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Audits of Percentage-Rental Leases

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It is becoming a common practice, even with one-store tenants, to pay rental for business premises based on a percentage of the receipts.

The percentage-rental lease is, or at least ought to be, a highly equitable instrument for determining the landlord's share of the gross income of a retail or wholesale business; but it brings the landlord into close business relations with his tenant and must be fairly handled if one of the parties is not to make an undue profit at the expense of the other.

A percentage-rental lease may extend over a period of years, with a provision for audit once a year. It may provide for a sliding scale of rents, according to the volume of business done by the lessor; and there may be a stated minimum rental, below which the sliding scale is not operative.

The lease may provide different rates of rent for different departments of the lessee's business. The hours of operation, the lighting of the show windows, the value of the inventory to be carried, and the amounts which the lessee is to spend for advertising, all may be the subject of leasehold stipulation; or, if the lessee is a corporation, even the payment of officers' salaries and dividends may be restricted by agreement. Consequently the landlord must, under the percentage-rental method, not only use care in selecting his tenant, but he must take an active interest in the conduct of the business after the lease is made.

The percentage of receipts to be paid as rental is subject to a wide variation according to the location and the nature of the business. Commonly it may run anywhere from 2½ to 25 per cent. of the receipts, or even more, with perhaps a concentration of frequency around 6, 8 or 10 per cent.

The lease should distinguish between receipts which are to be subject to the rental-charge and those which are not to be subject to that charge. The following lists indicate certain classes of receipts which are often made subject or not subject to the rental charge:

Subject to rental charge:
- Cash sales, less refunds.
- Charge sales, whether collected or not, less outgoing freight, postage and express.
- Commissions earned or received.

Not subject to rental charge:
- Sales to employees at reduced prices.
- Occasional wholesale sales by one retail store to another.
- Transfers of goods between two stores of the same retail chain.
- Proceeds from the sale of securities, fixed assets, etc.
- Sales of postage stamps.
- Borrowed money.
- State sales taxes collected from customers for payment to the state.

Percentage leases usually contain a provision by which the lessor may have the lessee's books audited to verify the sales or to determine the lessee's compliance with other provisions of the lease.

There is sometimes a pronounced difference of opinion between the lessor and lessee as to what does or does not constitute income subject to the application of the rental percentages; and there is unfortunately no board of appeals from which an adjustment may be demanded. The auditor, if he has been employed by the lessor, is not in a position to act as an arbitrator.

The basis for a rental examination does not differ from that for any other audit. The rental audit would naturally be classed as a limited examination, made for a special purpose. But it is difficult to verify a sales account without verifying many of the other accounts with which it is closely connected. The best verification therefore would be a general audit, but the auditor does not usually have the opportunity to make so comprehensive a test. The time on the job must be kept within proper limits, and the emphasis put in the right places. A chain-store organization operating a hundred stores may be somewhat reluctant to open all its records to an auditor who represents the lessor of only one store; nevertheless, the auditor knows that his work is incomplete unless he can fit the one store into its place with the other ninety-nine.

The lease itself is the auditor's starting point. In addition to verifying the receipts, he may be expected to check the lessee's compliance with various other sections of the lease, such as those relating to inventories, advertising expenditures and hours of operation.

If the tenant's business is done principally for cash, as in a restaurant or drugstore, the examination will tend toward an emphasis on the cash records, with the auditor in the position that he may determine that all recorded receipts are properly accounted for but be unable to tell if there have been unrecorded receipts.

Cash-register readings may be taken once a month, in the presence of the landlord's representative, and the cash registers may be turned back at that time. The other cash records need be inspected only once a year. They may consist of cash-register summaries, cashbooks, deposit slips and bank statements. All receipts should be traced from the cash registers to the bank.

An inspection of the cash records alone, however, is not sufficient. Some businesses make nearly all sales for cash and yet have occasional receipts of income from business handled on a charge basis.

If the tenant is an institution such as a wholesale house, doing business on a bill-and-charge basis, the examination must follow the lines of a general audit, but the work must be cut short in any direction that does not contribute to a verification of the sales account.

The auditor's report will naturally contain a statement of the work that has been done, with comments on any unusual conditions which have been encountered. The schedules may show month-by-month results or yearly totals only.

The report schedule for a lessee who sold for cash only, and where no differences were found by the auditor, took the following form:

Lessee's total receipts for the year........................	$..........
Less receipts which are not reportable for rental purposes....	....
Net amount reported by lessee...........................	....
Disbursements made from the receipts before the receipts were deposited...	....
Plus or minus any other necessary items of reconciliation between receipts and deposits............................	....
Lessee's bank deposits for the year......................	....

If the auditor has found differences between the income as reported by the lessee and as determined by subsequent audit, it will be desirable to include an additional schedule on which the differences may be listed and the refund or additional rent calculated. Such a schedule would take the following form:

Income:

As reported by lessee..........................	$..........
Differences....................................	....
As determined by this audit.....................	....

Rates applicable (sliding scale):

Income subject to 9% rental	$..........
Income subject to 10% rental	....
Income subject to 11% rental	....
Total income, as above	....

Rental calculations:

Rental at 9%	$..........
Rental at 10%	....
Rental at 11%	....
Total rental due	....
Rental previously paid	....
Additional rent or refund due	....