CHAPTER 4

STATEMENT OF INCOME IN DETAIL

4-1  All HUD projects deal with revenue and expenses. The Asset Management/Loan Management staff examines the relationships between a project's revenue and expenses in order to determine if the project is being operated efficiently and in accordance with HUD regulations.

Overview  This chapter will enable you to:

1. Discuss the types of revenue, their use and their importance to the project.
2. Discuss the types of expenses, their use and their importance to the project.
3. Define Net Income or Loss and its importance in the evaluation of the project.

4-2  Revenue

Definition  Revenue is the inflow of cash or other assets in exchange for services provided.

Components  The three types of revenue that will be discussed are:

- rental revenue,
- service revenue, and
- financial revenue.

Rental Revenue

What it is  Rental revenue is the result of a contractual agreement between the owner of a HUD project and a tenant for the occupancy of a unit of housing.

<table>
<thead>
<tr>
<th>Components of Rental Revenue</th>
<th>COMPONENTS OF RENTAL REVENUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>GROSS POTENTIAL RENTAL REVENUE</td>
<td></td>
</tr>
<tr>
<td>OCCUPIED APARTMENTS</td>
<td>RENT-FREE APARTMENTS</td>
</tr>
</tbody>
</table>

4-1  6/92
Definitions

Gross Potential Rental Revenue refers to the maximum amount of rental revenue (i.e., 100% paying occupancy) a project could earn.

Occupied Apartments are those presently earning revenue.

Rent-Free Apartments are those apartments assigned to project employees at no charge. It is not appropriate to show the value of these units as vacancies. However, since they represent part of the project's potential revenue, they are included here. To account for the fact that they do not add to the project's revenue, rent-free apartments show an "artificial" revenue with an offsetting expense under an appropriate caption like "manager salary".

Unoccupied Apartments refer to units which are not earning income because no one is living in them.

Skips refer to units where a tenant vacates without notice prior to the end of a lease. Revenue has been earned but will probably not be collected.

Why it is important

Rental revenue is evaluated for two reasons:

- to see if the project is going to have enough income to meet its expenses, and
- to see if the rental revenue is in compliance with the HUD approved amount.

Service Revenue

What it is

Service revenue is revenue the project earns for providing services (other than rental units).

Examples

Examples of services that provide revenue include:

- laundry and vending,
- NSF and late charges,
- damage and cleaning fees,
- forfeited tenant security deposits, and

Comment

If the amount of service revenue is large, IPAs are required to provide a breakdown of the amount in the Notes to the Financial Statements. Loan Management staff should review the Notes to the Financial Statements to see if the explanation of large amounts is reasonable and
Financial Revenue

What it is

Financial revenue is usually the result of interest earned.

Components

Financial revenue is derived from one or more of the following:

- project operations,
- reserve funds,
- security deposits,
- residual receipts, and
- Interest Reduction Payments (IRP) for Section 236 projects.

How they are used

- The Loan Management staff should encourage the owner to invest cash that is set aside or that is not being used to meet current operating expenses.
- If the Notes to the Financial Statements show that reserves or security deposits are invested, the Loan Management staff will expect to see financial revenue on the Statement of Income.

Expenses

Definition

Expenses are the outflow of assets or increases in liabilities that occur as the result of providing the products or services that generate revenue during the period.

Types of Expenses

The following are basic types of expenses found on HUD projects:

- administrative expenses,
- utilities expenses,
- operating and maintenance expenses,
- taxes and insurance,
- financial expenses,
- elderly and congregate service expenses,
- corporate or owner entity expenses, and
- depreciation.

Interaction

All expenses interact with the operating budget. All expense items are compared to the budget. Variances are
identified and explained.

Expenses also interact with cash and liabilities, especially accounts payable and accrued liabilities. For example, the project is billed for a service and decides not to pay it immediately. Under the accrual method of accounting, an account payable is created or increased.

<table>
<thead>
<tr>
<th>Why they are important</th>
<th>The operating budget and rent schedule assumes that expenses will be reasonable and necessary. If expenses are not controlled, the revenues generated may be insufficient to cover expenses.</th>
</tr>
</thead>
<tbody>
<tr>
<td>How they are used</td>
<td>Increases in expenses which are beyond the control of the project managers usually justify a rent increase. The Loan Management staff will often compare these expenses to those of similar projects to determine if rent levels are reasonable and appropriate.</td>
</tr>
</tbody>
</table>

Administrative Expenses

<table>
<thead>
<tr>
<th>What they are</th>
<th>Administrative expenses are monies expended to manage the project.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Why they are important</td>
<td>Administrative expenses are important in that they can be used to tell if the project is being managed in compliance with the management agreement. It is also an area in which abuse is common.</td>
</tr>
<tr>
<td>How they are used</td>
<td>Administrative expenses are used by the Loan Management staff to check for common abuses like:</td>
</tr>
<tr>
<td></td>
<td>o fees accrued in excess of that permitted in the management agreement, and</td>
</tr>
<tr>
<td></td>
<td>o unreasonable legal and audit costs.</td>
</tr>
<tr>
<td>Example</td>
<td>If the project has a stable and high occupancy rate and a waiting list for apartments, it should not be spending a large amount on advertising. If there is a poor occupancy rate and no evidence of sufficient advertising, the Loan Management staff should inquire as to why. If the advertising costs are excessive, the Loan Management staff should check to see if the type of advertising is appropriate.</td>
</tr>
<tr>
<td>Components</td>
<td>The components of administrative expenses include the following items:</td>
</tr>
</tbody>
</table>
operating, 
office salaries, 
office expenses, 
office rent, 
management fee, 
manager or superintendent salaries, 
legal expenses (project), 
auditing expenses (project), 
telephone and telegraph, 
bad debts, and 
miscellaneous.

Operating and Maintenance Expenses

What they are
Operating and Maintenance (O&M) expenses are the costs of running and maintaining the project.

Why they are important
Operating and maintenance expenses are the expenses most difficult to control. Even if the manager shops wisely and operates the project efficiently, inflation and other factors often drive operating expenses up. Increases in these costs are the most common reason for rent increases.

Components
The components of operating and maintenance expenses include the following items:

- elevator payroll,
- elevator power,
- fuel,
- engineer payroll,
- janitor payroll,
- janitor supplies,
- bus operator payroll,
- gasoline, oil and grease,
- electricity,
- water,
- gas,
- exterminating payroll,
- exterminating supplies,
- exterminating contract,
- garbage and trash removal,
- miscellaneous,
- protection payroll,
- protection fee, cost of contracts,
- grounds payroll,
- grounds supplies and replacements,
grounds contract,
cleaning payroll,
repairs payroll,
repairs material,
repairs contract,
repairs - extraordinary and nonrecurring,
elevator maintenance,
air conditioning repair and maintenance,
decorating payroll,
decorating supplies,
motor vehicle repairs,
maintenance equipment repairs, and
miscellaneous.

How they are used
The project's operating and maintenance expenses are often compared to similar projects to see if they are reasonable. Large increases in operating and maintenance expenses are sometimes an indication of the need for a rent increase.

If operating and maintenance expenses are significantly higher than those of similar projects, the Loan Management staff should investigate to see if the owner is shopping and comparing prices to ensure that materials, supplies and services are the most advantageous to the project and are not in excess of amounts normally paid for such items. Management should also maintain an active list of vendors and contractors which offer competitive pricing. Loan Management staff can also suggest improvements which will enhance the efficiency of operations.

Why they are important
Operating and maintenance expenses are important because they can be used to evaluate the efficiency of both the maintenance and management operations. By taking advantage of discounts and shopping for the best buy, the manager can exert more control over these expenses than can be exerted over other expenses.

Depreciation
What it is
Depreciation is the process of expending a portion of an asset's cost as it is used during each year of the asset's estimated useful life. This is necessary to charge the correct portion of the asset's value "used up" during the year. Generally accepted accounting principles require that depreciation be computed by a systematic and rational method over the estimated useful...
life of an asset. However, in 1981 and 1986 the tax laws established cost recovery provisions that have no relationship to the estimated useful life of an asset. The tax legislation was designed to stimulate investment and development by profit-motivated investors.

Why it is important

Depreciation is important because it is an non-cash expense item (that required cash up front) but gives the owner a tax deduction. The fact that the owner can lose a part of this tax write-off if HUD forecloses is a motivating factor that helps convince the owner to correct any noted deficiencies.

Components

Assets which are depreciated include the following items:

- alterations,
- buildings,
- building equipment - fixed,
- building equipment - portable,
- furniture for project administration use,
- furniture and equipment - project owned for rental or lease,
- furnishings,
- maintenance equipment,
- motor vehicles, and
- miscellaneous.

Types of depreciation

Exhibits 4-1 and 4-2 describe types of depreciation commonly used in HUD projects. Traditional methods of depreciation include straight-line, which allocates the cost equally over the life of the asset, and accelerated depreciation which allocates more of the cost during the early years of an assets life. Accelerated depreciation methods include the declining balance method and the sum-of-the-years-digits method. Under the declining balance depreciation method, an asset can be depreciated up to twice the straight-line rate (200%) without considering salvage value. To determine the double-declining rate, first determine the straight-line rate by dividing 100% by the estimated life of the asset. Then multiply the straight-line rate by the desired acceleration (125%, 150%, 200%). Calculate the annual depreciation by multiplying the declining-balance rate by the end-of-year book value. Under the sum-of-the-years-digits method, the years in an asset's life are added (e.g., 1+2+3+4+5 = 15). The sum becomes the denominator of a series of fractions used in calculating the annual depreciation. The numerators are the years in the assets life (e.g., 5/15, 4/15, 3/15).
Unlike the declining balance method, depreciation is calculated each year on the cost of the asset less the salvage value.

Recent tax laws enacted by the IRS allow for two new methods of depreciation that vary from the traditional methods, but have similar characteristics of accelerated depreciation. For assets purchased after 1980 but before 1987 the tax law allows for a method of depreciation called Accelerated Cost Recovery System (ACRS). For assets purchased after December 31, 1986 ACRS was revised to allow for a method of depreciation known as the Modified Accelerated Cost Recovery System (MACRS). The ARCS method allows rapid recovery using a fixed recovery schedule over a prescribed statutory period. Therefore, the property's salvage value and the estimated useful life are not required. For example, 5-year property (e.g., office furniture, equipment, heavy-duty trucks) is depreciated at 15% the first year, regardless of when it was placed in service during the year. The second year at 22% and the remaining three years at 21% percent. The MACRS method, like ACRS, does not consider useful life or salvage value, however, consideration is given as to when the combined bases of property was placed in service. Property in the 3-year to 10-year classes are depreciated using a 200% declining-balance method, switching to straight-line; 15 and 20-year classes are depreciated using a 150% declining-balance method, switching to straight-line method; and residential (271/2 years) and nonresidential (311/2 years) property is depreciated using the straight-line method. Awareness of the type of depreciation can assist Loan Management staff in negotiating workouts with owners of troubled projects.

Comment

Owners prefer accelerated depreciation because it defers the payment of income taxes from the early years of the project. Taxes are deferred because larger amounts of depreciation are charged, therefore reducing net taxable income. This provides more operating funds for the project which may be suffering insufficient rental income due to the project not being fully rented. However, the taxes are only deferred, they are not avoided. If the owner sells the project or HUD forecloses, the project owner may need to repay some of the income tax savings to satisfy the larger income taxes that may become due in the asset's later years.
Note that HUD will accept only GAAP treatment of computing depreciation.

Amortization

What it is

Amortization is the expending of a share of the cost of an asset, usually an intangible asset. An intangible asset is one that has no physical existence but has value due to the rights resulting from its ownership and possession. The most common intangible assets of a multifamily project is the costs associated with organizing a cooperative or corporation.

Why it is important

Amortization is an expense on the Statement of Income that does not use cash, (cash is required to purchase or acquire the rights to the asset) but provides for an income tax deduction.

Components

The types of assets that are amortized include:

- organizational costs of a corporation or cooperative,
- leasehold improvements,
- patents,
- copyrights,
- trademark, and
- trade names.

Note:

"Amortization" in this context should not be confused with the "amortization" of the mortgage principal, which does use cash to retire or repay, the mortgage indebtedness.

Exhibit 4-1. Types of Depreciation Per Generally Accepted Accounting Principles

METHOD OF DEPRECIATION - The procedure followed for calculating depreciation expense.

STRAIGHT LINE ACCELERATED - More
Cost allocated equally over the asset's life. of the cost is allocated to the earlier years of an asset's depreciable life.

<table>
<thead>
<tr>
<th>Method</th>
<th>Percentage</th>
<th>Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>200% Declining Balance</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>150% Declining Balance</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>125% Declining Balance</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>SUM OF YEARS DIGITS</td>
<td>10</td>
<td></td>
</tr>
</tbody>
</table>

Exhibit 4-2. Types of Depreciation Per Income Tax Basis

METHOD OF DEPRECIATION - The procedure followed for calculating depreciation expense for tax purposes.

Accelerated Cost Recovery System (ACRS) - Used for assets purchased after 1980 and before 1987.


5 YEAR 167K

Used for rehabilitation housing. A special life despite their much longer actual useful life.

Personal Property
3-year class to 7-year class

Personal Property
3-year class to 20-year class

Real Property
15-year class to 19-year class

Real Property
271/2-year class for residential rental property and 311/2-year class for all other real estate

Taxes and Insurance

What they are for two reasons:

- Taxes (payroll, county, etc.) and insurance are important
- If taxes (payroll, county etc.) are not paid, the IRS and local government might be able to place a lien or foreclose on the project;

- If the insurance is not paid, the building would not be properly protected against loss due to fire or natural disaster; and

- Payment is required by the Regulatory Agreement and mortgage note.

**How they are used**

The Asset Management/Loan Management staff often reviews the insurance expense to ensure that the property is adequately protected. If the tax expense is unusually low or high, the Asset Management staff will determine if the taxes are paid in full or if penalties and interest are included. Advice can be given to the project owner on how to lower these costs, if excessive. For example, the Asset Management staff can recommend the filing of a property tax appeal.

**Components**

The following three items are components of taxes and insurance:

- Property taxes,
- Payroll and other taxes, and
- Property and personal liability insurance.

**Financial Expenses**

**What they are**

Financial expenses are costs associated with the acquisition and use of assets from sources outside of the project.

**Examples**

Examples of financial expenses include the following items:

- The interest portion of each mortgage payment,
- Financing charges or interest on notes payable,
- Financing charges on purchases, and
- Interest paid on bonds sold by the project.

Financial expenses record the payment of the mortgage. This account may also reveal payments of other debts that may or may not have been HUD approved.

**Components**

The components of financial expenses include the following items:
interest on bonds payable,
interest on mortgage payable,
interest on notes payable (long term),
interest on notes payable (short term),
insurance on mortgage (MIP), and
miscellaneous.

How they are used
The Loan Management staff can check for compliance with HUD requirements by comparing the expense category against the approved debts of the project to see if there are payments for unapproved debts.

Service Expenses
What they are
Service expenses are the costs associated with tenant services other than housing.

Examples
Examples of service expenses include items such as:

- maid service,
- T.V. antenna rental, and
- laundry services.

Why they are important
Service expenses are important because they must be self-supporting and be independent of other project funds.

How they are used
The Loan Management staff can compare service expenses to service revenue to see if the services are self-supporting and not drawing on other project funds.

Corporate Expenses
What they are
Corporate expenses are the costs of maintaining the legal status of the corporation. These types of expenses are not found in partnerships, except for required filing fees.

Components
The components of corporate (other than Subchapter S corporations) expenses sometimes include the following items:

- officer salaries,
- legal expenses (entity),
- federal income tax,
- state income tax,
- other taxes (entity),
- other expenses (entity).
Some corporate expenses, such as taxes, are relatively unimportant unless the sum is large; others, such as legal expenses and officer salaries, could represent possible diversions of project funds for unauthorized expenditures. The Asset Management staff should review the Notes to the Financial Statements to determine if the owner is having personal legal expenses paid out of project income which is a violation of HUD requirements or if some of the corporate expenses that are listed might be unallowable distributions.

4-4
NET INCOME OR LOSS

What it is Net income or loss is simply the difference between a project's total revenues and its total expenses.

Why it is important Net income or loss is a major component used for evaluating the financial health and stability of a project. The financial success of a HUD project is not measured solely on the basis of its net income or net loss, which is only one factor used to determine a project's financial health and stability.

Other factors that should be considered with net income or loss include a project's:

- ability to maintain high levels of occupancy and collections;
- ability to maintain reasonable rent levels when compared with similar projects;
- ability to meet all obligations as they become due;
- financial and organizational ability to maintain the project in good physical condition;
- availability of funds for necessary replacements, major repairs, and unforeseen circumstances;
- ability to maintain reasonable levels of expenses, compared to similar projects; and
- availability of cash for distribution to owners.

Comment Most HUD projects show a loss at the bottom of the Statement of Income. This is mainly due to depreciation, which is a large expense, that does not require the use of cash. To obtain a clearer picture of the project's cash basis income or loss, the Loan Management staff
should add all "non-cash" expenses (like depreciation) back into the bottom line of the Statement of Income. This provides a more meaningful "net income or loss" figure which can be used to evaluate the efficiency of the operations. (See Chapter 5 of this Handbook for a complete discussion of cash flows.)

Non cash expenses other than depreciation include:

- accounts receivable,
- prepaid items,
- accounts payable,
- accrued expenses,
- tenant Security Deposit Payable,
- deferred income, and
- accrued year-end revenue.

The Loan Management staff can evaluate the impact of these other non-cash expenses on net income or loss by comparing the current year end balances in these accounts with the beginning balances.

Example

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>($240,000)</td>
</tr>
<tr>
<td>Accrued Revenue</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Depreciation</td>
<td>220,000</td>
</tr>
<tr>
<td>Accrued Expenses</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Gross Profit (Loss) before Depreciation</strong></td>
<td>$(20,000)</td>
</tr>
</tbody>
</table>

Comments

Financial ratios which assist in the evaluation of the Statement of Income are discussed in Chapter 3 of this Handbook.

Chapter Summary

The relationship between revenue, expense and net income or loss can be summed up in the following equation:

\[
\text{REVENUE} - \text{EXPENSES} = \text{NET INCOME OR LOSS}
\]

The Loan Management staff can get a clear picture of a project's efficiency and stability by studying The Statement of Income. This information can be used to identify a project's strengths and weaknesses and can be used to evaluate adherence to HUD standards of operation.
CHAPTER 4

ACCOUNTING KNOWLEDGE QUIZ

QUESTIONS

1. The inflow of cash and other assets resulting from rental and other services relating to HUD projects is called ________________.

2. The three types of revenues are:
   a. __________________________
   b. __________________________
   c. __________________________

3. Outflows of assets are called ________________.

4. Management fees are an example of ________________ expense.

5. Repairs payroll is a part of ________________ expense.

6. MACRS, ACRS, straightline, accelerated and 5-year 167K are types of ________________.

7. Finance charges and purchases are components of__________ expenses.

8. The project's owner should not have personal legal expenses paid out of ________________.

9. Is the value of apartments used as employees' rent-free residences and as project offices properly considered a vacancy loss? If not, how is this rental loss accounted for?

   __________________________
   __________________________
   __________________________

10. What is the effect and purpose of depreciation?

    Effect: __________________________
    __________________________
11. Can a project show continuous net losses and still survive without additional capital contributions?

____ Yes     ____ No

ANSWERS

1. Net Revenue (i.e. income) (p. 4-1)

2. a. rental  
b. service revenue  
c. financial revenue (p. 4-1)

3. Expenses (p. 4-4)

4. Administrative (p. 4-5, 4-6)

5. Maintenance (p. 4-7)

6. Depreciation (p. 4-8, 4-9)

7. Financial (p. 4-11)

8. Project income (p. 4-13)

9. This use is not a vacancy loss. It can properly be shown as revenue with an offsetting expense, or as reduced rent potential.

10. A. The effect is to allocate more of the cost of the asset to the early years of its depreciable life, or match the expense with revenue generated over the life of the assets. (p. 4-8, 4-9)

    B. The purpose can be to match depreciation expense with corresponding revenue, but is used most often to reduce the owner's taxable income. (p 4-8, 4-9)

11. No. While net losses may be due primarily to depreciation expenses or other non-cash expenses that do not require the current use of cash, the project must eventually break even at a minimum to be an ongoing concern. (p. 4-8, 4-9)