APPENDIX 24a

SAMPLE OWNER EXPLANATION OF EXPENSE ESTIMATES
September 20, 1983

Advertising and Renting Expense. This includes: I $200 for periodic ads in local newspaper; and 2) the cost of credit reports on new applicants.

Bookkeeping Payroll and Services. Includes this project's share of centralized accounting operation. Costs are prorated over all of the 20 projects managed by our agent, Professional Management, Inc. Costs are prorated according to each project's relative volume of transactions.

Clerical and Occupancy Salaries. Includes one-fourth of one occupancy clerk's time. Occupancy clerk also works for XYZ Apts. and Evergreen Apartments.

Office Supplies. Consistent with published economic forecasts, this line projects for a 4% increase in supply costs. This is less than last year's 8% increase.

Manager's Salary. Includes manager's salary plus contract rent on a 2-bedroom apartment. As payroll schedule shows, manager will receive a $100 per month increase for cost of living and performance bonuses.

Legal. This represents retainer for an attorney who handles all routine project matters. This is less than last year's actual expense. Last year, a larger than usual number of evictions were required because of the former agent's failure to effectively screen applicants. Agent was removed six months ago.

Auditing. Represents the contract price for the annual audit required by Handbook 4372.1. After obtaining proposals from two other firms, we executed a contract with Jones and Smith Inc. Their bid was $1,200 less than the other bids and we understand that HUD Field Offices have found their work acceptable.

Telephone and Answering Service. Includes local telephone service and answering service for evenings and Sundays. Allows for $15 per month increase in answering service, effective November 1, and $5 increase in base telephone service rate.

Miscellaneous Administrative. Last year's actual. Project has consistently incurred this amount.

Electricity. Reflects 4% rate increase and 5% decrease in consumption because of energy conservation initiatives implemented last year. These initiatives are described in our cover letter. NOTE: Utility company has requested a 6% increase. Since the Commission usually approves only about 2/3 of the requested rate, we are budgeting for only a 4% increase. We are assuming that the increase will become effective February 1, 1983, the date requested by the utility company.

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Water. This is a 10% decrease over Fiscal Year 1983 costs. While no rate changes are expected, consumption should decline somewhat. Last year's consumption was increased by: 1) drought conditions; and 2) watering of newly seeded lawns.

Gas. Reflects 5% rate increase that has been approved by utility commission and will become effective December 1983.

Sewer. Represents a 10% decrease from last year's actual. Sewer expense is one third of water expense and water expense is expected to decrease for reasons discussed above.

Elevator. Cost of service contract with Elevators, Inc. This amount was the lowest of the three bids we obtained last Spring.

Janitorial and Cleaning. Last year's actual plus 4% inflationary increase.

Motor Vehicle. Used last year's actual.

Exterminating. Project's contract with Bug-Off provides for one visit per month at cost of $100 each. This amount was $10 higher per visit than other proposals but we accepted this proposal because contractor's performance over past three years has been excellent.

Trash Removal. Contract rate increased by $30 to $380/month, effective last May. This increase is partly reflected in the partial year's HUD-92410 and fully reflected in the budget. Trash is removed twice a week.

Security. Cost of new deadbolt locks for 15 units on Evans Street. There have been several break-ins at single family homes near that side of the project. We also have asked the police department to increase patrols in that area.

Grounds. Contract with Evergreen Grounds covers supplies and labor at $6,000/year. Contract expires in June 1985.

Decorating and Interior Painting. Represents cost of repainting 12 units. Apartments of long-term residents are repainted every four years. Replacement reserves will pay for any needed drapery or carpet replacement.

Repairs Materials. Represents last year's repairs plus a 4% inflationary increase. None of prior period's repair expenses were reimbursed out of replacement reserves - all were routine repairs.

Maintenance Payroll. Includes two maintenance men at rates shown in payroll schedule. One maintenance man receives 50% discount on his rent.

Property Taxes. The county has increased assessed value by 9%; assessment rate is unchanged. Increase in assessed value will be implemented in three annual increments, each equal to 3% of FY '83 assessed value.

Payroll Taxes. Budgeted at 11.3% (7.0% FICA, 4.3% combined state and Federal employment) of salaries listed in payroll schedule. Increased cost is due to cost-of-living increases in base pay and .3% increase in FICA rate that will become effective January 1, 1984.

Miscellaneous Taxes and License. Includes local licensing fees for project elevators.

Property and Liability Insurance. Cost of an all-risk policy with Safeguard, Inc.

Workmen's Compensation. Policy covers all of agent's employees. This is this project's prorated share of total cost of policy.

Replacement Reserve. Includes $15 PUM increase in monthly deposits to be implemented in conjunction with rental increase. Deposits have not been increased since project commenced occupancy in 1978. Attached is an Agreement formalizing this increase in deposits.

Service Income. Used last year's actual. Laundry machines are leased from Wash and Dry, Inc.

Occupancy Percentage. Decreased from prior year because we expect new agent to reduce tenant turnover and more aggressively market units.

Management Fees. Will request a 1/2% increase in fees, effective March 1, 1983, if new agent performs as expected. Agent has already made significant progress in turning the project around.

GUIDANCE ON ASSESSING THE REASONABLENESS OF THE PROJECT'S PROPOSED BUDGET

I. Big Picture Considerations

A. Consider the Owner's and Management Agent's Past Performance on this and Other Projects.

- o Have budget estimates often significantly exceeded actual expenses later reported on the project's financial statements?

- o Have your past analyses shown that this agent's or owner's projects consistently operate at expense levels in excess of those of similar projects?

- o Have your management reviews or GAO's or IG's audits detected weaknesses in cost controls or purchasing procedures (e.g., failure to compare prices or take advantage of discounts)?

If you answered "yes" to any of the above questions, you should scrutinize each line of the owner's budget. In these instances, you will generally need to reduce the owner's projections. If past expenses were unreasonable and the excessive amount will not be offset by legitimate increases, you will need to allow even less than the prior period's expenses.

B. Consider Project Conditions.

- o Is the owner requesting any change in the services or equipment now provided to tenants?

- o What is the current physical condition of the project?

- o Is the owner requesting a rent increase to cover expenses and physical improvements for which previous rental increases were authorized?

C. Compare this Project's Past and Projected Expenses With Those of Similar Projects. To compare projected expenses, manually compare budgets submitted on comparable projects. At this point in your review, focus on expense categories (e.g., administrative, maintenance) rather than on individual expense lines and consider dollars per unit-per month (PUMS) rather than total dollars. Using PUMS minimizes differences caused by variations in project size. Using category totals minimizes differences caused by owners' decisions to use contract rather than project staff or by owners' differences in classifying expenses.

1. When selecting projects:

a. Choose projects that are located in similar neighborhoods and have similar construction, design, unit mix and sizes, utility arrangements and tenant bodies.

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b. Compare projects using identity-of-interest companies with projects that purchase goods or services through arms length transactions.

c. Compare projects using centralized services with projects not using such services.

d. Select projects that are managed by agents who do not manage the subject project.

2. Consider the absolute expense levels most recently reported as well as trends over the past few years. If other agents consistently have smaller percentage increases in costs, it may mean that the subject project could operate more efficiently.

3. Keep the following in mind:

a. Similar projects may legitimately have different operating costs. If, for example, an agent has recently assumed management of a project and is correcting deferred maintenance, maintenance expenses may temporarily be higher than in similar projects. Be concerned if the owner's choice of delivery systems (e.g., use of identity-of-interest company, use of contract rather than project staff) causes higher expenses.

b. Keep in mind that both underestimating and overestimating expenses can have undesirable impacts. If expenses are underestimated, deferred maintenance and defaults can result. If expenses are overestimated, HUD's subsidy outlays will increase or residents will pay rents that are higher than necessary.

c. Relatively high costs or rates of increase can be due to special circumstances; management inefficiency (e.g., overstaffing, poor maintenance, or poor purchasing procedures); or to management or owner abuse (e.g., paying excessive amounts to identity-of-interest firms, kickbacks, or improper allocation of costs that are prorated among several projects).

d. It is project management's responsibility to prove that high costs are due to special circumstances rather than to inefficiency or abuse. Regulatory agreements require that the owner provide for management which is satisfactory to HUD and that "at the request of the Commissioner, his agents, employees, or attorneys, the Owner shall...give specific answers to questions upon which information is desired from time to time relative to the income, assets, liabilities, contracts, operation, and condition of the property..."

II. Considerations For Particular Expenses

A. Administrative Expenses

1. Advertising and Renting. Advertising and other rental expenses should vary according to the project's vacancy and turnover rate, the size of the project s waiting list and the project's planned marketing efforts. Before allowing significant amounts, assure that the owner's advertising techniques are appropriate for the type of applicants he/she is seeking. To do so, look at any recent management review reports or talk with the owner/agent.

2. Bookkeeping Payroll and Services. Compare PUM amounts for projects having approximately the same number of units. If the project shares a centralized accounting service with several other projects, these costs should be prorated according to the projects' relative volume of transactions. If your on-site reviews or the IPA's comments on the Compliance and Internal Control Questionnaire have reported accounting deficiencies, strongly question any high bookkeeping costs.

3. Clerical and Occupancy Salaries. Unless the management agreement requires the agent to pay these expenses from the management fee, this expense account may include salaries for all "front-line" clerical staff and occupancy technicians. These staff's salaries may be included regardless of whether these employees operate out of the project site or the agent's office. This account must also include the HUD-approved contract rent for any apartment provided rent-free to these employees. If these staff work for several projects, the owner must prorate the salary expense and apartment rent according to the relative amount of work required for each project. NOTE: This line should not include payroll taxes or employees' benefits. Payroll taxes are included on Line D2 and employee benefits are budgeted on Line D6.

4. Office Supplies. While bulk purchasing can reduce PUM supply costs, absolute levels will probably increase according to project size. If past expenses were reasonable, allow for inflationary increases in costs.

5. Management Fees. Include only fees not quoted as a

percentage of actual collections. Fees quoted as a percentage of collections will be included in Part II of the Rent Computation Worksheet.

6. Manager's Salary. Salaries may vary according to the manager's performance and seniority and the difficulty of managing the project. This account should include the HUD-approved contract rent for any apartment provided rent free to the manager. This Line may allow reasonable amounts for planned cost-of-living adjustments and promotions.
NOTE: This line should not include payroll taxes or employees' benefits. Payroll taxes are included on Line D2 and employee benefits are budgeted on Line D6.

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7. Legal. If this amount is significant, satisfy yourself that these amounts are for the benefit of the project (e.g., evictions) rather than for the principals' of the mortgagor entity (e.g., income tax guidance). If this project's eviction costs are higher than those of comparable projects and the agent is evicting tenants he/she admitted, assess the effectiveness of the agent's applicant screening techniques.

8. Auditing. This line should include only the cost of the annual audit required by Handbook 4372.1; bookkeeping costs should be included on Line A2 of the budget. If this project's audit costs are higher than the audit costs of other projects having approximately the same number of units, determine the cause of the higher costs. To do so, talk with the IPA or review prior management review reports and the IPA's comments on the Internal Control and Compliance Questionnaire. Audit costs can vary according to the number of units, the size of the accounting firm or the quality of the project's records and accounting systems. See Page 7-4 of Handbook 4370.4, Basic Accounting Desk Guide, for a further discussion of how audit costs vary.

9. Telephone and Answering Service. Compare these with telephone and answering service costs incurred by other projects. Since the management fee compensates agents for supervisory costs and asset management fees are not allowable project expenses, long distance calls initiated by owners and agents should not be charged against the project.

10. Apartment Resale. Complete this Line only for cooperatives. This represents repair costs required following sale less any portion of the seller's equity

that was applied against repair costs. Because it is usually difficult to anticipate when members will wish to sell, generally coops should use the average number of resales that occurred during the prior three years and the average per unit cost of those resales.

11. Bad Debts. Do not project for bad debts.

12. Miscellaneous Administrative Expenses. If this Project's PUM for administrative expenses is reasonable and the project has traditionally charged costs against this account, some allowance is reasonable. This amount should be small compared to other administrative costs. High amounts may mean that the owner is not classifying costs as required by IG Handbook 4372.1's chart of accounts.

B. Utilities

1. Assure that owners have analyzed utility rates and requested the rates they determined to be most advantageous. Rates vary according to consumption levels and types of usage (e.g., commercial or residential). Often projects can apply for either residential or commercial rates, whichever will be cheaper.

2. If the owner has taken the action required by Paragraph B-l above, allow for rate increases which have been, or are commonly expected to be, approved and implemented. Remember that the impact will vary according to date the rate increases are effective.

3. Do not project for increased consumption. Consumption should increase only because of severe weather. Project for consumption levels to decrease below prior periods if: (a) the prior period had severe extremes of weather that are not expected to occur during the period the rents will be in effect; or (b) recent energy conservation initiatives can reasonably be expected to reduce consumption levels.

4. If you cannot rely on the Agent's utility analysis, ask your maintenance engineer to analyze the project's utility costs or compare this project's utility costs with utility costs of comparable projects. Remember that projects must be similar in terms of unit size, climate, construction, landscaping and metering.

C. Maintenance Expenses

1. Contracts for Elevator, Exterminating, Trash Removal,

Snow Removal, Pool Service). If the project purchases these services on a contract basis, the owner should have obtained firm quotes from the contractors and amounts budgeted should be accurate. Compare these amounts with elevator and exterminating expenses of projects having similar design and tenant bodies. Question these amounts if: (a) the owner's past estimates have exceeded the actual costs later incurred; or (b) the rate of increase or the absolute level of current expenses significantly exceeds amounts reported by comparable projects. High contract costs could mean that project management has not shopped for the best contract terms.

2. Security Service. Amounts should be tied to a specific plan and to that project's needs. If security is provided by a contractor, the owner should have obtained this amount from the contractor. Compare this project's contract cost with contract costs of projects that are located in similar neighborhoods and have similar layout. Remember that owners can sometimes reduce ongoing security costs by installing security "hardware" -- e.g., alarms, locks, well-placed lighting.

3. Maintenance Payroll. Unless the management agreement will require the management agent to pay these expenses from the management fee, this line should include salaries for all "front-line" maintenance employees. These salaries may be included regardless of whether these employees operate out of the project site or the agent's office. This account must also include the HUD-approved contract rent for any apartment provided rent-free to the employees. If staff operate out of the agent's office and work for several projects, the salary expense and apartment rent must be prorated directly according to the volume of work required for each project. Recognize reasonable amounts for employee bonuses and cost-of-living increases.

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4. Other Maintenance Expenses. To assess the reasonableness of other maintenance expenses, consider the project's recent and current physical condition and compare the total for these lines with projects having similar design, tenant bodies and size. Comparing totals, rather than individual lines, will eliminate differences caused by owners' choice of delivery systems (e.g., contract or on-site staff) and by classification differences (e.g., charging an expense against the janitorial rather than the decorating account). While maintenance costs can

legitimately vary according to projects ages and physical conditions, costs should not increase because of an owner's choice of delivery systems (e.g., use of contract rather than on-site staff or use of identity-of-interest companies or centralized services).

a. Compare this project's costs with maintenance costs of projects that are similar in design and age. Compare:

   o projects using centralized maintenance services with projects using on-site staff.

   o projects using identity-of-interest companies with projects purchasing maintenance goods and services through arms-length transactions.

b. Consider project conditions. Does the project need to budget for correction of deferred maintenance? Is the owner planning to use project income to pay for any major repairs or decorating. To answer these questions, review any recent on-site review reports, Form HUD-9250 releases from replacement reserves, and the owner's rent increase request. Do not budget for costs that will be paid from sources other than project income (e.g., replacement reserves, residual receipts, owner contributions, or flexible subsidy).

   NOTE: Costs of energy conservation or other major physical improvements should not be included in Section C. These costs should be included in Section I, Project Improvements.

c. If prior periods' expenses include amounts related to major one-time repairs or costs that were reimbursed from a reserve (e.g., residual receipts or replacement reserve) and similar costs will not be paid from project income during the budget period, mentally adjust prior periods' expenses downward before projecting next year's costs. This situation will occur when replacement reserve withdrawals or other non-recurring improvements have been expensed rather than capitalized.

d. Before projecting repair and cleaning costs, mentally exclude any sizeable damage reimbursements received through Section 8 Special Claims or forfeiture of tenant security deposits.

e. Some inflationary increase in supply costs is warranted if: (1) activity levels are expected to stay the same; (2) past expenses have been reasonable; and (3) the project is complying with the terms of the Management Certification shown in Appendix 4.

D. Taxes and Insurance

1. Real Estate Taxes. Since changes in tax rates and assessments are widely publicized and often announced in advance of billing dates, owners should be able to accurately estimate property tax bills. If impound requirements exceed the actual annual tax bill, budget taxes at the impound amount. Impounds will exceed the annual tax bill if the mortgagor is paying an escrow shortage in monthly payments. Compare this project's property tax PUM with that of comparable projects located in the same taxing jurisdiction. If this project's taxes are significantly higher, ask the owner if the project has filed for the tax abatements or appeals discussed below.

NOTE: Property taxes are not necessarily uncontrollable. Many State, county or local taxing authorities offer tax reductions (abatements) to elderly and/or low-income housing projects. In all States, owners can appeal tax assessments. Owners should file appeals when the assessment was based on an inflated estimate of project value or income. Appeals are most appropriate when the project's value has deteriorated or when assessors have used the income capitalization method and have inaccurately estimated net income or operating expenses.

2. Payroll Taxes. This line includes the project's share of FICA and State and federal unemployment taxes. Rates will generally be around 10% to 13% of project payroll. Budgeted amounts will exceed prior periods' actuals if the salary base or tax rates have increased.

3. Miscellaneous Taxes and Licenses. The owner's budget comments should identify the purpose of any amounts included on this line. These amounts will usually be small. NOTE: Sales tax should not be included on this line. Owners should report sales tax as part of the total purchase price and categorize the total cost, as required by Handbook 4370.2's chart of accounts. Do not allow for broker or other business licenses required of the Agent or the agent's supervisory staff. Recognize only costs associated with

"front-line" project operations (e.g., elevator and swimming pool licenses).

4. Insurance. Compare this project's insurance PUM's with PUM's of projects located in similar neighborhoods. Compare projects that purchase insurance through identity-of-interest companies with projects that purchase insurance through arms length transactions. While insurance costs will justifiably vary according to the type of coverage and the

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project's prior claim rates, relatively high insurance rates may mean that the agent did not obtain bids or compare costs. High rates can also result from insurance company redlining or "kickback" arrangements.

F. Elderly and Congregate Services. This Section should show expenses for elderly and congregate services the project is authorized to provide.

G. Reserves. Be sure the owner has budgeted for any required repayments of unauthorized uses or changes in deposits that will be required during the period the rents will be in effect. If you have agreed to suspend reserve deposits for any portion of the budget year so that those funds can be used for other project needs, the owner should have ignored the suspension and budgeted for the reserve deposits that would be required if the suspension were not in effect. Do not include cooperatives' general operating reserves (GORS). Because the GOR is always a percentage of the carrying charges, the GOR is included in the allowance section on the backside of the Rent Increase Worksheet.

H. Financial. Use this for financial obligations other than the mortgage. Include loan payments which the owner is authorized to pay from project income. Do not include payments that may be made only from surplus cash or amounts available for distribution to owners.

I. Project Improvements.

1. Be sure the owner has: (a) identified the total cost, scope of and schedule for completing any capital improvements included on this Line; and (b) provided a breakdown (i.e., payee's name, purpose, amount and date incurred) for any accounts payable included on this Line.

2. Do not allow for costs that will be paid from project improvement funds (e.g., Flexible Subsidy or TPA proceeds) or reimbursed from a painting, replacement, residual receipts or general operating reserve.

3. Prorate capital improvements over an appropriate period of time, generally for three-to-five years.

4. Consider allowing amounts to clear accounts payable only on troubled projects having significant operating deficits. Allow for accounts payable only if the project's purchasing procedures are acceptable, expenses are reasonable and management is satisfactory.

III. Considerations for Estimating Income

A. Service Income. Include income derived from laundry facilities, parking, vending machines, meals programs or other charges collected for non-shelter goods and services provided by the project. Allow the prior period's actual unless there is good reason to believe that income will be less (e.g., laundry is not operational). NOTE: If the project owns the laundry and vending machines, income from

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those sources will be the gross amount collected. If the project leases the machines, income will be the net amount received from the contractor. If prior period's financial reports or your knowledge of the project leads you to believe that service income is understated, talk with the management agent.

IV. Adjustments

A. Occupancy Rates. Do not accept fixed, arbitrary amounts. Compare the project's past and projected occupancy rates with occupancy rates of other projects located in the same market area. If this project's past occupancy rate was significantly less than that of comparable projects or if the owner is projecting an occupancy rate that is less than the prior period's rate, determine the cause of the difference. You may allow less than 95% only if: (l) you document the cause of the excessive vacancies; and (2) satisfy yourself that the owner is taking all feasible steps to reduce vacancies. Do not allow for:

1. vacancies caused by poor tenant selection and waiting list practices, inadequate or poorly directed marketing, or unnecessary delays in repairing vacant units; or

2. vacany losses which HUD pays through special claims on Section 8 Loan Management Set-Aside projects.

B. Management Fees. The Management Fee is shown in the header data on the face of the Rent Computation Worksheet. If the fee will change during the budget period, use a percentage that represents the weighted average of the two fees that will be in effect during the year following the implementation of the rent increase.