Affordable Housing Institute
20 Winthrop Square, 4th Floor
Boston, MA 02110-1229
Tel: (617) 338-9484 x215 Fax: (617) 338-9422
dsmith@affordablehousinginstitute.org
David A. Smith

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Affordable Housing: The Operating Budget Simplified

Expenditures		*Expenditures* is a better term because it means money going out the door, whereas *expense* is a tax concept meaning deductible against income. Replacement reserve deposits are a cash expenditure but not an expense; depreciation is an expense but not a cash expenditure
Operating expenditures		Everything spent on a property before considering its financing or capitalization.
Controllable	+________	*Controllable* expenses are those where the owner/ manager has a large if not decisive say in what money is spent on, how it is spent, and how much is spent. The four major categories are: 1. *Administration and renting*, which includes recordkeeping, compliance, reporting, advertising, and concessions. 2. *Management fee* to the management agent, essentially the price of good decision-making. 3. *Operating* which includes all regular activities like groundskeeping, janitorial, and the superintendent 4. *Maintenance* of the property; everything that is done once a year or more frequently.
Non-controllable	+________	Necessities of life that are usually beyond the owner/ manager's control because they are attributes of the particular property: 1. *Security* for the residents and property. 2. *Utilities* for heat, light, water and sewer. 3. *Real estate taxes* and related charges. 4. *Hazard insurance*.
Reserves	+________	Pre-funding or level funding of all costs that are incurred once a year or *less* frequently. Usually limited to major capital items (appliances, siding, roofing, building systems) but can be extended to rolling items (painting, redecorating).
Operating expenditures	=________	Operating expenditures are what a property *must* pay even if it has no debt service, no cash flow, and no required return on equity investment.
Financial expenditures		Financial expenditures are the costs of capitalization or financing. Although indirect, they are as necessary as operating expenditures, because no one finances a property without (i) a clear expectation of return and (ii) some security or remedies if it is not paid.

Debt service	+________	All *required* payments on all loans. For more loans this means not just the interest but also some amortization of principal, so that the loan will be steadily paid off over some term. (By this definition, therefore, soft debt is in reality no more than a priority claim on all or some cash flow, not an element of true debt service, even though for tax, accounting and economic reasons it is always labeled debt service.)
Cash flow	+________	Cash flow is a necessity, for two reasons: (i) *coverage*, which in essence represents the amount by which the budget can be wrong without imperiling the property, and (ii) *return on investment* for the equity investors. Tax-motivated equity requires less cash flow because most of its return on investment is derived outside the property (Federal income tax benefits).
Financial expenditures	=________	The cost of capital affects total financing expenditures – cheaper financing, lower rents required for breakeven, more potential for cash flow – but all too often, cheaper financing is merely plowed back as a narrowing of debt service coverage, which actually makes a property *riskier* than if it used more expensive financing with better coverage.
Total required income	=________	If the property cannot generate enough income to cover all its costs, sooner or later it will fail – and usually sooner, and by the time the failure is apparent (mortgage default), the problem has usually been made much worse by deferred maintenance or corner-cutting in the controllable expenses, almost always to the property's long-term detriment. A rental property's value by the income approach is measured by its ability to deliver a return to investors or lenders. This is normally expressed as its Net Operating Income (NOI), which is total income achieved minus all operating expenditures. NOI divided by required debt service is known as *coverage*, because if it is greater than 100%, for every dollar of debt the property is generating more than a dollar of income, and therefore the property *covers* its loan. Conventional debt service coverage is typically 120% to 130%; with FHA insurance, coverage is typically 110%.