CHAPTER 6. OPERATING EXPENSE ESTIMATES

6-1. ANALYSIS OF OPERATING EXPENSES. A determination is made of the portion of gross income which must be used to maintain, operate and repair the property and to defray the costs of ownership arising from it. Under proper management, these expenses are a first claim upon income and must be met if predicted gross income is to be realized. Accurate analysis of operating expense is essential to determining realistic net income.

6-2. EXPENSE DATA. Estimates of operating expenses can be made valid by comparison with operating expense developed by comparable properties situated in areas which are comparable with regard to climate, custom, labor and operating material costs, type and amount of services provided, and methods of operation and management. Differences in type of building materials, construction and design also must be considered in comparing operating costs. Estimates of operating costs made by engineers, cost estimators or other competent persons after study of project plans, specifications and locations also may be accepted. It is imperative that estimates be based on the project under consideration. The use of statistical average or formulae can be extremely misleading particularly if the project involved is markedly different in design or use of materials. Averages arrived at by the use of widely divergent or unverified data are of no value.

6-3. FILE DOCUMENTATION. Multifamily project expense data will be recorded on Valuation Data Sheets, Forms FHA-2275, 2276, 2277, and stored in the data bank. Comparable projects are selected from the bank and the amount of individual expenses from such projects, adjusted as necessary for significant differences, is utilized in processing. Where the sponsor's expense estimate is reasonable, his dollar amount should be used in processing to eliminate conflict over immaterial differences. Processing of Operating Expenses and Taxes on Form FHA-2274 must include the individual expense estimates for each component item listed. The expense estimates will be documented in the processing file by the inclusion of Form FHA-2274 which will contain the information for at least three similar projects and an explanation of the adjustments made to this operating experience in the development of the expense estimates.

a. See Reference 2 of the Foreword for the Operating Analysis Worksheet, Form FHA-2274 to be used in the development of the expense estimates.
b. The appraiser must pay particular attention to the trending adjustment when analyzing the operating expenses and the rental estimate.

c. Inadequacies in the expense estimate are often attributable to improper time and trend adjustments. The result is the necessity of increasing rents at the beginning of the first year of operation to offset the deficient expense estimate.

d. The factor used as trend will consider past and anticipated economic climate and occupancy experience. Included in the analysis of data relating to past performance as a forecast of future performance, the appraiser must consider rates of change of various expense components and arrive at a component trend rate.

e. Consideration must be given to the age of the data used; the time required for processing through the initial closing and the estimated construction time. For purpose of calculating trend, time of initial occupancy will be that time when construction of the project is estimated to be completed plus 2 months leeway normally allowed for the time between completion of construction to the time that cost certification occurs.

(1) For example, assume an appraisal being made on 1/1/77 using expense data recorded on Forms FHA-2275 or 2276 showing a beginning date of the period of expense operation of 1/1/75. Further, assume a six month target date for initial closing and an estimated construction period of 10 months plus 2 months for purpose of calculating carrying charges. The operating expense data in this instance would be trended a total of 3 1/2 years from the beginning date of the expense data through construction time to the date of anticipated initial occupancy.

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\begin{align*}
\text{eg:} & \quad 1/1/75 \text{ Date of data} \\
& \quad \text{To} \quad 1/1/77 \text{ Date of appraisal} = 2 \text{ years} \\
& \quad \text{To} \quad 6/1/77 \text{ Est. processing time} = 1/2 \text{ year} \\
& \quad \text{To} \quad 6/1/78 \text{ Est. const. time & 2 mos} = 1 \text{ year} \\
& \quad \text{Total Time and Trend Period} = 3 1/2 \text{ years}
\end{align*}
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Note: Trend Factors for taxes may vary from other trend factors.

(2) The foregoing procedure results in income and expenses being trended to the same date.
f. After completion of the worksheet the appraiser will enter in Section E of the Form FHA-2264 the total annual estimates for lines 21, 22, 28 and 29 properly updated to the time of initial occupancy. The individual expense items on the Form FHA-2264 will not be required. A complete expense analysis worksheet, Form FHA-2274 will be attached to the file copy of the Form FHA-2264 and included in the project binder in every case.

6-4. DATA ANALYSIS.

a. Expense Estimates. The estimate of operating expense should reflect the needs of the income group to be served. In some cases the operating expense may be higher than the operating expense of other similarly constructed projects. Additional management expense may be incurred due to delay and effort required in collecting rents. These problems are most often found in those projects occupied by lower income tenants.

b. Maintenance Expense. The total estimate of maintenance expense should reflect the level of maintenance and repair costs which may be expected because of the intended occupants. Such costs may be higher because of tenant behavior in a lower income project and also because there may be more vandalism from the outside than is usually the case in similarly constructed but higher-income projects. In making comparisons with either higher or lower income projects, it is important that adjustments for the project in question be applied to individual amounts of operating, maintenance and repair expenses, rather than to an expense ratio. This is true of all expense estimates.

c. Reserve for Replacement. While processing requires utilizing expenses based on data, the reserve for replacement estimate must be identified as a specific dollar item for entry on the commitment. The reserve will in all instances be computed on a furnished factor times "total structures." This method recognizes that any laborious computation based on expected life of various building items is inaccurate at best and overlooks the various uses to which the reserve
account may be put. The reserve account may be considered a contingency fund and as such need not specifically identify the various items which will need replacement in the life of the property.

d. Estimate of Taxes. The methods of assessors in arriving at the assessed value of real property vary so widely that it is imperative that complete information be obtained in order to make possible a fair estimate of future taxes. It is necessary to become fully informed as to the various practices and mechanics of assessing employed locally in order to prepare a valid estimate of the probable real estate taxes to be levied against a proposed project. It will be necessary to compare the actual current tax on competitive rental housing properties with the estimate for the proposed project.

6-5. MARKET DATA. All offices must have a data bank containing sufficient information to process cases. The data bank will consist of not less than the following information:

a. Absorption Data. FHA Form 184 will be maintained for each HUD insured project. This data must also be maintained on conventionally built rental projects. Each project binder must contain absorption data to support conclusions reached with respect to operating deficits. Where it is anticipated that no deficit will occur, this must also be supported by data.

b. Data Forms FHA 2275 - (Rental). A Valuation Data Form will be prepared at the conclusion of firm commitment processing and thereafter maintained as annual operating statements are received by the office. It is the responsibility of the Field Office Director to see that copies of operating statements (FHA Forms 2410, 92410, and 2474 or 9801) are provided to the Multifamily Data Appraiser as soon as they are received in the office. The Multifamily Data Appraiser must also collect data and complete data forms on conventionally financed projects.

c. Rental Data. The rental and occupancy portion of the FHA 2275's must be kept current. This can be accomplished by the processing appraiser when he uses a particular comparable as well as the regular updating by the data appraiser.

d. Land Sales Data. The land appraisal process is dependent upon the collection, analysis and systematic recordation of current
land sales data. Land sales information shall be developed and maintained by the Multifamily Data Appraiser, with basic information required for proper determination of land values. This land sales data bank must be maintained on an active and continuing basis. The land sales data card should contain a sketch or photo of the site, information on any unusual site conditions, available utilities and distance to them, special appeal features, zoning, taxes, special assessments, and specific conditions of the sales transaction.

(1) Items which represent a cost to the purchaser, in addition to the sales price, should be noted. These may include off-site improvement cost, demolition cost, and any cost to bring the site to a usable condition.

(2) Five appropriate arms length land sales will be selected from the data bank, of which two must be conventional sales. A conventional land sale for this purpose is:

(a) A site on which a conventional (non-HUD insured) rental project is under construction or recently completed.

(b) A vacant site, whose sale has been closed, and has not been submitted to the Field Office for project mortgage insurance.

The appraiser will indicate the conventional sales by the letter "C" preceding the comparable number, on FHA Form 2264 Section J item number 8. The land sales cards selected will be reproduced and made a part of the processing package.