

Arming Yourself for a Tenant Audit

By: Michael ("Mickey") M. McClune, RPA®, FMA®

IT'S COMING SO BE PREPARED

Whether or not you've ever received that dreaded letter from one of your tenants that says "... *Tenant hereby notifies the Landlord it intends to conduct an audit of the Landlord's financial records ... to evaluate the accuracy of the rental charges ...*", know with certainty that someday you'll be receiving (another) one.

And just why would they want to audit? Here are some basic reasons:

- They're paying a lot and they're truly upset about it;
- It's part of their standard operating procedure;
- They're going to be using it for a negotiation tool for later events such as a lease renewal;
- They have a fiduciary responsibility to their stockholders, members, etc., to ensure that what they are paying is legitimate and correct;
- They've been convinced by an auditor that a lot of money could be returned to them
 - Some auditors are good, and could in fact be correct
 - Other auditors, however – for example, the ones that took the week-end crash course and then opened for business on Monday – are only guessing and are just fee-hungry

In any event, once you've received the audit notice, you can't ignore it and you'll have to deal with it. So why not

prepare yourself in advance?

There is much that can be written about this topic on how landlords and their property management firms should anticipate and then handle lease audits. But the best advice actually comes from the founder of the top lease auditing firm in the nation, CyberLease, LLC. In an article written in the late 1990's by Terry Barger, the Managing Member of CyberLease, from whom we've received permission to re-print his article below, landlords and property management firms are succinctly and wisely advised on the best ways to prepare for the audit and deal with the auditor.

Although the following article was written after the economic downturn of the early 1990s but before the very troublesome downturn of 2008-2011, its advice and premise still hold today.

[* Mr. Barger's article begins on the next page.]



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ARMING YOURSELF FOR A TENANT AUDIT

By: Terry Barger

Why do commercial tenants audit landlords? In part it may be the times. During the recession of the early 1990s, corporate cutbacks brought severe pressure to reduce costs. The relatively new idea of lease audits was considered an innovative way to “find” money.

Even though the economy has now improved, corporations continue to audit leases as a matter of policy and as a way to assure shareholders that money is being well managed.

However, the main reason most tenants audit leases is much more personal. They resist the idea of being asked to pay a considerable sum of money without any explanation of why they owe it.

The scenario goes something like this: a tenant receives a year-end reconciliations bill for operating costs that is significantly higher than previous years; just the bill, no explanation, no cover letter, no schedule showing actual itemized expenditures.

This lack of disclosure, especially when followed by inattention or unresponsiveness to tenant inquiries, causes the same reaction in tenants the average person would have if Visa failed to adequately respond to a request for more information on a charge. In such situations, people tend to see red, become obstinate, form opinions regarding the other party’s honesty, and sometimes refuse to pay. As a result, the relationship between landlord and tenant takes on an adversarial character that may not have previously existed. Thus, the primary motivation to audit comes into being.

Perhaps the simplest way to prevent an audit is to provide basic information along with the bill. First, tenants should be supplied with detailed year-end reconciliation statements that show how the amount being billed was calculated, annual expenses for each of the major account categories, and an explanation of why those account categories have risen or fallen from previous years.

Second, tenants should be provided with frank and timely answers to their questions. When a tenant asks for back-up, don’t take two months to provide it. This simple, common sense approach will satisfy the majority of tenants, who will consequently not find it necessary to go through the expense and hassle of an audit.

Cooperation

If the tenant still wants to audit, the landlord’s best approach is the reasonable one. Even if the lease does not permit it or severely restricts the tenant’s ability to audit, the landlord or property manager should consider whether enforcing the lease by denying the audit is worth damaging the relationship with the tenant, and perhaps even losing the tenant if a renewal is being considered. In many cases, particularly if the property manager has done its job properly, allowing the audit and negotiating a settlement of the audit claim is far less expensive.

Many landlords and property managers have decided to accommodate the audit requests of larger tenants, but still refuse the requests of smaller tenants. The problem with this is that the tenant who has been refused may team up with another tenant and go after the landlord. Or, worse yet, the tenant could organize all of the tenants to audit the landlord. And if the tenant is a law firm (or knows a good one, preferably in the same building), the landlord may find itself in court over its refusal to allow a tenant to audit.

Smoothing the Road

Before agreeing to be audited, the landlord or property manager should require the tenant to provide a written statement of whom it intends to use as an auditor. Beware of unscrupulous auditors who falsely claim to represent a tenant in order to get that tenant’s business.

Once an audit has been agreed upon, the landlord or property manager should establish in advance what documents the auditor will need to review. These may include the general ledger, supporting invoices or purchase orders, service contracts, management agreement, and property tax records. Records should be gathered for the time period being audited before the audit actually commences. Items that have been placed in storage should be retrieved.

In 35 percent of all audits, the general ledger does not match the reconciliation statement. Be prepared to provide all documents necessary to track account totals from the general ledger to the expense categories reflected in the final reconciliation statement. It is not necessary to provide invoices on non-escalatable expenses, but be ready with worksheets containing a listing of the various general ledger account groupings included in each reconciliation expense category, reversals of accrued expenses, gross-up calculations, reclassification of accounts, and deductions of non-escalatable items.

Do not volunteer a copy of the management agreement, but be prepared to provide it if the auditor wants to compare the management fees with the contract. Also, have vendor contracts available but do not volunteer them. Filing should be organized by vendor – not by date or activity – so that the auditor can easily check for suspect vendors. Otherwise, the auditor may ask to see all invoices.

One can never be too cautious about volunteering information to an auditor. The landlord or property manager should establish one person as the single point of contact to avoid leaking unnecessary, unrequested information during conversations with the auditor.

While it is not necessary to wine and dine the auditor, courtesy and openness during the audit will definitely convey that the landlord has confidence in its own records and has nothing to hide. Nothing raises suspicion faster than an unwillingness to provide certain documents and an unfriendly attitude. While this would seem to be common sense, it is amazing how often common sense is overlooked.

Finally, once the audit has been completed, if overcharges or allegedly improper pass-throughs have been identified, cool heads should prevail. The auditor should provide a justification for deleting any item from escalatable expenses. If there are special circumstances surrounding certain expenses of which the auditor was unaware, the landlord or property manager should be given the opportunity to describe them and state its case.

The negotiations necessary to reach a fair settlement should be conducted in good faith with an eye toward what is reasonable for both sides. Obviously, if the landlord has some liability for overcharges and the property manager fails to adequately respond in a way that will appease the tenant (and its auditor), the landlord may open itself up to a lawsuit for breach of contract or even fraud.

One of the most important tenant retention tools a landlord has at its disposal is an open, straightforward approach to addressing tenant concerns regarding operating expenses. Tenants are much more concerned with what comes out of their pockets than with whether or not the property manager buys them lunch or sends them a Christmas gift. Where operating expenses are concerned, tenants want landlords and property managers to recognize and honor the tenant's right to know what is being billed. As long as the tenants are footing the operating expense bill, this right should be respected. By recognizing this right, and keeping good records, an operating expense audit might even prove to be a good experience for both the landlord and the tenant.

"Don't Waive Your Rights"

To keep the audit process as painless as possible include a specific audit period in the lease. Allow tenants to audit only every two years and require them to request an audit within 90 days of the receipt of the reconciliation statement. This way, you won't have the same tenants auditing you every year. Contract law for most states will allow the tenant to audit back the statute of limitations – often four years – if the lease is silent on this right.

Some other audit pointers to keep in mind are:

- Require tenants to provide written authorization of the auditor's arrival in advance of the date.*
- Include a specific provision in the lease that the tenant bears the expense of any audit.*

- Never volunteer information, but don't be secretive either.*
- Agree to answer questions from the auditor only during certain periods each day; otherwise you will never get your work done.*
- Request that the tenant and the auditor not share the audit outcome with anyone. Some auditors sell information to obtain other clients.*
- Never demand a report from the auditor. A tenant may choose not to pursue findings for a variety of reasons, but you may incur liability from other tenants if you are aware of a discrepancy and do not act upon it.*
- If the auditor does give you a report, ask for line-item explanations and require justification for everything the auditor is doing.*
- Respond to any report in the same format so that comparisons and reconciliations are easier.*
- Avoid taking it to court. Incorporate a settlement clause in the lease or go through arbitration in negotiating the results of the audit.*

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Mickey began his career in commercial real estate in the early 1980's with the preeminent national real estate firm, LaSalle Partners (now Jones Lang LaSalle), as its General Manager for all of the office and industrial properties that it had acquired in the Los Angeles and Ventura County areas, and as its Asset Manager for various client portfolios in the Western U.S. While at LaSalle, he was recognized for numerous accomplishments both by the company and the commercial real estate industry. In 1993, he left LaSalle to form his own property management company, New America Asset Management Services, where he was the President and the senior partner of this Long Beach-based commercial real estate property management firm. In late 1997, LaSalle acquired NAAMS and its two million square foot management portfolio, and Mickey then served as LaSalle's Regional Vice President for the Southwestern U.S. In 1999, he joined EPS Solutions, a national corporate services consulting firm, as a Director of Real Estate Services. While at EPS Solutions he assisted property owners with their property acquisition due diligences, their properties' annual Operating Expense Escalations, and with the abstracting of their tenant leases, and he assisted tenants by performing over 50 CAM/OE Escalation Audits for them of their landlords' billed rent charges. In 2001, he again formed another commercial real estate property management firm,

MKC Management Services, where he served as CEO and senior partner. Soon thereafter, MKC merged with New York City based Newmark & Company Real Estate and became its California-based Asset Management Group. In mid-2003, Mickey was instrumental in merging Newmark & Company's California-based Asset Management Group's operations into a new start-up entity that then became known as RiverRock Real Estate Group. At RiverRock, Mickey was its Senior Managing Director, where he established all of the firm's property management systems, oversaw selected property management teams, and was responsible for all of the firm's consulting business. In early 2006, Mickey left RiverRock to start MKC Asset Management.

Over the course of his 25+ year career in commercial real estate property management, Mickey has personally managed and leased well over 18 million square feet of commercial office, industrial, and retail space, abstracted over 5,000 leases, performed over 400 annual CAM/OE Escalations for landlords' buildings, saved clients well over \$4 million in cash savings, received four (4) "Management Excellence Awards" from LaSalle Partners, was a LaSalle Partners' "Manager of the Year", and was awarded by BOMA of Greater Los Angeles four (4) "Building of the Year Awards" (in "100,000-250,000 SF" and "Over 500,000 SF" categories) and two (2) "Special Achievement Awards" including one for "Overall Design Improvement".

Prior to entering the real estate industry, Mickey was commissioned as an officer in the United States Air Force and spent 11 years in the USAF and private industry with Hughes Aircraft Company specializing in the business management of major aerospace industry programs.

Mickey has a California Real Estate Broker License, and is RPA and FMA certified by the Building Owners and Managers Institute. He is a past Chairman of the Board and past member of the Executive Committee and Board of Directors of BOMA of Greater Los Angeles, has served on BOMA Orange County's and BOMA California's Executive Committees and Boards of Directors, and on BOMA International's Board of Governors and Strategic Planning Task Force. Mickey graduated from the University of Southern California with a Bachelor of Science degree in Civil Engineering and a Master of Business Administration (MBA) degree.