Financial management of not-for-profit organisations

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CPA AUSTRALIA

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Table of contents

Why good financial management is important for not-for-profits

The term 'not-for-profit' can be misleading, as profitability does have a role in ensuring that NFP organisations achieve their objectives through adequate financial support.

NFP organisations are an essential part of every community. They exist to provide benefits to members of the community. They can vary in size, from the very large to the local sports club. Operations are based on the receipt of grants, donations, fundraising or receipts from members as the principal income source. In some instances, NFPs supplement this income with trading activities. Although these organisations operate on a not-for-profit basis, appropriate good practice financial management will ensure that there are adequate resources to meet their objectives, remain solvent and continue support the community.

Although profitability is not the core purpose of an NFP, it is necessary to ensure that the NFP is sustainable, properly capitalised and funded. It would be fair to say that NFPs need to ensure they have adequate cash flow to support their operations over the duration of their lives and contribute to achieving their goals.

Therefore, sound financial management for NFPs is important if people are to see how they have used the money they received. This guide has been produced to assist in the implementation of sound financial management practices to make certain that the social objectives of the community organisation are met.

Of course, for each organisation, some of the areas may not be relevant. For instance, where there are no trading activities, then the areas that discuss stock management will not be relevant. Also the type of industry in which the organisation operates will determine the implementation process when considering good financial management, for example, if the NFP runs a cafe then stock levels will be reviewed every week. However, a small retail shop may do a stock-take only once a year.

By implementing good financial management your NFP will deliver the strategic goals in a financially sound manner.

This guide has been developed to discuss the key financial aspects NFPs should focus on to ensure that good financial management is in place. The topics discussed in the guide cover all the financial areas that should be considered and understood to guarantee that the NFP delivers a socially valuable service in a financially sound manner.

Glossary of terms

There is a wealth of jargon and terminology associated with financial management. It is helpful for you to understand these terms when reading financial statements or when talking to finance professionals, for example, bank managers. The most basic and useful of these are described as follows:

Accrual accounting	Recognising income and expenses when they occur rather than when income is received or expenses paid
Accounting entry	The basic recording of business transactions as debits and credits
Accounting period	A period for which financial statements are prepared – normally monthly and then annually
Amortisation	The process by which the value of an asset is gradually reduced (based on its expected life)
Asset	Anything having a commercial value that is owned by the organisation
Break even	The amount in either units or dollar value that the organisation needs to achieve before a profit is generated
Budget	A financial plan for an organisation, typically done once a year
Capital expenditure	The amount of money that is allocated or spent on assets
Cash accounting	Accounting for income and expenses as they are received or paid
Cash Flow	The flow of cash into and out of the organisation
Cost of goods sold	The total cost of all goods sold during the period (COGS)
Creditors	The money which you owe your suppliers
Current	Refers to the time period of less than 12 months which assists in allocation of assets and liabilities
Debtors	The money which is owed by your customers to you
Deferred tax	The postponement of tax payable to a future period
Depreciation	The write-off of a portion of a fixed assets value in a financial period
Expenses	The costs associated with earning the organisational income
Financial accounting	Preparing financial statements for general purposes rather than tax requirements
Financial ratio	The method in which an organisation can measure the financial health and compare their organisational operations to those of similar organisations in the same industry
Forecasting	The process of predicting the future financial performance of an organisation
Inventory	The stock that an organisation holds to sell
Intangibles	Assets that don’t have a physical form, e.g. patents
Liability	The amount the organisation owes to external stakeholders
Margin	Profit from sales before deducting overheads, often referred to as gross margin, or after all expenses, often referred to as net margin
Mark-up	The percentage by which the sales price exceeds the cost
Mutuality principle	A person’s income consists only of monies derived from external sources. Accordingly, subscriptions and contributions from members for particular services provided by a club of association are generally excluded from the assessable income of that club or association
Non- Current	Refers to the time period of greater than 12 months which assists in allocation of assets and liabilities
Overheads	Costs not directly associated with the products or services sold by the organisation
Profit (surplus)	Revenue minus expenses

Purchase order	A commercial document issued by a buyer to a seller, indicating the type, quantities and agreed prices for products or services the seller will provide to the buyer
Receivables	Amounts that are owed to a organisation, also known as debtors
Revenue	The income the organisation earns from its activities, including grants, donations, fundraising and any trading income
Retained earnings	Profits that have remained in the organisation
Stock	Goods that the organisation purchases to sell
Working capital	The excess of current assets over current liabilities
Work in progress	Where an order has been taken from the customer and is in the process of completion

Setting the scene for good financial management

Understanding your organisation's financial position is important for the successful provision of NFP services. Good financial systems will assist in managing and monitoring the financial situation, and measuring the success of the organisation.

Good financial management starts with precise record-keeping that will generate accurate financial statements. Knowing how to read these financial statements and use the information to improve the organisation's activities will improve its financial management. Using historical financial information to plan for the future of the organisation will ensure that proposed activities will be financially viable and provide sustainable long-term operations.

In this first section, we look at financial statements, record-keeping and budgeting and forecasting. Each of the three key financial statements and what they mean are discussed, together with the types of information that can be found through analysis of these reports. The key areas to consider for good record-keeping to support accurate financial statements are discussed in the section on record keeping for improved financial information. Finally, there is a section on how to prepare and use budgets and forecasts.

This first section of the publication sets the scene for good financial management.

Understanding financial statements

Financial statements provide information on how the organisation is operating financially and why. Once this is understood, the information can be analysed to show the areas of financial strengths and weaknesses.

Financial statements record the performance of the organisation and allow management and other stakeholders to see the strengths and weaknesses by providing a written summary of the financial activities for a given period. This is particularly important for NFP organisations because it enables them to demonstrate the viability of the services provided, hence encouraging further community and government support.

Every organisation requires assets to run its operations. This could be as simple as having cash in the bank, but there are more likely to be a number of assets, such as office equipment, vehicles and perhaps even stock (only unsold stock is an asset). All of these items need to be paid for, and for NFP organisations, payment will be funded by grants, fundraising, donations, possible trading activities and perhaps some borrowings from a financier. There are three financial statements that record financial information on your organisation:

- **Balance sheet** (also known as the statement of financial position)
- **Income and expenditure statement** (also known as the profit and loss statement or statement of financial performance)
- **Statement of cash flows** (also known as the statement of receipts and payments)

To proactively manage your organisation, you should generate these financial statements on a monthly basis, review the results and analyse them for improvements. Let's look at the financial statements and see how they can assist in monitoring your organisation's performance.

Balance sheet

The balance sheet provides a picture of the financial health of an organisation at a given moment (usually the end of the month or the financial year). It lists in detail the various assets that the organisation owns, its liabilities and the value of the organisation's equity (or the net worth of the organisation).

- **Assets** are the items of value owned by the organisation
- **Liabilities** are the amounts owed to external stakeholders of the organisation
- **Equity** is the accumulated funds from the operations of the organisation, often referred to as accumulated funds in the balance sheet for NFPs

The organisation requires assets in order to operate and these assets are either funded by accumulated funds from the operations of the organisation or by borrowing money from external parties.

Assets ($170,000) are funded through liabilities ($43,500) and accumulated funds ($126,500)

Assets $170,000	Funded through:	**Liabilities** $43,500	and	**Accumulated funds** $126,500

The balance sheet equation can also be illustrated as:

Assets ($170,000 – liabilities ($43,500) = accumulated funds ($126,500)

Assets $170,000	minus	**Liabilities** $43,500	equals	**Accumulated funds** $126,500

That is, the value of all of the assets of the organisation less the value owed to external parties (liabilities) will equal the net worth of the organisation, that is, the value of the organisation after all its debts have been paid.

Balance sheet categories:

- **Assets** can include cash, investments, inventory, land, buildings, equipment, machinery, furniture, patents, trademarks, and money due from individuals or other businesses (known as debtors or accounts receivable)
- **Liabilities** can include funds acquired to support the organisation's operations by way of loans, overdrafts and other credit used to fund the activities of the organisation including the purchase of capital assets, inventory, and for the payment of general organisational expenses.
- **Equity** (or net worth or capital) is money injected into the organisation for use by the organisation in acquiring assets and paying for its (sometimes ongoing) cash requirements. For an NFP, this would generally include fundraising funds, grants etc. The general principle is that this figure should never be negative as this would indicate that all the capital has been depleted and the organisation is unable to pay its debts. For all organisations, insolvency is a very serious matter.

The categories in the balance sheet will highlight those items that can be turned into cash quickly.

Because of the particular focus of NFPs on cash and cash resources, the categories contained within the balance sheet hold significant relevance. Assets are shown in order of how quickly they can be turned into cash with current assets shown first and typically including items that are likely to be realisable within a 12-month period. Fixed assets come next and are 'longer-term assets'. In the same way, liabilities are listed in order of how soon they must be repaid with current liabilities (less than 12 months) coming first then non-current liabilities (longer than 12 months), followed by the equity in the organisation.

An example of a balance sheet for a disability service is shown below.

Hancock Regional Disability Services: Balance sheet – As at 30 June 200X

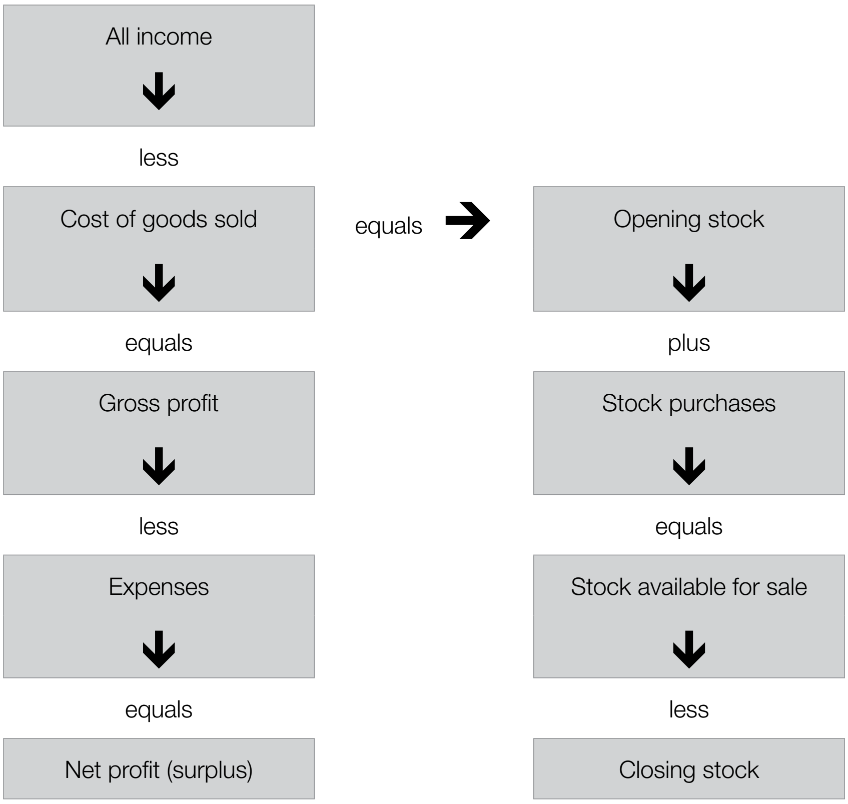
	$	$	$
Current assets			
Cash		6,500	
Debtors		18,000	
Stock		5,500	
Total current assets			30,000
Non-current assets			
Computers		5,500	
Furniture and fittings	30,000		
Less accumulated depreciation	(4,000)	26,000	
Office equipment	15,000		
Less accumulated depreciation	(500)	14,500	
Motor vehicle	45,000		
Less accumulated depreciation	(6,000)	39,000	
Capital investment account		55,000	
Total non-current assets			140,000
TOTAL ASSETS			170,000
Current liabilities			
Credit cards	5,500		
Creditors	8,000		
GST (net)	15,000		
Total current liabilities		28,500	
Non-current liabilities			
Bank loan	15,000		
Total non-current liabilities		15,000	
TOTAL LIABILITIES			43,500
NET ASSETS			**126,500**
Accumulated funds			
Accumulated surplus	122,000		
Retained earnings (current year profit)	4,500		
TOTAL ACCUMULATED FUNDS			**126,500**

Income and expenditure statement

The profit and loss statement (sometimes referred to as the income statement) is a summary of an organisation's income and expenses over a specific period of time. It is prepared at regular intervals (usually monthly and at financial year end) to show the results of operations for a given period.

This statement is important for NFP organisations, as it shows how received funds have been allocated against operating expenses during the reporting period, providing information to all donors and the board or management committee.

Income and expenditure are calculated as shown in the diagram below.



Only those NFPs that have products to sell will calculate the cost of goods sold.

An example of the income and expenditure statement for Hancock Regional Disability Service appears below.

Hancock Regional Disability Services:

Income and expenditure statement for the period ending 30 June 200X

					Totals
Income					
Grants –	Federal		46,000		
	Local		3,500		
	Reciprocal	Community Bank[1]	5,000	54,500	
Donations				2,500	
Interest				800	
Total contributions					57,800
Trading statement					
Sales income				35,000	
Less cost of goods -		Opening stock	8,500		
		Purchases	12,000		
			20,500		
		Less closing stock	5,500		
Total cost of goods sold				15,000	
Total trading income					20,000
Total income					77,800
Expenses					
Salaries		Administration	8,500		
		Gardeners	4,000		
		Instructors	11,500		
		Clients	17,500	41,500	
Rent				11,000	
Vehicle expenses				5,500	
Utilities				1,900	
Stationary				300	
Marketing				2,100	
Client support supplies				120	
Computers				2,280	
Consulting				7,000	
Staff training				1,600	
Total expenses					73,300
Net profit (surplus)					4,500

1. A reciprocal grant is a grant that has an agreement specifying the conditional use of the contribution.

Calculating the cost of goods sold

Calculating the cost of goods sold will only be relevant where the NFP sells product. For retail and wholesale sales, computing the cost of goods sold during the accounting period involves beginning and ending stock. This, of course, includes purchases made during the accounting period. Where the NFP is manufacturing, the calculation takes into account finished-goods stock, plus raw materials stock, work-in-progress stock, direct labour, and direct factory overhead costs.

Where the NFP is a service organisation calculating the cost of goods sold is not relevant, as there are no goods sold. The diagram on page 7 shows how the cost of goods sold is calculated.

Income

Most NFP organisations receive most of their income from grants, donations and membership fees (rather than receiving fees for services) and these are often referred to as contributions. Some organisations will also receive income from trading activity, such as sale of branded goods or goods produced from workshop activities undertaken by clients.

Each source of income for NFPs carries specific characteristics and should be appropriately disclosed in the financial statements. Where income is received with specific conditions on how it is to be used, these conditions should be reported through the financial statements. This is particularly relevant for grants received that carry reciprocal conditions. A reciprocal grant is a grant that has an agreement specifying the conditional use of the contribution. For reciprocal grants, reporting should include stages of completion. This may be measured by reporting the extent to which the conditions of the grant have been met (i.e. the percentage of funds spent or resources used).

Non-reciprocal grants are essentially transfers of resources from one party to another where the transferers do not directly receive approximately equal value in return. These include everyday transfers such as gifts, donations, government grants and taxes. They may be received as cash, or as other assets, or as reductions in liabilities (for example, forgiven loans). Non-reciprocal transfers are a major source of funding for government and other NFP organisations.

Expenses

In order to complete the financial picture of the operational activities of the NFP, all income (after deducting any cost of goods sold) must be matched against the expenses incurred during the reporting period. Expenses can include items such as wages and salaries, rent, advertising, fundraising expenses, client support expenses, etc.

The most appropriate way of reporting expenses is to classify them into what is known as functional expense classifications. The two main functional expense classifications are program services and supporting activities.

- Program services are segregated activities that can be clearly identified and recorded separately. For example, where the organisation undertakes various workshop activities, expenses for each activity would be separately reported under that activity
- Supporting activities typically include management and general activities, fundraising, and membership development

For each NFP, the classification of functional expense can vary widely.

Segment reporting

One of the beneficial ways to report the income and expenditure statement is through segment reporting. Segment reporting is where distinguishable operating activities are reported separately in the income and expenditure statement. For NPFs, this is most likely to be separated into two categories: program activities and support activities.

Program activities are activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfil the purposes or mission for which the organisation exists.

Support activities are all other activities. These may be further detailed in the income and expenditure statement. Some NFPs will detail separately fundraising and membership development as well as general activities. Fundraising activities can include advertising and cost of undertaking fundraising campaigns, maintaining donor mailing lists, special fundraising events, preparing and distributing fundraising manuals, instructions and other materials, and all other activities involved with soliciting contributions from individuals, foundations, government agencies and others. Membership development activities can include seeking prospective members, membership fees, and all activities related to membership relations.

Management and general activities include oversight, business management, general record-keeping, budgeting, financing and related administrative activities, and all management and administration except for direct conduct of program services or fundraising activities.

Expense allocation can vary widely for each NFP. For example, time spent by the chief executive officer developing and overseeing programs can be considered a program services expense. However, some NFP organisations will allocate all of the CEO's salary into the management and general activities function. Similarly, rent, utilities, insurance, supplies, and other expenses may be fairly divided among the various functional classifications and should not necessarily be considered exclusively management and general activities costs. A further example of the allocation process may be to review staff resources dedicated to each segment and allocate the expenses accordingly. It is important to ensure that the allocation provides transparency and is consistent across segments and reporting periods.

A segmented income and expenditure statement may look similar to this:

Hancock Regional Disability Services:

Income and expenditure statement – For the period ended 30 June 200X

	Totals	Gardening program	Printing program	Program totals	Management and general	Fund-raising	Supporting totals
Income							
Grants - Federal	46,000	22,000	24,000	46,000			
Local	3,500	1,500	2,000	3,500			
Reciprocal							
Community Bank	5,000	5,000		5,000			
Donations	2,500					2,500	2,500
Interest	800				800		800
Total Contributions	**57,800**	**28,500**	**26,000**	**54,500**	**800**	**2,500**	**3,300**
Trading statement							
Sales income	35,000	20,000	15,000,000	35,000			
Less cost of goods -							
Opening stock	8,500	5,000	3,500	8,500			
Purchases	12,000	7,000	5,000	12,000			
	20,500	12,000	8,500	20,500			
Less closing stock	5,500	3,000	2,500	5,500			
Total cost of goods sold	15,000	9,000	6000	15,000			
Total trading income	20,000	11,000	9,000	20,000			
Total income	77,800	39,500	35,000	74,500	800	2,500	3,300
Expenses							
Salaries - Admin	8,500	1,000	1,000	2,000	6,000	500	6,500
Gardeners	4,000	4,000		4,000			
Instructors	11,500	4,000	7,500	11,500			
Clients	17,500	4,500	10,500	15,000		2,500	2,500
Rent	11,000	3,500	2,500	6,000	3,500	1,500	5,000
Vehicle expenses	5,500	3,000	1,000	4,000	1,500		1,500
Utilities	1,900	350	500	850	450	600	1,050
Stationary	300	100	100	200	50	50	100
Marketing	2,100	1,050	1,050	2,100			
Client support supplies	120	70	50	120			
Computers	2,280	1,400	880	2,280			
Consulting	7,000	1,200	5,800	7,000			
Staff training	1,600	1,200	400	1,600			
Total expenses	73,300	25,370	31,280	62,650	11,500	5,150	16,650
Net profit (surplus)	**4,500**	**14,130**	**3,720**	**17,850**	**(10,700)**	**(2,.650)**	**(13,350)**

Statement of cash flows

> The statement of cash flows only shows the historical data and differs from a cash flow forecast.

The statement of cash flows is a summary of money coming into and going out of the organisation over a specific period of time. It is prepared at regular intervals (usually monthly and at financial year end) to show the sources (where the cash comes from) and uses (where cash was spent) of cash for a given period.

For NFP organisations, this statement will clearly set out the cash impact of any trading activities as a comparison against cash received from contributions.

The cash flows (in and out) are summarised on the statement in three categories as follows:

Operating activities: These are the day-to-day activities that arise from the selling of goods and services and usually include:

- receipts from trading income
- payments for expenses and employees
- funding of debtors
- funding from suppliers (i.e. the supplier supplies goods on credit)
- stock movements

Investing activities: These are the investments in items that will ensure or promote the future activities of the organisation. They are the purchase and sale of fixed assets, investments or other assets and can include such items as:

- payment for purchase of plant, equipment and property
- proceeds from the sale of plant, equipment and property
- payment for new investments, such as shares or term deposits
- proceeds from the sale of investments

Financing activities: These are the activities by which an organisation finances its operations via the proceeds of borrowings and equity injections, the repayment of debt or equity and the payment of dividends. Examples of the types of cash flow included in financing activities include:

- proceeds from additional injection of funds into the organisation. For NFPs this will include contributions
- cash borrowed
- repayment of cash borrowed

As already mentioned, the statement of cash flows can be a useful tool to measure the financial health of an organisation and can send warning signals to the reader. Three signals that can indicate the potential for an organisation to fail are:

- Cash receipts less than cash payments – the organisation is running out of money
- Net operating cash flow is an outflow
- Net operating cash flow is less than profit after tax which means the organisation is spending more than it is earning.

Below is an example of a cash flow statement:

Hancock Regional Disability Services:

Statement of cash flows for the period ending 30 June 200X

	$	$	$
Cash flows from operating activities			
Receipts from trading income		35,000	
Payments of expenses	-73,300		
Funding to debtors	-18,000		
Stock movement	-20,500		
Funding from creditors	8,000	-100,800	
Net cash from operating activities			-68,800
Cash flows from investing activities			
Payments for property, plant and equipment	Nil		
Net cash from investing activities	Nil		
Cash flows from financing activities			
Proceeds from donations	800		
Proceeds from fundraising	2,500		
Proceeds from grants	54,500	57,800	
Net cash from financing activities			57,800
Net increase in cash			-11,000
Cash balance as at start of year			17,500
Cash balance as at end of year			**6,500**

Analysing the financial health of an organisation

Using financial ratio analysis regularly will assist in monitoring the financial health of the organisation.

Financial ratio analysis is the common method of analysing the financial health of an organisation and predicting the organisation's potential for success or failure and its progress. Ratio analysis enables you to spot trends in the organisation and to compare its performance and condition with the average performance of similar organisations in the same industry.

Although there are many financial ratios you can use to assess the financial health of your organisation, we will discuss the main ones that you can use easily. The ratios are grouped together under each area the organisation should focus on for financial survival and prosperity.

Liquidity ratios

These ratios indicate the ease of turning assets into cash to assess your organisations' ability to pay its bills as they fall due. They include the current ratio, the quick ratio, and working capital (which is discussed in detail in the section on working capital management). In general, the higher the ratios in this category, the sounder are the organisation's activities and its ability to withstand tight cash flow periods.

$$\text{Current ratio} = \frac{\text{Total current assets}}{\text{Total current liabilities}}$$

One of the most common measures of financial strength, this ratio enables you to see if the organisation has current assets sufficient to meet its due debts with a margin of safety. A generally acceptable current ratio is 2 to 1. However, this will depend on the nature of the NFP and the form of its current assets and liabilities. For example, an NFP may have current assets made up predominantly of cash and would therefore survive with a lower ratio.

$$\text{Quick ratio} = \frac{\text{Current assets – inventory}}{\text{Current liabilities – overdraft}}$$

Sometimes called the 'acid test' ratio, this is one of the best measures of liquidity. By excluding inventory which could take some time to realise unless the price is 'knocked down,' it concentrates on real, liquid assets. It helps to answer the question, 'If the organisation does not receive income, will it be able to meet its current obligations with the readily convertible "quick" funds on hand?'

Solvency ratios

These ratios indicate the extent to which the organisation is able to meet the all debt obligations from sources other than cash flow and hence remain solvent and able to continue to operate. Commonly used solvency ratios are the leverage ratio, debt to assets and interest coverage.

$$\text{Leverage ratio} = \frac{\text{Total liabilities}}{\text{Equity}}$$

The leverage (or gearing) ratio indicates the extent to which the organisation is reliant on debt financing versus equity. Generally speaking, the higher the ratio, the more difficult it will be to borrow more money.

$$\text{Debt to assets} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

This measures the percentage of assets being financed by liabilities. Generally speaking, it should be less than 1, indicating adequacy of total assets to finance all debt.

Interest coverage = $\dfrac{\text{Net profit}}{\text{Total interest}}$

This measures how many times your net profit covers your interest expense obligations. The higher the ratio, the more likely the organisation will be able to be able to meet its interest expenses.

Profitability benchmarks

These are ratios that measure your organisational performance and ultimately indicate the level of success of your operations.

Gross margin benchmark = $\dfrac{\text{Gross profit}}{\text{Net income}}$

This ratio measures the percentage of sales dollars remaining (after obtaining or manufacturing the goods sold) available to pay the overhead expenses of the organisation. This ratio is only relevant to the trading segments of the NFP.

Net margin benchmark = $\dfrac{\text{Net profit}}{\text{Net income}}$

This measures the percentage of sales dollars left after all expenses (including stock), except income taxes. It provides a good opportunity to compare NFP's 'return on income' with the performance of other NFPs.

Operational benchmarks

These are ratios that measure the performance of each distinct activity within the NFP. They enable management to see quickly how successful each activity is.

Activity expense benchmark = $\dfrac{\text{Activity expenses}}{\text{Activity income}}$

For example:

Fundraising ratio = $\dfrac{\text{Fundraising expenditure}}{\text{Fundraising income}}$

This ratio measures cost of fundraising against the income derived from fundraising. It can be used for discrete activities within the NFP.

Activity expense to total expense benchmark = $\dfrac{\text{Activity expense}}{\text{Total expense}}$

This is the ratio of the cost of the activity to total expenditure. It allows management to see quickly which activities are the most expensive.

Activity expense to total income benchmark = $\dfrac{\text{Activity expense}}{\text{Total income}}$

For example:

Fundraising expense to net income = $\dfrac{\text{Fundraising expense}}{\text{Net income}}$

This shows fundraising expenses as a fraction of the total of all income derived from the activities of the NFP. Where this ratio is calculated for each discrete activity within the NFP, management can clearly see which fundraising activities are the most expensive.

$$\text{Activity income to total income benchmark} = \frac{\text{Activity income}}{\text{Total income}}$$

For example:

$$\text{Fundraising income to net income ratio} = \frac{\text{Fundraising income}}{\text{Net income}}$$

This is the ratio of the income from fundraising to the net income derived from the all the activities of the NFP. Where this ratio is calculated for each discrete activity of the NFP, management can clearly see which activities generate the highest proportion of the NFP's net income.

Management ratios

Management ratios monitor how effectively you are managing the key cash flow activities of the trading operations. These measures are referred to as 'working capital'.

$$\text{Days' inventory} = \frac{\text{Inventory}}{\text{Cost of goods sold}} \times 365$$

$$\text{Days' debtors} = \frac{\text{Debtors}}{\text{Net income}} \times 365$$

$$\text{Days' creditors} = \frac{\text{Creditors}}{\text{Cost of goods sold}} \times 365$$

Balance sheet ratios

These ratios indicate how efficiently your organisation is using assets and equity to make a profit.

$$\text{Return on assets} = \frac{\text{Net profit before tax}}{\text{Total assets}} \times 100$$

The return on assets indicates how efficiently profits are being generated from the assets employed in the organisation. The ratio will only have meaning when it is compared with the corresponding ratios of similar organisations. If the ratio of your organisation is low in comparison with those of similar organisations, it indicates that you are using your assets inefficiently.

$$\text{Return on investment} = \frac{\text{Net profit before tax}}{\text{Equity}} \times 100$$

The ROI is perhaps the most important ratio of all as it tells you whether or not the organisation is achieving its objectives and making an appropriate return on the funds it raises and receives.

TIP

By comparing each of these ratios after each reporting period, you will be able to see the strengths and weakness of the organisation's operations.

Net operating cash flow is less than profit after tax which means the organisation is spending more than it is earning.

Record keeping for improved financial information

Only accurate data that is recorded in a systematic way will provide the necessary financial information that can lead to improved financial performance.

Most organisational decisions depend on a review of the financial position of the organisation. It is therefore extremely important to ensure that the financial information is accurate and provided in a way that will assist in making those decisions. When we look at the financial statements (see 'Understanding financial statements'), it is apparent that there are many different categories to consider when recording the financial information. In most cases, your accountant will have assisted in setting up your recording system. However, it is a valuable exercise to review annually how the information is being reported and used to ensure that it continues to meet the organisation's requirements.

Preparation of financial information

To ensure that the financial information used by the organisation is meaningful and will assist in making informed decisions, it is important to have policies and procedures in place that support accurate and up-to-date information. All financial transactions should be recorded regularly. The most common method of recording this information is through the use of a financial management software system. There are a number of alternatives and it is best to consult your CPA to ensure that you are using the most appropriate system for your organisation.

Once you have the system to record the financial information, the next step is to ensure that the transactions are entered regularly and accurately. The best way to do this is to implement the internal control policies that will support the necessary procedures. For more information see the section on financial controls.

Chart of accounts

The chart of accounts is a list of all accounts that the accounting system will track. It should be designed to capture the financial information you need to make sound financial decisions. Only amounts owed by or owed to the accounts listed in the chart of accounts will be recorded in the accounting system and from there the amounts will be transferred into financial statements.

The chart is divided into five categories: assets, liabilities, equity, revenues and expenses. Each account is assigned to one of these categories. The chart of accounts can be designed to suit your organisation's specific needs.

You can review your chart of accounts using the following checklist.

Chart of accounts checklist

- [ ] What reports do you want to prepare?
- [ ] What financial decisions, evaluations and assessments do you need to make on a regular basis?
- [ ] What level of detail do you require?
- [ ] What is your capacity for tracking financial information?

Once you have answered these questions and you have reviewed the chart of accounts, you may need to consider the following:

- Income: separate reciprocal and non-reciprocal grants, separate trading activities, identify corporate donations to monitor fundraising efforts
- Expenses: how detailed do these need to be? should electricity and gas, be separated or should they be bundled together as utilities
- Parts of the organisation in different locations may require separate charts of accounts.

When deciding on the level of detail to record, remember that keeping track of very detailed information can require good bookkeeping skills and be time-consuming. Since most NFPs are always short of resources, it is important to consider cost versus benefit – will more detailed information improve the organisation's financial position and practices? A good rule is to keep the chart of accounts as simple as possible, and revise it as your need for information increases over time.

Segment reporting

Many NFPs have more than one type of organisational operation. Therefore it is important to consider segment reporting. This type of reporting segregates the financial information into separate organisational operations. An example could be a disability service that provides workshops for its clients as well as health care and support services. In this case, the financial reporting of income and expenditure would be presented in at least two separate

HINT

Keep your chart of accounts simple to start with and review and revise as the need arises.

reports – one income and expenditure statement for the workshop activities, and one for the health care and support services. For administration functions that overlap both operations, such as salaries or executive staff, a percentage based on resource allocation could be applied. Further discussion on segment reporting can be found in the section on understanding financial statements.

Accounting concepts

Cash accounting versus accrual accounting

There are two methods for recording the financial transactions of any organisation, including NFPs: cash and accrual. Most small NFPs will use the cash method. This is where income is only recorded as it is received, and expenses only recorded when they are actually paid.

The accrual method is a more accurate method of accounting. Under this method, income and expenses are matched together by recording income and expenses when the obligations are incurred. This means that if sales are made on credit, the sale is recorded when the invoice is generated (not when the invoice is paid) and matched to the relevant expenses for the sale. This way, the true profit is identified.

Most accounting systems can record under either method. However, there are taxation implications (where applicable for NFPs) and so before deciding which is the most appropriate method for your organisation to use, you should discuss it with your accountant, tax adviser or financial adviser.

Profit versus cash

In many cases, it is easy for organisations to confuse cash with profits. It is a common error to think that 'if we have money we must be making money'. An organisation may have good reserves of cash but for many different reasons the trading activities may not be profitable. This is particularly important to NFPs that undertake trading activities. If their activities are not profitable, then they could be eroding income generated from other income streams of the organisation, such as donations, and thereby reducing the cash available to achieve their objectives.

To assess the financial health and the performance of the organisation, we must look not only at the raw financial figures but also at the financial ratios.

TIP

If you are not sure which accounting method you should be using, speak to your CPA accountant.

Budgeting and forecasting

Budgeting and forecasting are the future financial plan of the organisation. They are where the strategic plans are translated into financial numbers to ensure that the strategic plans are financially viable.

Budgeting and forecasting are essential elements of financial management for NFPs. They are the tools that develop the strategic plans of the organisation into a financial statement. The financial statement enables boards and management committees to evaluate and monitor the plans. Most NFPs operate without large reserves to draw on. Therefore budgeting and forecasting will provide the financial information to enable management to decide if the strategic plans will support the ongoing operations. In short, budgeting is the process of planning the finances over the budget period. Budgeting can also provide an opportunity to plan ahead for several years in an effort to identify changing conditions that may impact on the organisation's operations and cause financial difficulty. Forecasting then reviews actual outcomes against budgeted activities, identifying changes in anticipated events. Forecasting provides the financial information that shows if plans need to be amended and enables the organisation to be proactive in achieving its goals.

Good budgeting and forecasting require the following:

- preparation against strategic goals set and approved by the board or management committee
- budgeted timelines aligned to the preparation of financial statements
- regular comparison of budgets against actual financial results as disclosed in the financial statements
- scope for amending activities and targets where actual results indicate that budgeted outcomes will not be met

In short, for NFPs, budgets and forecasts provide information on the future of the organisation and if planned and managed well, they will be the central financial statements that allow the board and management to monitor the financial impact of the organisation's strategic plans.

Income and expenditure budget

An income and expenditure budget is an important tool for NFPs because where activities can generate profit, this enables the organisation to be less reliant on external funding. This budget is a summary of expected income and expenses set against the board-approved activities for the budget period. This period is usually for one year, although in some cases, the period can be shorter or longer, depending on the direction set by the board or management committee.

For example, if the NFP has a specific approved program that requires to be funded over a two-year period, then the budget will need to be formulated over this timeframe. In some instances, NFPs that have a variety of discrete activities that have distinct income and expense items for each activity (or program), will require a budget for each of these activities.

The board or management committee should outline the key activities for the organisation and then it is the responsibility of management to prepare the budget. Although your accountant can be of assistance in this preparation, it is important that management and staff be involved in the process, as the income and expenditure budget will be used as a key management tool to drive operations of the organisation to achieve the required financial outcomes.

When setting strategic goals for the budget process, the board or management committee should be aware that the approved budget will provide direction to management on the operations of the organisation. Therefore, the budget becomes a governance tool that the board will use to monitor the overall management of the organisation.

Preparing the income and expenditure budget

The key to successful preparation of an income and expenditure budget is to do it in an orderly manner, involving all key staff and ensuring that the goals of the organisation are clearly understood from the outset. There are two methods:

- incremental: where previous years' activities are used as the basis for preparation
- zero-based: where all the financials are prepared without consideration of past activities

For annual budgeting, the preferred method would be incremental, as zero-based would an require enormous amount of resources and time to prepare. In the case of project or activity-based budgets, then zero-based may be more suitable, particularly for new programs where there is no previous financial data.

> **HINT**
> For some programs that have a lifespan of more than one year, the budget may need to match the period of the program

An annual budget preparation policy should be documented and followed. It could include some or all of the following steps:

1. review the approved strategic plan and note all required activities for the budget year
2. separate the activities into existing and new
3. document all assumptions that will be made from the approved strategic plan
4. review the previous year's income and expenditure statements by agreed period (monthly, quarterly etc)
5. Separate income and expenses by activity or program
6. Determine the income and expense for each program and work out the changes required for each
7. Combine all income and expenses into one statement and review the financial outcome (profit or loss?)
8. Discuss any amendments required. For example, if a program is running at a loss, you may decide to drop it or else allow other profitable programs to fund the loss
9. Present the income and expenditure budget to the board or management committee for approval

The following provides further information on some of the critical aspects of the steps outlined above.

Documenting assumptions

As you are preparing your estimates on income and expenditure, you will be using certain assumptions to establish a financial number that reflects the event. When making your assumptions, you should use targets that you believe will be achievable. Using your historic financial information and looking for any trends in this information is a good place to start. It always helps if any industry information provided by reputable independent companies can give your assumptions credibility.

It is important that management reviews all assumptions required for the budget, documents the critical ones and evaluates the risks associated with each. Because the budget will be the tool for measuring the effectiveness of management and the organisation, it must be realistic. By evaluating the assumptions, areas that need to be amended or managed to ensure that the budget will be achieved will be highlighted.

Good budget preparation should include documentation of all your key assumptions. This way you will remember what you anticipated, and when reviewing your forecast against actual, it will help to see what has changed if the actuals turn out differently. When listing your assumptions, if you believe that there is some risk that the event may not occur, include this information with the assumption and any actions that you may have thought of in the event that a particular assumption turns out to be incorrect. That way, you will already have an action plan in place. The table below is an example of documenting assumptions.

Assumption	Forecast	Source	Risk	Action
Grants	Grants will decrease by 11%	Released government information as attached	Grants available will be less than anticipated	Increase fundraising and donation activity
Trading operations	Overall trading income will decrease by 13%	Current economic data and industry information	Overall the decrease will be greater than anticipated	Implement aggressive marketing campaign to increase sales. Review expenditure
Salaries	Salaries will increase by 2.3%	In line with CPI and market conditions	Salaries will increase by more than 2.3%	Review all staffing levels and employment contracts to identify possible savings
Expenses	Expenses will decrease by 8%	Prior-year historical data identified excess expenditure	Expenses will decrease by less than 8%	Continually review operational activities to identify any expense savings

Once the assumptions have been documented and reviewed, the income and expenditure budget can be prepared. The first step is to review current year activity against proposed budget activity. An example of the income and expenditure budget for Hancock Regional Disability Services is shown on the following page.

TIP

You may want to consider presenting the key assumptions to the board or management committee for approval before developing the new budget. This way, they will be fully informed of what has been estimated for the key events for the budget year and they will be able to see clearly what is going on. If you do seek approval, then at each board or committee meeting, you should also advise the board or management committee of any changes that may have occurred that have or are likely to have an impact on your assumptions.

Hancock Regional Disability Services: Budget 200X+1

	Gardening program		Printing program		Fundraising		Management		Totals	
	Last Year	This year	Last year	This year	Last year	This year	Last year	This year	Last year	This year
Grants-Federal	22,000	25,000	24,000	20,000					46,000	45,000
Local	1,500	2,500	2,000	None					3,500	2,500
Reciprocal	5,000	None							5,000	None
Donations					2,500	3,000			2,500	3,000
Interest							800	500	800	500
Total contributions	28,500	27,500	26,000	20,000	2,500	3,000	800	500	57,800	51,000
Trading statement										
Sales income	20,000	18,000	15,000	12,500						
									35,000	30,500
Less cost of goods	9,000	8,100	6,000	5,000					15,000	13,100
Total trading income	11,000	9,900	9,000	7,500					20,000	17,400
Total income	39,500	37,400	35,000	27,500	2,500	3,000	800	500	77,800	68,400
Expenses										
Total salaries	13,500	14,000	19,000	19,250	3,000	3,100	6,000	6,250	47,500	48,600
Rent	3,500	4,000	2,500	2,750	1,500	1,600	3,500	4,000	11,000	12,350
Vehicle expenses	3,000	3,500	1,000	1,250			1,500	1,750	5,500	6,500
Utilities	350	350	500	550	600	660	450	500	1,900	2,060
Stationary	100	50	100	100	50	40	50	50	300	240
Marketing	1,050	1,050	1,050						2,100	1,050
Client support supplies	70	50	50	70					120	120
Computers	1,400	700	880	650					2,280	1,350
Consulting	1,200		5,800						7,000	
Staff training	1,200	800	400	300					1,600	1,100
Total Expenses	25,370	24,500	31,280	24,920	5,150	5,400	11,500	12,550	73,300	67,370
Net profit	**14,130**	**12,900**	**3,720**	**2,580**	**(2,650)**	**(2,400)**	**(10,700)**	**(12,500)**	**4,500**	**1,030**

Hancock Regional Disability Services have prepared this budget on the assumption that there will be a reduction in funding available and that trading for the gardening and printing program will decline slightly. This is in line with the assumptions documented. Although the overall result indicates a small profit, there appears to be little room for any operating adjustments that may occur throughout the year. The board or management committee should consider that this current budget may also place a drain on cash reserves, as the profit of $1,030 is a reduction of 77 per cent from the previous year.

At this point, management can either submit the budget as prepared, or request that the board review the plans for the following year making amendments to either increase total income or reduce expenses. Under direction from the board, a new budget would then be prepared that provided for a more appropriate flexibility on operations to ensure that unfavourable events did not reduce profit and ultimately cash reserves. If an amended budget is prepared, don't forget to update the assumptions table.

The financial operations of the organisation must then be monitored and managed in accordance with the approved budget.

Monitoring and managing the income and expenditure budget

There are a number of ways that the income and expenditure budget can be managed. As noted at the beginning of this section, it is important that regular financial statements – in particular, income and expenditure statements – be prepared so that the actual activities can be compared to the budgeted activities. Standard practice would be to prepare monthly statements. However, for smaller NFPs, the board or management committee may agree to quarterly preparation. Remember, the more frequent the reports, the better operations can be reviewed for financial impact and action can be taken quickly where required.

Where the income and expenditure statements are prepared monthly, the budget will need to be separated into months for the budget period. Where the NFP is also preparing segment reports, each segment budget should also be separated into months. At the end of each month, the actual results are compared to the budgeted results and any variances noted and analysed. All variances should be noted on the reports presented to the board or management committee and explanations provided. Variances should be categorised as either timing or permanent. A timing variance is where the estimated result did not occur but is still expected to occur. A permanent variance is where the expected event is not likely to occur at all.

The beauty of this analysis is that each variance can be considered and action can be taken to counteract future variances or to implement new or improved activities to ensure that the strategic goals that underlie the budget can still be achieved.

Forecasting

Where variances are highlighted in the analysis, and management make decisions to amend certain activities, the amendments need to be reflected in a forecast. A forecast is essentially a budget that has been amended to reflect actual events as they occur. The two forecasts used by most organisations are the income and expenditure forecast and the cash flow forecast.

HINT

Forecasting is different to budgeting. A forecast is where the budget is updated with actual events to show what has happened and the impact of these events of the predicted outcomes.

Income and expenditure forecasting

The income and expenditure forecast will be developed once variations to the budget have been identified, usually at the end of the month. For both permanent and timing differences, adjustments to the financial information will be required. Before undertaking any amendments, you must ask if the end result (i.e. the profit target) has changed. If the answer is no, then amendments can only be made within the months reported. However, the final result will remain. In the event that the management or the board decide that, under the changing conditions, the end result needs to be adjusted, a new budget should be developed and approved based on this decision.

The key to successful income and expenditure forecasting is to regularly review results, identify variances and implement strategies early to ensure that the approved budget will be met. The section on managing profitability and cash flow has further information on possible strategies to assist in maintaining profitability.

Cash flow forecasting

A cash flow forecast is the most important tool for NFPs. With limited cash reserves, heavy reliance on contributed funds and possible restrictions to accessing external finance, cash flow planning is essential for these organisations. A cash flow forecast will predict your organisation’s ability to maintain the cash necessary to support its operations. It will also indicate any cash flow gaps the may be experienced — periods when cash outflows exceed cash inflows. A cash flow forecast can be developed from the existing information you already have in the organisation. After 12 months you'll have a good idea as to what your cash balance will be, month by month for your next year of operations.

There are a few ways to use a cash flow forecast as a planning tool:

- short-term planning to see where more cash than usual is needed: in a month, for example, when several large annual bills are due, and there is not likely to be much cash in the bank
- organisational planning (long-term planning) to ensure that the NFP maintains adequate cash reserves to support its long-term strategic goals.

A cash flow forecast differs from an income and expenditure forecast in that it gives the timing of payments and receipts. It is the difference between profit and cash that makes it necessary to prepare a cash flow forecast in addition to an income and expenditure forecast.

The easiest way to prepare a cash flow forecast is to break up the income and expenditure forecast into shorter timeframes and then bring all the information together at the end.

The five steps to preparing a cash flow forecast are:

1. prepare a list of assumptions
2. forecast receipts (i.e. list all the grants, donations, fundraising activity income etc that you expect to receive)
3. detail any other estimated cash inflows
4. detail all estimated cash outflows
5. assemble all the gathered detail to create the cash flow forecast

The key to preparing an accurate cash flow forecast is in accurately estimating the times of receipts and payments.

Step 1: Assumptions
The assumptions used in the cash flow forecast are the same as those used for the income and expenditure budget process – refer to page 18.

Step 2: Forecasting receipts
Contributions and trading sales are included in an income forecast for NFPs.

Forecasting contributions for NFPs is an essential part of preparing the cash flow forecast. Often grants, donations and fundraising occur throughout the year in discrete, rather than regular, payments. It is due to the nature of these receipts and in addition to the uncertainty of these cash inflows that a cash flow forecast becomes a critical planning tool for all NFPs. The timing and level of contributions to be included in the cash flow forecast can be estimated through historic information, together with other information gathered through the expertise of management. The assumptions used in the development of the income and expenditure budget can also be used.

You might like to use the example on the following page from Hancock Regional Disability Services as a basis for developing the first step of forecasting cash inflows from contributions.

The next area for forecasting income is the sales forecast. This forecast will only be relevant to those NFPs that have trading activities and sell products or services on credit.

Estimating your sales is often one of the most difficult tasks in the forecast process. If you think about it, your sales will depend on many variables, such as the types of customers you have, the terms you offer your customers, economic events such as interest rate increases or employment rates, and competitive influences. It is not possible to predict all the events that may have an impact on your sales over the timeframe of the forecast. This is why many organisations do not do sales forecasts. However, if you accept that your forecast sales will most likely not match your actual sales, you can then focus on estimating a realistic figure for the sales of the organisation over the period for which the forecast will be prepared.

For existing organisations, the best starting point will be last year's sales figures. Do you believe that you will continue to achieve these figures, or have you implemented improved organisational operations to increase sales over the coming year? Once you have estimated the amount by which your historical sales figures need to be adjusted, you can then estimate the sales for the period.

Once you have estimated the sales for the period, the next step is to break these numbers up into sales receipts. Remember that we talked about the timing of cash as the key to cash flow forecasts. Again this information will be estimated, although existing organisations will have records to help them to estimate their actual sales receipts.

Cashflow forecast

		Total	**Expected**											
Contributions		**budgeted**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**
Grants:	Federal	$45,000	$25,000						$20,000					
	Local	$2,500		$1,000						$1,500				
Reciprocal Community Bank:														
	Donations	$3,000	$700			$800			$700			$800		
	Interest	$500	$42	$42	$41	$42	$41	$42	$42	$42	$42	$41	$42	$41
Total contributions		**$51,000**	$25,742	$1,042	$41	$842	$41	$42	$20,742	$1,542	$42	$841	$42	$41

After reviewing their sales records, Hancock Regional Disability Services can see that the following sales receipt pattern from trading activities occurred over the previous year:

- Cash sales receipts equalled 20 per cent of overall sales.
- Credit sales receipts equalled 80 per cent of overall sales and the collection rate on credit sales was:

Sales receipts collected in month following sale	60%
Sales receipts collected in 2nd month following sale	30%
Sales receipts collected in 3rd month following sale	10%

So applying the above percentages to their estimated credit sales for the next six months, Hancock have been able to calculate the estimated actual cash receipts from sales.

Monthly credit sales totals (80% of 30,500) $		**Monthly cash receipts**											
		Jul 200X +1	**Aug 200X +1**	**Sep 200X +1**	**Oct 200X +1**	**Nov 200X +1**	**Dec 200X +1**	**Jan 200X +1**	**Feb 200X +1**	**Mar 200X +1**	**Apr 200X +1**	**May 200X +1**	**Jun 200X +1**
July 200X+1	2,000		1,200	600	200								
August 200X+1	2,500			1,500	750	250							
September 200X+1	3,000				1,800	900	300						
October 200X+1	1,500					900	450	150					
November 200X+1	2,500						1,500	750	250				
December 200X+1	1,000							600	300	100			
January 200X+1	1,000								600	300	100		
February 200X+1	2,400									1,440	720	240	
March 200X+1	2,500										1,500	750	250
April 200X+1	1,500											900	450
May 200X+1	2,500												1,500
June 200X+1	2,000												
Total sales	**24,400**												
Monthly cash received from credit sales		**These months will include credit sales collections from previous year**			**2,750**	**2,050**	**2,250**	**1,500**	**1,600**	**1,840**	**2,320**	**1,890**	**2,200**

Total monthly cash sales (20% of 30,500) $	**Montlhy cash receipts**											
	Jul 200X +1	**Aug 200X +1**	**Sep 200X +1**	**Oct 200X +1**	**Nov 200X +1**	**Dec 200X +1**	**Jan 200X +1**	**Feb 200X +1**	**Mar 200X +1**	**Apr 200X +1**	**May 200X +1**	**Jun 200X +1**
Cash sales receipts	500	625	750	375	625	250	250	600	625	375	625	500

Other cash inflows

To complete the cash inflow information in the cash flow forecast, you will need to identify any additional cash coming into the organisation. Although the types of cash inflows for each organisation will vary, the list below may assist you in recognising other cash inflows in your organisation.

- GST refund
- Tax refunds
- Loan proceeds
- Proceeds from sale of assets

Cash outflows

As we have indicated earlier, one of the major inputs into the forecast is sales. Coupled with this inflow is the cost of purchasing those goods to sell. Therefore, when determining your cash outflows, it is suggested that you calculate your cost of goods sold in line with your sales forecast. By doing this, if you do need to change your sales numbers, an automatic change to the cost of goods sold figure should occur. Many computer programs will allow you set up a link between two items, such as your sales and cost of goods sold, to make the forecasting a little easier. You may like to refer back to page 9 when estimating the cost of goods sold for your forecast.

As shown in the table on page 29, Hancock Regional Disability Services Gardening Program's gross margin is 55 per cent. What this means is that for every $100 of sales they make, it cost them on average $55 to have the goods ready to sell. To calculate a cost of goods sold for the cash flow forecast, they have used the following table.

Monthly sales totals $		**Cost of goods at 55 % of sales $**	**Month purchased**
July 200X+1	2,500	1,375	June 200X
August 200X+1	3,125	1,719	July 200X+1
September 200X+1	3,750	2,063	August 200X+1
October 200X+1	1,875	1,031	September 200X+1
November 200X+1	3,125	1,719	October 200X+1
December 200X+1	1,250	688	November 200X+1
January 200X+1	1,250	688	December 200X+1
February 200X+1	3,000	1,650	January 200X+1
March 200X+1	3,125	1,719	February 200X+1
April 200X+1	1,875	1,031	March 200X+1
May 200X+1	3,125	1,719	April 200X+1
June 200X+1	2,500	1,375	May 200X+1
July 200X+2	2,500	1,375	June 200X+1
Totals	**30,500**	**16,777**	

To prepare the stock ready for sale, Hancock (on average) purchases the stock the month before sale. So, for the cash flow forecast, the cost of stock purchases will be put in the template on the month shown in the above table.

Expenses

Expenses are those cash outflows that relate to the operations of the organisation that are not included in the cost of goods calculation. These are often referred to as administration or operational expenditure. Again, the items of expense will depend on the type of organisation you are starting or currently operating. Generally, there are a number of standard type expenses. Your income and expenditure budget will assist you in identifying your expenses and this is where you should start for the expenses to be included in your cash flow forecast.

Other cash outflows

In addition to the cost of goods sold and operational expenses, the organisation may have other cash outflows during the forecast period that would not appear in the income and expenditure statement. Here are some examples of these cash outflows.

- purchase of assets
- one-off bank fees (i.e. establishment fees)
- principal repayments of the loan
- GST payments
- other tax payments where applicable
- investment of surplus funds

Finalising the cash flow forecast

Now that all the relevant information has been collected, it is time to prepare the forecast. At the beginning you will have determined the time period the forecast is to cover. Remember that cash flows are all about timing and the flow of cash, so you will need to have an opening bank balance, then add in all the cash inflows and deduct the cash outflows for each period, usually by month. The number at the end of each month is referred to as the 'closing' cash balance and this number becomes the opening cash balance for the next month.

Once finalised, a cash flow forecast will provide the closing cash balance for each month. When compared to an income and expenditure forecast, the balances at the end of each month will be different, as the cash flow forecast will include cash items that do not appear in the income and expenditure statement. For example, the purchase of assets will appear in the cash flow forecast. However, this is not included in the income and expenditure statement (it is entered into the balance sheet). Therefore, the cash flow forecast will enable you to see how much cash is available. This is extremely important for all organisations. The example on the flowing page shows how Hancock Regional Disability Services will, on certain months, need additional funds to cover a cash shortfall although the income and expenditure budget on page 29 indicates that a profit will be made.

Cash flows	Budget	Monthly cash receipts											
		Jul 200X +1	Aug 200X +1	Sept 200X +1	Oct 200X +1	Nov 200X +1	Dec 200X +1	Jan 200X +1	Feb 200X +1	Mar 200X +1	Apr 200X +1	May 200X +1	Jun 200X +1
Cash receipts													
Grants-													
Federal	45,000	25,000						20,000					
Local	2,500		1000						1,500				
Donations	3,000	700			800			700			800		
Interest	500	42	42	41	42	41	42	42	42	42	41	42	41
Cash sales	6,100	500	625	750	375	625	250	250	600	625	375	625	500
Credit sales	24,400	1,600	2,150	3,100	2,750	2,050	2,250	1,500	1,600	1,840	2,320	1,890	2,200
Total cash receipts		27,842	3,817	3,891	3,967	2,716	2,542	22,492	3,742	2,507	3,536	2,557	2,741
Less cash outflows													
Cost of goods (stock)	16,777	1,719	2,063	1,031	1,719	688	688	1,650	1,719	1,031	1,719	1,375	1,375
Total salaries	48,600	4,050	4,050	4,050	4,050	4,050	4,050	4,050	4,050	4,050	4,050	4,050	4,050
Rent	12,350	1,030	1,030	1,030	1,030	1,030	1,030	1,030	1,030	1,030	1,025	1,030	1,025
Vehicle expenses	6,500	350	375	350	1300	850	325	450	300	500	700	450	550
Utilities	2,060	170	170	170	170	170	190	170	170	170	170	170	170
Stationary	240	20	20	20	20	20	20	20	20	20	20	20	20
Marketing	1,050		1,050										
Client support supplies	120	10	10	10	10	10	10	10	10	10	10	10	10
Computers	1,350									1,350			
Staff training	1,100				600							500	
Total cash outflow		7,349	8,768	6,661	8,899	6,818	6,313	7,380	7,299	8,161	7,694	7,605	7,200
Net cash flow		20,493	(4,951)	(2,770)	(4,932)	(4,102)	(3,771)	15,112	(3,557)	(5,654)	(4,158)	(5,048)	(4,459)
Opening bank balance		5,500	25,993	21,042	18,272	13,340	9,238	5,467	20,579	17,022	11,368	7,210	2,162
Closing bank balance		25,993	21,042	18,272	13,340	9,238	5,467	20,579	17,022	11,368	7,210	2,162	(2,297)

This cash flow forecast indicates that there will be a negative balance in June 200X+1. Although the income and expenditure budget (page 29) shows that the organisation will be profitable for the year, the cash flow forecast indicates that there will be a requirement to fund cash flow shortages.

TIP

The key to successful forecasting is to regularly review results, identify variances and implement strategies early to ensure that the approved budget will be met

Financial management

Good financial management means that the financial information provided in the financial statements and budgets and forecasts can be used to improve operational activities and accomplish important daily and future financial objectives

The financial management of an NFP organisation includes obtaining funds for the operations of the organisation and ensuring their effective use in line with the overall objectives of the organisation.

Good financial management means that the organisation will use the financial information to undertake a more detailed review of operations in line with the financial information provided. In other words, the financial statements and budgets and forecasts will provide the financial information that will be used to improve the operational activities of the NFP.

This section has been developed to assist those organisations that support their community services through trading activities and/or by accessing finance through a financier. It is important when providing goods or services for profit, to understand the key aspects of managing profitability and cash flow.

HINT

Improved profitability will be achieved through the following three key areas:

- Regular monitoring
- Awareness of impact of discounting
- Tight management of expenses

Managing profitability and cash flow

Profitability

It would be fair to say that no matter what the organisational objective of your NFP, it will be in an improved financial position and it will be more likely to achieve its strategic objectives if it makes a profit. Where an NFP has trading activities, they must be profitable if they are not to erode the cash reserves. This section discusses the ways of ensuring profitability which apply to NFPs that have trading activities and those that rely solely on contributions.

In the following sections, we will explain each of these topics in more detail.

Monitoring profitability

The following tools can be used to monitor profitability and ensure that you know:

- that your profits are not being eroded by increasing prices in stock or expenses (margin)
- how to set new selling prices when stock costs increase (mark up)
- how much you need to sell before the organisation is making a profit (break even analysis)

Margin

There are two margins that need to be considered when monitoring your profitability: gross and net. For most NFPs, only net margin would be relevant. However, for those that trade, gross margin should also be reviewed.

Gross margin is the difference between the cost of goods sold and net sales. By 'net sales' we mean all the sales dollars less any discounts that have been given to the customer and commissions paid to sales representatives. You must be sure that the selling price of your goods is higher than the cost of buying them. Gross margin is not commonly used for service organisations, as they most often do not have 'cost of goods'.

The margin can be expressed either in 'dollar value' (gross profit) or in a percentage value that measures the percentage of sales dollars remaining (after obtaining or manufacturing the goods sold) available to pay the overhead expenses of the company.

Gross margin is calculated as follows:

Dollar value =	Net sales less cost of goods sold		= Gross profit
Percentage value =	$\frac{\text{Gross profit dollars}}{\text{Net sales dollars}}$	X 100	= Gross margin

Under the heading, Income and expenditure statement, you can see how to calculate the cost of goods sold.

Net margin is the sales dollars left after subtracting the cost of goods sold and the overhead expenses. The net margin tells you how much profit you have made before you pay any tax. Tax is not included in net margin because tax liabilities can vary from one NFP to another, making comparisons after taxes much more difficult. Net margin can be expressed either in dollars (net profit) or as a percentage.

Net margin is calculated as follows:

Dollar value =	Net sales less total of both cost of goods sold and overhead expenses		= Net profit
Percentage value =	$\frac{\text{Net profit dollars}}{\text{Net sales dollars}}$	X 100	= Net margin

Mark up

Mark up is the amount that you sell your goods above what it cost to purchase them. It is generally only meaningful when it refers to the sale of products (as opposed to services). It can be useful to calculate the mark up to ensure that your selling price will cover all the costs of the sale.

Mark up is calculated as follows:

Percentage value =	$\frac{\text{Sales – cost of goods sold}}{\text{Cost of goods sold}}$	X 100	= Mark up

Break even calculation

The break even calculation shows how many sales have to be made, in either dollars or units, before all expenses are covered and actual profit begins.

The break even point is calculated as follows:

Dollar value =	$\frac{\text{Expenses}}{\text{1 – (cost of goods sold/total sales)}}$	= the total sales value needed before a net profit will occur
Number of units =	$\frac{\text{Expenses}}{\text{(Unit selling price – cost to produce)}}$	= the total number of units needed to be sold before a net profit will occur

Examples of each of these calculations for Hancock Regional Disability Services Gardening Program are shown below.

	Gardening program
Income	
Grants - Federal	22,000
Local	1,500
Reciprocal Community bank	5,000
Donations	
Interest	
Total contributions	**28,500**
Trading statement	
Sales income less cost of goods	20,000
Opening stock	5,000
Purchases	7,000
	12,000
Less closing stock	3,000
Total cost of goods sold	9,000
Total trading income	11,000
Total income	**39,500**
Expenses	
Salaries - admin	1,000
Gardeners	5,000
Instructors	5,000
Clients	8,500
Rent	3,500
Vehicle expenses	3,000
Utilities	350
Stationary	100
Marketing	1,050
Client support supplies	70
Computers	1,400
Consulting	1,200
Staff training	1,200
Total expenses	**31,370**
Net profit	14,130

$$\textbf{Mark up}\ \% = \frac{\text{(sales income less cost of goods sold)}}{\text{Cost of goods sold}} = \frac{20{,}000 - 9{,}000}{9{,}000} = 22\%$$

$$\textbf{Gross margin}\ \% = \frac{\text{Total trading income}}{\text{sales income}} = \frac{11{,}000}{20{,}000} = 55\%$$

$$\textbf{Break even}\ \$ = \frac{\text{Expenses}}{\text{1 less (cost of goods sold/total income)}} = \frac{31{,}370}{1 - (9{,}000/39{,}500)} = \frac{31{,}370}{0.77} = 40{,}626$$

$$\textbf{Net margin}\ \% = \frac{\text{Net profit}}{\text{Total income}} = \frac{14{,}130}{45{,}500} = 31\%$$

Discounting sales

By focusing on improved profitability, additional funds will be generated that can be used to support the operations and goals of the organisation.

If your organisation has trading activities, you must be aware that discounting sales to entice customers to purchase your goods or services could erode your profits. Of course, some discounting can be beneficial. However, it is important that you understand the impact discounting will have on your profits before you decide to offer discounts. Alternatives such as add-on products or services may deliver more dollars of gross profit to the organisation and should be considered before you decide to offer discounts

When you are discounting, you are offering your goods or services at a reduced selling price. Where discounts are offered you will need to sell more goods in order to achieve your gross margin.

The Gardening Program needs to keep its gross margin at 30 per cent to ensure that it covers its expenses without eroding the net profit. So if it decides to discount its sales by 5 per cent, it will need to increase sales volume by 20 per cent (see table below).

Expense management

Good management of general expenses will contribute to increasing profits. By monitoring your organisational expenses, you can see where costs are increasing and take action to ensure that you maintain your net profit margin.

When monitoring expenses, don't forget to identify the expenditure that keeps the organisation operational and keep these at sustainable levels (e.g. presentation of premises, marketing, staff training).

Continual review of your expenses will help you to see where they are getting out of hand. Don't forget to use the methods discussed in the previous section, as they are the simplest way to quickly see if your profits are being eroded. consider joining forces with other organisations to benefit from group buying, investigate using companies that allow discounts on bulk orders and always get quotes for different services to ensure that you pay the best possible prices for them.

TIP

By focusing on improved profitability additional funds will be generated that can be used to support the operations and goals of the organisation.

The effect of discounting

	If your present gross margin is:						
	10%	**15%**	**20%**	**25%**	**30%**	**35%**	**40%**
and you cut your prices by:	then you will need to increase your sales by:						
5%	100.0%	50.0%	33.3%	25.0%	20.0%	16.7%	14.3%
6%	150.0%	66.7%	42.9%	31.6%	25.0%	20.7%	17.6%
8%	400.0%	114.3%	66.7%	47.1%	36.4%	29.6%	25.0%
10%		200.0%	100.0%	66.7%	50.0%	40.0%	33.3%
12%		400.0%	150.0%	92.3%	66.7%	52.2%	42.9%
5%			300.0%	150.0%	100.0%	75.0%	60.0%

Cash flow management

> **HINT**
> By undertaking active cash management your organisation can ensure that funds are available to pay all debtswhen they fall due

Cash flows in NFP organisations can often be lumpy or sporadic. Cash flow management is critical to ensure that the objectives of the organisation are met. The basic reason for cash flow management is to preserve the liquidity of your organisation so that debts can be paid as and when they fall due. This is the definition of being solvent. It is important therefore to keep tight control on movement of cash and forecasting changes in cash availability.

Short-term liquidity can be assessed by daily, weekly and monthly monitoring of cash. You should prepare strategies to deal with any sudden, unexpected liquidity crisis. These strategies should include regular cash flow monitoring through a cash management plan and ensuring that you have access to finance in case of emergencies.

The best way to manage short-term liquidity is to prepare a cash management plan that covers all expected cash flows over a selected period. For organisations with high volume sales or payments, this is best done on a daily basis. However, if you only make payments once a week, then a weekly cash flow plan will be adequate. When determining how far out you should prepare this plan, the key factors to consider are organisational cycles such as seasonal trends, how much surplus cash you currently have (working capital) and if you have any finance in place, such as an overdraft or similar that you can call on at short notice if needed.

For most organisations, a cash management plan should be prepared at least a month in advance. When preparing the plan, first you should decide the period that the plan should cover. Then you need to decide how often you will review it. When making these decisions, be realistic: how much time do you have to do this? There is no point putting the effort into preparing a plan if you are not going to use it as a management tool on a regular basis.

An example of a weekly cash management plan is shown below. The forecast column is where you would put your

	Forecast	Actual	Variance	
Opening daily cash balance	**15,000**	**15,000**		
Sales banked	10,000	5,000	(5,000)	Why was sales below expectations?
Total cash in	10,000	5,000	(5,000)	
Cash out				
Administration, Insurance	1,200	1,200		
Bank service charge	25	25		
BAS/GST				
Credit card fees				
Marketing/advertising	110	110		
Stock purchases	5500	5,500		
Interest expense				
Payroll	2500	2,500		
PAYE	225	225		
Professional fees (legal, accounting)		1,200	1,200	Unexpected bill arrival?
Capital costs				
Loan establishment fees				
Rent or lease	1000		(1,000)	Cheque not presented
Utilities/telephone	1500	1,500		
Other payments	650	650		
Total cash out	12,710	12,910	200	
Daily cash movement	(2,710)	(7,910)	(5,200)	
Closing bank balance	**12,290**	**7,090**	(5,200)	

anticipated cash flows in and out and at the end of the week you would then review your bank statement to see what really happened and insert the actual cash flows. The important step is the next one: check the difference between the forecast and actual and find out why your forecast was different. There will essentially be two types of differences, timing and permanent.

A timing difference is where an item of cash flow did not occur when it was expected but will occur eventually. For example, you expected a cheque to be drawn on your bank account but it has not yet been presented. You will need to take account of these differences when preparing your plan for the next planning period. A permanent difference is where an item of cash flow did not occur as expected and it will not occur. Permanent differences are most likely to occur in your predicted sales when you overestimate the value of the sales to be made during the planning period.

TIP

Reviewing the variances between the expected and actual cash flows will minimise any unexpected surprises in cash flow.

Mutuality

All incorporated clubs, societies, organisations and associations are regarded as companies for tax purposes. The same is true of unincorporated clubs, societies, organisations and associations that cannot be categorised as partnerships. Under longstanding Australian Taxation Office practice, subscriptions and contributions from members and payments from members for particular services provided by the club or association are generally excluded from the assessable income of that club or association. This practice is founded on the principle of mutuality which, simply, recognises that a person's income consists only of monies derived from external sources. (CCH 2009, *Australian Master Tax Guide 2009,* Wolters Kluwer, Sydney, p115)

Working capital management

Working capital is the short-term capital that works for the organisation. This includes stock, work in progress, payments to suppliers and receipts from customers. By working your cycle more efficiently, cash is more readily available to use in other parts of the organisation.

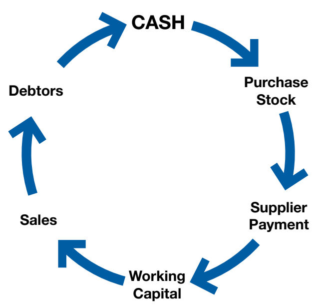
One of the most important things in running an organisation is to ensure that there is adequate cash flow to meet all of the short-term obligations. This is particularly important for NFPs as cash flow in these organisations can often be sporadic or lumpy: grants and membership receipts are often received annually and donations are sporadic. Where the organisation runs trading activities through the sale of products or services, cash flow can often be tied up in the working capital cycle. Working capital management is about setting up strategies to ensure that cash is not unnecessarily caught in this cycle. By undertaking these strategies, your organisation can free up cash to support other activities without causing a cash crisis.

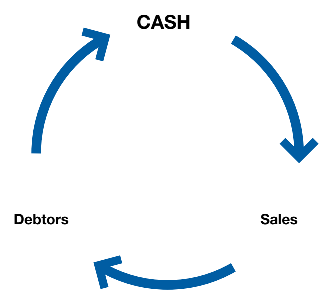
Working capital in an organisation is made up of these core components:

- stock management
- payment of suppliers (creditor payments)
- work in progress
- collection of cash from customers (debtor collection)

Often referred to as 'the working capital cycle', this is really about the length of time it takes from using your cash to purchase stock, (perhaps from a supplier on credit terms) to using the stock possibly for a manufacturing purpose – hence creating part of the cycle called 'work in progress' – to securing the sale and receiving the cash.

The diagrams below show the working capital cycle for trading activities that involve the sale of product (left) and sale of services (right):





Between each stage of the working capital cycle there is a delay. For some organisations this could be a substantial length of time required to make and sell the product. For these organisations a large amount of working capital (cash in the form of stock, credit from suppliers or sales to debtors) will be required. Others may receive their cash very quickly after paying out for stock (perhaps even before they've paid their bills). Because service organisations do not need to buy stock, they need less working capital.

The key to successful cash management is watching carefully all the steps in the working capital cycle. The quicker the cycle turns, the quicker you will convert your trading operations into available cash, which means that you will have increased the liquidity in your organisation and that you will be less reliant on external stakeholders such as banks, customers and suppliers, for cash or extended terms.

The key processes of managing the working capital cycle are:

- managing stock
- managing your suppliers (creditors)
- managing work in progress
- managing your customers (debtors)

There are many ways you can make the working capital cycle move faster and we will discuss these in the following sections.

Managing stock

Stock management is about having the right level of stock to satisfy the needs of your customers and managing the stock to identify excess or aged stock.

Of course stock has to be funded, either from existing cash in the organisation or from borrowings, so it is important the stock levels are managed to minimise this expenditure. It is not necessarily about keeping low levels of stock but ensuring that stock is held for the shortest possible time, which means that it must be converted into cash quickly. Maintaining stock comes with a cost: it is estimated that the cost of holding stock can be anything between 10 and 30 per cent of the value of the stock. This cost includes the storage, insurance, keeping accurate tracking records and proper controls to prevent theft.

> **HINT**
> Setting up good stock control procedures will ensure that cash is not tied up in holding stock unnecessarily.

Efficient stock control is a three-step process:

1. stock review
2. buying policy
3. operational issues

> Good stock management ensures that cash is not tied up in unnecessary stock.

Checklist for managing stock

The following checklist will help you determine what measures for stock control you may need or can be used to improve to your existing procedures.

1. Review current stock levels and sales volume of stock items

- Determine the current level of stock held and the value of stock
- Look at sales records to find out which items are good sellers and which are slow moving. Don’t forget to look at seasonal trends
- Work out which of the items of stock sold have the highest gross margin. This is important as you may then be able to focus more attention on these sales for improved profit
- Make a list of slow moving, aged and excess stock items and develop a plan to move this stock immediately, even if it is at lower than the cost of the item. This will generate cash to invest in new stock that will move more quickly
- Update your stock records with the current levels and then implement a policy to track all movement of stock. This will help with you to reorder stock only when it is needed and it will highlight any theft or fraud that may occur

2. Establish a buying policy

- Identify stock that you must always hold in order to maintain sales momentum and ensure that customers are never disappointed
- Tighten the buying of stock. Knowing the volume sales per stock item will help you buy the right amount. Carrying too little stock may discourage customers as you may not be immediately able to satisfy their needs and carrying too much stock means you are tying up cash that could be put to better use

- Negotiate deals with suppliers but avoid volume-based discounts. When money is tight, there is no point investing in next month's stock without good reason. Instead of volume discounts, try to negotiate discounts for prompt settlement (unless your cash position is poor) or negotiate for smaller and more frequent deliveries from your suppliers to smooth out your cash
- Don't let discount prices drive your stock buying decisions. Buy stock you can sell at a profit in a reasonable timeframe

3. Identify other areas of the organisation that can impact stock management

- Supplier service can assist in stock management through access to stock only when you need it and good delivery service. By ordering less more frequently and arranging better delivery schedules stock quantities can be reduced saving valuable cash resources and improving liquidity without reducing sales
- Advertising and promotion will impact on stock levels. Ensure that you have adequate stock or can source adequate stock before launching a promotion. If you have taken on larger than normal quantities, make sure you have a back-up plan if the items don't sell during the promotion
- Sales policy can also have a strong influence on stock levels and should be managed with a view not just to achieving maximum sales but also to minimise the investment in working capital. This can be achieved by directing policy towards a higher turnover of goods, selling goods bought at bargain prices faster and clearing slow moving items
- Delivery to customers can impact on stock holdings. By ensuring that the goods are delivered to the customer faster, the stock will be moved and the cash for the sale will come in quicker

Days' inventory ratio

This ratio reveals how well your stock is being managed. It is important because it indicates how quickly stock is being replaced. The more often that inventory can be turned in a given operating cycle, the greater will be the profit.

Day's inventory is calculated as follows:

$$\frac{\text{Closing inventory}}{\text{Cost of goods sold}} \times 365$$

Hancock Disability Services

$$\text{Day's Inventory} = \frac{\$\,5{,}500}{\$15{,}000} \times 365 = 133.83 \text{ days}$$

This calculation shows that stock is held on average for 133.83 days.

Stock turn

This ratio shows the effectiveness of your planning of stock holdings. A low stock turn ratio will show that you are not moving stock. This could lead to excess or aged stock and of course higher holding costs. A high stock turn ratio indicates that you run the risk of not having adequate stock on hand to supply customer needs.

Stock turn is calculated as follows: $\frac{\text{Cost of goods sold}}{\text{Stock on hand}}$

Hancock Regional Disability Services

$$\text{Stock turn} = \frac{\$15{,}000}{\$5{,}500} \times 365 = 2.73 \text{ times}$$

This calculation shows that the Disability Services program replaces total stock on average 2.73 times a year.

TIPS FOR IMPROVING STOCK CONTROL

- For fast moving stock, negotiate with suppliers for delivery when required (just in time), and thereby eliminate the need for large stock holdings.
- For aged and excess stock, either sell it at whatever price is necessary to move it, or else give it to charity. Don't forget to let people know that you have made a donation!
- Keep accurate stock records and match the records to a regular physical count – at least once a year. If there are wide variances between the records and the physical count, do the physical count more frequently
- Understand your stock, which items move quickly and which ones are seasonal etc.
- Use your financial system to track stock items. This will help you with automating your re-order requirements and matching different stock items to sales and identifying high margin sales.
- Good stock control will ensure that you keep aged and excess stocks to a minimum, reduce the likelihood of theft and have enough stock to satisfy demand.

Managing suppliers and supplier payments (creditors)

Payment to suppliers prior to receiving cash for the sale of product can impact your cash flow. Making full use of your terms of trade with your supplier is effectively an interest free loan. Therefore it is important that you manage your suppliers and the payments to them in the same way as you manage the other key components of the working capital cycle.

Effective management of suppliers and the payments to suppliers consists of three key elements:

1. supplier selection
2. payment terms
3. managing relationships

> **HINT**
> Setting up good management procedures will ensure that you get the most out of your suppliers

Checklist for managing supplier payments and relationships

The following checklist will assist in reviewing what procedures you may need or can be used to improve your existing supplier procedures.

1. Supplier selection

- Decide what is most important thing you look for in your supplier: is it the quality of the goods, reliability, returns policy, price, terms or a combination of these?
- Prepare a list of preferred suppliers
- Check credit and trade references for each supplier on the list
- Select your suppliers based on the qualities you are looking for and the results of the credit and trade checks
- If you chose one main supplier, be sure that you have an agreement in place with an alternative supplier in case the chosen supplier cannot provide the agreed service at any time
- Regularly monitor the selected suppliers against your priorities. As your organisation grows, often the things you require from your suppliers will change

2. Payment terms

- Negotiate payment terms with suppliers before entering into the transaction
- Document standard payment terms on each purchase order
- Calculate the benefit of taking discount for early payment
- Ensure that all suppliers are paid on agreed terms, not earlier. Check this on a regular basis
- Have an agreed process in place in case damaged or unsuitable goods are supplied. Do not withhold payment without letting the supplier know that there is a problem
- Review the terms with each supplier regularly. If you find a supplier that can provide better terms, discuss this with your existing supplier before changing over. Your existing supplier may be able to match these terms and will appreciate the loyalty you have shown

3. Maintain creditor relationships (these are just as important as customer relationships)

- Meet regularly with your main suppliers to discuss the progress of your organisation (they often may be able to assist you with better credit terms, new products etc)
- Ensure that agreed payment terms are adhered to
- Ensure that you have someone suppliers can contact if they are not paid on time
- Where payment to a supplier needs to be delayed, advise the supplier and if possible set up an agreed payment arrangement and make sure you stick to it. Put the agreement in writing and ensure that the senior finance person or owner receives a copy
- Be seen as a solid, dependable customer

TIPS FOR IMPROVING SUPPLIER PAYMENTS

- Extend payment terms
- Lengthening the payment days from 30 days to 45 could assist in smoothing out fluctuations in cash flows.
- Some larger companies (such as utilities) may accept quarterly payments, which can help in forecasting cash flow requirements
- Payment terms should specify that payment terms commence from complete delivery (as opposed to part delivery). This should also include goods or services that have not been provided as agreed
- Where goods are returned either
  - a new invoice should be raised and this should initiate the payment terms, or
  - disputed invoices should be held over until a credit note is received
- Initiate a structured payment run, usually once a month (i.e. on the last day of the month) and stick to it
- Ensure that your systems have good controls so that suppliers are not
  - paid early – where financial systems are used, ensure that payment date is automated from approved supplier details and no changes to automated date is possible without authorisation
  - over paid – all received goods are checked to purchase order and totals on invoices checked
  - paid twice – pay only on statement
- Continually review supplier contracts for opportunities such as
  - improved pricing
  - effective discounting
  - improved delivery (you will not need to order so early and hence defer payment)
- Remove any incremental pricing included

Days' creditors ratio

This ratio indicates how well accounts payable is being managed. If payables are being paid on average before agreed payment times, cash flow will be affected. If payments to suppliers are excessively slow then your relationships with your suppliers could be damaged .

The days' creditors ratio is calculated as follows:

$$\frac{\text{Creditors}}{\text{Cost of goods sold}} \times 365$$

To review Hancock Regional disability Services, we are using a monthly income and expenditure statement, so we need to adjust the formula above (for annual calculation) to a monthly calculation. This is done by dividing the number of days under the annual formula by twelve (number of months in the year).

Hancock Regional Disability Services

$$\text{Days' creditors} = \frac{\$8,000}{\$15000} \text{ X } \frac{365}{12} = 16 \text{ days}$$

This calculation shows that Hancock Disability Services pay their suppliers on average every 16 days. If the current terms of most suppliers is 30 days, this indicates that some suppliers may be being paid before they are due to be paid, thereby extending the time between the payment to the supplier and the receipt of cash from the sale.

Managing work in progress

Work is in progress when an order has been taken from the customer and you are in the process of working to complete it. Of course, there will be orders in progress for most of the time and you will need good management systems in place to keep track of them and supply them efficiently. Work in progress is often thought to be relevant only in manufacturing organisations. However, some retail and service organisations will also have a form of work in progress. Remember that work is in progress from the time of the customer order till delivery.

Managing work in progress is important because the quicker the job can be completed, the earlier the invoice can be raised and the cash received.

HINT

The key to managing work in progress is to have a good record keeping system.

Checklist for managing work in progress

The following checklist will assist you in setting up your work in progress procedures and may help to identify some improvements.

Make sure you have a good record keeping system

- Ensure that all orders are recorded when taken and all relevant details are noted, that is, when the order is due, any payment received (e.g. deposit), any progress payments to be invoiced, how long the job takes to complete, additional costs incurred in completing the job, and so on
- Have procedures in place to track all outstanding orders and rank by priority. The procedures should highlight any actual or potential delays and have actions outlined in case delays occur
- When an order is completed, ensure the invoice is ready to go with the goods
- The record keeping system should provide details of the expected completion date, delivery date, and invoice date. It should therefore provide you with information to assist you in forecasting your cash flow

TIPS FOR IMPROVING WORK IN PROGRESS

- Only order stock when ready to use, effectively reducing the number of days held (and hence paid) before production begins
- Identify any "bottle necks" in the production process and look for improvements
- Look at the process, including the physical layout of goods, and identify possible improvements to "speed up" the movement through the Work in Progress stage
- Ensure you know how much stock you need to have on hand to complete the order before accepting the order – delay in receiving goods is delay in preparing the sale
- Review Work in Progress procedures annually to identify possible procedures or technology that could improve in the progress life cycle
- Where specific materials are required for the customer order (e.g. fabric for covering sofa), include in your order agreement for the customer to pay a deposit up front before order is commenced

Managing debtors

Converting sales into cash is one of the most important processes in any organisation. Where sales are offered on credit, financial systems will refer to the amount outstanding as a debtor. You can waste a lot of effort in managing the payments from debtors if proper controls and procedures are not put in place at the outset.

Your customers are your key to trading success. However, until you receive the cash for the sale, you effectively have given a donation to your customer's business! So it is important to manage all outstanding payments from your customers and ensure that you have good procedures in place to encourage your customers to pay on time.

Efficient debtor collection procedures include credit controls, payment terms and managing your relationships with your customers.

HINT

Ensure that you have good procedures in place to encourage prompt payment

Checklist for managing debtors

1. Set up credit controls

- Check the creditworthiness of all potential customers. Have a system in place that documents each credit check to ensure that the process has been properly undertaken
- Rank all customers by credit risk. To do this you would need to consider the number of years they have been in business, the credit reference from their bank and the credit the bank was prepared to allow them
- Set a credit limit for the customer in accordance with its credit rating
- Do regular credit checks on all your customers. It is likely that their credit status may change during tough times
- Make sure that your system tracks any outstanding debts and that the appropriate staff are made aware of it before the next sale
- Document procedures that need to be undertaken when a debtor exceeds its credit limit and ensure that all relevant staff are aware of them

2. Establish payment terms

- Include your standard payment terms on each invoice
- Ensure that all your staff, including sales representatives, are aware of the payment terms and that they stick to them

- Implement systems to ensure that all payment terms are met. Send out regular reminders and chase up late payments
- Have a policy and a process in place for returned goods to ensure that payment is not unduly delayed

3. Maintain customer relationships

- Meet regularly with your customers. Sometimes visiting their premises will help you to better understand their business requirements and financial position
- Review the actual payment with the agreed terms for each customer regularly. If you find that a customer is continually paying outside of the agreed terms, meet with them and discuss the issues
- Ensure that there are processes in place for customers when products or services are not provided as expected (returned goods). Have a policy to cover this type of situation
- Where an order or delivery is going to be delayed, advise the customer and discuss alternative solutions. Only agree on a completion date for the customer if you are certain you can meet it.
- Be seen as a solid, dependable supplier to your customers

Days' debtors ratio

This ratio indicates how well the receipts from debtors are being collected. If receivables are not collected in reasonable accordance with their terms, management should rethink its collection policy. If receivables are excessively slow in being converted to cash, liquidity will be severely affected.

TIPS FOR IMPROVING DEBTOR COLLECTIONS

- Send out invoices as soon as work is completed, not at the end of the week or month
- Provide incentives to pay early – discount but know the impact on profit margin
- Make it easy to pay – direct credit arrangements, EFTPOS or credit card
- Where commission is paid to sales staff, pay commission on amounts collected, rather than on total sales amount booked
- Run regular reports to identify when payments are due – aged debtors report
- Identify slow paying customers and make contact early to discuss any issues – faulty goods, inadequate service, inability to pay etc

The days' debtors ratio is calculated as follows:

$$\frac{\text{Debtors}}{\text{Trading sales}} \times 365$$

Again, to review Hancock Regional disability Services, we are using a monthly income and expenditure statement, so we need to adjust the formula above (for annual calculation) to a monthly calculation. This is done by dividing the number of days under the annual formula by 12 (number of months in the year).

Hancock Regional Disability Services

$$\text{Days' debtors} = \frac{\$18,800}{\$26,000} \times \frac{365}{12} = 22 \text{ days}$$

This calculation shows that the Disability Services collects from their debtors every 22 days on average. If their collection terms are thirty days, this indicates that most customers are paying early. However, when we compare the 22 days to collect from customers against that fact that the days' creditor ratio on page 36 shows that they pay their suppliers within 16 days on average, this indicates that they are still requiring additional funding to support the time between payment of suppliers and receivable from customers.

Working capital cycle – cash conversion rate

The number of days to convert your trade from the cash outflow at the beginning of the working capital cycle to cash received at the end of the cycle can be calculated by the cash conversion cycle.

The cash conversion cycle is calculated as:

Days' stock + days' debtors – days' creditors

Hancock Regional Disability Services

Cash conversion cycle

Days' stock (137.83 days) + days' debtors (22 days) – days' creditors (16 days) = 139.83 days

This calculation shows that for Hancock Regional Disability Services, it takes 139.83 days from the start of the transaction to when it is completed and converted back to cash.

Financing

Ensuring that all types of financing available are fully understood and matched to the organisation's needs will result in good financial management

Many organisations will require additional financing to support operational activities at some time or another. For NFPs this additional financing will generally come from retained profit, grants, donations, fundraising and membership subscriptions. Usually grants and debt finance come with a number of conditions attached. These conditions must be understood before the organisation accepts the relevant funds or finance.

Grants

Before accepting a reciprocal grant, make sure you understand all the conditions.

There are various types of grants. The most common are either reciprocal or non-reciprocal. A reciprocal grant is usually provided with conditions that must be met if you are to receive the grant. These grants need to be managed in the same way as other external financing arrangements. The conditions will vary depending on the provider of the funds. For example, a local council grant may be provided for a local football club to buy new carpet. The money may be given on condition that the club provides half of the required funds and the council provides the other half. If the football club cannot raise its half, then the council will not grant the other half.

When considering whether or not to accept reciprocal grants, NFPs must ensure that they understand all the conditions. If the grant is accepted, the NFP should produce a report that details all the requirements of the grant and the way in which they will be managed, including appropriate monitoring of the milestones.

Debt financing

Debt financing comes from an external source, such as a bank, and it must be repaid. Funding with debt will incur associated costs which can include establishment fees, ongoing usage and interest charges. Debt financing can be provided in a number of different forms: some that require regular principal and interest repayments that can have an impact on cash flow and others that have less impact. It is important to ensure that the financing product matches the organisation's requirements and that all the conditions can be met.

Understanding your debt financing options – long term versus short term

To select the right debt product for your funding needs, you should:

- be aware of other debt products in the market, their nature, their features and their tax implications, so you can make an informed decision about which is the most suitable for your requirements
- consider each debt product in the light of your specific requirements and circumstances, and select accordingly

HINT

In a competitive market, financiers will package finance products under different names and introduce a range of features to differentiate themselves.

Evaluating debt products

In selecting a debt product, you should ask the following questions.

- What the funds are going to be used for?
- How long are the funds needed for?
- Short-term funding may be required to fund working capital
- Long-term funding may be required to fund a building extension
- How much capital do you need?
- How much funding is needed?
- Be realistic about the amount of money required. Make sure you ask for enough
- What security can you offer?
- Will the financier accept your valuation of the security?
- If you offer real property as security, you will probably have to pay less interest on the loan than if you offer other organisational assets
- How will the financier assess the risk of lending to your organisation?

TIP

It important to consider the purpose of the financing, together with security and repayment requirements and applicable fees to ensure that the chosen facility is the best suited to the organisation's needs.

Short-term funding

Debt product	Description	Repayment / interest	Fees
Overdraft **Overdraft facilities are generally used to finance the day-to-day fluctuating cash requirements of an organisation.**	A facility that allows the customer to operate a bank account with a pre-agreed limit which can be drawn down. Overdraft accounts will usually only be provided to an organisation that has been successfully operating for a few years.	Overdraft facilities do not have a specific maturity date. The product is 'at call' or on demand, which means that the bank has the right to cancel it at any time. Interest is usually paid on a monthly basis. The rate of interest is determined in accordance with a risk margin that the bank will determine. The customer will only pay interest on the amount drawn down.	Generally include: application fee: a one-off fee to initiate the facility line or facility fee: generally charged on the available limit in arrears and payable monthly or quarterly. Cheque account fees and transactional costs are also payable account keeping fees: charged monthly for operating the account.
Line of credit **Purpose** **A line of credit is usually used to access funds for working capital requirements.**	A line of credit or equity loan can provide access to funds by allowing the borrower to draw on an account balance up to an approved limit. As long as the balance does not exceed the approved limit, funds can be drawn at any time. These loans are usually secured by a registered mortgage over a property.	Repayments are usually required to at least cover the interest and fees on the loan. Interest is usually paid on a monthly basis. As this type of loan is usually secured against property, interest rates tend to be lower than for overdrafts. However, if you fail to make your payments you can put your property at risk.	Generally include: application fee: a one-off fee to initiate the facility line or facility fee: generally charged on the available limit in arrears and payable monthly or quarterly. Cheque account fees and transactional costs are also payable account keeping fees: charged monthly for operating the account

Transactional banking to suit your organisational needs

The relationship with your bank is as important as all other business relationships and will assist in achieving good financial management if handled well.

Banking relationships are an important part of the overall financial management of the organisation. All organisations will have some banking requirements and it is essential that the relationship with the bank is handled in the same way as all other business relationships of the organisation, such as customers and suppliers. A good partnership between the bank and the organisation will provide many benefits to both parties.

The Small Business Victoria and CPA Australia Financial Survival Guide (2008) **http://gfc.cpaaustralia.com.au/wp-content/uploads/2009/06/financial-survival-guide.pdf** contains comprehensive information on how to handle your bank, including applying for loans, managing the relationship, transactional banking and what to look for before changing banks. The focus of this section is on transactional banking. The everyday banking that an organisation needs to do to operate effectively is known as transactional banking. Primarily, it includes the operation of your deposit accounts and the payment services provided by your bank or other financial institution (e.g. credit union or building society).

All organisations need some transactional banking services. However, you should decide what sort of services you require, remembering that these services usually incur different fees depending.

There are essentially two types of transaction banking groups:

- Transaction banking
- Merchant facilities

Transactional banking products

If your NFP organisation engages in trading activities, then you should consider what the organisation is offering to its customers, what it requires of its suppliers and how it wants to manage its cash flow. Although many organisations believe that paying by cheque will give them a few extra days before the funds are withdrawn from the bank account, in reality, paying by cheque involves some uncertainty because you can't be sure when the cheque will be presented. With so many options available, it is wise to ask the bank account manager to help you to choose those products that will help you to manage your cash flow and reduce the time you will need to spend in managing your banking.

This is a list of the most common transaction banking products currently available.

- Electronic desktop/internet banking
- Credits to accounts – electronically, manually or by direct credit
- Debits to accounts – electronically, by manual cheque, GDES, EFT, via real time gross settlement or overseas transactions
- Bpay via credit card
- Bpay via debit card
- Overdraft and other limit facilities
- Cheque production facility
- Lockbox – the processing of a mailed cheque, money order or credit card payment
- Payroll processing arrangements
- Other services – cheque encashment facilities

Merchant facilities

These should be considered for NFPs that have trading operations. Merchant facilities provide customers with various options to pay by either a credit or debit card. They enable payments made on these cards to be processed either manually or electronically. Merchant facilities provide a real benefit to your organisation's business cash flow because your customers do not need to have cash in the bank to pay for your goods or services.

These are some of the benefits of merchant facilities.

- You are guaranteed payment within 48 hours of the purchase (no more 30-, 60- and 90-day payment terms)
- Your improved cash flow will improve your organisational performance
- You will be able to keep less cash on your premises
- Your administration costs will be reduced. You will no longer have to wait for a purchase order, issue paper invoices or chase debtors for payment
- You will no longer need to establish accounts for one-off or infrequent transactions
- You will use less paper

Here are some questions you should consider before discussing merchant facilities with the account manager.

- Does your organisation have a retail store where customers pay for goods with their credit cards? If so, you may require an EFTPOS terminal to swipe their cards
- Does the organisation take most of its orders via mail, the phone, fax or the internet? Is an EFTPOS terminal required or is there an alternative method of taking payments?
- Could you have an EFTPOS terminal to swipe the cards of walk-in clients but key-enter the details of remote orders?
- What is the ratio of credit card transactions to cash or other payment methods?

Transactional fees

Unfortunately, most banks and financial institutions do not provide free transactional services. In fact, the fees related to these services can substantially affect the profitability of the organisation. With so many financial institutions providing these services, you should consider the fee structures of a number of providers before selecting the provider you feel is best for you. See the section below on how to switch banks.

Most organisations do not know how much they are paying in bank fees. This can be attributed to the fact that they do not spend time reviewing their transactional banking arrangements and of course banks do not make it easy to clearly establish the total amount of fees being charged.

In June 2002, the Australian Securities & Investments Commission (ASIC) released a guide for financial institutions entitles *Good transaction fee disclosure for bank, building society and credit union deposit and payments products (transaction accounts).* This guide provides information on what type of disclosure institutions should provide to assist them in making informed decisions on their transactional banking requirements and the relevant fees. It provides the following guidelines, which in most cases, have been implemented by the financial institutions:

- Fee summary information should, where relevant, be provided on transaction account statements to enable customers to make informed choices about how they conduct their transactions

- The information should enable customers to clearly understand the fees, by distribution channels and number of transactions, which apply to their accounts during the charging period and other relevant information
- Fees should be shown separately, not bundled, and the basis on which charges are calculated should be explained
- Foreign ATM fees should be included in the fee summary information

TIP

Your banker can assist in choosing the transactional services best suited for your organisation.

The guide notes that the disclosure statement provided by the financial institution will vary depending on the agreed fee structure of the transactional banking arrangements. 'Some accounts have a number of free transactions, with the free transactions either calculated at the end of the period, based on which were the most expensive or charged when the number of transactions exceeds the free limit. Other accounts charge for all transactions, but provide a fee rebate, the amount of which depends on the customer's overall relationship with the institution.'

Therefore, it is likely that your organisation will currently have , or will receive from its transactional bank, a schedule of fees that relate to its banking arrangements. This will assist you when you are planning your cash flow and also if you are thinking about switching from one bank to another.

Financial management governance

Good financial management must be supported by policies and procedures to ensure that the financial information is complete and accurate and will lead to the correct decisions.

Governance is the processes by which organisations are directed, controlled and held to account. It is concerned with the overall structures and processes for decision-making, accountability, control and behaviour and should be directed by the board or management committee.

Financial management governance is a core component of the governance framework. In this section, the two key areas for financial management governance are discussed.

Financial controls

Financial management is not only about understanding the financial information in your organisation and using this information to improve organisational operations, it is also about ensuring that the right policies and procedures are in place to ensure that the financial information you are using is accurate and that you can protect your investment in the organisation. For complete financial management of your organisation, you need to consider implementing good financial controls.

A financial control is a procedure that is implemented to detect and prevent errors, theft or fraud, or policy non-compliance in a financial transaction process. Financial control procedures can be implemented by either an individual or as part of an automated process within a financial system.

Each financial control procedure is designed to fulfil at least one of these eight criteria:

Completeness – ensures that all records and transactions are included in the reports of the organisation

Accuracy – ensures that the right amounts are recorded in the correct accounts

Authorisation – ensures that the correct authorisations are in place to cover such things as approval, payments, data entry and computer access

Validity – ensures that the invoice is for work performed or products received and the organisation has incurred the liability properly

HINT

Financial control procedures ensure that all financial information is recorded and accurate. If the financial information is being used for decision making, and it is not accurate, wrong decisions could be made.

Existence – ensures the existence of assets and liabilities. Has a purchase been recorded for goods or services that have not yet been received? Do all assets on the books actually exist? Is there correct documentation to support the item?

Handling errors – ensures that procedures are in place to ensure that errors in the system have been identified and corrected

Segregation of duties – ensures that certain functions are separated. For example, the person taking cash receipts does not do the banking

Benefits of financial controls

- Understanding the financial position of your organisation
- Regular reporting will provide accurate financial information that can be used by those responsible for the operations of the organisation (e.g. sales numbers can be provided to sales representatives to monitor targets and budgets)
- Organisations can make informed decisions on budgets and spending
- Provides documentary proof for compliance requirements (e.g. GST calculations)
- Organisational standards are set and all persons within the organisation are informed of these standards through reporting

Good financial controls will:

- Help to align the objectives of the organisation – to ensure thorough reporting procedures and to ensure that the activities of the organisation are in line with its objectives
- Safeguard assets – to ensure that the organisation's physical and monetary assets are protected from fraud, theft and errors
- Prevent and detect fraud and error – to ensure that systems quickly identify any errors or fraud

- Encourage good management – to ensure that the manager receives timely and relevant information on performance against targets, as well as figures that can indicate variances from targets
- Allow action to be taken to correct undesirable practices – authorise a formal method of dealing with any fraud, dishonesty or incompetence
- Reduce exposure to risks – to minimise the chances of unexpected events
- Ensure proper financial reporting – to maintain accurate and complete reports as required by legislation and management, and to minimise the time lost in correcting errors and ensuring resources are correctly allocated

Financial controls checklist

To manage the risk of financial transaction processing failures, manual or automated control procedures should be implemented at key stages of the process. Some of the questions that can be asked are:

- How well are the financial aspects of the organisation managed?
- Are the organisational operations protecting the organisation against disasters, internal theft and unfavourable external audits?
- How comprehensive are management practices?
- Are the financial records accurate?

Review the following checklist. Organisations with sound financial management practices would answer 'yes' to most of the following questions:

1. General	Yes?
Is a chart of accounts used?	
Is it detailed enough to give adequate management information?	
Is a double entry bookkeeping system used?	
Are journal entries used?	
Are journal entries approved?	
Do you use budgets and cash projections which are: • compared to actual results? • investigated if there are major discrepancies?	
Do you understand the form and contents of the financial statements?	
Are comparative financial statements produced and reviewed?	
Are the books and records kept up-to-date and balanced?	
Is financial information produced regularly?	
Are reasonable due dates for preparation of financial information imposed?	
Are storage facilities safe?	
Is insurance cover regularly reviewed?	
Is there a records retention schedule?	

2. Sales	Yes?
Is there a policy for credit approval for customers?	
Are credit files kept up-to-date?	
Are credit checks on customers done regularly?	
Are sales orders approved for price, terms, credit and account balance?	
Are all sales orders recorded on pre-numbered forms and are all numbers accounted for?	
Do you review the monthly debtors' statements for outstanding balances?	
Is the accounts receivable subsidiary ledger balanced monthly?	
Is an aging schedule of customers' accounts prepared monthly?	
Are write-offs and other adjustments to customer accounts approved?	

3. Cash receipts	Yes?
Do you or a responsible employee other than the bookkeeper or person who maintains accounts receivable: • open the mail and pre-list all cash receipts before turning them over to the bookkeeper? • stamp all cheques with restrictive endorsement 'for deposit only' before turning them over to the bookkeeper? • compare daily prelisting of cash receipts with the cash receipts journal and the duplicate deposit slip?	
Are cash receipts deposited intact on a daily basis?	
Are cash receipts posted promptly to appropriate journals?	
Are cash sales controlled by cash registers or pre-numbered cash receipts forms?	

4. Cash used (disbursements)	Yes?
Are all disbursements except for petty cash made by cheque or internet payments?	
Are cheques pre-numbered and all numbers accounted for?	
Are all cheques recorded when issued?	
Are all unused cheques safeguarded, with access limited?	
Is a mechanical cheque protector used to inscribe amounts as a precaution against alteration?	
Are voided cheques retained and mutilated?	

4. Cash used (disbursements) *continued*	**Yes?**
Do you sign or view all cheques and internet payments?	
If a signature plate is used, do you have sole control?	
Are supporting documents, processed invoices, receiving reports, purchase orders, presented with the cheques and reviewed by you before the manager signs the cheques?	
Are supporting documents for payments properly cancelled to avoid duplicate payment?	
Are cheques payable to cash prohibited?	
Are signed cheques mailed by someone other than the person who writes them?	
Are bank statements and cancelled cheques: • received directly by you • reviewed by you before they are given to the bookkeeper	
Are bank reconciliations prepared: • monthly for all accounts? • by someone other than the person authorised to sign cheques or use a signature plate?	
Are bank reconciliations reviewed and adjustments of the cash accounts approved by a responsible person other than the bookkeeper?	
Are all disbursements from petty cash funds supported by approved vouchers?	
Is there a limit on the amounts of individual petty cash disbursements?	
Are petty cash funds on an imprest basis (the total amount is set e.g. $100, you can only spend what you have and it's only topped up with what's spent)?	
Are petty cash funds: • kept in a safe place? • sufficient to require only monthly reimbursement? • controlled by one person? • periodically checked by someone other than the custodian?	

5. Accounts payable	**Yes?**
Are supplier invoices matched with relevant purchase orders and receiving reports?	
Are all available discounts taken?	
Is there written evidence that invoices have been properly processed before payment, e.g. stamped?	
Are there procedures which ensure that direct shipments to customers are properly billed to them?	
Do you verify that the total of accounts payable agrees with the general ledger control account?	
Are expense reimbursement requests submitted properly and approved before payment?	

6. Goods received	Yes?
Are all materials inspected for condition and independently counted, measured, or weighed when received?	
Are receiving reports prepared and used promptly?	
Are receiving reports: • pre-numbering and accounting for the sequence of all numbers? • promptly provided to those who perform the purchasing and accounts payable function? • controlled so that liability may be determined for materials received but not yet invoiced?	

7. Employees	Yes?
Are all employees' job references checked?	
Are individual personnel files maintained?	
Is access to personnel files limited to a person who is independent of the payroll or cash functions?	
Are wages, salaries, commission and piece rates approved?	
Is proper authorisation obtained for payroll deductions? Are adequate time records kept for employees paid by the hour? Are salesmen's commission records reconciled with sales records?	
If employees punch time clocks, are the clocks located so they may be watched by someone in authority?	
Are time records for hourly employees approved by a foreman or supervisor?	
Are there controls to ensure that the absence of any employee is noted?	
Is the accuracy of the payroll checked?	
Are payroll registers reviewed by a responsible person?	
If employees are paid in cash, is the cash requisition compared to the net payroll?	
Is there control over unclaimed payroll checks?	
Are staff cross-trained in accounting functions?	
Are annual vacations required?	

Review those questions in the checklist that are applicable to your organisation but for which you have not answered 'yes'. Ask management to implement appropriate policies and procedures, including naming the people who will be responsible for them and a completion date. When the appropriate policies and procedures have been set up, you should be able to answer 'yes' to all the questions. This checklist should be reviewed annually by the board or management committee.

TIP

For all those questions in the checklist that have not been ticked with 'yes', review which ones are applicable to your organisation and make an implementation plan that includes the names of those who will be responsible for implementing the policy and procedure and assign a due date for completion.

Board financial management

One of the responsibilities of the board or the management committee is to ensure that the organisation has good financial management practices in place to achieve the objectives of the organisation.

Generally, the role of NFPs is to provide benefits to members of the community in a financially sound manner. The role of the board or committee of management is to oversee the processes of the organisation to ensure that these objectives are achieved. One of the most important responsibilities of the board or committee is to ensure that there are policies and procedures in place to support the good financial management of the organisation.

Financial management governance checklist

The following is a list of key areas of financial management that need to be overseen by the board or committee of management.

Solvency – making sure that the organisation:	**Yes?**
• can pay all bills when due	
• that there are adequate funds in the accounts for scheduled bills and expenses	
• can fund all its programs and all other contractual obligations	
• regularly reviews its cash flow forecast, identifies any variances and notes their potential impact on solvency	
Budgeting – ensuring that:	**Yes?**
• all expected income and expenditure is included	
• all sources and amounts of income are identified	
• all expenditure included in the budget is approved	
• expenditure is not greater than income	
• the annual budget is approved	
• there is a regular review of budget to actual results (monthly, quarterly)	
• the impact of any variances from budget to actual are identified and explained	
• the budget is amended where material changes have occurred that impact original budgeted income and expenditure	
Financial statements – ensuring that:	**Yes?**
• appropriate record keeping is maintained	
• key financial accounts are regularly reconciled	
• there is regular reporting of income and expenditure, balance sheet, cash flow statement, budgets and forecasts	
• financial statements are audited annually	
• the balance sheet is reviewed for financial health of the organisation	
• appropriate financial controls are in place for accurate records	
Preventing fraud and mismanagement – ensuring that:	**Yes?**
• controls are in place to safeguard assets	
• money is used in line with approved budgets	
• controls are in place for approval of spending	
• controls are in place for banking transactions	

Review those questions in the checklist that are applicable to your organisation but for which you have not answered ‘yes’. Ask management to implement appropriate policies and procedures, including naming the people who will be responsible for them and a completion date. When the appropriate policies and procedures have been set up, you should be able to answer ‘yes’ to all the questions. This checklist should be reviewed annually by the board or management committee.

Summary

Accurate and complete financial information that is reported in a suitable format is crucial to the sound financial management of your organisation. Staff must develop, understand and use financial information when they are delivering, monitoring, evaluating and planning activities and programs. Continual monitoring of all financial aspects of the business, including cash resources and profitability will ensure that the organisation is sustainable, properly capitalised and funded. Maintaining good relationships with all stakeholders, including banks, suppliers and customers, forms part of sound financial management.

To support the preparation and reporting of financial information, financial controls that consist of policies and procedures that align with the objectives of the organisation are vital. The board or management committee also have a role in good financial management. They must know how to oversee the finances of the organisation. This means that they must understand the financial information that is prepared and presented. They are ultimately responsible for transparency, accountability and stewardship of all financial matters to ensure that the social objectives of their community organisation are met.

In this publication, we have described the following tools that are necessary for sound financial management.

Financial statements – balance sheet, income statement and cash flow statement

Ratio analysis – analysis of financial information contained in the financial statements to show the organisation's strengths and weaknesses

Budgets and forecasts – a method used to predict the financial viability of the organisation's planned programs

Profitability and cash flow – a process that allows the organisation to monitor and measure the sustainability of its financial operations

Working capital management – the method of financial management to ensure the efficient use of cash resources

Financing and banking relationships – used to support the overall financial management of the organisation

Financial management governance – the role of financial controls and the board or management committee in ensuring that all financial information is in line with the overall objectives of the organisation and is complete and accurate

Useful websites

CPA Australia
www.cpaaustralia.com.au

Community Door
www.communitydoor.org.au

Our Community
www.ourcommunity.com.au

NSW Government Acquital
www.dpc.nsw.gov.au/publications/grants_administration/monitor_and_acquit_grants

Appendix – Summary of hints and tips

Section	Comment	Topic	Hint	Tip
Setting the scene	Having good financial information and understanding how it is put together, what it is telling you and how you can use it to plan for the future are critical for all not-for profit managers			
Understanding financial statements	Financial statements provide information on how the organisation is operating financially and why. Once this is understood, the information can be analysed to show the areas of financial strengths and weaknesses	Balance sheet	The organisation requires assets to operate and these assets are either funded by accumulated funds from the operations of the organisation or by borrowing money from external parties (liabilities).	The categories in the balance sheet will highlight those items that can be converted to cash quickly.
		Income and expenditure statement	Only those NFPs that have products to sell will use the calculation of cost of goods sold.	Segment reporting will provide transparency on each distinguishable operating activity of the NFP.
		Statement of cash flows	The statement of cash flows only shows the historical data and differs from a cash flow forecast.	The statement of cash flows will provide three warning signals: • cash receipts less than cash payments – the organisation is running out of money • net operating cash flow is an 'outflow' • net operating cash flow is less than profit after tax which means the organisation is spending more than it is earning.
		Financial ratio analysis	Using financial ratio analysis regularly will assist in monitoring the financial health of the organisation.	By comparing each of these ratios after each reporting period, you will be able to see the strengths and weakness of organisation's operations.

Section	Comment	Topic	Hint	Tip
Record keeping for improved financial information	Only accurate data that is recorded systematically will provide the financial information that is necessary for improved financial performance	Chart of accounts	Keep your chart of accounts simple to start with and review and revise it as the need arises.	
		Accounting method		If you are not sure which accounting method to use, speak to your CPA accountant.
Budgeting and forecasting	Budgeting and forecasting are the future financial plan of the organisation. They are where the strategic plans are translated into financial numbers to ensure that the plans are financially viable.			
		Income and expenditure budget	For programs that have a lifespan of more than one year, you may need to extend the budget to match the life of the program.	You may want to consider presenting the key assumptions to the board or management committee for approval before developing the new budget. This way, they will be fully informed of what has been estimated for the key events of the budget year and they will be able to see clearly what is going on. If you do seek approval, then at each board or committee meeting, you should also advise the board or management committee of any changes that may have occurred or that could occur that could have an impact on your assumptions.
		Forecasting	Forecasting is different to budgeting. A forecast is where the budget is updated with actual events to show what has happened and the impact of these events of the predicted outcomes.	The key to successful forecasting is to review results regularly, identify variances and implement strategies early to ensure that the approved budget will be met.

Section	Comment	Topic	Hint	Tip
Financial management	Good financial management means that the financial information provided in the financial statements and budgets and forecasts can be used to improve operational activities and accomplish important daily and future financial objectives.			
Managing profitability and cash flow		Profitability	Improved profitability will be achieved through the following three key areas: • regular monitoring • knowing the impact of discounting • tight management of expenses	By focusing on improved profitability, additional funds will be generated that can be used to support the operations and goals of the organisation.
		Cash flow management	By undertaking active cash management your organisation can ensure that funds are available to pay all debts when they fall due.	By reviewing the variances between the expected and actual cash flows, you can minimise any unexpected changes in cash flows.
Working capital management	Working capital is the short-term capital that works for the organisation. It includes stock, work in progress, payments to suppliers and receipts from customers. By working your cycle more efficiently, cash will be more readily available to use in other parts of the organisation.	Stock	Setting up good stock control procedures will ensure that cash is not tied up unnecessarily in holding stock.	See page 34 for complete list of tips.
		Suppliers	Setting up good management procedures will ensure that you get the most out of your suppliers.	See page 36 for complete list of tips.
		Work in progress	The key to managing work in progress is to have a good record keeping system.	See page 37 for complete list of tips.
		Debtors	Ensure that you have good procedures in place to encourage prompt payment.	See page 38 for complete list of tips.

Section	Comment	Topic	Hint	Tip
Financing	Ensuring that all types of financing available are fully understood and matched to the organisation's needs will result in good financial management.	Grants	Before accepting reciprocal grants, ensure that all conditions are fully understood and can be met.	
		Debt financing	In a competitive market, financiers will package finance products under different names and introduce a range of features to differentiate themselves.	It important to consider the purpose of the financing, together with security and repayment requirements and applicable fees to ensure that the chosen facility is the best for the organisation's particular requirements.
		Refinancing your debt	When considering refinancing of borrowings, there are many factors to consider. The decision should not be based on pricing alone, but on the overall package available to the organisation.	Comparative information on bank finance is available on the CPA Australia website at: https://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FECB-D5D9767B/cpa/hs.xsl/986_13523_ENA_HTML.htm and Small Business Victoria Loan Finder at: http://www.business.vic.gov.au/scripts/nc.dll?BUSVIC:STANDARD:1001:pc=PC_62522.html
Transactional banking to suit the needs of your organisation	The relationship with your bank is as important as any of your other business relationships. If it's good, it will assist you to achieve good financial management.	Preparing a loan application	When preparing a loan application, ensure that all relevant information is provided and presented to the bank in person. The bank will not only be reviewing the application, it will also be making an assessment of management and their ability to run the organisation.	If the loan application is denied, find out as much as you can about why. This will assist you with any future loan applications.

Section	Comment	Topic	Hint	Tip
Transactional banking to suit the needs of your organisation		Managing banking relationships	A good banking relationship depends on both parties. You need to keep the bank fully informed at all times on all key aspects of the operations of the organisation.	One of the advantages of a good banking relationship is that the experienced bank manager can assume some of the role of an unpaid financial adviser. Bank managers have experience with many types of organisations and, since they are not closely involved, they can give impartial advice.
		Transactional banking	Transactional banking services can incur large unnecessary fees. Regular review will ensure that the services are being provided at the best available cost.	Your banker can help you to choose the transactional services best suited to your organisation.
		How to switch banks	Before changing your banking arrangements, make sure that a number of alternatives are considered and compared to your current arrangements.	Before switching banks, see if your current bank is prepared to offer you a better deal. Often the current bank will be willing to match the offer made by the alternative bank.
Financial management governance	Good financial management must be supported by the appropriate policies and procedures to ensure that the financial information is complete and accurate and will lead to the correct decisions.			

Section	Comment	Topic	Hint	Tip
Financial controls			Financial control procedures ensure that all financial information is recorded and accurate. If it is not accurate or complete, then wrong decisions could be made.	Review those questions in the checklist that are applicable to your organisation but for which you have not answered 'yes'. Ask management to implement appropriate policies and procedures, including naming the people who will be responsible for them and a completion date. This checklist should be reviewed annually by the board or management committee.
Board financial management			The oversight role of the board or management committee includes ensuring that the organisation has good financial management practices in place to achieve the objectives of the organisation.	Review those questions in the checklist that are applicable to your organisation but for which you have not answered 'yes'. Ask management to implement appropriate policies and procedures, including naming the people who will be responsible for them and a completion date. This checklist should be reviewed annually by the board or management committee.

1 A reciprocal grant is a grant that has an agreement specifying the conditions of the grant.

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