

# KEY FINANCIAL RATIOS TOOL

Part of the NDIS Provider Toolkit, this tool will help you assess organisational performance and identify areas where your business is underperforming.



# THE KEY FINANCIAL RATIO TOOL

## HOW IT WORKS

Financial ratios are commonly used by organisations to assess performance and identify where the business is underperforming.

Monitoring figures closely allows the organisation to maximise efficiency and minimise waste, which will help during transition to the NDIS.

Financial risk for organisations is increased under the NDIS because most organisations will move from block funding paid in advance to individual payments made in arrears. In this context it is critical to monitor and manage activity levels and cash flow. Further, where block payments end, your organisation will no longer earn interest from investing payments made in advance.

The Toolkit uses high level ratios that can be calculated from the annual reports of most organisations.

The table on the next page describes the ratios and what they measure.

RATIO	WHAT THIS RATIO EXPLAINS
<b>Revenue concentration</b>	This ratio identifies the percentage of your income which comes from disability service provision. The higher the percentage, the greater the potential impact the NDIS could have on your organisation. A diversity of major revenue sources is sometimes considered to be more desirable. However, this depends on your organisational strategy.
<b>Liquidity ratio: month of spending</b>	This ratio establishes the number of months of cash available to cover expenditure. This may indicate whether your organisation can make the transition from payments in advance to payments in arrears. As a rule of thumb, 3 months or more of spending is recommended.
<b>Liquidity ratio: current</b>	This ratio measures your organisation's ability to meet its financial commitments in the next 12 months. A ratio of less than 1.5 is concerning, while a ratio of less than 1 indicates that your organisation should seek accounting and legal advice as it is possibly trading while insolvent. A very high current ratio might indicate opportunities for the more effective use of cash funds. This is because you might have more money in operating accounts than you need.
<b>Debt ratio: debt to total assets</b>	This ratio measures the extent to which assets are funded by debt. The preferred result is low, towards 0.00. Higher ratios may indicate an organisation's inability to service its debts.
<b>Sustainability ratio: surplus margin (profit margin)</b>	This ratio explains the rate at which your organisation currently builds reserves from revenue. These reserves can be used for working capital, for future service delivery, for investment in the organisation's infrastructure or for investment in revenue-generating activities. The preferred result for both periods is a positive figure. An organisation which regularly has negative returns will not be viable in the longer term. Boards and management teams might establish a target level of surplus (profit) margin.
<b>Sustainability ratio: return on assets</b>	This ratio is an indicator of the organisation's effectiveness in managing its assets to generate a surplus (or profit). It is an indicator of efficiency. The preferred result is higher than the annual rate of inflation.

## KEY FINANCIAL RATIOS

The key financial ratios in this tool are high-level ratios only, drawing on the organisation's Balance Sheet and Profit and Loss Statement. The ratios are calculated from your financial records at the date they were generated. Significant changes in your organisation's circumstances since that date will not be reflected in the key ratios and therefore need to be considered when analysing and responding to the results.

The results also need to be viewed in the context of your organisation's overall circumstances, including its strategy and financial history. Trends in the ratios across time can be important; however, the impact of changes under the NDIS might result in your pre-NDIS history being less relevant. As such, it is only an indicator of future performance. Further analysis can give a more complete understanding of your organisation's financial position.

The comments about preferred results are for guidance only.

## HOW TO COMPLETE THE ANALYSIS OF KEY FINANCIAL RATIOS

You will need your latest audited Balance Sheet and Profit and Loss Statement. This is important because an audited Balance Sheet will account for unexpended grants. If you use a Balance Sheet that is yet to be adjusted for unexpended grants, the results are likely to overstate your financial position. In addition, the Profit and Loss Statement needs to be for the most recently completed financial year. If you use a Profit and Loss Statement for a part financial year, the Months of Spending result will not be correct.

Here's how to calculate your organisation's ratios:

1. Enter the relevant items from the Balance Sheet and Profit and Loss Statement in this form to calculate the ratios. Completing the ratios online will allow automatic calculation of figures.
2. Share the results with your board and your management team. They include vital information about the financial sustainability of your organisation.
3. If you need help in understanding the ratios, discuss the results with a staff or board member with financial expertise, or with your organisation's accountant or auditor.

## REVENUE CONCENTRATION

### DISABILITY REVENUE CONCENTRATION RATIO

#### Ratio

$$\frac{\text{DISABILITY REVENUE SOURCES}^*}{\text{TOTAL REVENUE \%}} = \%$$

#### Your Organisation

$$\frac{\text{DISABILITY REVENUE SOURCES}}{\text{TOTAL REVENUE \%}} = \%$$

\* Disability revenue sources should include all current revenue sources for supports that are and will be included in the NDIS

#### What this ratio explains

This ratio explains the degree of potential impact that the NDIS could have on your organisation.

The higher the percentage, the greater the likely impact.

A diversity of major revenue sources is sometimes considered to be more desirable. However, this depends on your organisational strategy, and sometimes there are advantages in concentrating on one revenue source and one type of service. If this is the case, any risks to the revenue source need to be identified and managed where possible.

## LIQUIDITY RATIOS

### MONTHS OF SPENDING RATIO

#### Ratio

$$\frac{(\text{CURRENT ASSETS} - \text{CURRENT LIABILITIES})}{(\text{TOTAL EXPENSES} - \text{DEPRECIATION})} \times 12 = \text{MTHS}$$

#### Your Organisation

$$\frac{(\text{CURRENT ASSETS} - \text{CURRENT LIABILITIES})}{(\text{TOTAL EXPENSES} - \text{DEPRECIATION})} \times 12 = \text{MTHS}$$

#### What this ratio explains

This ratio explains the number of months of cash currently available to cover expenditure.

This indicates whether your organisation can make the transition from payments in advance to payments in arrears.

As a rule of thumb, 3 months or more is preferred.

## LIQUIDITY RATIOS CONTINUED

### CURRENT RATIO (ALSO KNOWN AS LIQUIDITY RATIO)

#### Ratio

$$\frac{\text{CURRENT ASSETS}}{\text{CURRENT LIABILITIES ( includes unexpended funds )}} = ?$$

#### Your Organisation

$$\frac{\text{CURRENT ASSETS}}{\text{CURRENT LIABILITIES ( includes unexpended funds )}} = ?$$

#### What this ratio explains

This ratio explains the ability to meet financial commitments in the next 12 months. A ratio of less than 1.5 is concerning. A ratio of less than 1 indicates that your organisation should seek accounting and legal advice as it is possibly trading while insolvent.

However, very high current ratios might indicate opportunities for the use of cash funds. This is because you might have more money in operating accounts than you need. These are idle funds. It may also indicate a conservative approach to investment and financial risk. Remember though, your board should consider these issues and develop policies based on the organisation's context and needs.

## DEBT RATIO

### DEBT TO TOTAL ASSETS RATIO

#### Ratio

$$\frac{\text{TOTAL LIABILITIES}}{\text{TOTAL ASSETS}} = ?$$

#### Your Organisation

$$\frac{\text{TOTAL LIABILITIES}}{\text{TOTAL ASSETS}} = ?$$

#### What this ratio explains

This ratio explains the extent to which assets are funded by debt.

The preferred result is low, towards 0.00. Higher ratios are often an indication of an organisation's inability to service its total debts.

## SUSTAINABILITY RATIOS

### PROFIT MARGIN (ALSO KNOWN AS SURPLUS MARGIN)

#### Ratio

$$\frac{(\text{TOTAL REVENUE} - \text{CAPITAL GRANTS} - \text{TOTAL EXPENSES})}{(\text{TOTAL REVENUE} - \text{CAPITAL GRANTS})} = \%$$

#### Your Organisation – Most recent financial year

$$\frac{(\text{TOTAL REVENUE} - \text{CAPITAL GRANTS} - \text{TOTAL EXPENSES})}{(\text{TOTAL REVENUE} - \text{CAPITAL GRANTS})} = \%$$

#### Your Organisation – Previous financial year

$$\frac{(\text{TOTAL REVENUE} - \text{CAPITAL GRANTS} - \text{TOTAL EXPENSES})}{(\text{TOTAL REVENUE} - \text{CAPITAL GRANTS})} = \%$$

#### What this ratio explains

This ratio explains the rate at which your organisation currently builds reserves from revenue. These reserves can be used for working capital, for future service delivery, for investment in the organisation's infrastructure, or for investment in revenue-generating activities.

The preferred result for both periods is a positive figure. An organisation which regularly has negative returns will not be viable in the longer term.

Boards and management teams might establish a target level of surplus (profit) margin.

### RETURN ON ASSETS RATIO

#### Ratio

$$\frac{\text{TOTAL REVENUE} - \text{TOTAL EXPENSES}}{\text{TOTAL ASSETS}} = \%$$

#### Your Organisation

$$\frac{\text{TOTAL REVENUE} - \text{TOTAL EXPENSES}}{\text{TOTAL ASSETS}} = \%$$

#### What this ratio explains

This ratio is an indicator of the organisation's effectiveness in managing its assets to generate a surplus (or profit). It is an indicator of efficiency.

The preferred result is higher than the annual rate of inflation.

## CONCERNED ABOUT YOUR ORGANISATION'S RESULTS?

The following suggestions need to be considered in light of the organisation's circumstances and strategy. To some extent, the suggestions are related. For example, actions to reduce cost will increase surplus/profit and ultimately improve the organisation's current assets and total assets. Increasing profitability will improve liquidity, debt, and sustainability-related ratios. There are three broad strategies for improving your organisation's results:

1. improving profitability and sustainability;
2. making better use of any assets; and
3. reducing liabilities<sup>14</sup>.

## HOW TO IMPROVE PROFITABILITY AND SUSTAINABILITY

Questions to consider:

- Can you do something to generate more income without disproportionately raising expenses?
- Can you generate more income by serving new clients?
- Can you provide more valued services to existing clients?
- Can you be confident that the additional income generated will exceed the additional expense?
- Even if you are confident that income will exceed expense, do you have access to the working capital to cover the additional expense, given that under the NDIS you will be paid in arrears?
- Can you increase service delivery for those service types which generate a greater surplus?
- Are you ensuring that you receive prompt and accurate payment for services delivered, for example, by having payment by credit card at the time of delivering services to clients who are self-managing their NDIS package?
- Are you effectively managing your debtors?
- Are you effectively managing your suppliers, for example, by negotiating favourable terms?

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<sup>14</sup> See Healthy Cash Flow Pillars, [www.adhc.nsw.gov.au/sp/sector\\_reform/financial\\_management/managing-your-cash-flow](http://www.adhc.nsw.gov.au/sp/sector_reform/financial_management/managing-your-cash-flow)



You might look for ways of **reducing or controlling expenditure**.

Questions to consider:

- Ways to reduce costs without unwanted impacts on quality. Can you reduce administrative overheads, for example, through expenditure reviews, outsourcing back office functions, or merging with another organisation?
- Providing services to clients that are not funded. If you are already doing so, what strategies could be used to fund these services, wind them back or stop them entirely?
- Are you providing more services than you are contracted to provide? For clients who have transitioned to NDIS, do the services you provide to the client exceed what the client is purchasing?
- Are there efficiencies that can be realised in staffing costs, for example, by improved rostering?

## **MAKING BETTER USE OF ASSETS**

The other way of improving liquidity-related ratios is to make better use of assets. For example, an organisation might have low net current assets, but high net fixed assets. For example, your organisation might own property or vehicles, or reconsider the proportion of current to fixed assets, or generating income from the fixed assets.

Questions to consider:

- Could your organisation sell some of its fixed assets and increase the proportion of current assets to gain greater access to working capital?
- Could your organisation generate income from fixed assets, for example, by renting out facilities?

## **REDUCING LIABILITIES**

- For organisations yet to transition to the NDIS, can you reduce annual leave liabilities now (while you are still block-funded) by encouraging staff to take any backlog of annual leave?

## MONITORING YOUR PROGRESS

While analysis and planning are both important steps, taking action based on the plan is critical and should be prioritised. Here's how to stay on track:

- Review the list regularly, for example, at the start of each week when planning the week ahead.
- Set up regular (say monthly) reporting requirements on progress against the plan.
- Ensure these reports go to the board or management team, and are actively discussed. Active discussion helps ensure everybody understands the issues and their priority to the organisation.
- Establish timeframes for major reviews against progress, such as every three or six months.
- Seek coaching to help you keep on track.
- Acknowledge and communicate significant achievements against the plan, whether they be your own or those of others.





