BULLETIN

Canada Mortgage and Housing Corporation

Net Operating Revenue; Pre-1986 Section 95 Co-operatives

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NET OPERATING REVENUE

What is "net operating revenue"?

"Net operating revenue" is another expression for an operating surplus. It occurs when a co-op's annual operating revenues are more than its eligible operating expenses.

"Operating" revenue comes from operations (occupancy charges, federal assistance, parking, laundry revenue and so on). Revenues from member shares or investments of the replacement reserve funds or subsidy surplus funds are not included.

The term "net" means the revenue left over after:

- reconciling income-tested assistance, then
- deducting the year's eligible operating expenses such as maintenance, property taxes, administration costs, the annual allocation to the replacement reserve and other expenses related to running the shelter portion of the co-op.

As is current policy, if a co-op uses some of its space for a commercial venture then any profits earned are included in revenue while losses are not an eligible expense.

What is the new policy?

Previously CMHC policy required that the portion of a co-op's operating surplus that was due to CMHC subsidy would have to be returned to CMHC.

You may be familiar with CMHC's former process of performing a ROC (Regular Occupancy Charge) calculation to help determine the portion of a co-op's surplus that came from CMHC subsidy. Under the new policy a ROC calculation is no longer necessary. While it is still true that a portion of the surplus comes from CMHC subsidy, the new policy will see co-ops keeping all of their operating surpluses within their respective projects.

CMHC has a new policy to address operating surpluses in co-ops. The policy will simplify year-end reporting and keep the operating surpluses within the projects that earned them, where they can provide future benefits to all co-op occupants.

CMHC and the Co-operative Housing Federation of Canada (CHFC) have agreed on this policy for operating surpluses among Pre-1986 Section 95 Co-operatives. The policy will be applied beginning with the current operating year but may be applied retroactively to 1999 upon request.

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Does this mean that co-ops will keep all the federal assistance that they receive?

Let's not confuse "net operating revenue" and "income-tested assistance". The new policy deals mainly with net operating revenue but it recognizes that unused income-tested assistance must still be refunded to CMHC, subject to funding the subsidy surplus fund.

Income-tested assistance (ITA) is specifically intended to help bridge the gap between graduated occupancy charges (those geared to occupant income) and a co-op's full occupancy charges (those charged to non-subsidized occupants).

If the amount of ITA that a co-operative has received is more than it has used then, according to the operating agreement, the co-op may make a transfer to its subsidy surplus fund up to a total within the fund of $500 per unit (not including interest). When the subsidy surplus fund has reached the maximum $500 per unit, any excess must be returned to CMHC.

This reconciliation of income-tested assistance does not change.

How does the net operating revenue policy work?

There are 2 parts:

Part I - The first step is always to reconcile income-tested assistance used versus income-tested assistance received. The calculation is made on a co-op's Annual Project Data Report and is sent to CMHC with a co-op's annual audited financial statements.

For example, a co-op receives $25,000 in income-tested assistance from CMHC but uses just $24,000. The excess $1,000 is either transferred to the subsidy surplus fund or returned to CMHC. This unused portion is not counted to determine net operating revenue since it is not earned revenue.

Part II - The second step is to review eligible operating expenses against project revenues. The resulting net operating revenue is to be allocated **in the following order**:

1. to eliminate any *accumulated deficits* from previous years
2. to the subsidy surplus fund (up to the $500 maximum), where need is demonstrable
3. to transfer as a "supplementary contribution" to any special reserves approved by CMHC (such as a sinking fund to retire a debt related to the land), if applicable
4. to transfer as a "supplementary contribution" to the replacement reserve fund, or
5. to transfer to a reserve that is specifically required by provincial or territorial statute.

Is the co-op allowed to transfer to any other reserve funds?

The operating agreement with CMHC recognizes just two reserve funds, the replacement reserve fund and the subsidy surplus fund. Any special reserve fund would require the prior concurrence of CMHC.

Accumulated Deficits: Before a co-op starts setting extra money aside in other areas it should ensure that any previous year's deficits have been addressed.

Subsidy Surplus Fund: The co-op's subsidy surplus fund provides a cushion of income-tested assistance in case of increased ITA use in the future. The policy says that net operating revenue shall be used to add to the subsidy surplus fund "where need is demonstrable". Co-ops who have not used the maximum ITA available from CMHC in recent years may not have a need to add to their subsidy surplus fund.

Special Reserves: A co-op may choose to transfer any remaining net operating revenue, as a supplementary contribution, to its CMHC approved special reserve, if one exists. This transfer would be in addition to its regular allocation. Special reserves are an exception which require the prior approval of CMHC. They are funded by regular allocation in a manner similar to replacement reserves.

Replacement Reserve: Any supplementary contributions to the replacement reserve made from net operating revenue would be identified as a separate balance within the replacement reserve.

Reserve Required by Statute: Some provinces and territories have statutory requirements to fund certain reserves.

Should our co-op try to generate net operating revenue?

When a co-op has significant net operating revenue it is an indication that housing charges may have been set higher than is needed to break even.

Market conditions permitting, CMHC recommends that housing charges be set at a level that will permit the co-op to cover all their current year eligible operating expenses, adequately fund their replacement reserve and address any previous operating deficits.

In other words, housing charges should be set to attempt to break even while providing for long-term replacements. In this way, housing charges are kept more affordable for all co-op occupants.

Is there a new limit on the amount of the replacement reserve fund?

This policy does not mean there is a new maximum limit on the replacement reserve.

Co-ops are however, encouraged to put together a capital replacement plan that considers the current condition of the co-op, the current balance of their replacement reserve, a forecast of costs to replace capital items and other variables. Such plans, once approved by CMHC, may alter the annual allocations and the overall maximum amounts within replacement reserves.

Capital replacement plans help ensure that co-ops safeguard their assets for the long term.

It is important that such plans are reviewed regularly and kept current so that the funds are there when they are needed.

Some co-ops may discover that their replacement reserves are more than adequate and that annual allocations can be reduced. These lowered annual allocations to the replacement reserve would lower the occupancy charges required to break even. Lower occupancy charges improve affordability for all the co-op's occupants.

Capital replacement plans have the added benefit that, once approved, a co-op can proceed with its capital replacement projects during the three-year approval period of the plan without first getting CMHC approval to spend the dollars.

Your local CMHC office or Co-op Housing Federation can assist in developing a capital replacement plan.

What if the co-op has a deficit in the next year?

A co-op that has an accumulated surplus from previous years will first use this accumulated surplus to offset any current year operating deficit.

A co-op without an accumulated surplus from previous years would normally have no choice but to address any current year operating deficit by a combination of increasing occupancy charges and decreasing expenses in the following year.

Under the new policy however, if a co-op has no previous accumulated surplus and

has a balance of "supplementary contribution" in its replacement reserve, it may be able to offset the deficit right away.

If previous years' transfers of net operating revenue have created a sufficient balance of "supplementary contribution" within the fund, the co-op may draw upon that balance to offset the deficit.

The amount of current year deficit that can be offset is limited to the available balance of "supplementary contributions" that have been transferred from previous years' net operating revenues. For example:

> In 2000 a co-op transfers $20,000 in regular allocation and $15,000 in net operating revenue to its replacement reserve fund. This $15,000 will be shown as a "supplementary contribution" balance within the replacement reserve.
>
> In 2001 the co-op suffers a $7,000 deficit. To offset the deficit the co-op uses $7,000 from its "supplementary contribution" balance within the replacement reserve.

Within the replacement reserve fund the "supplementary contribution" balance is reduced from $15,000 to $8,000.

Once the supplementary contribution within the replacement reserve is used up, any further operating deficit would have to be carried forward and addressed in subsequent years.

How does this new policy benefit co-ops?

This policy gives co-ops more control over their resources because co-ops keep their operating surpluses. It also encourages long-term planning and the completion of capital replacement plans.

In the long term, it allows co-ops to keep their occupancy charges more affordable for all their occupants. This benefits all co-op occupants and allows co-ops to better utilize their CMHC subsidies.

Want more details?

For more detailed information on how this new policy affects your co-op you may want to obtain CHFC's *Guide to the CMHC Net Operating Revenue Policy* from CHFC or your Regional Federation. You may also contact your regular CMHC representative.