

# MODULE 1

## UNDERSTANDING THE FINANCIAL IMPACT

PART OF A MODULAR TRAINING RESOURCE

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## UNDERSTANDING THE FINANCIAL IMPACT

### INTRODUCTION

Following a business change, the income that your organisation receives and its expenditure base will change. This Module is designed to help you assess the financial impact of a business change, and to provide you with a number of tools to monitor financial performance as changes take effect during the transition period and beyond.

Further, financial tools have been provided to assist in the assessment of solvency.

### KEY DEFINITIONS

Term	Definition
Accrual accounting	The recognition of income and expenses in the period when they are incurred rather than when cash amounts are received or paid.
Break even	The point at which an organisation's revenue is equal to its expenses.
Budget	The financial plan of an organisation. A budget is usually prepared once a year. A budget may cover either the current year or the current and future years.
Cash accounting	Cash accounting recognises amounts as they are received or paid.
Cash flow forecast	Estimate of the timing and amounts of cash inflows and outflows over a specific period (usually one year).
Creditors	A person or entity to whom an organisation owes money (or its equivalent).
Debtors	A person or entity that owes debt to the organisation.
Equity	Equity is the difference between assets and liabilities and represents the net worth of the organisation. Equity is usually comprised of owner capital contributions and retained earnings (the organisations' history of profit and losses).

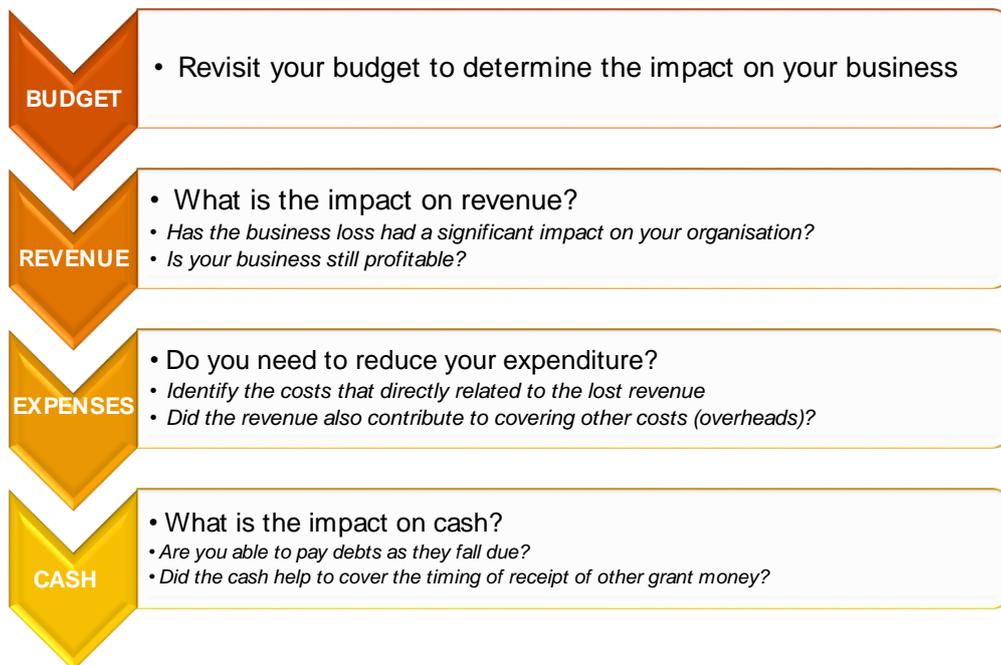
Term	Definition
Expenses (Costs)	<p>The costs associated with operating the organisation such as salaries, rent, insurance, utilities and job seeker support services.</p> <p>Expenses can be classified in a number of ways; for example, (1) Direct and indirect; (2) Fixed and variable; (3) Discretionary and non-discretionary. (Refer to Module 2 for definitions).</p>
Forecasting	<p>The process of projecting the future financial performance of an organisation. Forecasting looks at actual progress against budget and takes into account known events. This provides an indication of whether the budget will need to be amended to achieve the goals of the organisation.</p>
Operating budget	<p>A planned financial budget for the revenue and expenditure of an organisation.</p>
Revenue	<p>The income flowing to an organisation from its operations, such as grants, donations, fundraising amounts and other funding sources. Many not-for-profit organisations (NFPs) refer to revenue or income as contributions.</p>

## UNDERSTANDING THE FINANCIAL IMPACT ON YOUR ORGANISATION

Detailed and strong financial management will be a critical component of the management of your business over the next six months.

Financial performance can be analysed in a number of ways. This Module discusses:

- budgeting and re-forecasting
- review of financial statements over time: profit and loss (income) statement, cash flow and balance sheet
- ratios: types, formulae, rules of thumb and how to interpret them with a particular focus on profitability.



## RE-FORECASTING YOUR BUDGET

The operating budget that you have in place for 2014-15 and your 2015-16 budget, may now need re-forecasting due to the business change.

It is assumed your operating budget is a financial plan of your projected financial performance (revenue less expenses) and is based on accrual accounting methodology.

*A budget is the financial plan of an organisation. A budget may cover either the current year or the current and future years.*

*Forecasting is the process of projecting the expected financial performance of an organisation based on actual progress against budget and the impact of known events.*

Consider scenarios with regard to job seeker referral flows that you can use to predict your likely revenues during the transition period. The following three areas require careful modelling:

- job seeker flow
- service fees
- outcome fees

Note your assumptions in your revised budget. Consider the transition arrangements discussed below when adjusting your assumptions.

Develop a revised operating budget for the total revenue and expenses for your organisation for the 2015—16 financial year and then also, depending on your size and situation, develop a forecast of revenue and expenses for each service line you deliver. Also, consider generating a cash flow forecast as well as an operating budget if you are dealing with a significant business change. A cash flow forecast is usually built from your budget, adjusted for non-cash items, changes in working capital and additional cash items such as repaying borrowings. Cash flows are discussed further in this Module.

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## TRANSITION ARRANGEMENTS TO UNDERSTAND REVENUE IMPACTS FOR JSA PROVIDERS

Transition arrangements will vary between organisations depending on the outcomes of the Employment Services 2015—2020 RFT, for the fifty-one employment services regions. Transition arrangements, which may affect revenue of exiting organisations include possible changes to referrals, service fees and outcomes:

- The existing caseload of Stream Services participants will be transferred to a Provider (or Providers) that have gained business through the RFT process by 30 June 2015 in accordance with the transition rule.
- The referrals of job seekers to non-continuing JSA Providers may be reduced or ceased from April 2015.
- Exiting JSA Providers will be eligible to claim Outcome/Placement Fees for a transitioning Job Seeker where the Outcome Start Date is prior to the Employment Services Deed 2012-2015 end date.
- Exiting JSA Providers will have access to the Employment Services System for up to 12 months to receive any 13 or 26 weeks Outcome Payments due.
- The Department of Employment will only honour Employment Pathway Fund commitments that are made by JSA providers by 30 June 2015 (or completion date where the JSA provider exits earlier). These commitments must be made in accordance with the Employment Pathway Fund Guidelines, the Employment Services Deed 2012—2015 and recorded in the Employment Services System.
- Claims for reimbursement from the Employment Pathway Fund must be completed in 60 days from the date of purchase, but not later than 30 August 2015 (or 60 days from the completion date where the JSA provider exits earlier). The exception is claims for reimbursement for wage subsidies and post placement support which must be sought within 210 days of the commitment being created but not later than 27 January 2016 (or 210 days from completion date where the JSA provider exits earlier).
- Employment Pathway Fund batch purchases must be acquitted within three months of the date of reimbursement. But not later than 30 September 2015 (or three months from completion date where the JSA provider exits earlier). If the Provider is not able to acquit a batch purchase the Department may undertake recovery action.

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## UNDERSTANDING THE IMPACT ON EXPENDITURE

Understanding the total cost of operating a business is key to remaining profitable. It is also important to understand the cost of operating different service lines (or cost centres). For current providers, these may include services such as employment business or training services.

By understanding the cost of each of your services, you will be able to make better decisions regarding cost reduction and ongoing service delivery. To start with, ask yourself the following:

- Are you able to clearly articulate the direct and indirect/overhead expenses that are associated with each of the service lines you deliver?
- Do you have a methodology for allocating overheads? Do you have cost centres for each of your service lines?

Options for optimising your costs are explored in Module 2.

The following section provides guidance on dealing with indirect costs.

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## ALLOCATING AND APPORTIONING OVERHEADS/INDIRECT COSTS

Whilst direct costs can be allocated to each service in a relatively straightforward manner, it is harder to allocate indirect costs (such as utility bills), as they often do not relate directly to the delivery of services. This section provides an overview of different methodologies for allocating your overheads and indirect costs.

### COST ALLOCATION

Overheads can be allocated to a particular service line when they can be accurately ascertained and attributed. Usually wages or labour costs will be known and quantified which means that each service line can be allocated a portion of their costs. If this is not possible then overheads can be apportioned.

### COST APPORTIONMENT

Overheads are apportioned when an item of expenditure benefits two or more service lines/cost centres but the amount chargeable to each cannot be calculated with any certainty. A basis of apportionment therefore needs to be found in order to distribute the cost between cost centres. The basis should distribute overheads as fairly as possible and in theory relate to the consumption of the resource.

Some common bases for apportionment are:

Type of overhead cost	Basis of apportionment
Rent, rates, heating, lighting and insurance	Relative floor area occupied
Human resource and Finance team costs	Relative number of employees/Relative service fees generated by each employment service contract
Executive Management costs	Basis for allocation can include revenue, time estimates etc.

In practice, revenue is typically used as a basis of allocation for overheads given its ease of application.

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## UNDERSTANDING THE IMPACT ON YOUR CASH FLOW

Cash flow forecasts include cash inflows/cash outflows and cash balances for the forthcoming period. Management of your cash flows is extremely important; if you run out of cash and cannot pay your employees or your suppliers then your organisation is likely to run into trouble and become insolvent.

- Cash flow budgets are therefore key to ensuring you understand how much cash is required to operate your business at any given time. This enables you to manage your funds to ensure you have cash available to pay your bills when they fall due.
- The cash flow forecast will show you if, and when, you will run out of cash that is essential to run your business. The forecast should give you prior warning of this event so that you can be proactive in trying to prevent this.

## ANALYSING AND INTERPRETING YOUR CASH FLOW POSITION

Analysis and interpretation of the organisation's cash flow position is key to ensuring that your business does not run short of cash. Here are some tips to assist:

- Timing and phasing of items is crucial. When completing forecasts, consider delays in payments being lodged, transmission delays if payment is not electronic, and clearance delays (time taken by the bank to clear the transaction).
- If the operating cash flow position is stable or increasing over time, this is an indicator of less risk. A declining position is an indication of risk and the need for action.
- In periods where there is a deficit forecast you may need to arrange for an overdraft or loan in advance to avoid any unauthorised borrowing fees or problems in making essential payments, such as salaries and wages.
- Whether the balance is in surplus or deficit, you should consider ways in which your cash position can be improved. For instance, are there any receipts that could be received sooner (and need to be chased) or expenditure which could be delayed or spread out over a longer period.
- Non-cash items such as depreciation or bad debts should not appear in your cash flow forecast.

## MONITORING SOLVENCY – CASH FLOW WARNING SIGNALS

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Is insolvency looming? Cash flow statements are the best financial statement to monitor solvency issues. The following are warning signals:

- net cash balance results in operating cash outflows (negative operating cash flows)
- payments to employees are higher than income from funders
- net operating cash flows are lower than profit.

Management accounts should be current for each Board Meeting (if applicable) and should be produced promptly at each month-end. Australian Securities and Investments Commission (ASIC) Practice Note 22 mentions the following for Directors to consider in forming their opinion as to the business's solvency:

- review of profit and cash flow forecasts
- ability to realise current assets, particularly debtors, in order to quickly generate cash
- ability to meet suppliers' credit terms
- removal of financial support by major lenders
- effect of contingent liabilities.

What should you do if you are concerned that the business is likely to be insolvent?  
Consider:

- not incurring further debts
- ceasing trading, but consider the impact on the ability to resume at a later date if trading is ceased for even a short time
- obtaining immediate financial support
- seeking professional advice
- using a voluntary administrator with the view to restructuring affairs and to continue trading
- appointing a liquidator.

You should note that the laws against insolvent trading or incurring debts whilst insolvent apply as much to NFPs as they do to for-profit organisations. Module 4 provides additional information regarding insolvency and winding up your business. Additionally, you can contact, as appropriate depending on your organisation's legal structure:

- Australian Securities Investment Commission (ASIC): [ASIC Website](#) or contact 1300 300 630
- Office of the Registrar of Indigenous Corporations (ORIC): [ORIC Website](#) or call 1800 622 431
- Australian Charities and Not-For-Profits Commission (ACNC): [ACNC Website](#) or call 13 22 62
- Your state or territory's government business authority:
  - [Fair Trading \(NSW\)](#)
  - [Business Development \(ACT\)](#)
  - [Department of Business \(NT\)](#)
  - [Business and industry portal \(QLD\)](#)
  - [Business, industry and trade \(SA\)](#)

- Business Tasmania (TAS)
- Business Victoria (VIC)
- Small Business Development Corporation (WA).

## TOOLS TO MONITOR YOUR PERFORMANCE

### FINANCIAL RATIO ANALYSIS

Ratio analysis provides a valuable tool to monitor the financial wellbeing of your organisation and should therefore form a regular part of your management reports. Ratios are calculated using the figures contained within your organisation's financial statements (profit and loss statement, balance sheet and cash flow statement) to show a variety of calculations to demonstrate financial performance. Commonly used ratios include debt–equity ratio, working capital and price–earnings ratio. These are easy-to-use tools to monitor financial performance.

*Analysis and interpretation of ratios needs to be undertaken in the context of your organisation's circumstances, not in isolation*

Using ratios helps to identify trends in your organisation's performance over time enabling you to be proactive in taking action to identify any risks. If you are able to prepare financial statements on a monthly basis then the preparation and analysis of your performance using a series of core ratios is a valuable exercise.

Useful indicators of financial health are included in the following tables under headings of Liquidity Risk, Revenue Risk and Financing Risk. These are the key indicators to monitor financial performance and also 'test' re-forecasted cash flows and budgets.

### LIQUIDITY RISK – ABILITY TO MEET YOUR DAY-TO-DAY OPERATING EXPENSES

#### CURRENT RATIO

*Calculation:* Current assets/ Current liabilities

*Source:* Balance Sheet

Current ratio is a short-term measure that indicates solvency; that is, whether your organisation has enough short-term assets (i.e. cash and receivables) to meet its short-term obligations (i.e. debts). The higher the ratio, the lower the risk for both creditors and your organisation.

A ratio > 1 indicates that the organisation has sufficient access to assets to pay its debts as and when they fall due.

A ratio < 1 indicates that liquidity may be an area of significant risk and that you would not be able to meet obligations if they all fell due at once. A ratio < 1 is a clear signal to take action and seek other sources of financing.

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## REVENUE RISK – ABILITY TO BREAK EVEN OR RETURN A SURPLUS

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### TOTAL REVENUE

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*Calculation:* Total revenue

*Source:* Profit and Loss Statement/Budget

Declining trends in revenue over time indicate increasing levels of risk to the viability of your business.

This is particularly significant if you are unable to reduce expenditure in line with falling revenue due to the fact that a high proportion of your cost base is fixed.

### NET PROFIT MARGIN

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*Calculation:* Net profit after taxes / Total revenue

*Source:* Profit and Loss Statement/Budget

Declining trends in net profit margin over time indicate financial risk.

If expenses are increasing at a faster rate than revenue this is a significant indicator of risk. If your organisation is in this situation, you should identify strategies to reduce your costs (See Module 2 Cost Optimisation).

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## FINANCING RISK

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### DEBT TO EQUITY RATIO

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*Calculation:* (Current assets + Non-current borrowings – cash in hand) / Total equity

*Source:* Balance Sheet

This ratio is applicable if your organisation holds debts. For many Not-for-Profit Organisation (NFP)s this is not a relevant ratio, however if your organisation is operating from an overdraft or has significant debts then this ratio will assist to determine the relative levels of equity and debt the organisation is using to finance its assets/operations.

The Debt to Equity ratio indicates the gearing of your organisation. The higher the ratio the higher the level of risk for your organisation, particularly as you are likely to have large interest commitments associated with repayment of debts. As a rule of thumb, the ratio should be < 1.

If the level of debt repayments that your organisation faces is significant, this represents a strain on the business. In such an instance it will be important to seek financial advice.