements and procedures for completing a lease audit. The details of such processes and procedures may, or may not, be stated in the lease. Due to individuals' or organizations' need for verifying compliance with legal contracts, it is obvious that the concept of auditing leases must have begun as far back as when the first commercial real estate lease agreements were executed. However, as a business, the origin of the commercial real estate lease auditing industry is quite recent (within the last 40 years) but remains unclear.

To gain better insights into the intricacies of commercial real estate lease auditing, there are several interrelated areas which need to be understood. These areas include commercial real estate leases, parties to a lease audit, real estate, accounting, auditing, audit timing, audit scope, auditor requirements and qualifications, why audits are necessary, and types of errors found in an audit.

Understanding Commercial Real Estate Leases:

A commercial real estate lease agreement ("Lease") is a written legal contract between a landlord and a tenant that details the legal and financial rights and obligations of the parties related to a real property. The key to a proper lease audit is the thorough understanding of a lease, its structure and importance in the relationship between the landlord and tenant and their respective obligations. In simple terms, the lease for all or part of a real property (land, including any building, improvement, etc. on it) is a legal contract for the rental of real property for a given period and certain monetary sum. A Lease details the financial, operational, and legal responsibility of both parties. The original Lease terms may be modified as needed by the parties. The modification documents are typical referred to as amendments, modifications. However, letter agreements, settlement agreements resulting from disputes may also have the same impact as amendments if specifically stated as such in the modifying document. All modifications, amendments, etc., form part of the Lease.

Another important knowledge that may be important for an auditor is a basic-to-superior knowledge of the general life cycle of a lease. Key processes that occur from the origination, administration and termination of a lease typically provide an insight and clarity to the intent of the parties when certain lease clauses are too ambiguous to interpret.

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July 1, 2016

Lease Life Cycle Activities

Lease Origination:

- Need: The tenant has a need for a space (office, retail, data center, land, parking, etc.) necessary for the tenant's business activities.
- Research: The search for property by the tenant and its brokers and agents. This process takes into consideration the tenant's needs, the preferred geographic market, property type, etc. Multiple properties are usually selected during this stage.
- Review and Assessment: The key metrics of the selected properties developed through research are reviewed to ensure that the broad net cast during research did not capture properties that are not ideal for consideration and do not meet the broad requirements of the tenant.
- Analysis, Comparison and Offers: More detailed financial and operation analysis of likely properties are compared. Additional information and confirmation of terms (rent, incentives, term of the lease, etc.) may be sought and from multiple landlords through submissions of, and revisions to, "letter of intent" which detail the tenant's specific interests related to the lease. A letter of intent (or offer to lease – in Canada) can sometimes be used to clarify the intent of an ambiguous lease provision.
- Selection: Based on the best response received, the tenant selects and commences more detailed negotiation of lease terms with the landlord.
- Execution: The tenant accepts and executes the lease which specifies the date in which the lease's "life" commences.

[*Note: The results of past audits may aid the parties in research, review, negotiation of terms for a current lease.*]

Lease Life:

- Security Deposit: The lease may require that the tenant pay a security deposit, in the form of cash or letter of credit issued by the tenant's bank.
- Premises Preparation: The landlord or the tenant, per the lease terms, prepares the space for tenant's occupancy. This process is referred to as tenant improvement or tenant fit out and may include a requirement for the landlord to reimburse the tenant for certain costs incurred by the tenant in preparing for and moving into the premises. The lease *commencement date,* which usually signifies the commencement of the legal life of the lease, may be different from the rent commencement date which signifies the commencement of periodic rental payments. The lease commencement date is usually tied to when the landlord releases the premises to the tenant for (1) physical occupancy or (2) commencement of tenant's improvement work to ready the premises for tenant's physical occupancy.
- Physical Occupancy: Physical occupancy occurs when the tenant moves into the premises to commence its business activities. The physical occupancy impacts

certain costs, such as electricity and other utilities which are consumed by the tenant's employees, customers and information technology systems (e.g., lighting, water usage, heating and cooling, etc.) and janitorial (cleaning) services which have to be performed in the premises. The expenses that are affected are referred to as "variable" expenses because they increase with the physical occupancy. Variable expenses are subject to the "gross-up" concept which is discussed later.

- Financial/Economic/Legal Occupancy: When tenant becomes obligated to make periodic (monthly, quarterly, annual, etc.,) base rent and/or operating expenses payments and abide by all requirements and legal obligations related to the lease. Financial occupancy occurs on the effective date of the Lease even if cash payment of rent commences later. A tenant may be obligated to commence payment of rent from the lease commencement date even if the tenant has not commenced physical occupancy because the space is being readied for physical occupancy. A tenant may be obligated to pay rent even if, during the life of the lease, the tenant prematurely vacates and ceases to occupy the space with its employees. Financial occupancy affects property expenses (such as management fees based on the landlord's rental income) which are tied to rent obligations by tenants. As such, although management fee may be a "variable" expense tied to financial occupancy, it is not a variable expense based on physical occupancy of premises.
- Amendments: After a lease is signed, it may be amended to extend the life, or to modify other terms of the lease. Unless an amendment specifically modifies a provision in a prior lease, the terms of the prior lease that are not specifically referenced in the amendment are to continue as intended in the prior documents.
- Administration and Audit: Both the tenant and the landlord periodically perform multiple functions related to their respective obligations. The landlord may be required at certain points during the term of the lease to either refund all, or portions, of the security deposit paid by the tenant. The tenant may be entitled to rental abatements several months or years into the lease. The landlord may submit monthly rental statements, which the tenant reviews and may question prior to paying. The tenant may, as stipulated in the lease, seek to audit the landlord's books and records in order to determine whether the landlord is in compliance with the terms of the lease.

Lease End:

- Expiration: A lease may *naturally* terminate (or naturally expire) at a date and time stated in the lease which coincides with the original term period in the lease. If a lease, which commences on February 19, 2017, is slated for a ten (10) year term expiring on February 18, 2027. Its natural termination date is February 18, 2027. If for any other reason the actual end of the lease term occurs on February 17, 2027 or earlier, such termination is referred to as an *early* termination. Early terminations could occur for several reasons which include, the destruction of the property, eminent domain seizure by the government for public use, tenant's financial difficulties, the landlord's need for the space, etc.

- Restoration: Upon termination, the tenant may be required to restore the property to the original or other condition (if significant alterations were made to the premises by the tenant) or leave it *broom clean* which condition. Broom clean condition typically requires the tenant to move out only furniture, fixture and equipment, not affixed to the premises.
- Holdover: Holdover refers to when a tenant continues to physically occupy a space after the natural or early termination of the lease. In most cases, the tenant pays a punitive form of rent which may equal 150%, 200% or 300% of rent that was payable prior to the termination of the lease. An audit of the last year of the lease which results in the receiving a refund for overcharged rent may, or may not, affect the holdover rent that was paid after the termination.
- Final Financial Obligation: At the expiration of the lease, the landlord may be required to return the security deposit it has held to the tenant with, or without, interest. Many tenants fail to request the security deposits. The tenant may be required to pay the landlord a fee or cost reimbursement for restoring the premises to an agreed upon condition.
- Audit: The tenant's right to audit the landlord's records usually extends beyond the expiration of the lease because the costs of operations related to the last year of tenancy are not known or reported until after the tenant's lease has expired. Except in percentage rent scenarios where retail tenants are to report sales information to the landlord, the tenant is the party that usually needs to initiate an audit of the landlord's costs of operating the building for which the tenant paid a proportionate share.

Although a lease auditor is most active during the lease term (or life) and after the expiration of a lease, the auditor's experience interpreting lease clauses, auditing property expenses and negotiating lease audit resolutions with the landlord is important in the lease origination phase where they may lend their expertise in formulating effective lease clauses, analyzing building operating cost and rental terms, and providing operational knowledge of a given landlord and building management type (i.e., institutional, governmental, corporate or individual landlord).

Lease Audit Participants:

The primary parties to a lease audit are the landlord (owner) and the tenant (occupant) of the building. However, due to the increasing technicalities and the required skills necessary for completing a lease audit, the landlord typically assigns the responsibility for managing the process to the property manager, accountant, legal or lease audit professional and the tenant typically assigns the audit to a lease auditor or other lease administration professional. In summary the typical lease audit participants are as follows:

- Tenant: The party leasing the space or land in a real property owned or leased (in a sublease environment) by the landlord. The tenant is legally responsible for performing the lease obligations reserved for the tenant even if the occupant is not the tenant. When a tenant subleases the premises to another party, the tenant becomes a sub-landlord to a sub-tenant however, the sub-landlord will still perform the obligations of the tenant per the lease with the landlord – unless the landlord authorizes the assignment of such tenant obligations to the sub-tenant or other party.

- Landlord: The owner of the real property in which the space or land leased by the tenant exists. The landlord may be a person or persons, business or government entity. The landlord's "ownership" could be in fee-simple, outright, ownership form, or be via rental rights to another party with the authority to lease all or aspects of the property to another party.
- Property Manager: The person or entity authorized by the landlord to manage the operation of the property on behalf of the landlord. The landlord and the property manager's relationship are typically governed by a management contract. The landlord may also choose to serve as the property manager.
- Landlord's Accountant or other Professional: The person or legal entity engaged by the landlord, or the property manager on the landlord's behalf, to provide the necessary documentation needed by the tenant and address all matters concerning the lease audit.
- Lease Auditor: A person or legal entity engaged by the landlord or the tenant to perform the lease audit.

Understanding Real Estate (with emphasis on commercial property operations):

As a commercial real estate lease is for the use of real property and a lease audit depends on interpretation of lease terms, a firm understanding of real estate, real estate principles and standards, and ultimately, real estate operations and related costs, is imperative to understanding how the landlord's and tenant's obligations are impacted by broad, undefined or ambiguous terms in leases. In addition, the understanding of the property operations helps an auditor understand:

(1) The types of activities that occur as part of property operations for tenant occupancy and the factors (use-type, size, components – buildings, garage, land, equipment, etc.) that impact the activities and related costs,

(2) The nature of the documents and accounting records that capture the transactions because the auditor would have to trace back the transactions during an audit and

(3) The transactions and activities that are related to the building but are not related to property operations for tenant occupancy, and for which the tenant may therefore not have a financial obligation to the landlord.

The underlying principle is that the landlord, at its costs and expense, supplies a property (building, structure, land, facilities and systems) in normal operating condition which and also at its cost and expense (to the extent "head-hunting" or other staffing fees are paid for the acquisition) of appropriately qualified staff. In turn, the tenant pays fixed rent and reimburses the landlord the actual costs of utilities, property taxes and operation (including salaries/wages of staff during the period of the tenant's occupancy), which encompasses maintenance, repairs and security of the property. For example, if the landlord pays a placement firm (head-hunter) to acquire a property manager, the fee to the head-hunter should, rightly, be the landlord's financial obligation in the same way the cost to acquire the building is the landlord's obligation. The tenant will then reimburse the landlord the property manager's salary for time spent operating the building during the tenant's lease term and tenant will also pay base rent for the space in the building during the tenant's lease term. However, it will be unfair for the tenant to *assist* the landlord in acquiring the employee the landlord is obligated to supply and, also, reimburse the landlord for the salary of the employee. Likewise, in a more dramatic scenario for illustrative purposes, it will be unfair for the tenant to pay the landlord net rent and at the same time also reimburse the landlord mortgage costs related to the acquisition of the property. To understand property operations, it is critical to know the components of a property (i.e., building and related systems, land and facilities). Further, it is important to know the component parts of a building (i.e., structure, foundation, systems, etc.).

Understanding Accounting:

Basic accounting skills are necessary for conducting basic lease auditing procedures (to be described later). As leases vary in complexity, the more complex a lease agreement is, the greater the accounting skills and knowledge required to complete a successful audit of the financial obligations of the parties to the lease. If there are operating costs responsibilities with extensive, or complicated, excluded costs, or requirements to adhere to sound accounting principles, a strong knowledge of generally accepted accounting principles ("GAAP") is necessary.

Understanding Auditing:

GAAS, generally accepted auditing standards, is relied upon by financial statement auditors. GAAS are sets of general, field work and reporting standards established by the American Institute of Certified Public Accountants. The lease audit industry is not currently governed by any specific standards, but it is imperative to adopt the principles on which GAAS is based so that a consistent approach aligned with known standards of quality audit performance can help reduce the risk of bias and error during a lease audit. However, as the access to documentation in a lease audit process is primarily controlled by the landlord or may be restricted by the negotiated terms of the lease, complying with GAAS may be difficult or impossible when access to all related financial documents may be limited.