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## **Chart Your Course for Success: Auditing Income Codes**

By Jennifer Nevitt Casey

A chart of accounts is the classification vehicle used by management to report the financial activities of a real estate asset. With all the discussion and concern about corporate governance today, there is no better time to specifically audit income codes to paint a relevant, accurate and complete financial picture for investors. We have traditionally focused on the accuracy of expense accounts giving little thought or commitment to organizing income codes in the same degree of intimate detail. Now more than ever, it is time to identify all revenue possibilities in a manner that clearly defines high payoff activities associated with each income possibility. For example, if the insurance rates increase next year, it will force us to reclassify income line items in much greater detail in an effort to achieve an improved NOI.

As an industry, multifamily managers have expense management down to a science, but we have yet to see income realizing its full potential. Remember that to manage something, we must first measure it. The time has come to measure revenue even more accurately and consistently with the intention of improving NOI. As an owner or investor in real estate today, it is a necessity to manage by exception so that we have clear parameters and can further optimize income potential.

In addition to corporate governance issues, many property management firms are transitioning to the new Web-enabled accounting programs. Since many property management companies have added more ancillary service income opportunities over the past five years, it is easy for us to make a case to completely review a chart of accounts relative to income codes. More importantly, the first step in initiating a revenue or yield management automated system is a complete audit and reclassification of a company's income codes to reflect today's revenue opportunities. Let's get started!

There are two types of income charges to consider – recurring and non-recurring charges. The first step is to carefully review each type of charge and to classify each income charge in one or both of these categories. For example, a fee is a non-recurring charge, but many owners mistakenly call their month-to-month rent premium [recurring] a month-to-month fee [little or no possibility of occurring again]. Where corporate governance is concerned, owners and managers need to take seriously our statements to residents concerning any charge and make certain we are clearly defining the charge accurately. Fees are different than recurring premiums.

Beginning with Recurring Charges, the first to consider is rent that is classified into three sub-categories: (1) **Income Producing Fixed Asset [IPFA]** - this is the primary asset or apartment base charge ("the monthly base rent"); (2) **Other Income Producing Fixed Asset [OIPFA]** - other assets such as detached garages, storage, carports and boat slip rentals/rentable items other than the primary asset and not amenities; and (3) **Rent Other** - are residents that are paying pet rent really paying a pet premium? Often, pet rent is found in the Rent Other category.

Amenity pricing is the next step in performing a recurring charge audit. The addition of favorable and unfavorable adjustments in the form of amenities is how we optimize an income producing fixed asset's value once base rent charges are accounted for. Amenity categories should be broken down into five (5) basic sub-sections: (1) **Amenity Design** - recurring charges that define a design component of the primary asset (examples include corner unit, end unit and fireplace charges); (2) **Amenity Interior Finishes** - recurring adjustments for updated or new flooring or cabinetry (charging for new carpeting means an accelerated return on investment [ROI] for that value added amenity); (3) **Amenity External** - recurring charges that have external value to the specific address such as views, exposure and satellite dish placement adjustments. Some owners place views in premiums, which is fine as long as they are consistent; (4) **Amenity Equipment** - recurring adjustment for the addition of a washer and dryer, microwave or other appliances. Unfortunately, equipment is often classified as a rentable item in Other Income Producing Fixed Assets, but the equipment's depreciation rate and maintenance upkeep are reasons enough to classify this equipment amenity correctly; (5) **Amenity Other** - creative owners always have a recurring amenity charge that just doesn't seem to fit anywhere else.

Next, we should audit **Premiums** and begin with the seven **Premium Lease Term** section: (1) **Premium Daily** - recurring premium for daily opportunities; (2) **Premium Weekly** - recurring premium for weekly stays; (3) **Premium Month-to-Month** - recurring premium for complete lease term flexibility; (4) **Premium-Short Term** - recurring premium for a lease term less than three months, but greater than one month; (5) **Premium Flexible Term** - recurring adjustment for a four to nine-month agreed upon lease term; (6) **Premium Extension Term** - recurring adjustment for lease terms exceeding current, common practice [example: twelve-month term common nineteen-month term agreed]; (7) **Premium Corporate Housing/Executive Stay** - recurring premium for a corporate defined residence. By breaking out this income premium individually, an owner clearly can see if offering corporate housing outweighs the additional risk associated with short-term furnished apartments.

By defining each of these line items more accurately, we increase the ability to evaluate the relative risk/reward ratios of revenue streams.

**Premium General** is the next recurring income charge. A client in Baton Rouge, LA, has invested wisely and heavily in state-of-the-art unit infrastructure specifications. There are multiple phone lines, duplicate cable outlets per room and more than sufficient electrical outlets per unit. A Premium Infrastructure adjustment is added to all base rents and falls under the Premium General category.

**Ancillary Services** is the next category. Offering renter's insurance, high-speed Internet access or other ancillary services for a profit would be classified in their own area because of the need to clearly define the Return on Investment [ROI] and due to a tremendous investment of time, money and resources involved in setting up these programs.

**Recurring Concessions/Incentives** that are amortized over the term of the lease are classified next. Concessions should be classified in the same manner as each revenue category: Income Producing Fixed Assets, followed by Other Income Producing Fixed Assets, Rent Other, Amenity Charges, Premiums Lease Terms, Premiums General and finally Ancillary Services. Concessions that are given completely up front and off the top should be classified as non-recurring. Recurring concessions are the "red flag" of poor management.

**Discounts** are recurring, have a different market value than concessions, and should be completely broken out into a separate income code section since discounts are used to build market share specifically within a target market while maintaining compliance of all Fair Housing laws. Employee, law enforcement, preferred employer, longevity and seniors are just a few examples of defined discounts.

**Income General** is the category where clubhouse rent and management fees reside and any other income items that would skew the identification of an asset's true Gross Potential Income relative to its primary asset class' net rentable square footage.

**Income Interest** would have its own income category so that at the time of asset disposition, money earned that may not be in the transaction is not underwritten and would be clearly reflected.

The final recurring charges are **Utilities**, which are the exception to the rule. For years, utilities have actually been classified as accurately as management has classified expenses.

Now it's time to move to **Non-recurring Charges** and the long-time favorite, **Fees**. Charges titled non-refundable deposits are truly fees and should be communicated to the consumer and accounted for as such. The idea of a deposit is that it has the potential of being refunded. Calling part of a deposit non-refundable takes it out of the running for deposit status and clearly makes it a fee. The list of fees is long as they are one-time and non-refundable charges. Application, cable installation, administration, decoration, cancellation, insufficient funds and late charges are all examples of fees. Sometimes late fees are recurring, but the idea is that owners would prefer that they not be recurring. Management would not want to make this a premium with recurring status; collecting rents is difficult enough.

In **Non-recurring Concessions/Incentives**, we again follow the revenue subcategories: first the base rent categories of Income Producing Fixed Assets, Other Income Producing Fixed Assets, Rent Other, Amenity Charges, Premiums Lease Term, Premiums General and Ancillary Services. Resident Care is one of my favorite non-recurring concessions [hopefully, you won't find this income code in concessions recurring] since for companies with service guarantees this income code only gets used when existing residents have been compensated for inadequate service. This income code, therefore, assists management in putting a price on poor service, which has never, if rarely, been done before.

A sub-section of non-recurring concessions are **Waived Fees**, not seen previously in recurring charges. Waived fees become a marketing vehicle different than rent concessions, but used often as a closing tool in a property's leasing efforts.

**Collections, Write-Offs, Deposit Forfeits, Refunds-Rent and Reimbursements** complete the list of non-recurring activities.

By redefining income codes with categories and sub-categories that better represent the state of potential revenue today, as we have traditionally done with expenses, management has the ability to set specific goals, create action plans and more accurately measure the results of our efforts to optimize income by each recommended category and sub-category.

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### **Brief Biography: Jennifer Nevitt Casey**

Jennifer Nevitt Casey, Chief Executive Officer of Bravo Strategic Marketing, Inc. since 1993, has developed return-on-investment strategies for multifamily real estate investment portfolios with a capitalized value exceeding \$6 billion. She is also a highly successful income growth strategist for residential assets.

Since 2003, Ms. Nevitt Casey's focus has been devoted to providing marketing efforts to a major single family homebuilder in the Philadelphia, PA, region. She has also provided marketing, budgeting and pricing consultation for a condominium/multifamily project in Baton Rouge, LA. In the multifamily arena, she currently provides consultation on product design and development, correct marketing positioning and proven successful leasing strategies for two major multifamily companies in the north and southeast.

In the past, Ms. Nevitt Casey served as Chief Strategist for Tarragon Realty Investors, opening its condominium marketing division in 2003, and advised Tarragon on revenue optimization, product design and development, leasing and marketing on its for-lease portfolio. She supervised the implementation of her pricing model tool, the Nevitt Availability Profile®, used

by on-site teams. In 2003, this manual tool increased Tarragon's Net Operating Income line by over \$9 million on only 43 for-lease assets.