



The Tenant's Advantage

Operating Expense Reconciliations Need Review

It pays for tenant to scrutinize statements

We are headed into that time of year when landlords provide tenants with their operating expense reconciliations. This is basically a “true-up” of the actual costs incurred versus the costs budgeted and already paid by the tenant. When you receive this document, it might be worthwhile to take a closer look to discover if the charges are appropriate.

In spite of best efforts, there are often mistakes on these documents. As a tenant, aside from wanting to make sure the math has in fact been calculated accurately, it's important to realize most landlords issue their reconciliations based upon the “standard” lease, and your lease may include material differences from that standard. You should first refer to the detailed Lease Abstract provided to you by your real estate adviser at the time that the transaction was consummated.

What should tenants know?

A well-negotiated lease document will clearly define what are allowable operating expenses, making explicit their proper accounting treatment, and also define which costs are not allowed to be charged to the tenant. Typically, “operating costs” include your real estate taxes, cleaning, common area maintenance, building insurance, management fees and repairs that had to be done during the year. In practice, a landlord will estimate the expenses of your property for the upcoming calendar year. As a tenant you will pay your percentage share of these estimates throughout the year. After the end of the year, when the actual expenditures can be calculated (typically 90 to 120 days into the year) the landlord sends a bill for any amount that exceeded the budget. Over the course of the lease, this can become a significant expense that should, at the very least, be understood. There is enough gray area in calculating operating expenses that entire businesses exist for the purpose of auditing these costs for clients.

When should tenants be concerned?

If you think the expenses are extraordinary, you should ask your landlord for an explanation of the charges. Upon receipt of that explanation, if there is still concern, you can contact your real estate adviser. Often the best way to go about assuring accuracy is to perform a “desk-top” audit which your real estate adviser should be able to accomplish for you.

What you should look for is the percentage of increase from your last year's operating expense statement. With the exception of taxes, insurance, utilities, and repairs and maintenance (based on the age of your building) it's customary for most categories of operating expenses to escalate 5 percent per year. If you move beyond this number you probably want to question that and certainly if you hit a double digit number and explanation is due.

The following issues are often predictive of errors and overcharges:

Major work done to a building during the year. If this is your situation you want to pay very close attention to make sure that the treatment of your operating expenses is done according to generally accepted accounting principles (GAAP). For instance, if you have a new roof put on your building, or if the lobby was redone, those things should be capitalized and, in the case of most leases, excluded from the operating costs charged to tenants.

Most often after a sale of a building the new owners or property managers often implement their own accounting practices and methodologies, and this can create artificial increases in tenant obligations. In the event of a sale, we also frequently see significant clerical mistakes simply made because the new owner did not properly read your Lease.

Vacancy frequently leads to errors and overcharges as a result of the landlord's process of extrapolating the building's expenses to reflect what they would have been at full occupancy (commonly referred to as a "gross up").

What can be done to mitigate expenses?

Since you as a tenant do not control the operation of the building you need to rely on the professional expertise of the landlord. The items that a tenant can control are typically limited to your HVAC and electric consumption. Keeping thermostats at a reasonable temperature and turning lights off or, better yet, having light sensors installed can help.

Another way to mitigate your expenses is to have a well-negotiated lease document and have the right to audit operating expenses. Without this right in your lease you have limited recourse if expenses escalate rapidly. Just the simple fact of having the right to audit should help in making sure that expenses are properly accounted for. In some cases we see companies performing annual audits on the expenses as a matter of business practice. This certainly puts all parties on notice that attention is being paid to this item and tends to lead to a higher degree of accuracy on the statements. Considering that 80 percent of reconciliation statements contain items that need further clarification, 25 percent

of which are material enough to warrant an in-depth audit, tenants should pay very close attention to these bills when they receive them.

What should landlord provide?

When you have requested expense information, the landlord should be able to provide the documentation that showed what was budgeted for by category for the year as well the actual expenses incurred. This documentation should include a **detailed** line-item statement. There should be an explanation, by account of the actual versus the budgeted charges. It is not unreasonable for the tenant to request at least two prior year's worth of history, if you have had the same landlord or property manager. By having this history, it will help you to ascertain the charges category by category.