Lease Auditing: An Untapped ROI Opportunity

Identifying and Recovering Excessive Billings From Landlords

Issue

Is your landlord complying with the financial aspects of your lease? Commercial leases are often structured to include ambiguous and complex cost terminology aligning with the landlord's financial interest. On top of a base rent payment, these leases often include subsequent expenses that vary year to year, such as common area maintenance allocations, management fees, tenant improvement allowances and real estate taxes, as well as escalation clauses for annual increases in expenses.

Interestingly, landlords are rarely equipped or staffed to manage the complexities of their leases to ensure that each tenant is properly billed, resulting in incremental occupancy costs for tenants. These costs can easily go unnoticed by tenants, depending on a tenant's lease management and invoice review process. This deficiency points to a major issue that tenants experience worldwide*: a lack of transparency into costs borne by the tenant*.

Many landlords default to passing through facilities management and capital costs to tenants, regardless of the terms of the lease. This may result in the inclusion of corporate overhead costs such as routine repair and maintenance (R&M), insurance claims, employee gatherings, marketing expenses, asset purchases, and even employee bonuses. There is very little preventing landlords from attempting to include any possible transaction to see what sticks. This is exemplified by the assumption that tenants rarely execute the right-to-audit clause included in standard lease agreements.

Challenges and Opportunities

While tenants usually are experts in their respective industries, they frequently do not possess the specialized cost control capabilities or dedicated resources required to thoroughly review and monitor the landlord's cost allocations throughout their corporate office space or portfolio of leases.

Further, the departments responsible for creating the lease(s) are rarely involved in detailed cost control activities beyond high-level budget monitoring. Landlords may find themselves passing down non-reimbursable costs, simply due to unfamiliarity with the specific lease terminology or a misunderstanding of which costs may be capitalized per accounting principles. All of these factors can result in unnecessary occupancy costs that the tenant is blindly paying.

Our Point of View

In such instances, tenants may benefit from conducting an audit of their corporate office space or portfolio of leases to benchmark costs and potentially recover nonallowable transactions. An initial audit, coupled with any reimbursements identified, serves as a starting point for implementing a robust lease cost control and compliance process. The following are examples of key indicators demonstrating when an audit or process improvement opportunity would be valuable from a tenant’s perspective:

- Operating one or more long-term lease(s) (i.e., more than three years) exceeding 20,000 square feet of leasable space
- Leases across multiple locations and/or regions that roll up to different levels of leadership
- Lacking a dedicated lease management team or lease management software
- Experiencing significant improvements and other construction occurring throughout the building(s)
- Year-over-year increases in annual expenses or variable costs (e.g., common area maintenance allocations, management fees, tenant improvement allowances and real estate taxes)

How We Help Companies Succeed

Protiviti offers a variety of lease solutions that are customizable to support each client’s unique needs, including:

- **Execution of annual or one-time lease audits** — Utilizing a blend of substantive and sampling-based testing procedures to validate the tenant’s cost burden to ensure that the tenant is not billed for inappropriate or unwarranted transactions.
- **Facilitation of cost recovery from the landlord** — Supporting legal counsel or other stakeholders to prepare all landlord notifications and address responses from the landlord.
- **Assessment and redesign of lease management processes** – Ensuring that the organization has sufficient processes in place (e.g., clearly defined roles and responsibilities, review and approval procedures) to mitigate the unique risk factors of each lease.

Examples

A tenant with a 150,000-plus-square-foot corporate office located in New York City expressed concern over an increase of 25% in the building's annual operating expenses paid to the landlord. Protiviti performed a detailed review of the transactions passed through to the tenant and identified numerous transactions that were nonallowable per the terms of the lease. This combination of incorrectly passed-through capital expenditures, duplicate billings and corporate overhead not attributable to the office building resulted in agreed-on recoveries totaling roughly $150,000, representing a return on investment of over 375%.

Another tenant experienced an increase of $1 million in direct expenses from the prior year — attributable almost entirely to R&M, as a major renovation of the building's parking garage had been underway. Through a detailed review of the scope of work, payment applications, change orders and more, Protiviti was able to identify that the project should have been capitalized rather than passed down to the tenant as an expense. This finding, coupled with several others, such as an overallocated labor burden and improper inclusion of various asset purchases, resulted in the identification of over $2 million in inappropriate pass-through of costs to the owner.

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