

# Registrar of Community Housing

## 5. Financial Viability



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# 1. Introduction

## 1.1 What is financial viability?

Financial viability is about being able to generate sufficient income to meet operating payments, debt commitments and, where applicable, to allow growth while maintaining service levels.

Assessment of financial viability is an integrated process involving a review of a provider's audited financial statements, Financial Performance Reports, business plan and other information that supports financial analysis.

The initial focus of the financial viability assessment is a provider's audited financial statements for the previous financial year. The results are assessed with the budget and financial projections in the business plan. The trends in actual results over a three year period are then assessed and projected forward over one to three years (depending on the registration class of the provider).

To place these results into a broader context, the provider's business plan is used in order to understand their future plans as well as their perspective on the business, growth (where applicable) and risks.

The business plan will provide insights into the provider's resource management, growth plans (where applicable), capital structure and liquidity. The business plan provides the roadmap to guide the provider towards its long term goals. The financial plan is a vehicle to allow the provider to realise its long term goals.

While it is imperative to ensure that providers **do not** operate with excessive levels of risk, the capacity of Class 1 and Class 2 providers to develop and increase the availability of community housing is also assessed. Therefore, in the assessment of financial performance, a view is gathered of the extent to which providers are optimising.

## 1.2 Financial Performance Report

A financial performance report is used to assess the viability of providers. The report reviews provider performance over a six year period for Classes 1 and 2 and a four year period for Classes 3 and 4 using a comprehensive suite of performance measures. Linked with the business plan, the report is a powerful tool for the assessment of provider performance and the impact of future decisions on provider viability.

The Registrar's expectations of providers will vary, and will depend on a number of factors, including:

- whether the provider is registered as a Class 1, 2, 3 or 4 provider
- the risks that impact on the provider
- whether the provider has a major development or growth program relative to its size and experience
- the range of activities undertaken by the provider

The majority of work undertaken to assess provider financial viability is desk based via the review of documents submitted to the Registrar. The nature of the review is determined by the risk assessment of each provider. Other documents reviewed during assessment include the business plan and management accounting information.

A provider's most recent financial performance report will be regularly reviewed.

## 2. Collecting information

For registration and compliance reviews, registered providers are required to submit their business plan, financial performance report and audited financial statements, together with the auditor's management letter and provider's response.

Providers are first required to demonstrate financial viability during the registration process.

### 2.1 Information collected at registration

Copies of the past three financial year's audited statements are collected as well as a financial performance report. The Registrar also collects information about:

- financial management and financial policies
- detailed budget for the current year
- tracking against current budget
- approach to growth and funding
- non-housing activities undertaken by a provider

Class 1 and 2 providers are engaged in development activities, together with the financing of a proportion of this growth through external sources (such as private debt), which results in higher risk profiles than Class 3 and 4 providers. Therefore the level of data required from Class 3 and 4 providers is less than that required from Class 1 and 2 providers.

All providers are required to submit financial performance reporting in electronic format.

The information collected in the Financial Performance Report enables the Registrar to analyse a provider's viability. The Financial Performance Report also allows providers to carry out self analysis of financial performance and viability.

Providers can:

- be aware of information used for assessment and how it is used
- review ratios calculated automatically as data is entered in the online template
- provide comments to assist in the interpretation of the provider's performance

### 2.2 Compliance review information requirements

Once a provider achieves registration, financial viability is assessed periodically to ensure compliance with the Regulatory Code. providers must submit audited financial statements, the business plan and a financial performance report to the Registrar.

In addition, details of any significant variations to a provider's financial policy should be provided to the Registrar as soon as possible.

### 3. Assessing viability – what we look for

In assessing financial viability, both short term and longer term viability are taken into account.

The financial viability of a provider is largely assessed from information generated by the Financial Performance Report. The report demonstrates a provider's performance over the past three years and the next three years for Classes 1 and 2. Classes 3 and 4 provide historical data for the past three years and budget information for one year only.

#### 3.1 Assessing profitability and cash flow

Longer term financial viability concerns the ability of a provider to meet future financial obligations as they fall due.

The ultimate financial basis of viability is adequate profitability and cash generation over the asset cycle together with the management of long term debt.

Although registered providers may be 'not for profit' entities, the profitability of a provider is important from a number of perspectives, including:

- providing a 'buffer' against future adverse circumstances
- allowing for the long term replacement/refurbishment of housing stock
- funding growth (where applicable)

Each provider's profitability is affected by its environment, condition of housing stock, growth projections and client requirements.

Given the potential for significant discrepancies between accounting profit and cash flows, a provider's cash flow is also assessed.

The analysis of cash flows is likely to provide indicators subject to greater volatility due to the impact of capital expenditure and movements in working capital. Consequently, analysis is focused on trends and average movement over a number of periods. Trends are also reviewed before and after the removal of capital grants and non-recurring items.

In analysing profitability and cash flows, the focus is on:

- Sustainability – the extent to which historical cash flows and profits are sustainable, and not reliant on non-recurring items or capital grants
- Growth – where applicable, the potential for growth and also the impact of growth on profitability and surpluses
- Stability – the extent to which cash flows and profits provide a stable base for growth and debt service

The assessment of profitability and cash flow ensures a provider's operations offer sufficient resources to enable growth where applicable, replacement of assets as required and protection against adverse situations.

Indicator type	Examples	Rationale
Stability and growth of earnings	<ul style="list-style-type: none"> <li>• EBIT</li> <li>• EBITDA</li> <li>• Net Profit</li> <li>• Return on Assets</li> </ul>	Provides insight into the stability of earnings and the provider's ability to generate surpluses on an ongoing basis.
Revenue and expense analysis	<ul style="list-style-type: none"> <li>• Percentage of income from rent</li> <li>• Revenue per property</li> <li>• Social housing expenditure per property</li> <li>• Maintenance of properties</li> </ul>	Provides an indication of the sustainability of an agency's revenue and expenses.
Efficiency measures	<ul style="list-style-type: none"> <li>• Housing stock owned and/or managed</li> </ul>	Provides an indication of the provider's capacity for growth and resource utilisation.
Cash flow measures	<ul style="list-style-type: none"> <li>• Operating cash flow</li> <li>• Internal financing ratio</li> </ul>	Analysis of operating cash flow provides an indication of the provider's ability to generate cash.

### 3.2 Assessing short term liquidity

Assessment of a provider's short term financial viability is based on data submitted in the Financial Performance Report with the focus on whether the provider is able to meet short term commitments as they fall due.

Organisational problems are also considered to determine whether they foreshadow financial concerns or might lead to loan covenants being breached.

Indicator type	Examples	Rationale
Immediate liquidity	<ul style="list-style-type: none"> <li>• Quick ratio</li> <li>• Amended quick ratio</li> </ul>	Provides an indication of provider ability to meet short term liabilities as and when they fall due.
Short/medium term liquidity	<ul style="list-style-type: none"> <li>• Refinancing risk</li> <li>• Net assets</li> </ul>	Provides an indication of more systemic liquidity issues.
Tenancy liquidity measures	<ul style="list-style-type: none"> <li>• Arrears</li> <li>• Bad debts</li> <li>• Vacancy/voids</li> </ul>	Provides insight into the provider's tenancy management.

### 3.3 Assessing capital structure

Capital structure refers to a provider's long term funding structure and reflects the sources of funding the provider has utilised to acquire fixed assets.

Providers may be funded from a number of sources including:

- external borrowings
- capital grant contributions
- donations of cash from stakeholders in the provision of affordable housing
- cash and asset contributions from parent or associated entities

Undertaking external borrowings enable a provider to leverage the investment in community housing and potentially deliver greater growth in the level of community housing.

Increased levels of external borrowings do result in an increased level of provider financial risk as it becomes contractually obligated to pay interest and repay debt.

The optimal level of provider external borrowings is dependent upon the ability of a provider to service borrowings and assets available as security to borrowers.

Analysis of a provider's capital structure is focused upon the:

- level and growth of external funding
- covenants placed on borrowed funds
- ability of the provider to service external funding

Longer term viability concerns the ability of providers to meet all future financial obligations as they fall due.

Growth for providers typically results from the purchase of property which is supported by government capital grants, operating surplus, private finance and contributions from philanthropic organisations. Therefore, assessment of capital structure applies primarily to registered Class 1 and 2 providers.

The following table summarises the indicators used to assess capital structure.

Indicator type	Definition	Rationale
Debt analysis	<ul style="list-style-type: none"><li>• Balance and growth in net interest bearing debt</li><li>• Leverage</li><li>• Interest coverage</li><li>• Debt coverage</li><li>• Cost of capital</li></ul>	Used to determine the extent to which a provider is reliant on external funding.
Asset based	<ul style="list-style-type: none"><li>• Balance and growth in fixed assets</li></ul>	Provides insight into provider growth

### 3.4 Overall financial assessment

In assessing overall provider financial viability, the following aspects are considered:

- History and management - the traditional and future clients of the provider, financial and management policies adopted by the provider and the provider's business risks and mitigation strategies
- Operating environment - the strategic response of management to factors operating within that environment and the impact of those strategies on the scale of the operation
- Profitability - in particular looking at operating margins and financial efficiency after removing the impact of capital grants and other one-off financial impacts
- Cash flow dynamics - and a provider's ability to meet its financial obligations
- Capital structure and debt management

Other information that effects the determination of a provider's financial viability includes the provider's capacity to meet its financial obligations.

It is not possible to prepare a comprehensive financial analysis of a provider, or any organisation, by focusing solely on available financial data.

Financial ratios quantify and highlight key financial relationships but have limitations. They do not explain underlying causal factors and whether such factors might improve or worsen.

Financial data is considered within the environmental context in which the provider operates, including the quality and experience of management, the provider's strategic objectives and the risks to achievement of those objectives.

Before making a final assessment, the business plan and other performance criteria are used to apply a context to financial information.

The following indicators give an indication of a provider's willingness and ability to provide sufficient information on which to base a financial assessment.

Indicator type	Definition	Rationale
Unqualified accounts	<ul style="list-style-type: none"> <li>• Existence of an unqualified audit report</li> </ul>	A qualified report may highlight potential concerns about a provider's financial management and viability. The Registrar investigates further and discusses results with the provider and its auditor.
Timeliness of submission	<ul style="list-style-type: none"> <li>• Extent to which required information is submitted in a timely fashion</li> </ul>	Extended delays in submission of information may indicate issues with respect to a provider's financial management and solvency.
Commentary on financials	<ul style="list-style-type: none"> <li>• Explanation of major variances, changes or events in most recently completed financial statement</li> </ul>	Assists with the analysis of the underlying viability of a provider and allows the Registrar to more clearly understand the provider's financial statements.

For more information, please refer to the other guides in this series:

1. The Regulatory Framework
2. The Registration Process
3. The Evidence Guidelines
4. Application Guide





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