


**Budgeting and Bottom-Line Thinking**



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- Licensed Construction Supervisor
- Credential for Green Property Management
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**Workshop Overview**

The goal of this workshop is to provide participants with a practical understanding of what is required when it comes to effective budgeting.

We will review the budget process through the lens of an owner or asset manager, all the time focusing on achieving the highest bottom-line.



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### Key Objectives

- Gain a better understanding of the budgeting process
- Learn key financial terms
- Learn how to manage to a budget
- Identify how to analyze budgets
- Explore forecasting techniques



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### Key Objectives

- Learn how to Identify and manage trends
- Identify smart procurement practices
- Understand the legal aspects of budgeting



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## Budgets & Budgeting Process



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### Where to Begin – What to Identify

- **Goals:** Identifying the Owner’s goals is the first step to creating a budget.
- **Money:** How much money will be collected to support those goals
- **Costs:** You will need to determine how much are the costs related to your goals.
- **Bottom-Line:** Know the owner’s expected NOI, Cash Flow and ROI



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### Know The Key Players

- ✓ Board of Directors
- ✓ CEO, CFO, COO
- ✓ Senior Leadership Team
- ✓ Accounting Department
- ✓ Asset Management
- ✓ Agency & Government Regulators
- ✓ Finance Department
- ✓ Department/Division Managers
- ✓ Investors
- ✓ Creditors



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### Understanding Financial Terms - A Glossary -



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### Accrual Method vs. Cash Method

An accrual is an accounting function whereby income and expenses are recognized as they are earned or incurred, even though they may not have been received or actually paid.  
The alternative is Cash Basis Accounting.

Cash basis accounting records revenue and expenses when actual payments are received or disbursed.  
It doesn't account for either when the transactions that create them occur.



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### After-Tax Cash Flow

After Tax Cash Flow is the bottom-line of a budget.  
It is the amount of money (spendable cash) produced that is available to the real estate investor, after the IRS has been satisfied – thus “after taxes.”



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### Amortization

Amortization is an accounting procedure that gradually reduces the mortgage indebtedness by making regular payments of principal and interest to pay-off the loan by its maturity date.



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Assets

Assets are classified as anything that has commercial (or exchange) value that is owned by an individual, corporation, partnership or institution.



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Budget

- In the simplest of terms, a budget is a projection of both revenue and expenses that occur over a specified period to achieve an owner’s objective.





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Balance Sheet

The balance sheet is a report on the financial condition of a property and is required by GAAP. In the balance sheet, assets are expressed in terms of liabilities and capital, which must equal each other.

Assets are the cash on hand, real estate owned, equipment, and any monies owed and can be liquidated and pay the debt.

Liabilities are the debts the property owes its creditors, and this goes against assets.



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Balance Sheet

All the property’s assets belong to the owners and is commonly called capital.

Balance sheets are presented in columns always comparing the assets versus the liabilities and capital.

Most of the time, balance sheets will show the previous month or previous year’s data for comparison.

Understanding the balance sheet will make you better attuned to the financial needs of the property.



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CAPEX

The term CAPEX is oftentimes used when referring to long-term capital expenses or projects that are not routine (consumable) purchases.

Another way to explain this is the outlay of money on order to improve capital assets like the building or its systems.



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CAPITAL


Capital is money!

Capital is typically viewed from the perspective of current operations and investments in the future.

With capital, there comes a cost.

For debt capital, this is the cost of interest required to repay the encumbrance.

Equity capital is the cost of distributions made to owners or stakeholders.



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CASH FLOW

In simplest of terms, cash flow is the amount of cash that flows into and out of a property.

EGI, Effective Gross Income (GPR - any offsets) - Total Expenses = NOI.

NOI - all financial expenses and capital improvements = cash flow.



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CONCESSION

Concessions are usually some form of rent reduction or other rebate that a property owner offers a prospective renter to encourage them to move into the property.

These can be actual monetary rental discounts, or some other form of enticement, unit enhancements or other service, like free parking or a free health club membership.



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CREDIT

The term credit has multiple meanings. For this class, we are using the following:

Credit is an accounting entry that increases liabilities, owners' equity, revenue and gains, and decreases assets and expenses.



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DEBIT

A debit is an accounting entry that results in either an increase in assets or a decrease in liabilities on a company's balance sheet.

In traditional accounting, debits are balanced by credits, which operate in the exact opposite direction.



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DEBT SERVICE

Debt Service is the cash required within any period for payments of principal and interest on outstanding debt.

This is paid monthly or possibly quarterly to a mortgage company or other financial institution.

DSCR's should always have a minimum value of 1.1 or higher. The higher, the better.



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DEPRECIATION

- Depreciation is the amortization of fixed assets like a building and equipment so as to allocate the cost(s) over their depreciable life.
- Depreciation reduces taxable income, but does not reduce cash.



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### EGI

EGI stands for effective gross income.

Effective Gross Income (sometimes referred to as effective gross revenue) is the sum of total Rental Revenue and total other Income, less any adjustments for vacancy loss and other credit losses



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### EQUITY

Owner’s equity is defined as the amount of money invested by the owner in the business minus any money taken out of the business.

For example: If a real estate asset is valued at \$5,000,000 and the loan amount due is \$4,000,000, the amount of owner’s equity, using this example is \$1,000,000.



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### Expenses

In general, an expense is a cost of operations that a property needs to pay in order to generate revenue or additional revenue.





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GAAP

GAAP stands for *generally accepted accounting principles*.  
GAAP is a collection of rules, standards, procedures and principles that define accepted accounting practices.  
They include both broad guidelines as well as detailed procedures to be followed by many companies in the United States.



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Gain To Lease

A gain to lease is when the actual rent being paid by a resident is higher than the projected market rates.  
When there is a gain to lease, the income earned is more than the unit's GPR .  
However, you should verify that the market rents being compared against are in-fact, correct.



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GROSS POTENTIAL RENT

Gross Potential Rent (GPI) is the maximum amount of income a property would produce when 100 percent of the units and/or other rental spaces are leased at the full market rental rate within any given market.



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INCOME

Income in the broad sense is what a business can expect to receive for their goods, services, labor and/or products. In property management, it is what owners expect to receive for leasing of apartments, commercial spaces, rooftops, garage/parking fees, laundry/vending income, other fees.



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INCOME STATEMENT

The Income Statement is a financial document that presents the financial results of a business for a stated period of time. The statement quantifies the amount of revenue that was generated, and the expenses incurred during a specified reporting period, as well as any resulting net profit or loss.



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LIABILITIES

Liabilities are legally binding obligations that are payable to another person or entity. Settlement of a liability can be accomplished via the transfer of money, goods, or services. A liability is increased in the accounting records with a credit and decreased with a debit.



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LIABILITIES

- A liability can be considered a source of funds, since an amount owed to a third party is essentially borrowed cash that can then be used to support the asset base of a business.
- Examples of liabilities are accounts payable, accrued liabilities, deferred revenue, interest payable, notes payable, taxes payable, and wages payable.



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Loss To Lease

Loss to Lease is when there is a difference between a unit's market rent and the actual rent per the lease document.

While not really an actual loss, it is a loss of revenue within the budget.

The LTL amount represents the rental income that the property owner is losing by not charging the full market rents for the unit.



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NOI

NOI, net operating income, is a before-tax figure, appearing on a property's income and cash flow statement, that excludes principal and interest payments on loans, capital expenditures, depreciation, and amortization.



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NPV

Net present value (NPV) is the difference between the present value of cash inflows and the present value of cash outflows over a period of time.

NPV is routinely used in capital planning and budgeting to analyze the viability and profitability of a projected capital outlay.

NPV is the result of calculations used to find today's value of a future stream of payments.



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OPX

OPX, Operating Expenses are the necessary routine costs for running a property day-to-day.





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PROFORMA

In property management, a proforma budget is a way of calculating financial results, using certain projections and/or presumptions.

Pro forma financials may not necessarily be GAAP-compliant but can be used to highlight certain items for potential investors.

They are often used internally by management for planning.



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Revenue

Revenue is the money that is generated from normal business operations.  
For property management it includes the rents, plus all other forms of income. These numbers are found in the top lines of a budget.





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ROI

Return On Investment is a performance metric that is used to determine viability and/or profitability on an investment. This can be used when comparing current conditions “as is” to anticipated savings if something were to be done. For example, replacing older equipment with a new HVAC system or high-efficiency boilers.



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ROI Calculation

Return (Benefit)

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Investment (Cost)

= ROI



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# Managing to a Budget



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# Managing to a Budget

It is important that once you have the budget approved, that you manage the site’s operations to it every month.

This is an active and very important process – not a passive activity.

You need to know what the site’s financial condition is at all time and when and where you may need to shift gears and readjust.



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# Managing to a Budget

It is vitally important to take ample time when preparing the property annual budget.

If you rush the process, you are bound to miss things and the budget will not yield the required results.

Remember GIGO: Garbage-In = Garbage-Out!



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### Managing to a Budget

Each company/client has their own version of a budget, there is no wrong template, providing all key areas are covered.

You should always start with all the expense accounts first, going section-by-section, line-by-line and not missing any.

By starting with the expense accounts, you will not be trying to back-into a number based on costs versus the EGI, but rather what is needed.



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### Managing to a Budget


NEVER flatline a budget.

Expenses do not do that for the most part.

Do not just increase an account by just a percentage over the prior year's budget.

You will not do yourself or the owner any favors and you will most likely reporting variances every month.

Always look for ways to improve income streams before reducing or eliminating any OPX expenses.



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### Managing to a Budget

Many firms use an NOI target as the first number to meet or beat. This is fine, however there is another way.

When budgeting, focus on the bottom-line cash flow, endeavoring to always keep that number positive.

By doing this, you will make or even exceed the intended NOI.

Manage every dollar if it your own!



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# Understanding Financial Statements



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# Understanding Financial Statements

Know how to read key reports including:

- Balance Sheets
- Income Statements
- Cash Flow Statements
- Periodic Reports
- Audits



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# Balance Sheets

Oftentimes, property managers do not really know how to read and fully understand a balance sheet. If this is you, ask someone to take the time to give you an overview.

A property’s balance sheet is a snapshot of its assets and liabilities at a single point in time – unlike the income statement.



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### Balance Sheets

A primary reason to analyze a balance sheet is to determine if the property is fiscally stable.

Owners and regulators focus on the balance sheet when considering many possible scenarios including acquisition, financing, refinancing, issuing new loans, or possibly extending lines of credit, etc.

Many experts believe that the most important areas on a balance sheet are cash, accounts receivable, short-term investments, property, equipment, and other major liabilities.



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### Income Statements

The income statement, aka Statement of Operations, is another important report.

The income statement summarizes a property’s revenues and expenses over specified periods, usually monthly, quarterly, semi-annually and/or annually.

The income statement measures a property’s profitability and not its cash flow.



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### Cash Flow Statements

The purpose of a cash flow statement is to provide a detailed overview of what happened to the property cash during an accounting period.

The report is used to determine the site’s ability to operate effectively in both the short-term and long-term.

The reports helps owners predict the future based on how cash is flowing into and out of the property.



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### Periodic Reports


Managers need to know how to prepare periodic analyses and reports on the financial condition of the site

These reports are sent regularly to leadership, owners, agency officials and other stakeholders.

These reports are required monthly, quarterly, or annually.

Some companies use six-month periodic reporting as well as reforecasting, but this can vary from company to company.

Know what reports you need to provide and to whom and when.



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### Audits

Most properties are audited annually after the close of the fiscal year.

Objectives of an audit are to:

- ✓ Determine adequacy of internal controls
- ✓ Ensure best practices for controls
- ✓ Ensure compliance with company policies, procedures and regulations
- ✓ Identify operational inefficiencies and waste
- ✓ Review IT projects, systems, security controls and technology



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### Audits

- ✓ Provide objective insight into operations using testing, metrics and analytics
- ✓ Assess the efficient and responsible use of available resources
- ✓ Identify additional potential cost savings
- ✓ Assist in identifying and addressing complex and cross-functional issues
- ✓ Ensure compliance with all legal protocols



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### Audits

With respect to site budgeting, these audits can also provide invaluable insight into the historical trends of a site

When determining ranges of costs for line items within a budget, looking back at the audits over the last three to five years can be a very worthwhile exercise

You will be able to easily see and track trends



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### Budget Analysis



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### How Do I Analyze Budgets?

Budget analysis requires the reviewer to be able to exam and explain the various components of the entire budget, its revenue streams, expenditures, variances, and ultimately “how” they got to the bottom-line and why

The best way to do this is to understand all areas at a granular level

You need to ensure that it all makes sense



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### How Do I Analyze Budgets?

As a property professional, you want to be able to look at a budget and be able to clearly see its structure

The objective of budget analysis is to identify and analyze the entire report as well as to predict future fiscal needs

You also need to provide decision makers with the information that they need to prepare for the future



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### What To Look For

- ✓ Is all revenue properly accounted
- ✓ Are all increases forecast correctly
- ✓ Are proposed rent increases reasonable
- ✓ Are all offsets included
- ✓ Are all expense categories included
- ✓ Are there any major variations from a prior period and if yes, why
- ✓ Is the NOI as expected or required
- ✓ Is the ATCF bottom-line positive



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### Trends, Forecasting and Impacts to the Bottom-Line



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### The Crystal Ball



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### Looking Into The Crystal Ball

None of us have a crystal ball to gaze into for answers, but there are a few ways for us to predict the future, at least when using the right perspective

One way is to identify any trends that have emerged from prior periods.

Another is by using data and reports to look at the site prescriptively, to determine its current and future needs

Consider having a CNA performed



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### Looking Into The Crystal Ball

- Ensure that all of the site’s routine, periodic, preventive and now predictive maintenance is being performed.
- If any of the above are missed or otherwise neglected, costs will certainly rise across the board; manpower/labor, service calls, increased utility costs, nullified warranties, and other possible financial impacts.
- An ounce of prevention is worth a pound of cure – or maybe a pound of gold.



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# Smart Procurement Practices



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## Purchasing and Contracting

- Planning plays a key role in a site’s purchasing and contracting
- Both are key parts of the recurring operations cycle and are integral to the annual budget process
- Having effective inventory controls are very important
- Advance purchasing is also an option to save money or to take advantage of seasonal preventive maintenance specials



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## Purchasing and Contracting

- By leveraging advance purchasing, you ensure that goods and even services are available when and where they are needed, at a competitive price, and within the resources available of the approved operating budget
- You should identify the best times to do this with your various MRO and service providers



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Purchasing and Contracting


The property manager and maintenance supervisor should review the following:

➤ Annual apartment inspections

➤ Service request history, both completed and outstanding over the past 12-24 months

➤ All service contracts currently in-place.

➤ The record of spending for all goods, materials, equipment, services, etc., from the prior 12-24 months



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Purchasing and Contracting

➤ Review the site property capital needs assessment to determine if the site is on-track with recommended asset preservation activities

➤ Research low-cost or no-cost grant programs that might help the property minimize its energy load or otherwise positively impact sustainability

➤ Early renew utility contracts



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Legal Aspects of Budgeting



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### Legal Impacts of Budgeting

There sometimes will be legal ramifications when site budget isn't done correctly, items missed or even not included

Areas like "duty of care" violations, willful negligence or safety issues in lawsuits can be also become an issue

Inadequate staffing – resulting in employee incidents, accidents or other issues



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### Lawsuit and Claims Avoidance

- Environmental non-compliance fines
- Inadequate insurance for a property
- Legal implications of management and/or maintenance non-responsiveness



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### Additional Resources



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| Sample Cash Flow Statement |             |             |             |             |             |             |             |             |             |             |
|----------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Cash Flow                  |             |             |             |             |             |             |             |             |             |             |
|                            | Year 1      | Year 2      | Year 3      | Year 4      | Year 5      | Year 6      | Year 7      | Year 8      | Year 9      | Year 10     |
| Potential Gross Revenue    | \$1,572,624 | \$1,627,058 | \$1,683,343 | \$1,741,540 | \$1,801,715 | \$1,855,766 | \$1,911,439 | \$1,968,782 | \$2,027,846 | \$2,088,661 |
| Vacancy                    | 76,831      | 81,353      | 84,187      | 87,077      | 90,006      | 92,788      | 95,572      | 98,439      | 101,382     | 104,434     |
| Concessions                | 47,179      | 32,541      | 16,833      | 17,415      | 18,017      | 18,558      | 19,114      | 19,688      | 20,278      | 20,887      |
| Net Effective Rent         | 1,448,614   | 1,513,164   | 1,582,342   | 1,637,048   | 1,691,612   | 1,744,420   | 1,796,753   | 1,850,655   | 1,906,175   | 1,963,360   |
| Other Income               | 41,400      | 42,842      | 43,921      | 45,239      | 46,596      | 47,994      | 49,434      | 50,917      | 52,444      | 54,016      |
| Effective Gross Revenue    | 1,489,214   | 1,555,006   | 1,626,263   | 1,682,287   | 1,740,206   | 1,792,414   | 1,846,186   | 1,901,572   | 1,958,619   | 2,017,376   |
| Expenses:                  |             |             |             |             |             |             |             |             |             |             |
| Real Estate Taxes          | 216,000     | 222,490     | 229,154     | 236,019     | 243,110     | 250,403     | 257,915     | 265,653     | 273,622     | 281,831     |
| Insurance                  | 26,520      | 29,378      | 30,287      | 31,145      | 32,100      | 33,062      | 34,034      | 35,076      | 36,128      | 37,212      |
| Utilities                  | 25,000      | 25,750      | 26,523      | 27,318      | 28,138      | 28,982      | 29,851      | 30,747      | 31,669      | 32,619      |
| Repairs & Maintenance      | 21,000      | 21,630      | 22,279      | 22,947      | 23,636      | 24,345      | 25,075      | 25,827      | 26,602      | 27,400      |
| General & Administrative   | 14,700      | 15,141      | 15,595      | 16,063      | 16,545      | 17,041      | 17,553      | 18,079      | 18,622      | 19,180      |
| Contract Services          | 9,000       | 9,270       | 9,548       | 9,835       | 10,130      | 10,433      | 10,746      | 11,069      | 11,401      | 11,743      |
| Management Fee             | 52,995      | 54,335      | 56,222      | 57,909      | 59,646      | 61,435      | 63,279      | 65,177      | 67,132      | 69,146      |
| Marketing                  | 1,500       | 1,545       | 1,591       | 1,639       | 1,688       | 1,739       | 1,791       | 1,845       | 1,900       | 1,957       |
| Reserves & Replacements    | 21,000      | 21,630      | 22,279      | 22,947      | 23,636      | 24,345      | 25,075      | 25,827      | 26,602      | 27,400      |
| Total Expenses             | 389,715     | 401,406     | 413,440     | 425,352     | 438,627     | 451,788     | 465,540     | 479,500     | 493,679     | 508,489     |
| NOI                        | 1,099,499   | 1,153,600   | 1,212,813   | 1,256,935   | 1,301,579   | 1,340,626   | 1,380,647   | 1,422,272   | 1,464,940   | 1,508,887   |
| Debt Service               | 724,500     | 724,500     | 691,025     | 691,025     | 691,025     | 691,025     | 691,025     | 691,025     | 691,025     | 691,025     |
| Cash Flow                  | 374,999     | 429,100     | 521,788     | 565,910     | 610,554     | 649,601     | 689,622     | 731,247     | 773,915     | 817,862     |
| Cash on Cash               | 6.93%       | 7.96%       | 5.96%       | 6.77%       | 7.40%       | 8.33%       | 9.07%       | 9.84%       | 10.63%      | 11.44%      |
| Effective Cap Rate         | 6.10%       | 6.41%       | 6.74%       | 6.98%       | 7.23%       | 7.45%       | 7.67%       | 7.90%       | 8.14%       | 8.38%       |
| Effective OIRM             | 11.43       | 11.08       | 10.69       | 10.34       | 9.99        | 9.70        | 9.42        | 9.14        | 8.88        | 8.62        |
| OSCR                       | 1.52        | 1.59        | 1.36        | 1.41        | 1.48        | 1.50        | 1.55        | 1.60        | 1.64        | 1.69        |

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### Important Financial Agencies and Organizations

- American Institute of Certified Public Accountants (AICPA)
- Financial Accounting Standards Board (FASB)
- Governmental Accounting Standards Board (GASB)
- Internal Revenue Service (IRS)
- State Departments of Revenue (DOR)



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### Wrap-Up and Questions




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## Wrapping it Up

We hope that this class has given you some or additional insight into budgeting and bottom-line thinking, and how, when you follow the money, it will yield bigger and better results

Remember, timely and effective budgeting is an essential skill to have as you continue along the pathway of success



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