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BULLETIN BOARD

MCS EXECUTIVE COMMITTEE UNDERTAKES STRATEGIC PLANNING

The MCS Executive Committee undertook the first two phases of the process of strategic planning at its November 1992 and February 1993 committee meetings and will continue the process during its scheduled committee meetings this year (see related article on page 6). MCS section members are invited to use the MCS FaxSURVEY to suggest issues that the committee should be considering. A survey form is provided on page 7.

Continued on page 5

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SITTING ON THE HORN OF PLENTY

Property Leases Offer Opportunities to Provide Services

BY HERBERT "HAL" ROSENTHAL, CPA, FORT LAUDERDALE, FLORIDA

CPAs may be sitting on a cornucopia of opportunities to provide additional professional services to existing and potential clients. At the same time, they may be unwittingly exposing their CPA firms to claims of substantial damages arising out of possible negligence or ignorance. The new and supplemental services can be provided to clients that rent office space and other commercial property.

The opportunities and dangers are associated with lease provisions and rent escalations that may result in excessive charges and therefore increase the potential of having a significant impact on an organization's financial statement. Accordingly, CPAs should become aware of these overcharges and the reasons they exist. Even CPAs who choose not to provide these services should be aware of the possibility of lease overcharges as they manage their own accounting practices.

A rule of thumb to estimate the potential magnitude of these excessive charges is based on statistics that have been compiled: If four or more leases are involved, the gross overcharges can amount to \$1 per square foot or more of all leases in force. In my experience, more than one in four commercial property leases contain provisions that lead to overcharges by landlords and property management companies. These overcharges on individual leases can range from \$4 to more than \$10 per square foot, depending on the term of the lease.

A common cause of overcharges is *phantom costs*. These are additional charges to the tenant that do not represent actual increases in expenses provided for under the terms of the lease.

CPAs who are unaware of these phantom costs may approach an engagement assuming that anything unusual, such as a material hidden overcharge, because of its size, will come to their attention. This assumption is unfounded.

HOW OVERCHARGES HAPPEN

Base rent contains four key components, each carefully considered by an astute landlord. They are—

1. The landlord's debt service requirement
2. The projected operating costs
3. Provision for future major capital repairs (such as a new roof)
4. Profit

Continued

IN THIS ISSUE

- Environmental Consulting: Market Opportunities for the 1990s 4
- MCS Executive Committee Begins Strategic Planning Process 6
- Tell Us What You Think —The MCS FaxSURVEY 7

Of the four components, only profit is discretionary, and then only moderately so. The remaining three factors are usually firmed up during the project planning-funding process and are well known to a landlord by the time lease negotiations with prospective tenants begin.

The operating costs of commercial property, such as an office building, increase over time, primarily because of inflation, and will probably erode the landlord's profit. To prevent such erosion, most leases contain one or more provisions requiring tenants to reimburse the landlord for increases in operating expenses of the building during the term of the lease. The most common plan provides for the landlord to be reimbursed for any expense increases in the years after the first or base year of the lease. Such reimbursements are known as *rental escalations* or *pass-through costs*.

Rental escalation provisions come in several forms. Sometimes, formulas or indexes, such as the Consumer Price Index (CPI), are used as a basis for estimating increases of operating expenses. Whatever form the expense reimbursement provision takes, it does not alter the purpose of the provision: to reimburse expenses. The intention is the same as when an employee is reimbursed for business expenses. The employee is not supposed to make a profit on the reimbursement; neither is the landlord. Nevertheless, expense reimbursements sometimes provide enormous hidden profits to landlords and building management companies at their tenants' expense.

Careful attention to the basis of the terms of the lease will help prevent potential problem situations such as the following:

- The base year tax expense may be determined by using a low assessment valuation. Taxing authorities customarily provide low assessment valuations to landlords in contemplation of a lease-up period of several years.
- The rental escalation provision is based on a CPI index that is subject to seasonal swings. The starting index selected may be one that will soon change in favor of the landlord.
- The debt service for financing the cost of an office building garage is classified as leased "air rights" and passed on to the tenants.

These and similar situations (see the case study on this page) may result in excess expenses being passed to the tenant despite a property-lease arrangement that appears favorable.

IMPACT ON THE LANDLORD'S FINANCIAL STATEMENTS

When tenants are being overcharged, both the CPA and the client-landlord may be at risk. To the extent that overcharges can be proved, their effect on the landlord's financial statements must be considered. Excess expense reimbursements find their way to the bottom line of the landlord entity and become part of the accumulated equity shown in the landlord's balance sheet. In actuality, the overcharge is a liability, and the accumulated equity on the landlord's balance sheet is overstated to the extent of that liability (plus interest). A common result of reporting an overcharge on a landlord's balance sheet is

insolvency of the landlord's entity. This outcome is especially probable in the event of successful litigation by a single tenant to whom the landlord must pay damages. In such an instance, the landlord is estopped from forcing other tenants to go to court to obtain comparable damages if the basis of their claim is identical to that of the single tenant. Therefore, a contingent liability leading to insolvency may arise because of the potential for multiple liability.

Whether or not a balance sheet correction is required, disclosure may be mandatory and could have the same effect on the landlord's financial statements as it would if the correction were made.

If the landlord's CPA did not know of the overcharge, but should have known, he or she may be accused of negligence. Negligence alone is an insufficient basis upon which third parties may recover damages from a CPA. However, it is not

CASE STUDY: EXPOSURE TO LIABILITY FOR DAMAGES ASSOCIATED WITH PROPERTY-LEASE COSTS

The lease for a property called for the sole tenant to pay the landlord annual rent increases based upon the annual percentage increases of the wholesale price index, which is a specific index of the Consumer Price Index. However, the landlord used a different index of the CPI than the one specified in the lease and, as a result, overcharged the tenant hundreds of thousands of dollars—not counting interest—over the lease term.

Usually it is relatively easy for a CPA to verify that the rental escalations are calculated according to the terms of the lease. It is also prudent to do so. For these reasons as well as reasons of materiality, the landlord's CPA should have read the lease and tested the CPI calculation as part of the engagement procedures. Had that been done, the error would have been discovered, assuming the CPA knew that CPI can be a generic name for several different indexes. (For example, specific consumer price indexes that landlords can select from include the wholesale price index; the CPI, all urban consumer [CPI-U]; and the CPI, urban wage earners and clerical workers [CPI-W].)

In this case, by failing to read the lease and test the calculation, the CPA did not demonstrate due professional care. The tenant alleged that the CPA, in failing to do so over a period of years, aided and abetted the landlord in deceiving the tenant and thereby helped to cause and to perpetuate the damages to the tenant.

In addition, by failing to make proper provision on the landlord's financial statements and to make appropriate disclosures related to those financial statements, the CPA jeopardized the landlord's net assets, the fund from which a judgment in favor of injured third parties could be satisfied.

difficult to establish that the injured parties relied on faulty representations of the CPA.

Usually, the CPA's failure to uncover material overcharges can be shown to have assisted the landlord to improperly obtain and retain monies from tenants. This is particularly likely when the CPA should have known that the client used the lease engagement work product to legitimize charges to tenants.

OVERCHARGES ARE UNSTATED ASSETS AND RECOVERABLE COSTS

CPAs are encouraged to think of property-lease cost overcharges of a tenant client as an unstated asset, or as a recoverable cost. The aforementioned rule of thumb to estimate the potential magnitude of overcharges can be used as a basis, but not the only basis, to approximate the amount that may be involved.

For a company the size of IBM, \$70,000,000 of costs may be recoverable, depending on the statute of limitations. Although the overcharges for a small company may be only a fraction of those paid by a large company, the relative significance to profitability is equal.

CPA firms engaged to provide property-lease services should consider consulting with others to ascertain issues involving property-lease costs of which they may not be aware. Then, the firms can determine what, if any, additional services or procedures may be necessary to properly serve the client's interests and to fulfill the engagement responsibilities.

CPA consultants should consider advising their firms' audit departments to limit their responsibilities or expand their procedures in audit engagements in which there is the possibility of property-lease cost overcharges. For example, in an engagement to provide attest services related to the purchase or sale of rental properties, the issue of lease overcharges may exist. In this case, the projected profit of the owner is based, in great measure, on the property's historic profitability. The past or anticipated profitability of the property cannot be validly estimated unless existing, but as yet unclaimed, overcharges are uncovered. Estoppel certificates, normally required of tenants when a building is sold or refinanced,

LEASE AUDIT SERVICES

Lease auditing, an emerging field of expertise, only infrequently involves an actual audit and can be more accurately described as *forensic review of property-lease costs*. CPAs who wish to gain the benefits of lease auditing services for their clients or themselves should be aware that, of the amount of potential overcharges, less than 20 percent is accounting-related (e.g., cash/accretion differences) and more than 80 percent is nonaccounting-related overcharges (e.g., phantom costs). I call this the 80/20 factor.

The majority of providers of lease auditing services in the U.S. focus on accounting-related overcharges and may be unaware of the 80/20 factor. These providers do help to recover some overcharges and occasionally uncover nonaccounting-related overcharges. However, their results are inherently different from those of providers capable of discovering both classes of overcharges or those of providers proficient in the entire range of services associated with property-lease costs.

CPA consultants in this discipline, as with other technical areas, should be selected on the basis of their ability to develop and achieve the goals of the client.

do not effectively bar damage recovery.

OPPORTUNITIES FOR NEW OR EXPANDED SERVICES

CPA consultants can also advise members of their firms' audit departments on identifying situations in client organizations that may require consulting services associated with property-lease costs.

The consulting services that a CPA firm can offer include:

- Overcharge identification and verification
- Forensic investigation
- Litigation support services
- Arbitration and mediation
- Negotiated resolution of disputes
- Transaction reviews
- Development of overcharge avoidance methods
- Seminars and training programs

A CPA firm does not need to become proficient in each of these areas to provide new or expanded consulting services in connection with property leases. For example, it can be sufficient and valuable for the CPA to identify potential opportunities for tenant-clients to avoid overcharges or to point out areas of risk to landlord clients (see sidebar "Lease Audit Services").

Typically, whenever overcharge allegations are made, the need arises for additional conventional accounting and consulting services. In such circum-

stances, the CPA who provides accounting or consulting services to support a particular position needs to be well informed about property-lease costs. Otherwise, the result can be extreme embarrassment. Knowledge of real estate, however extensive, is not a substitute for knowledge about property-lease cost matters.

CPAs providing litigation support services—or those wishing to do so, especially those with a background in commercial real estate—should consider learning more about property-lease costs and offering associated services.

A properly developed overcharge claim is difficult to defeat in court. Knowing this, a CPA consultant specializing in property-lease costs can help bring about a more intelligent, fairer, and less costly result than might otherwise occur.

Because few precedents have been set in these matters, the judgment of a trier of fact is often based in great part upon the clarity, logic, and fairness of the positions presented by the CPA consultant. To apply their skills more effectively, astute attorneys rely on the concepts and arguments provided by the CPA consultant.

CPAs can and should assist their clients in negotiating a resolution of overcharge claims. Ultimately, a busi-

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