

# **The Not-for-Profit Balance Sheet:**

## **A resource for Directors and CEOs**

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# Document Data

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## Interests Statement

Professor David Gilchrist is a chartered accountant and has received funding from governments, industry peak bodies and individual not-for-profit organisations to undertake research primarily into the Australian Human Services Sector. He is currently chair of Australian Scholarships Ltd, a director of BaxterLawley Advisory, a member of the CA ANZ Trans-Tasman Charities and Not-for-profits Advisory Committee and a member of the Australian Accounting Standards Board Academic Advisory Panel.

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# Glossary

This glossary is provided in order to assist readers to understand the perspective the authors are taking in relation to the material covered in this resource. As such, the definitions provided are general and may vary when applied to specific organisations, industries or in other respects.

Concept	Meaning Adopted Here
<b>Accounting categories</b>	A term we use to identify and group types of accounting elements (e.g. we group elements as assets, liabilities, or equity).
<b>Accounting elements</b>	Each type of line item reported in a balance sheet (or other accounting report). Typically, we refer to these as accounts but use the term accounting elements in order to separate them from accounting categories.
<b>Accounting estimates</b>	Those accounting elements that are realised over a longer period than a financial year but which will have a detrimental significant impact on the financial capacity of an organisation if they are not recognised and planned for. Examples include employee entitlements, depreciation and doubtful debts. In the case of the former, the estimate is a liability. In the case of the latter two examples, the accounting estimate is a negative asset. They are called estimates because we do not know how much they will be until they are actually due to be received or paid. The longer the period between the present and actual realisation of the estimate, the harder it is to estimate the financial effect accurately.
<b>Accrual accounting</b>	Most concepts in this guide are only relevant to organisations using accrual accounting. In contrast to cash accounting, which recognises income and expenditure when cash changes hands, accrual accounting provides a fuller picture of the financial health of the organisation by recognising income (and expenses) when it is earned (incurred).
<b>Asset</b>	An item on the balance sheet that will result in cash inflow at some point in the future (e.g. debtors) or which can be used to support an organisation's operations for an extended period (e.g. buildings; motor vehicles). It is able to be measured/valued and the timing of the impact is usually predictable.
<b>Administered asset</b>	Administered assets (sometimes referred to as restricted assets) are assets provided/funded by philanthropists, government agencies or state lottery organisations which are provided with restrictions as to how the assets can be used and how they can be disposed of. These restrictions may be permanent or they may be for a specific period after which the asset becomes controlled (see page 5).
<b>Audit</b>	An examination of the organisation's annual financial report by a qualified and suitably licensed accountant in order to form a view that the financial reports reflect the true financial performance and financial position of the organisation.
<b>Board</b>	This is the group of people who are defined as directors in this document. They are ultimately responsible for the governance of their not-for-profit organisation and they may also be called a committee, committee of management or board of directors.
<b>Chief executive officer (CEO)</b>	Usually a paid person who is responsible for the day-to-day running of an organisation. They report to the board or committee which governs the organisation. Organisations might have a different title for the person we refer to as CEO, such as executive director, general manager, manager, executive officer or managing director.

<b>Concept</b>	<b>Meaning Adopted Here</b>
<b>Controlled asset</b>	A controlled asset is one that is available to your organisation to do with as the board might decide (e.g. sold, redirected to different activities). In commerce, this is the most common type of asset while administered assets are much more common in the not-for-profit and charitable sector and the public sector (see definition of administered assets on page 4).
<b>Depreciation</b>	The estimate used to allocate the cost of an asset over its useful life. Sometimes people talk about depreciation as if it is only an accounting issue and not a real expense for the organisation. If depreciation is not covered by income, the organisation will not be covering all of its costs of operation because its assets are being depleted without recognition in the expenses.
<b>Director</b>	A person who is part of the governing body (in this document, the board); the group of people who are ultimately responsible for the organisation and its operations. These people may be called different things in different organisations. For instance, they could be a committee member, board member or director of a not-for-profit organisation regardless of the type of incorporation structure used. We use the term director in this document to mean all of these titles.
<b>Equity</b>	It is the net wealth of an organisation after subtracting all of the liabilities of the organisation from all of its assets. As a very general guide, changes in the equity of an organisation can be reviewed as an indication of changes in its economic health.
<b>Liabilities</b>	A liability is an item on a balance sheet that represents an outgoing of cash or a reduction in sustainability that will impact the organisation at some point in the future. It is able to be measured/valued and the timing of the impact is usually predictable (e.g. a loan, creditors).
<b>Management balance sheet</b>	The internal balance sheet that is prepared to give management and directors the information they need to assess the financial position of the organisation. This balance sheet usually confirms to accounting practices but can be prepared more flexibly than the balance sheet that is published as part of the audited annual financial report of the organisation on an annual basis and prepared for external stakeholders. It can also be more detailed and formatted in accordance with the requirements of the board.
<b>Prepayments</b>	The instance where an organisation pays bills in advance of receiving any service or supply. These are usually termed assets as they represent future services and goods due to the organisation. However, they are non-cash assets as the payment has already been made.
<b>Solvency</b>	Being able to pay bills as and when they fall due.
<b>Sustainability</b>	For our purposes, sustainability means not only the survival of a not-for-profit organisation but the ongoing ability of that not-for-profit to pursue its objectives. That is, to continue to be able to provide the quantity and quality of services needed in a timely manner and in accordance with its mission.
<b>Unearned income</b>	Where a service funder or customer pays in advance of receiving a service from your organisation. This amount becomes a liability because the service must be delivered at some point in the future and the directors need to ensure that the organisation has sufficient resources to deliver the services when needed. The longer the timeframe between receipt of the payment and the provision of the service, the greater the risk that there will be insufficient resources to perform the task(s).

# How to Use this Resource

Readers should note that this resource has been developed with the following in mind:

1. We are not providing advice. This resource is a starting point designed to give readers a set of suggested issues for greater consideration. You should seek professional advice where necessary.
2. The primary intended audience is those people charged with the governance of a not-for-profit organisation and include committee members, management committee members, board members, and directors— those people who are ultimately responsible for their organisation.
3. Because the relationship between the senior-most employee (who we refer to as CEO) and the directors is so critical to the successful operation of not-for-profit organisations, we also consider CEOs to be an important audience. As such, in using this resource, it is hoped that the organisation benefits from the directors and CEO having a shared understanding and use a common language.
4. Each not-for-profit organisation is different. They operate in different ways, have different objectives and involve boards and CEOs differently too. Therefore, it is critical that readers consider how this resource might apply to their organisation.
5. While the principles of this resource are generally applicable, it has been tailored to organisations that adopt accrual accounting.
6. Those organisations that only use cash accounting in their management processes, may also need to consider whether it is necessary to make estimates of their assets and liabilities in order that they are able to better guard against short-, medium- and longer-term solvency and sustainability issues.

This resource is presented in such a way that those without accounting training are able to consider the material and ask questions of their CEO, financial support staff, advisors and others in a meaningful way. Organisations have different levels of support resources available to directors. It is up to directors to decide whether they have the skills and experience necessary to act effectively in that role. We do not consider this point in this resource and it may be appropriate for readers to obtain advice to ensure they understand their organisation's finances properly. As such, the objective of this resource is four-fold:

1. To describe the purpose, nature and governance frameworks associated with balance sheets in the context of not-for-profit organisations;
2. To present this material in a manner accessible to people who are untrained in accounting;
3. To identify a number of key risks inherent in balance sheet management and describe a set of questions that directors and CEOs might find useful in determining how these concepts apply to their organisation; and therefore,
4. To provide a starting point for the directors and CEOs to consider their organisation's balance sheet and to provide a set of key questions that may assist these people in that consideration.

# Resource Structure

This resource is grouped into four distinct sections. Each section includes a description of the material covered together with discussion pertaining to specific risks, their analysis and suggested questions for directors to ask. The sections are:

- Section 1** – The Balance Sheet: what it is, why it is important and the risks it helps to manage
- Section 2** – Cash: Key risks and methods of understanding this element
- Section 3** – Asset Replacement: decision making processes and planning
- Section 4** – Cash Flow Budgeting and Financial Planning: longer term financial assessment and planning



# Section 1: The Balance Sheet

At its heart, the balance sheet is simply a report that describes the net wealth of an organisation. It does this by listing assets, liabilities and equity: these are the basic categories of account types. Many readers will be familiar with concepts such as assets and liabilities in general terms, though they have very specific meanings in accounting circles. We have provided what we term working definitions of these concepts in the glossary and an example balance sheet is provided in Appendix 1. This appendix provides two views of the same balance sheet, one without any guidance notes and one with guidance notes.

The balance sheet is one of the traditional accounting reports produced on a regular basis by many organisations to assist directors and CEOs in managing an organisation's finances. It is also a report that forms part of the group of financial reports that are audited and published each year by many organisations. The year-end published version usually conforms to an agreed format (often using the Australian Accounting Standards for instance) and can be considered a summary of the financial position of the organisation. Indeed, sometimes it is referred to as a 'snap shot' at a point in time. However, a second type of balance sheet is also often produced for the board's use on a regular basis (usually monthly) and in a format that can be much more detailed depending on the directors' information needs. It is this second type of balance sheet that this resource refers to and which we call the management balance sheet. It can be created with the level of detail required by the board to support its decision-making needs.



## The Balance Sheet and Sustainability

Equity is the difference between the value of all of the assets and liabilities. It can be considered the net wealth or net worth of an organisation. It is this net wealth that is critical in ensuring ongoing sustainability of a not-for-profit organisation over its life. Sustainability is often assessed over three time periods, as described in figure 1 below. Figure 1, Table 1, on page 11, provides a breakdown of the components of the balance sheet and key aspects that are critical to an understanding of this report.



Figure 1: the balance sheet and sustainability





In order to make informed decisions relating to an organisation's sustainability, it is important to distinguish between current and non-current assets and liabilities. A current asset is one that will be turned into cash within 12 months (e.g. a debtor pays the amount they owe). Similarly, a current liability is one that will result in an organisation paying out cash within the next twelve months (e.g. the organisation pays a water bill when it becomes due). Non-current assets and liabilities are longer term in nature and, generally, will not turn into cash flowing in or out of the organisation within the next 12 months from the date of the balance sheet. Common examples include assets such as buildings and liabilities such as bank loans.

Oftentimes there is uncertainty about the future costs that the organisation is obligated to incur. In this situation, it is important to make estimates of these future costs in order to better account for liabilities and to plan for cash needs. We call these accounting estimates (estimates are also made in other reports, including the profit and loss report, but we are not concerned with those here). These accounting estimates need to be considered when reading the management balance sheet and we separate the current and non-current elements to assist us in this consideration.



The splitting between current and non-current assets and liabilities is an important concept. Generally, we would say that current assets should be greater than the value of current liabilities and we use the Current Ratio (Appendix 2) to calculate the proportion of current assets to current liabilities. We would also say that non-current assets should be greater than non-current liabilities. There are a number of points for readers to consider in applying these ideas to their organisation:

- 1) Even if your organisation has more current assets than current liabilities, it is also necessary to ensure that the timing of cash inflows from current assets occurs before cash outflows are required to pay liabilities.
- 2) It is also important to note that some current assets and some current liabilities may be accounting estimates (that is, we do not know exactly how much they will actually be when the cash inflows and outflows occur). Because of this, directors often use the Quick Ratio (Appendix 2) to calculate how much actual cash inflow and outflow is likely to occur and to use that figure to guide them in ensuring the organisation remains solvent,
- 3) Finally, some current assets and current liabilities never become cash because the cash inflows or outflows have already occurred. For instance, if an organisation pays expenses in advance, they represent an asset but there will be no further cash inflows. Similarly, if income is received in advance, this represents a liability but the cash outflows are part of operating expenditure rather than an additional outflow to the organisation. As such, the Quick Ratio may also be adjusted to recognise that no cash will flow directly from these two types of element.

The discussion above pertaining to current assets and current liabilities highlights another issue for directors to consider: that accounting elements need to be understood by directors and CEOs in order that the cash flow implications they have can be understood when reviewing solvency. It is not sufficient for directors and CEOs to simply look at the total current assets and compare them to the total current liabilities when analysing the management balance sheet.

Table 1: the components of the balance sheet

Category	Element	Timing	Examples
<b>Assets</b>	Current Assets	Within 12 months	Cash, Debtors
<b>Assets</b>	Non-current	After 12 months	Building, Motor Vehicle
<b>Assets</b>	Accounting Estimates	As needed	Depreciation represents an estimate of the reduction in value of an asset over time. It is only an estimate because we do not know exactly how long a particular asset will serve the organisation but we do need to account for its reduction in value as it is part of the cost base of the operations.
<b>Liabilities</b>	Current Liabilities	Within 12 months	Creditors, Employee Annual and other Leave including Long Service Leave that will be paid within 12 months because it is due.
<b>Liabilities</b>	Non-current	After 12 months	Loans, Employee Long Service Leave due for payment sometime after the expiry of the next 12 months.
<b>Liabilities</b>	Accounting Estimates	As needed	Employee leave entitlements



### Discussion – Employee Entitlements

Employee entitlements can be complex to consider and often require accounting estimates. This is because we generally know how many days or hours are due to a staff member but we do not always know how much those hours will cost the organisation at the point in time when the staff member actually takes leave. This is because the leave will be paid out at the prevailing salary or wage rate at the time of payment. Similarly, we usually do not know how much long service leave will be payable, because eligibility depends on employment length and the magnitude depends on their future salary.

While immediate annual leave liabilities may be relatively certain, the further into the future leave entitlements will be paid, the more difficult these entitlements are to quantify.

This is why employee entitlements are categorised as both current and non-current liabilities as well as accounting estimates.

## Balance Sheet Risks

Each element presented in a balance sheet carries certain risks. Understanding these risks can assist directors and CEOs to understand what decisions they may have to make in order to ensure sustainability in the short-, medium-, and long-term. Table 2 on page 14 provides a set of common risks associated with balance sheet categories and elements. It is important to note that not all organisations face these risks and some organisations may face additional risks that are not discussed here. Again, it may be appropriate for your organisation to obtain professional advice in order to develop a table that is specific to its needs.

Fundamentally, the risks associated with balance sheet items tend to relate to:

- Valuation (have we made accurate estimates of our liabilities? Are investments worth what we think they are worth? Will debtors pay the amount we think they owe?);
- Timing (will the element be realised within our expected time frame? Will debtors pay on time?); and
- Completeness (have we captured all relevant items?).

However, with not-for-profit organisations, there is also a potential additional element that needs to be considered: are assets controlled or administered? A controlled asset is one that is available to your organisation to do with as the board might decide (e.g. sell, redirect to different activities). On the other hand, an administered asset is one that is able to be used for a particular purpose but may not be able to be sold and/or applied to different activities.

Administered assets (sometimes referred to as restricted assets) are assets provided by philanthropists, government agencies or state lottery organisations which are provided but with restrictions as to how the assets can be used and how they can be disposed of. Examples include: a building might be provided subject to a caveat that it cannot be sold or used for a different purpose for ten years; a motor vehicle provided on the basis that it is to be transferred free of charge to a similar organisation should your organisation no longer provide a particular service; or cash provided to fund a particular asset or service provision which cannot be used in any other way. These assets usually meet the definition of assets for accounting purposes but they can mislead users of balance sheets who are concerned about the net assets of an organisation and solvency because they may lead readers to believe the asset may be sold to pay bills as a last resort when, in fact, an administered asset cannot be. Administered assets can convert to controlled assets if the restrictions only apply for a particular period.



### **Discussion – Splitting Controlled Versus Administered Assets:**

When formatting the management balance sheet, it may be useful to split non-current assets into administered and controlled non-current assets. This would be typically done by category and would allow a user of a management balance sheet to identify those assets that may be sold or applied to different services and those that cannot be. Aside from helping directors and CEOs to assess solvency, it also assists directors to ensure they are meeting their funder obligations by identifying those assets that are subject to funder-set obligations. See appendix 1 for an example management balance sheet that includes this split.

## Ratio Analysis

A common and useful tool applied by directors and CEOs to aid in balance sheet management is ratio analysis. Ratios are calculations used to evaluate the relationship between categories and elements on the balance sheet. (They are also used to evaluate other reports including the profit and loss report but we are not concerned with those ratios here.) Key attributes of ratios include:

- ratios are used to identify areas for the board's further consideration. Ratios are not answers in themselves, they simply direct users to those areas where it may be useful for further analysis to be undertaken. They are starting points;
- however, they are only a pointer and may not identify all areas of concern and so further analysis may need to be undertaken in order to ensure that all risks are identified;
- there are basically two types of ratios: (1) commonly used ratios—which we examine in this document and provide examples of at Appendix 2; and (2) ad hoc ratios—ratios created specifically for an organisation's use to examine an element that is of interest to the board or management and which we will not examine here as this is a general resource. Your accountant or other finance professional may be best placed to suggest ad hoc ratios of value to your organisation; and
- There is no universal ideal measure for any ratio. In order to effectively use ratio analysis, boards need to develop a set of ratio goals suited to their organisation. This allows a calculated ratio to be compared with a set of pre-determined goals so that further analysis can be undertaken if necessary. These ratio goals are likely to be determined by considering some absolute target, comparable organisations, or your own organisation's history. Once these ratios are selected and regularly reported, directors are able to spend the majority of their time considering ratios that are missing the target or trending in an undesirable direction.

In approaching the development of the table shown on page 14, we have used the term 'you' to describe your organisation in order to simplify the discussion. The cash flow budget process is further examined in sections two and four of this guide. It is also important to note that this table does not contain all elements possible and so is a general guide. Some further examples of risks are discussed in section two.

Table 2: key balance sheet elements and associated risks

<b>Category</b>	<b>Element</b>	<b>Risk</b>	<b>Governance</b>
<b>Current Assets</b>	Cash	Insufficient to meet outgoings	Ratio analysis – Quick ratio; Cash flow budget; informs short-term solvency (sometimes referred to as liquidity)
	Debtors (owed to you)	Debtors do not pay – cash not available	Ratio analysis – debtor average payment time Aged Debtors Report; Informs cash flow budget
	Short-term Investments (e.g. shares, fixed term deposits)	Not valued correctly – failed investment and cash not available or not all cash expected is available; cash not available when needed	Investment history; Financial advisor report; Informs cash flow budget
	Inventory (items held for sale)	They are incorrectly valued – not worth what they are reported as being worth; items are no longer saleable (there is no market); items are no longer there (e.g. stolen); and/or items are redundant or superseded.	Regular stock take; Ratio analysis - stock turnover timing; Informs cash flow budget
	Prepayments (amounts paid by you before goods or services received)	Supplier does not deliver service	Supplier history Prepayments listing; informs estimation valuation of assets
<b>Current Liabilities</b>	Creditors	Over- or under-stated; not being paid due to cash shortfall – liability increasing	Ratio analysis – creditors average payment time; Aged creditors report; Informs cash flow budget
	PAYG Payable	Insufficient cash to pay PAYG obligations when they are due to the Australian Taxation Office (ATO)	Regular review of Integrated Client Account from ATO; Informs cash flow budget
	GST Payable/ (Claimable)	Insufficient cash to pay GST obligations when they are due to the Australian Taxation Office	Regular review of Integrated Client Account from ATO; Informs cash flow budget
	Overdrafts / Loans	Cash unavailable to pay instalments or pay out loan when called; assets have to be realised in fire sale	Informs cash flow budget

<b>Category</b>	<b>Element</b>	<b>Risk</b>	<b>Governance</b>
<b>Current Liabilities (cont.)</b>	Unearned income	<p>You use cash received in advance for a particular purpose for unintended purposes and do not have sufficient funds to pay for staff to undertake the work paid for in advance.</p> <p>You do not have sufficient staff to undertake the work at the appropriate time.</p> <p>You have to pay back the money received in advance</p>	Can be useful to isolate unearned income into a separate bank account to preserve it; Informs operating budget; Informs cash flow budget
<b>Current Liabilities – Accounting Estimates</b>	Employee Entitlements (due in 12 months or less)	Leave not paid; leave entitlements not accrued at latest pay rate; cash insufficient to pay entitlements; leave entitlements increasing	Aged leave entitlements report; Informs cash flow budget; informs board's leave policy requirements
<b>Non-current Assets</b>	Long-term Investments	<p>Cannot convert to cash when needed</p> <p>Cash value less than investment value for emergency access</p>	Investment profile report; Informs financial plan
	Land	<p>Cannot use the land for its intended purpose</p> <p>Cannot change the use of the land</p> <p>Cannot convert to cash when needed</p> <p>Cash value less than book value for emergency access (e.g. fire sale)</p> <p>Land over-/under-valued</p> <p>An administered asset and so cannot be realised for cash and/or sold (e.g. land held as a Crown Grant but not recognised as such)</p>	Confirmation of use against contracted requirements annually or as required Informs financial plan
	Buildings	<p>Cannot use the building for its intended purpose</p> <p>Cannot change the use of the building</p> <p>Cannot convert to cash when needed</p> <p>Cash value less than book value for emergency access (e.g. fire sale)</p> <p>An administered asset and so cannot be realised for cash and/or sold</p> <p>The building becomes unserviceable (no longer adequate to requirements; does not meet accreditation requirements; does not support technology)</p>	Confirmation of use against contracted requirements annually or as required Informs financial plan

<b>Category</b>	<b>Element</b>	<b>Risk</b>	<b>Governance</b>
<b>Non-current Assets (cont.)</b>	Motor Vehicles	<p>Cannot use the motor vehicle for its intended purpose</p> <p>Motor Vehicles under/over valued</p> <p>Cannot change the use of the motor vehicle</p> <p>Cannot convert to cash when needed</p> <p>Cash value less than book value for emergency access (e.g. fire sale)</p> <p>An administered asset and so cannot be realised for cash and/or sold</p> <p>The motor vehicle becomes unserviceable (no longer adequate to requirements; does not meet accreditation requirements; does not support technology)</p>	<p>Confirmation of use against contracted requirements annually or as required</p> <p>Informs financial plan</p>
<b>Assets – Accounting Estimates</b>	Depreciation (see glossary)	<p>Depreciation not included in tenders for work and/or considered in budgeting for philanthropic donations.</p> <p>Prices offered for services are not analysed including depreciation.</p> <p>The full cost of service delivery is not recovered ensuring the organisation’s capacity for medium- and longer-term renewal impacted negatively</p>	<p>Board policy on depreciation charges reviewed regularly (e.g. annually); informs asset value</p>
<b>Non-current Liabilities</b>	Employee Entitlements	<p>Leave not paid; leave entitlements not accrued at latest pay rate; cash insufficient to pay entitlements; leave entitlements increasing</p>	<p>Informs financial plan</p>
	Loans / Mortgages	<p>Loan pay out/pay back loan and/or interest unable to be met; liability not changed to current liability as imminent pay out not recognised</p>	<p>Informs financial plan</p>





## **Section 1:** Questions for Boards

1. Is the management balance sheet created with enough detail to allow the board to make decisions regarding short-, medium- and long-term sustainability?
2. Are the items included on our balance sheet valued properly?
3. Are the items included in our balance sheet likely to be realised within the time frame expected?
4. Have we captured all relevant items for our balance sheet?
5. Have we identified those assets that are controlled and those that are administered?
6. If we use ratio analysis, have we identified our ratio goals against which we can then assess our ratio calculations?

# Section 2: Cash

Cash flow management is an incredibly important aspect of running any organisation, whether for-profit or not-for-profit. Without cash (or liquidity as it is sometimes referred to), the organisation cannot meet its commitments and it rapidly becomes unsustainable. Potentially there are also personal legal liabilities and risks to directors if they allow an organisation to operate with insufficient cash. In keeping with the general nature of the information provided here, we do not examine solvency or directors' responsibilities in this section—these are complex issues and we cannot address them sufficiently here. Suffice to say, it is important that organisations obtain any advice they deem necessary in order to ensure they are solvent and sustainable going forward.

In this section, we examine three elements: working capital; profitability in a market-style funding environment; and reserves.

## Working Capital

Working capital is the amount of cash needed to ensure the organisation meets its day-to-day payment obligations. Figure 2 (shown on page 19) demonstrates the working capital cycle. It needs to be closely monitored as, if there is insufficient working capital, the organisation risks insolvency and collapse. If there is too much working capital, the organisation is not using its cash resource efficiently and risks underperforming in terms of mission. As such, directors need to consider their organisation's working capital needs on a regular basis and the cash flow budget described in section four below is a critical tool in managing this aspect. Therefore, directors and CEOs need to understand the working capital cycle in their organisation and ensure they balance cash needs with efficiency.



### Discussion – Calculating working capital: an example:

ABC Association Inc  
Balance Sheet Extract

Current Assets		Current Liabilities	
Cash	\$10,000 (a)	Creditors	\$6,000 (x)
Debtors	\$5,000 (b)	Staff Leave Due	\$1,500 (y)
Prepaid Electricity	\$500 (c)	Income Received in Adv	\$2,500 (z)
<b>Total Current Assets</b>	<b>\$15,500</b>	<b>Total Current Liabilities</b>	<b>\$10,000</b>

Working capital = (a + b) – (x + y) or \$7,500 or \$2 current assets for every \$1 current liabilities.  
Or as a proportion - \$2:\$1

Items (c) and (z) are not included because they will not impact cash flow in future – the cash flows have already occurred.

### Typical Business Cycle

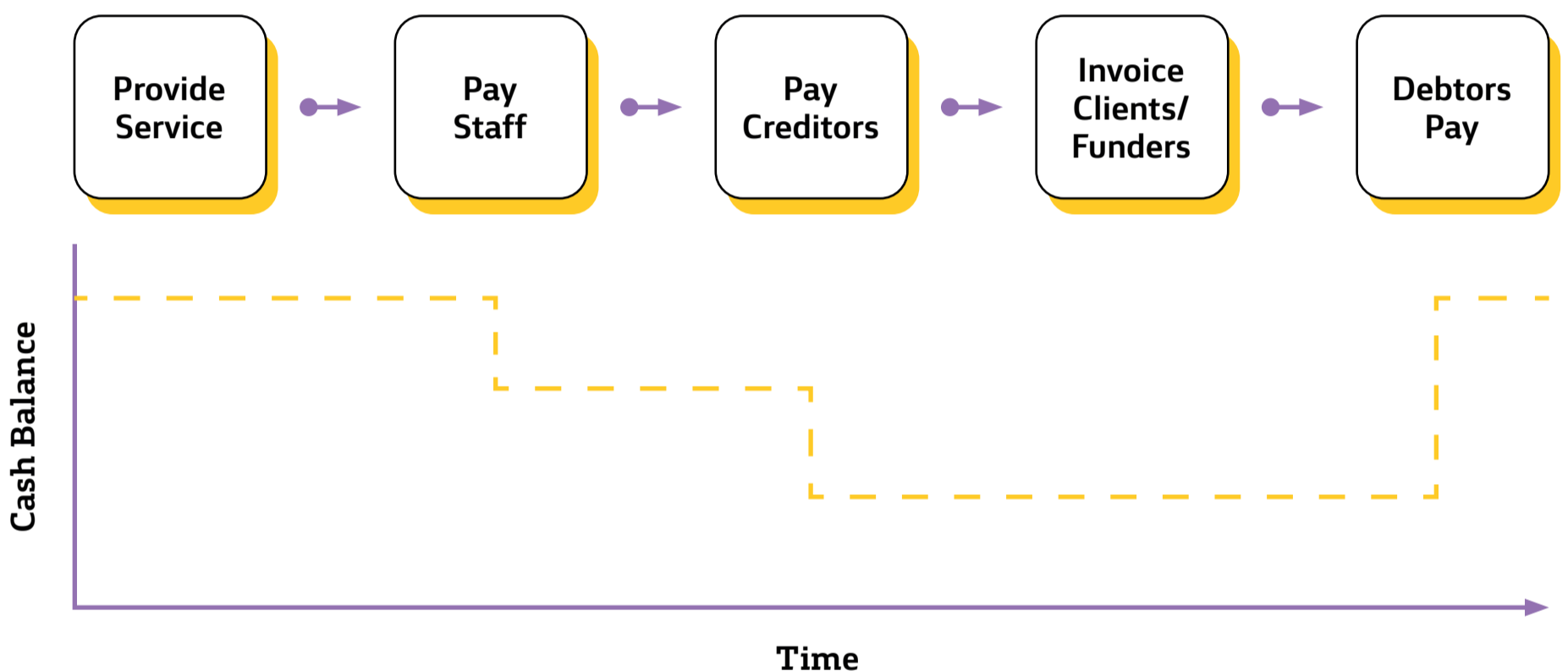


Figure 2: the simplified working capital cycle

Overall, managing working capital means having a cash buffer between the deepest point on the dotted line in Figure 2 above and zero cash holdings. Of course, this figure is simplified and other considerations, such as income from investments also needs to be considered.

Working capital needs change cyclically in accordance with the timing of receipts and payments made to and from an organisation. As such, if you receive income in advance (e.g., grant funding for future services) your working capital requirements may be lower than if you receive fees in arrears after invoicing. The timely invoicing of fees and services is critical to ensuring that debtors then pay within the terms allowed and cash is received in a timely fashion. If there are delays in service provision and/or invoicing, those delays will flow on to affect cash inflows and additional cash reserves will be required to cover outflows until the collection is achieved.

Often, organisations calculate working capital by subtracting the total of current assets they hold from current liabilities. However, it is often better to adjust this calculation by removing any non-cash elements (such as prepayments) where those non-cash elements will not impact working capital requirements. It is also important to remember that cash flow depends on the timing of service delivery—both inflows and outflows—and so ensuring productivity in terms of service delivery is often important to sustainability. Table 3, on page 20, below provides the governance objectives and feedback loops for working capital governance.

Table 3: governance objectives and feedback loops – working capital

<b>Working Capital Element</b>	<b>Objective</b>	<b>Governance</b>
<b>Income Invoiced in Arrears</b>	Collect Debtors as soon as possible	Ensure service delivery targets are met Set debtor collection target and report to board monthly Control via aged debtors report Set maximum time for invoicing after service delivery Ratio analysis: debtor turnover ratio Informs cash flow budget
<b>Income Paid in Advance</b>	Ensure cash is utilised only as needed and excess cash removed to reserves	Ensure services are provided per operations plan Informs cash flow budget Report to board when reserves are transferred to operating accounts
<b>Investment Income</b>	Ensure investment income timing aligns with cash flow needs of organisation	Establish investment parameters to avoid emergency access costs associated with investments (e.g. early withdrawal fees for fixed term deposits) Informs cash flow budget
<b>Creditors Payments</b>	Ensure creditors are paid in accordance with the agreed terms	Ensure creditor payments timing targets are established and reported on via aged creditors' report Ratio analysis: creditor turnover ratio Informs cash flow budget
<b>Salaries &amp; Wages Payments</b>	Ensure all wages paid on time	Informs cash flow budget
<b>PAYG Payments</b>	Payments to the ATO on time	Regular review of Integrated Client Account from ATO Informs cash flow budget
<b>Leave forecasting</b>	Ensure leave entitlements are taken as soon as possible after accruing	Set leave policy parameters Report leave balances against leave policy parameters at each board meeting Informs cash flow budget
<b>GST Payments</b>	All taxes collected on behalf of the ATO are paid in accordance with the deadlines required	Regular review of Integrated Client Account from ATO Informs cash flow budget
<b>Stock held for sale</b>	Ensure minimal stock maintained so that sales can be made but stock levels are not excessive as stock must be paid for	Ratio analysis: stock turnover ratio Informs cash flow budget

## **Profitability (Surplus)**

While balance sheet analysis does not focus on profitability, if an organisation is not profitable it is unlikely to remain solvent for a long period of time in a market economy such as that operating in Australia. An organisation is profitable if its income for services rendered exceeds the cost of providing those services. All costs must be recovered, including depreciation (because asset usage costs the organisation over time) and human resources costs (such as long service leave that employees might not yet be eligible for). If these costs are not covered and a profit earned, cash reserves will be insufficient to allow for reinvestment in the organisation. Profit should be used to:

1. replace assets as and when needed in order to maintain sustainability (see section 3);
2. provide emergency cash to support the organisation during periods of austerity (e.g. Coronavirus) to ensure clients continue to receive the supports and services they rely on and to be able to support client services while funding arrangements are being put in place (e.g. NDIS plan approvals / Emergency services); and
3. ensure the organisation has the financial flexibility to manage change processes, invest in new services and develop staff and capacity as environmental changes occur over time (including government policy, funding and philanthropy contexts).

Good governance requires profit targets to be developed commensurate with an organisation's longer-term financial plan. Profit targets should also inform decisions regarding service delivery mix and type so that services that are loss making activities but which are critical to the achievement of a not-for-profit's mission are offset by profit making activities. Finally, it is important to be able to explain your profitability goal because, although essential to sustainability, the importance of profit in the not-for-profit context is not always well understood either in the sector or the broader community.

## Reserves

The development of cash reserves in an organisation is also an important contributor to long-term sustainability. A distinguishing characteristic of not-for-profits is the fact that they do not distribute profit to owners (nor generally do they raise money from them), so reserves are a way that they can seek to future proof their financial sustainability. Reserves can be established in order to:

1. provide for cash necessary to pay out future cash outflows as and when necessary in order not to compromise the working capital of the organisation (e.g. ‘cash backing’ employee entitlements);
2. provide the board with time to strategically respond to instances of significant changes to business conditions (e.g. Coronavirus, drought, bushfire) or government policy (e.g. discontinuation of programs)—this is usually termed ‘xx months operating cash’; and/or
3. provide for future change management and investment in staff and organisational capacity.

It is important to ensure any reserves retained are supported by an appropriate explanation in annual reports so that potential donors and other resource providers do not assume the organisation is able to operate without their ongoing financial support. Demonstrating sound governance by establishing and maintaining reserves does, however, also provide confidence to resource providers that the board is focused on the short-, medium- and longer-term sustainability of the organisation itself. As with working capital, a balance should be struck between having not enough reserves and holding too much cash in reserves. The former situation compromises short-, medium- and long-term sustainability; the latter suggests that either the organisation isn’t making as much progress towards its objects as it could be or that it could operate with less financial support than it has previously enjoyed.



### Discussion – Balance Sheet Forecasting

Because the balance sheet can be used to assess solvency and sustainability, there can be a tendency for directors and CEOs to focus on the short-term. This is both understandable and important in the context of ensuring solvency. However, as time moves on, what appears to be a longer-term issue can fast become a short-term issue. For instance, will our buildings be serviceable for the foreseeable future? At what point in the future do our cars need to be replaced? To assist directors and CEOs to better consider solvency and sustainability in the longer-term, it can be useful to forecast the balance sheet. In other words, to calculate the likely current and non-current assets and liabilities at set points in the future. For instance, forecasting the balance sheet for three years in advance will assist in analysis because non-current assets and liabilities may become current during that period and an assessment may be estimated of solvency and sustainability at that point in time.



## **Section 2:** Questions for Boards

7. How much working capital do we need to operate our organisation? How much do we currently use?
8. Are services being provided on time?
9. Are invoices being created in a timely manner?
10. Is income paid in advance managed so as to avoid misusing cash intended to cover the costs of service delivery?
11. Have we established appropriate policy guidelines and targets to support the board in managing working capital, including profit targets?
12. Have we incorporated working capital targets into our financial plan?
13. Do we have sufficient reserves set aside to enhance the organisations ongoing sustainability?

# Section 3: Asset Replacement

Assets are a significant element reported in the balance sheet of any organisation. In this section we are concerned with considerations that inform decisions about if and when to replace non-current assets such as buildings, IT systems and motor vehicles. Boards should consider four fundamental questions when making asset replacement decisions:

1. What assets will need replacing?
2. When will they need replacing?
3. How much will it cost to replace them?
4. How do the answers to the above questions impact our cash flow and capital budget?

Good governance suggests that the above questions need to be answered and included in what might be termed an 'Asset Reinvestment Plan'. Like all important questions, they can be difficult to answer, so we provide a set of guiding principles to aid directors in this task in Table 4 below. The effectiveness of assets typically reduces over time, though the nature, importance, impact and timing of this reduction varies across asset types and organisations. This reduction is also hard to predict. The principles in Table 4 are designed to assist boards to make decisions about prioritisation in their asset replacement program and to reduce the risk of an unexpected reduction in performance. Of course, these principles are guides only and the board must make adjustments to them and determine their prioritisation by undertaking timely reviews of their asset reinvestment plan and of the longevity of their assets.

Table 4: asset replacement decision making principles

Replacement Principle	Risk	Governance
<b>Unserviceable</b>	Asset can no longer be used and sustainability negatively impacted	Establish serviceability minimum (e.g. maximum number of kilometres travelled by a motor vehicle asset; maximum age of a building)
<b>Unreliability</b>	Unexpected and sudden reduction in utility of asset causing lost capacity; impact heightened when unpredicted failure occurs	Establish age limits to assets and policy frameworks for assessment and/or replacement upon that age being reached
<b>Loss of Accreditation</b>	Asset no longer meets the minimum requirements of a service funder and is no longer able to be deployed in service delivery	Maintain accreditation assessments for all assessable assets (e.g. aged care facilities) and report to the board all prospective changes to accreditation requirements including timing
<b>Loss of Applicability</b>	Changes in funder policy and reporting frameworks or delivery modes cause assets currently deployed to no longer meet requirements	Maintain close monitoring of policy changes and potential impacts via industry peak bodies and funder agencies
<b>High Risk Assets</b>	Failure of these assets will impact health and safety of staff and/or clients	Maintain these assets in accordance with manufacturer guidelines on maintenance and replacement, and ensure they meet clinical and other relevant minimum standards





## **Section 3:** Questions for Boards

14. Do we have a workable asset reinvestment plan in place? Do we review and amend it regularly enough?
15. Have we estimated the cost and timing of asset replacement in the context of the principles used to make such decisions?
16. Have we identified high risk assets and established appropriate plans for management in the case of their no longer being serviceable?

# Section 4: Cash Flow Budgeting and Financial Planning

Most organisations, regardless of whether they are government, commercial or not-for-profit, are used to developing an annual budget (or operating budget); they are an essential component of any organisation’s financial management system. The budget development process is often a catalyst for strategic decision making and budgets act as both governance and planning tools by guiding the board in its deliberations when it compares the expected financial results against the actual results.

Given the importance of budgets, it is perhaps unsurprising that an annual budgeting cycle is insufficient for most not-for-profits when considering their balance sheet management requirements. Indeed, the traditional annual budget (or operating budget) should be supported by an annual capital budget (highlighting the capital inflows and outflows for the year), a cash flow budget (which is prepared annually and considers cash inflows and cash outflows and is used to compare to actual cash flows) and a financial plan which typically forecasts operating income and expenditure and capital income and expenditure over a three- to five-year period. These budgets then inform the balance sheet budgeting process which considers the balance sheet composition over a three- to five-year period. Figure 3 below shows how the components of the financial plan might be established in an organisation and what the timing and components of those plans may be composed of.

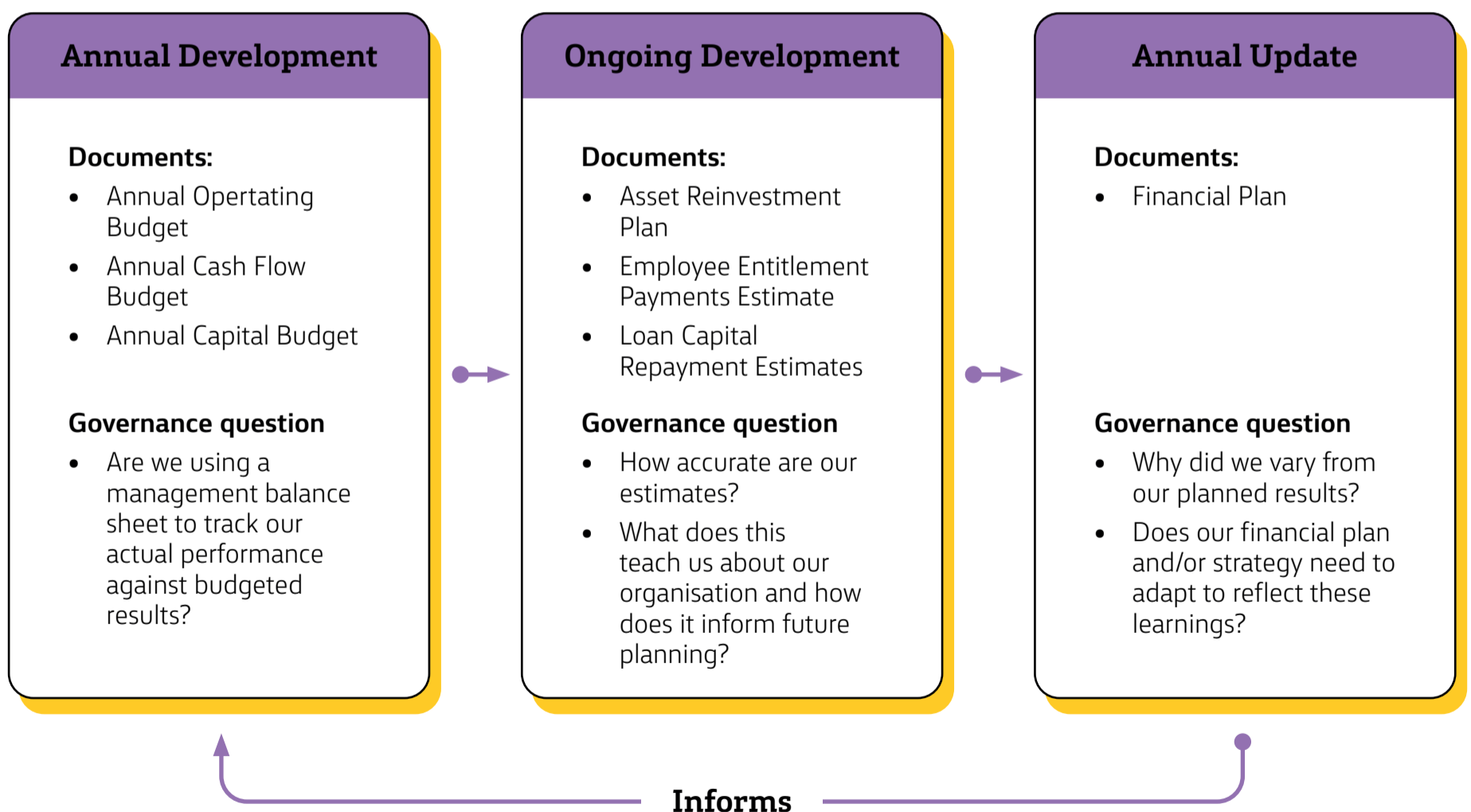


Figure 3: budgeting and planning framework – establishing a financial plan



## **Section 4:** Questions for Boards

17. Have we documented our financial planning process and agreed the components?
18. Do we regularly achieve our planned result and are we confident in our financial planning process?
19. Have we created a policy framework for assessing our financial resource requirements over a 3- to 5-year period and do we report on outcomes accordingly?

# Appendix 1 – Example Management Balance Sheet

Please review both pages of this appendix. The next page includes some additional guidance notes.

**XYZ Association Incorporated  
Management Balance Sheet  
As at xxth, Month Year**

**ASSETS**

**Current Assets**

Cash	\$15,000	
Debtors	\$8,000	
Prepaid Expenses	<u>\$2,500</u>	\$25,500

**Noncurrent Assets**

Buildings – Controlled	\$120,000	
Buildings – Controlled Acc. Depreciation	<u>(\$72,000)</u>	\$48,000
Buildings – Administered	\$250,000	
Buildings – Administered Acc. Depreciation	<u>(\$123,000)</u>	\$127,000
Motor Vehicles – Controlled	\$75,000	
Motor Vehicles Acc. Depreciation	<u>(\$16,500)</u>	\$58,500
IT Equipment	\$11,200	
IT Equipment Acc. Depreciation	<u>(\$9,200)</u>	<u>\$235,500</u>

**TOTAL ASSETS**

**\$261,000**

**LIABILITIES**

**Current Liabilities**

Creditors	(\$21,000)	
GST Payable	(\$12,300)	
PAYG Payable	(\$ 4,800)	
Unearned Income	(\$32,000)	
Employee Entitlements (Current)	<u>(\$ 6,800)</u>	(\$76,900)

**Noncurrent Liabilities**

Employee Entitlements (Noncurrent)	(\$ 7,200)	
Bank Loan – Buildings	<u>(\$43,000)</u>	<u>(\$50,200)</u>

**TOTAL LIABILITIES**

**(\$127,100)**

**NET ASSETS**

**\$133,900**

**EQUITY**

Retained Earnings		<u>\$133,900</u>
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**TOTAL EQUITY**

**\$133,900**

# Example Management Balance Sheet continued.

The same example balance sheet but with additional guidance notes.

**XYZ Association Incorporated  
Management Balance Sheet  
As at xxth, Month Year**

**ASSETS**

**Current Assets**

Cash		\$15,000	
Debtors		\$8,000	
Prepaid Expenses		<u>\$2,500</u>	\$25,500

**Noncurrent Assets**

Buildings – Controlled	\$120,000		
Buildings – Controlled Acc. Depreciation	(\$72,000)	\$48,000	
Buildings – Administered	\$250,000		
Buildings – Administered Acc. Depreciation	(\$123,000)	\$127,000	
Motor Vehicles – Controlled	\$75,000		
Motor Vehicles Acc. Depreciation	(\$16,500)	\$58,500	
IT Equipment	\$11,200		
IT Equipment Acc. Depreciation	(\$9,200)	<u>\$2,000</u>	<u>\$235,500</u>

**TOTAL ASSETS**

**\$261,000**

**LIABILITIES**

**Current Liabilities**

Creditors		(\$21,000)	
GST Payable		(\$12,300)	
PAYG Payable		(\$ 4,800)	
Unearned Income		(\$32,000)	
Employee Entitlements (Current)		<u>(\$ 6,800)</u>	(\$76,900)

**Noncurrent Liabilities**

Employee Entitlements (Noncurrent)		(\$ 7,200)	
Bank Loan – Buildings		<u>(\$43,000)</u>	<u>(\$50,200)</u>

**TOTAL LIABILITIES**

**(\$127,100)**

**NET ASSETS**

**\$133,900**

**EQUITY**

Retained Earnings			<u>\$133,900</u>
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**TOTAL EQUITY**

**\$133,900**

Always as at a particular day – it is a snap shot

Not included in Quick ratio as cash already spent

Separate Controlled and Administered Assets

This would be an asset if GST is owed by the ATO

Not included in Quick ratio as cash already received

Example of estimate: should include expected future long service leave

These two figures should always equal

# Appendix 2 – Standard Ratio Calculations

## Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

## Quick Ratio

$$\frac{\text{Cash} + \text{Cash Equivalents} + \text{Debtors}}{\text{Current Liabilities}}$$

## Debtors Turnover Ratio

$$\frac{\text{Net Credit Sales}}{\text{Average Accounts Receivable}}$$

## Creditors Turnover Ratio

$$\frac{\text{Net Credit Purchases}}{\text{Average Accounts Payable}}$$

## Stock Turnover Ratio

$$\frac{\text{Opening Stock} - \text{Closing Stock}}{\text{Average Stock}}$$

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