



HOW WELL DO YOU UNDERSTAND YOUR LEASE AGREEMENT?



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For landlords, rental income is their primary source of revenues. For the tenants, rent expense is usually one of the largest expenditures on their income statement. Thus, the misadministration of a lease agreement can be costly for both parties. The most common tenant related errors in administering a lease agreement are as follows:

Base Rent – Square Footage Issues

Most lease agreements will define the square footage of (a) the tenant's demised premises and (b) the entire building. Unless the lease agreement specifically states that the parties agree to the square footage amounts referenced in the agreement, the square footage for both are usually open for remeasurement. The significance of remeasuring the square footage is that if the lease states that the tenant's demised premises consists of 50,000 square feet and the building consists of 100,000 square feet (i.e. 50% of the building) and a remeasurement determines that the premises is actually 44,000 square feet and the building is 110,000 square feet (i.e. 40% of the building) then two errors may exist.

The first error that may exist is if the base rent is calculated based upon a price per square foot then there should be a direct reduction in the base rent. For example, if the base rent is stated as \$20 per square foot times 50,000 square feet, then the original base rent would have been \$100,000. If the remeasurement determined that the tenant's demised premises was only 44,000 square feet then the base rent would be reduced to \$88,000 (i.e. 44,000 s.f. x \$20/s.f.). This would represent a \$12,000 savings for every year of the lease term.

The second error that may exist is that given the facts of the previous remeasurement, the common area maintenance (CAM) and real estate taxes allocated to the tenant would be reduced from 50% of the total expenses to only 40% of the total expenses for each year of the entire lease term.

Base Year Escalation Issues

The basic premise behind base year type leases is that the initial base rent is assumed to represent (a) all costs incurred by the landlord for the base year plus (b) the landlord's expected profit for that base year. For each subsequent year of the lease term, as the CAM and real estate taxes increase, the tenant is expected to bear the burden of paying for the inflationary increases in those expenses and the landlord is allowed to maintain its expected profit margin. Issues will arise when the base year is not a true representation of the normally expected costs of a fully occupied and operational building.

For example, if the building is newly constructed then for the first year (i.e. the base year) the building may not be fully occupied. Therefore, the variable costs of the building will be understated for the base year and for each subsequent year in which the building is fully occupied, the tenant is overcharged. This occurs due to the fact that the tenant is only obligated to pay for inflationary increases over the base year expenses and should not be obligated to pay for increases in occupancy which occur after the base year. Most landlords will gross up the base year expenses and all subsequent lease year expenses to represent a fully occupied building, if occupancy issues exist.

Additionally, if certain expenses were not included in the base year, such as management fees, but were subsequently added to the escalation years, then the tenant is being forced to pay for 100% of these costs and not merely for the inflationary increases. Again, this goes back to the basic premise that the initial base rent is assumed to represent all costs incurred by the landlord for a fully occupied and operational building plus its expected profit for the base year.

Real Estate Tax Issues

Similar to base year escalations for CAM charges, the basic premise behind a base year type lease is that the initial base rent is assumed to include all real estate taxes incurred by the landlord for the base year for a fully occupied and operational building. For each subsequent year of the lease term, as the real estate taxes increase, the tenant is expected to bear the burden of paying for the inflationary increases in those expenses and the landlord is allowed to maintain its expected profit margin. Issues will arise when the base year is not a true representation of the normally expected costs of a fully operational building.

For example, if the building was newly constructed and had not received its final assessment until after or during the base year, then the real estate taxes charged for the base year would not represent those of a fully occupied and operational building. Therefore, the real estate taxes will be understated for the base year and the tenant will be overcharged for each subsequent year of the lease term.

How to Protect Yourself from Overcharges

There are many lease clauses which are designed to protect the parties of the agreement. Most leases will include an audit clause which stipulates the amount of time the tenant has to perform an audit of the landlord's bills. In some cases, this time period may be as short as thirty days. Therefore, time is of the essence since when the audit period expires, the tenant has no legal right to perform an audit for that lease year. Inasmuch as the base year amounts for CAM and real estates taxes impact the billings for each lease year, the base year CAM and real estates taxes are always open to audit however savings may be limited to future billings and the previous escalations, for which the audit clause has not been adhered to, may not always be recoverable.

Most companies do not have a real estate department which contains the available resources necessary to effectively review, administer and audit their lease agreements. For these companies, there are certified public accounting firms and lease audit companies that offer such services, usually on a contingency basis. The benefit of receiving such services from a third party audit firm is that the company does not put its own money at risk but still reaps the rewards of any findings, less the contingency commission. Additionally, even if no overcharges are identified, the company can feel confident that the landlord is administering the lease agreement as intended and subsequent overcharges are minimized if the landlord is cognizant that each year's billing statements will be subjected to audit.

The bottom line is that overcharges in administering lease agreements exist. Your landlord is not going to let you know when an overcharge has occurred, so who is your company relying upon to protect itself from being overcharged for rent? As one of the leading accounting and profitability consulting firms for the construction industry, Cowan, Guteski & Co., P.A., can effectively review, administer and audit your lease agreements. Contact Kevin Donovan, CPA, Director – Construction Services Group at 732-349-6880 extension 140 or kdonovan@cowanguteski.com to discuss your particular situation.



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About the Author

Kevin P. Donovan, CPA, Director, joined Cowan, Guteski & Co., P.A. in January 1999. Mr. Donovan's professional work experience includes several years as a lease auditor for a nationally recognized lease audit firm in which he pursued tenant over charges for various Fortune 100 companies. Subsequently, Mr. Donovan was retained by New York City's largest commercial real estate brokerage firm to be the Manager of their lease administration department. Mr. Donovan has more than 20 years of experience in both the public and private sector, providing accounting, auditing and financial consulting services to real estate and construction companies. Mr. Donovan is a member of both the American Institute of Certified Public Accountants and the New Jersey Society of Certified Public Accountants. He graduated from Rutgers University with a Bachelor of Arts degree in Economics.

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