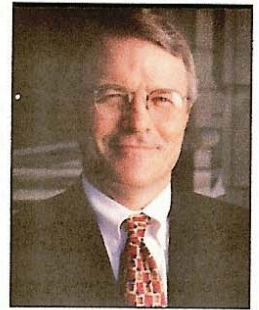


Escalations RULE!



By William H. Brownfield, CRE, CCIM
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Brownfield & Mayerhofer, Inc.

Oops. We meant to say “Escalation Rules.”

Everyone knows that rules are guidelines or principles to consider. Google™ the word “escalation” and you’ll get more than 3.8 million responses. Look for “escalation” on eBay®, and you’ll have a choice of 43 items to buy. It’s apparently a very popular and useful word for many things around us in our daily lives. But 99.9 percent of these responses don’t have anything to do with commercial real estate, and the one that does is usually accompanied by the silent question “Huh?,” grunted by an uninitiated tenant or property manager, or a heartfelt “Oh no!” exclaimed by the initiated tenant or even the well-meaning property manager being asked questions about escalation charges or invoices.

Operating expense escalations in office buildings can be both a blessing and a curse. For a landlord, escalations can be a legal and ethical method of recovering some, or

sometimes all, of a property’s operating expenses. But escalations can also be the biggest operational headache a landlord has to contend with during a tenant’s tenure. And from a tenant’s standpoint, escalations can be the single most defining issue that determines if the landlord is trustworthy ... or not.

Escalations are frequently the cause of misunderstandings with tenants. When *not* handled well, these misunderstandings can easily “escalate” into disputes and then into very serious legal proceedings between landlords and tenants. Want proof? Talk to property managers and property accountants at the largest commercial real estate companies in the United States and ask how many escalation audits they have under way. It might surprise you to find out how popular audits have become. They are routinely requested by tenants of all sizes and types.

Nevertheless, most escalation

disputes are avoidable. Follow these five rules to dramatically reduce the chances of getting into escalation disputes and audits.

In order of importance, here are our suggestions:

RULE #1: BE CONSISTENT

Most of us would assume that accuracy is the most important rule for escalation calculations, since they involve money and accounting. “Accuracy” and “accounting” certainly go hand-in-hand. But escalations are a not just a function of accounting. Two other disciplines are also involved: *legal* and *property management*.

Legal is represented by the lease document. When well written, the lease establishes the concepts and processes behind what can be escalated and how “gross ups” are to be performed. *Property management* is represented by

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operational contracts and practical processes for expense-generating activities performed by managers and engineers (such as utilities and janitorial expenses). A number of expenses from these activities are subject to gross ups.

Unlike *accounting*, the *legal* and *property management* concepts are sometimes based on interpretation

rather than quantifiable numbers. Different leases and different properties will consequently have unique interpretations, further complicated by parties with different skills and agendas (think tenants, auditors, property managers and property accountants). So mixing accounting, legal and property management concepts together at one property will create a set of circumstances completely different from another property.

So what is one to do about escalation calculations in such a fluid situation? Just remember that "being

consistent" is as important, if not sometimes more important, than "being accurate." The main point is that the same methodology should be used for each year throughout the term of a lease. For example, the same processes, and in some cases the same sets of assumptions, should be used for calculating a tenant's base year as are used in each subsequent year to calculate an escalation invoice. It's a very simple rule, but ignoring its importance will increase the likelihood of an audit.

RULE #2: DON'T FORGET RULE #1

Is consistency important enough to warrant being *both* Rule #1 and Rule #2? Yes, it is. Why? Think of it this way: Even if you make a calculation mistake or an error of judgment about a key assumption in a base year (which benefits the tenant), the odds are reasonably good that making the same mistake in subsequent years (which benefits the landlord) will cancel out that error.

This begs another question: "What should a property manager or accountant do when he or she finds an error in a tenant's past escalation charge?" Our answer may surprise

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you. Above, we said "the odds are reasonably good" that making the same mistake in subsequent years will cancel out a previous error. We did not say "absolutely certain," so the door remains open to the possibility that two wrongs do *not* make it right. When the error benefits both the tenant and the landlord in equal measure, we will generally leave the mistake alone until a lease expires before correcting it. However, if a mistake clearly and solely benefits the landlord, we suggest throwing consistency aside, admitting the error, recalculating the escalation charge and establishing new methodology for the remainder of the lease term. Why? Because honesty is good business. It is also a key to minimizing escalation disputes and audits.



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RULE #3: START WITH THE END IN MIND (AN AUDIT)

Anytime you know you can possibly be audited, it is best to assume the worst. This is a good strategy to follow whether the topic is escalations for tenants or personal taxes with the Internal Revenue Service. To paraphrase the title of the book Andrew Grove wrote about Intel (he was their CEO and chairman), "Only the Paranoid Survive ... *An Audit*." Tenants don't like paying escalations any more than they like paying for parking, so plan on being questioned or challenged by a tenant or an auditor. And keep your annual escalation records at least one year past the expiration of every lease.

RULE #4: COMMUNICATE EFFECTIVELY

This rule could also be labeled "Get to The Point Quickly" or "Don't Confuse Everybody With Too Much Information." Letters to tenants about escalation charges should be concise. They should include explanations for any significant expense changes (plus or minus). Brevity is

of great value with this type of communication. Ronald Reagan was known to not accept position papers presented to him if they were longer than one page. His explanation was that the writer didn't understand the issue well enough if he or she couldn't explain it in one page or less. Follow the same rule when communicating with your tenants.

And when you do get audited (remember: it's not "if" you get audited), follow the same rule and commit to doing your homework so you can communicate effectively with them. As an example, return phone calls from tenants and auditors immediately, even if it's to tell them you are collecting the information they requested. Accept that managing the communications is as important as what is being communicated.

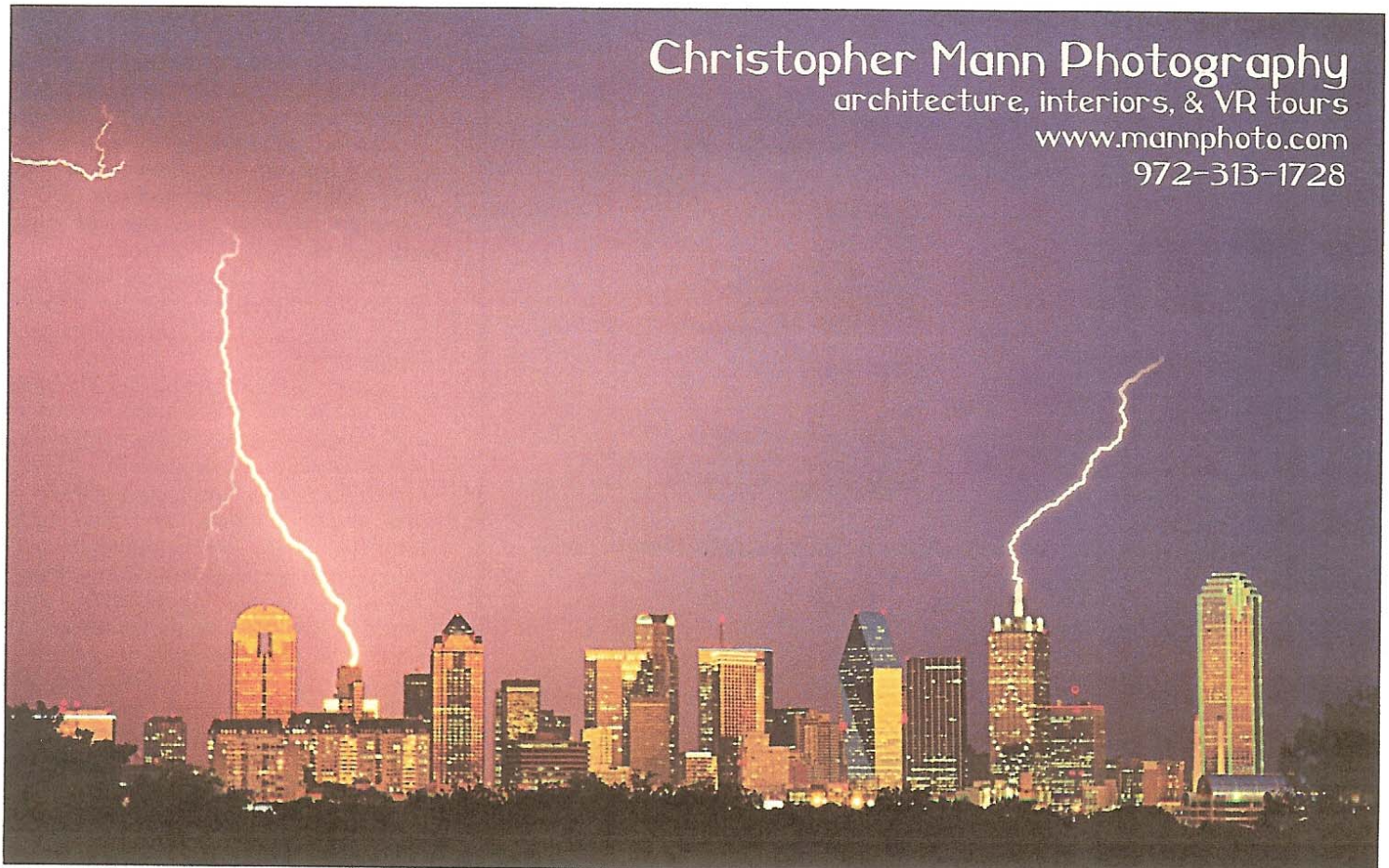
RULE #5: USE INDUSTRY STANDARDIZED METHODOLOGY

We can be especially brief explaining this rule. Very little published information exists that establishes standardized methodology, other than BOMA International's handbook and software (see side-

As tenants become more likely to request audits or engage auditors to represent them, it would be wise for property managers and property accountants to migrate to more broadly tested solutions.

bar), both of which we wrote. Some real estate companies continue to use home-grown logic and in-house spreadsheets developed in years past to calculate escalation charges. But switching to industry-endorsed methodology would help those landlords avoid escalation audits, and also better prepare

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them to manage the audit process. As tenants become more likely to request audits or engage auditors to represent them, it would be wise for property managers and property accountants to migrate to more broadly tested solutions.

Many formal accounting software packages have escalation modules. But for the most part these modules remain unused because the modules are not flexible enough to handle all sorts of leases and special lease clauses. Escalation calculations require much more than just accounting input (remember the *legal* and *property management* concepts mentioned above). To our knowledge, none of the major accounting software packages are flexible enough to generate *defensible* methodology for gross ups, CPI adjustments, caps, etc., because they can't accommodate the variety of lease clauses actually found in the office building market.

So what is the best way to comply with Rule #5? It's easy ... buy

BOMA's escalation products. They have survived the flexibility test and the test of time. Also, both are endorsed by BOMA International and are available for purchase through BOMA International's Website (see

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sidebar). And you can go to our Website for additional information (www.escalationadvisors.com). Thousands of property managers and property accountants use these products as resources and reference materials. They calculate escalation charges for *tens of thousands* of tenants. Because of their broad use and acceptance, these products reinforce standardization and the use of acceptable methodology within the

office building industry. And only BOMA has the size and scale to make that kind of impact in the industry, which is why tenants and auditors respect BOMA's products.

OK, so we really only have *four* rules to follow. It's even easier to avoid escalation disputes or manage audits than you imagined. To recap the Escalation Rules again:

- Be consistent.
- Assume that your tenants will audit your records, so store them in a safe place.
- Communicate clearly and effectively about escalations.
- Use industry-accepted methodology so your calculations are trusted.



Mr. Brownfield and Mr. Mayerhofer provide consulting, training and software solutions for operating expense escalations to landlords and tenants across the country. For more information, go to www.escalationadvisors.com.

Bill Brownfield is founder of Brownfield & Associates, a commercial real estate advisory firm. Mr. Brownfield is also the co-founder and president of Brownfield & Mayerhofer, Inc. The company specializes in consulting, training and software solutions for operating expense escalations for commercial real estate. Clients include REITs, commercial property owners, property managers and tenants. Mr. Brownfield is frequently engaged in landlord-tenant disputes related to operating expense escalations and methodology.

Larry Mayerhofer is a CPA with over 24 years of real estate accounting experience. He has been responsible for reviewing escalations for Equity Office Properties' national portfolio of over 14,000 leases and has been involved in the resolution of numerous escalation disputes. He designed the BOMA Escalation software, and provides support for the product. He resides in Chicago, and has worked for EOP for over 20 years where his positions have included tax supervisor, controller, VP-property accounting, JDE system implementation project manager, VP-corporate accounting, and currently serves as their vice president of financial projects.

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Details About BOMA's Escalation Handbook and Software

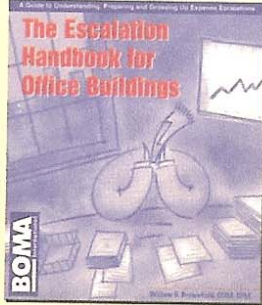
Tenants scrutinize their escalation bills more closely today than ever before. Getting their escalation invoices right the first time will enhance the landlord/tenant relationship and build trust. To standardize the escalation process, BOMA International and Brownfield & Mayerhofer, Inc. offer the following tools to assist you in preparing accurate, defensible escalation billings:

The Escalation Handbook for Office Buildings

Written in a user friendly style, both veterans and novices can benefit from this in-depth analysis of escalation theory and practice.

Chapter topics include:

- What are escalations? What are gross ups?
- Different types of escalation clauses.
- Types of expenses that are escalatable and the justification for grossing up expenses.
- Justification for grossing up expenses.
- Typical gross up calculations.
- Escalating capital expenditures.
- Creating an escalation package (includes a checklist to guide you through the escalation process).



The methodology for grossing up expenses has been endorsed by BOMA, creating the industry standard. It is an excellent resource for supporting your expenses and calculations during escalation audits. The Escalation Handbook can be ordered directly from BOMA at <http://www.boma.org/ProductsAndResearch/Accounting/TheEscalationHandbookforOfficeBuildings.htm>.

BOMA's Office Escalation System

BOMA's Office Escalation System is software that automates your escalation billing processes. This self-contained package can be loaded onto any Windows-based PC, laptop or network.



The software offers the following unique features:

- Historical building data for all years is maintained in a single file, which is especially useful in the event of employee turnover and for tenant escalation audits.
- In the event of the building's sale, the escalation software license can be transferred to the new owner.
- Works with calendar year or fiscal year expenses.
- Accepts any owner's unique chart of accounts.
- Property expenses can either be entered manually or uploaded with Excel.
- Accepts expense adjustments and year-end accruals.
- Accommodates an unlimited number of unique expense pools.
- Uses BOMA-endorsed methodology to calculate gross ups.
- Tracks the building's occupancy and utility histories for each year.
- Tracks amortizable capital improvements and automatically carries them forward to each new year. Has the capability to impute interest to each job and to begin amortization in any month (for jobs completed mid-year).
- Calculates both the annual reconciliation and the new monthly prepayment for each tenant.
- Unique lease clauses can be set up as the default to speed up lease input.
- Calculates escalations for various methods of segregating expenses (e.g., Combined Tax and Operating; Separate Tax and Operating; Real Estate Taxes Only).
- Accepts Base Years, Expense Stops and Net Leases.

- Reconciles each tenant's annual prepayments.
- Calculates expense caps on either an annual or cumulative basis, and on either controllable expenses only or on all operating expenses.
- All reports display the Building Name and Address along with the BOMA logo.
- Generates an impressive array of Reports:
 - Tenant by tenant summary billing reports including:
 - Detail of the final reconciled amount billed to each tenant.
 - Detail of the actual monthly prepayments billed to each tenant.
 - Detail of the upcoming year's budgeted monthly prepayment amounts for each tenant.
 - Escalatable expense reports include:
 - A three-year comparison of total escalatable expenses displaying both the per square foot expense and the percentage change between current year actual vs. prior year actual, and current year actual vs. next year's budget.
 - An expense pool summary report showing each escalatable expense category along with any manual adjustments, accruals, gross ups and capital amortizations.
 - An expense pool detail report showing each individual escalatable expense account along with any manual adjustments, accruals, gross ups and capital amortizations.
 - Detailed gross up schedules for each of the seven typical gross up accounts.
 - Capital and Amortizable expense reports detailing the treatment of each capital improvement.
 - Controllable vs. Non-controllable recap for verifying expense cap calculations.
 - The system generates tenant invoices including:
 - Individual tenant invoices for the final reconciled amount and for the new monthly prepayment.
 - Customizable cover letters for the final reconciled amount and for the new monthly prepayment.
 - Comparison with Typical Accounting Software
 - Almost all of the larger real estate accounting software packages include some type of escalation billing component. However, most have flaws that limit their usefulness:
 1. They assume that all leases are identical and will not work with all lease types.
 2. They are too cumbersome or complex to be used efficiently.
 3. They do not have a built-in gross up tools.
 4. They will not handle expense caps.
 5. The built-in reports are inadequate,
 6. They do not generate cover letters.

BOMA's Office Escalation System solves each of these problems.

For more information on the escalation software, go to Brownfield & Mayerhofer, Inc.'s Website www.escalationadvisors.com.

On-Site Training

Brownfield & Mayerhofer, Inc. conducts escalation seminars at local and national BOMA conferences using the Escalation Handbook as the foundation of the seminar. They also offer customized on-site escalation training for real estate accountants and property managers. For more information on scheduling training for your company please contact Bill Brownfield at bill@wbrownfield.com.