

Our regulatory framework

3

Financial viability



Housing Registrar



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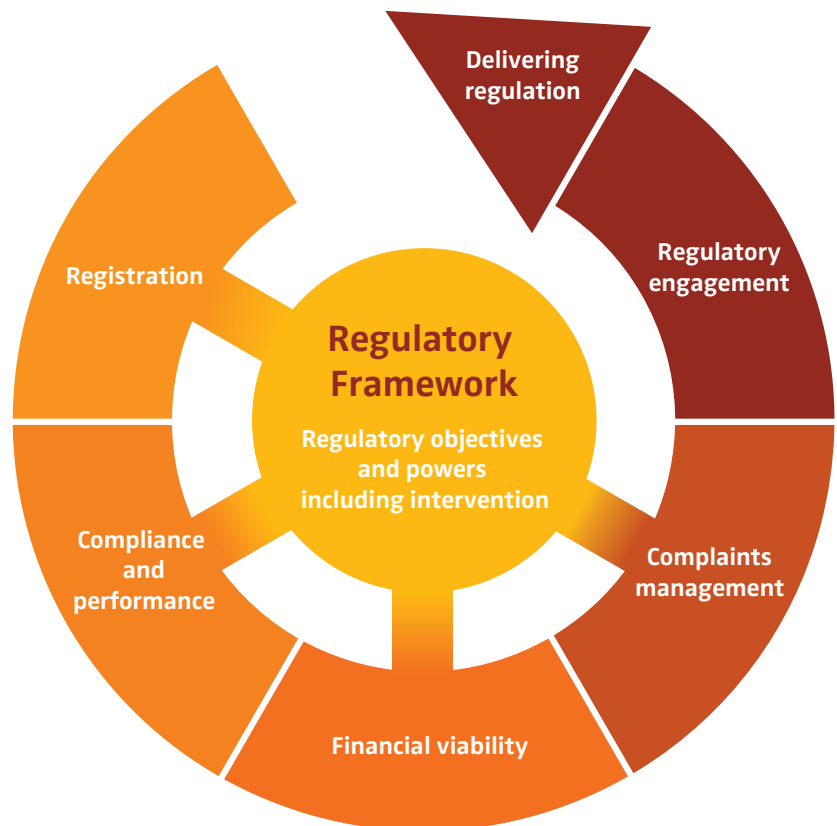
1 Introduction

Financial viability is part of the regulatory framework series. It outlines our approach to monitoring and assessing this critical feature of registered housing agencies.

Our Regulatory Framework provides an overview of how regulation and registration works under the new regulatory system. We now present a series of complementary publications that progress to the next level of detail.

Our overall approach to compliance and performance is addressed in another publication in the series.

Our regulatory framework



2 Legislative and other requirements

Financial viability is one of seven Performance Standards specified for registered agencies by the Minister of Housing, gazetted in August 2005.

Section 95 of the *Housing Act 1983* requires registered agencies to comply with Performance Standards.

The Victorian state government has invested and is continuing to invest in the growth of affordable housing for disadvantaged Victorians. We must ensure that the investment is managed effectively and that affordable housing is available well into the future. It is our role to ensure that registered housing agencies are financially viable social businesses.

On registration an agency must demonstrate its financial viability. Viability is reviewed in conjunction with the agency business plan, its financial policies and procedures, and its financial strategies into the future.

Once registered the agency must demonstrate continuing financial viability.

Section 105 of the Act requires registered agencies to submit an annual report to us that contains its financial statements and accounts. This annual report is due within 28 days of the agency's annual general meeting.

In addition to this legislative reporting requirement, we require agencies to submit a financial performance report in the same timeline. This report includes data on the past three financial years, as well as projected figures for the next five years.

3 What is financial viability?

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

Our assessment of financial viability is an integrated process. We review agency audited financial statements, financial performance reports, the business plan, and other information that supports our analysis.

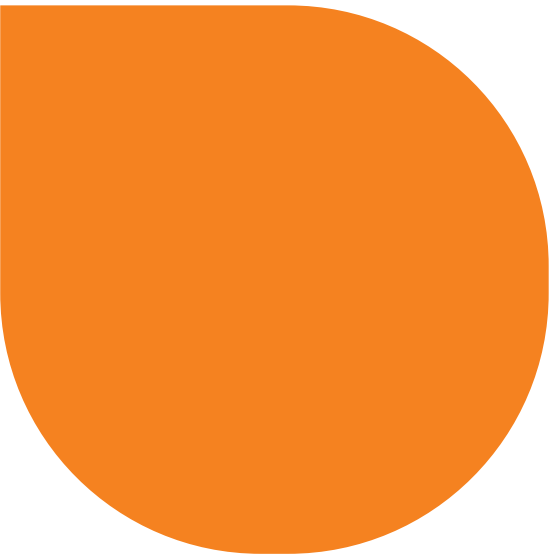
Our initial focus in looking at financial viability is an agency's audited financial statements for the year just ended. We assess the results with the budget and the financial projections in its business plan. Then we assess the trends in actual results over a three year period and project forward over five years.

To put these results into a broader context, we must return to the agency business plan. This allows us to be aware of the future plans of the agency, and familiarise ourselves with the agency perspective on its business, growth and the risks that it faces in running its business.

Here we are looking for agency insights into its profitability, resource management, growth plans, capital structure and liquidity. The business plan provides the roadmap to guide the agency toward its long term goals. The financial plan is a vehicle to allow the agency to realise its long term goals.

While it is imperative to ensure that agencies do not operate with excessive levels of risk, we also need to assess the capacity of agencies to develop and increase the availability of affordable housing. Therefore, in the assessment of financial performance, one of our roles is to take a view of the extent to which agencies are maximising the resources available through government grants and leveraging those grants.

So it is our role to assess the extent to which agencies are financially viable, and operating with an acceptable level of risk, while fulfilling the objective of maximising the availability of affordable housing in Victoria.



3.1 Financial performance report

We use a financial performance report, which assesses the viability of agencies. The report reviews agency performance over an eight year period, using a comprehensive suite of performance measures. Linked with the business plan, the report is a powerful tool for the assessment of agency performance and the impact of future decisions on agency viability.

Our expectations of agencies will vary, and will depend on a number of variables, including:

- > whether the agency is registered as a housing association or a housing provider
- > the risks that impact on the agency
- > whether the agency has a major development or growth program, relative to its size and experience
- > whether the agency has significant borrowings with the potential to affect the agency
- > the range of activities undertaken by the agency

The majority of work undertaken to assess agency financial viability is desk based in the form of a review of documents submitted to us. The nature of that review is determined by the risk assessment of each agency.

Other documents reviewed by us in this assessment include the business plan and management accounting information.

We keep an agency's most recent financial performance report under regular review. We expect it to be updated by an agency whenever any significant events occur that have an impact on data previously provided.

We also review our own approach and data requirements periodically and seek to simplify data collection where possible.

3.2 Levels of financial analysis

The Act recognises two types of housing agency, housing associations and housing providers.

In practice housing associations are larger, more complex business, and companies limited by shares or guarantee. In essence, the distinction between associations and providers represents a risk based approach at a strategic level.

We use separate financial performance reports for housing associations and housing providers, which reflect the differing risk profiles.

To be a registered housing association, an agency must have the capacity to undertake initiatives to grow affordable rental housing, using a mix of government funds and private sector investment.

With extensive housing portfolios and a level of commercial borrowings, housing associations must undertake long term financial evaluation of capital programs and their impact on agency operations.

Therefore, housing associations must complete a complex report, which includes information related to:

- > capital programs, including program scope, timing,
- > financing of the programs, for example internal sources, commercial debt, government grants, philanthropic contributions
- > loan commitments, including the agency's capacity to repay debt, and loan covenants
- > working capital management
- > maintenance and asset condition
- > accounting and financial treatment of grants, housing asset valuation, and depreciation of housing assets



Housing providers are essentially valued managers of property.

Housing providers that own housing assets have responsibility for the maintenance and condition of its housing assets. Ownership of assets requires a relatively long term approach to financial management and so these agencies must complete a report, which although less complex than associations includes information related to:

- > maintenance of agency stock
- > agency's approach to growth
- > other, non housing activities, undertaken by the agency
- > utilisation of community capacity building funds if available from the Office of Housing

A simpler financial performance report is used for housing providers that lease properties only through the housing provider lease. The financial performance report includes:

- > other, non housing activities, undertaken by the agency
- > utilisation of community capacity building funds if available from the Office of Housing

4 Incorporating risk

An organisation's financial position and ongoing viability are influenced by its history, operating environment, and planned future activities. We take account of these in our risk based approach.

We use a risk based model to obtain an overall risk assessment of each registered association. Comparatively, the affordable rental housing sector is stable with rental income more reliable than the turnover of many organisations.


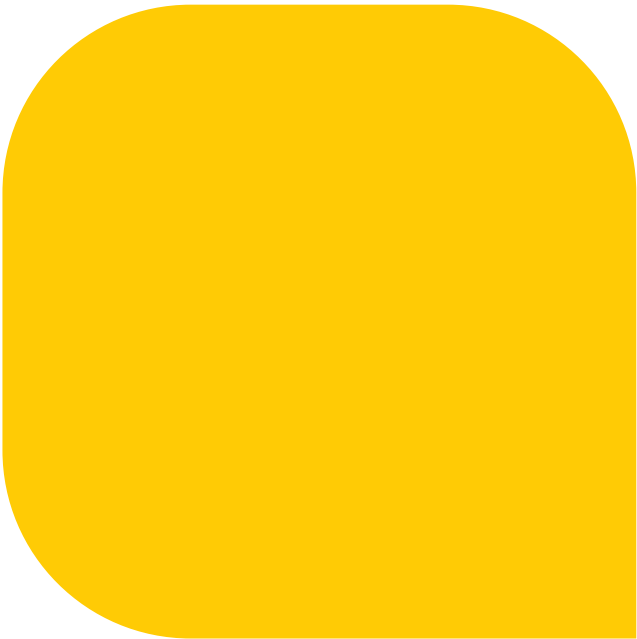
4.1 Historical and structural factors

A number of structural factors can impact on an agency's financial position and performance:

- > age of the agency's housing stock
- > recent regulatory history (how long registered)
- > number and geographical spread of housing units
- > type of agency (association or provider)
- > level of involvement in supported housing activities
- > level of involvement in diverse activities (and trends in that involvement)
- > level of involvement in contract income, rather than asset, based activities.

In analysing any potential impact of these factors, we consider composition, experience and effectiveness of board and management, together with track record of dealing with external or internal problems.

We take account of all knowledge we hold as a result of regulatory activities, not just with reference to financial viability, but also through our review of the two Performance Standards of governance and management. For example, governance issues associated with board reporting and/or board leadership on key financial decisions.



The degree of commercial orientation and financial sophistication of management are relevant to the ability of management to execute strategies and plans. This also applies to accounting and management information systems, together with planning, budgeting and control systems used to detect and respond to changes in the business environment or a deteriorating financial position.

We look for evidence that management is aware of key assumptions and business drivers, and has conducted sensitivity and scenario testing as part of a strategy for managing the risks to achieving organisational objectives.

4.2 Operating environment and activities

We recognise an agency's operating environment presents opportunities as well as risks. The flexibility available to agencies, for example from selling housing properties, is accounted for in arriving at our overall assessment of financial viability.

The risks faced by an agency vary according to financial structure, activities, geographical location and other factors, but can include:

- > delivering new homes (including growth areas)
- > involvement in the regeneration of deprived areas
- > plans to allow non-registered bodies to bid for capital grant
- > OoH's partnering agenda
- > social housing sector efficiency targets
- > compliance with rent affordability criteria
- > differential inflation rates, particularly in respect of maintenance and staffing costs
- > developments in the residential property market
- > funding decisions made by governmental residential support programs.

4.3 Low risk agencies

We conduct a basic financial health check on low risk agencies based primarily on the financial performance report and audited financial statements.

To be considered low risk, the probability of problems occurring should be low due to a stable operating environment and satisfactory governance.

The potential impact of problems should also be minimal. Issues that impact on agencies include:

- > agency size
- > level of growth forecast, including agency capacity to handle growth, and forecast use of interest bearing debt to finance growth
- > changes in agency operating environment.

4.4 Medium and high risk agencies

We undertake a more detailed analysis on medium risk and high risk housing agencies. The more detailed analysis focuses primarily on the areas of risk.

Agencies are considered high risk when:

- > the potential impact of failure is high due to size, complexity or amount of development funding
- > the probability of failure is high as the agency is badly run.

We may require visibility of the agency, and assess financial performance over a 30 year time horizon, to ensure we are prepared for an agency with significant development activity, engaged in a stock regeneration program.

During the process of drafting the detailed analysis, we conduct discussions with the finance director and other agency staff members as appropriate.

Firstly, we share the results of the analysis with the agency's chief executive for comment. Our final report is sent to the chair of the agency, copied to the chief executive.

5 Collecting information

Each year, registered agencies are required to submit their business plan, financial performance report and audited financial statements, together with the auditor's management letter and agency's response.

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

5.1 Information collected at registration

At registration we collect copies of the past three financial year's audited statements as well as a financial performance report. We also collect information about:

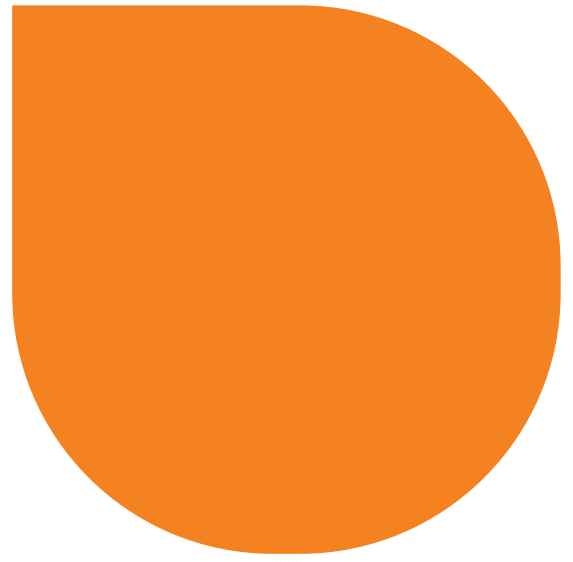
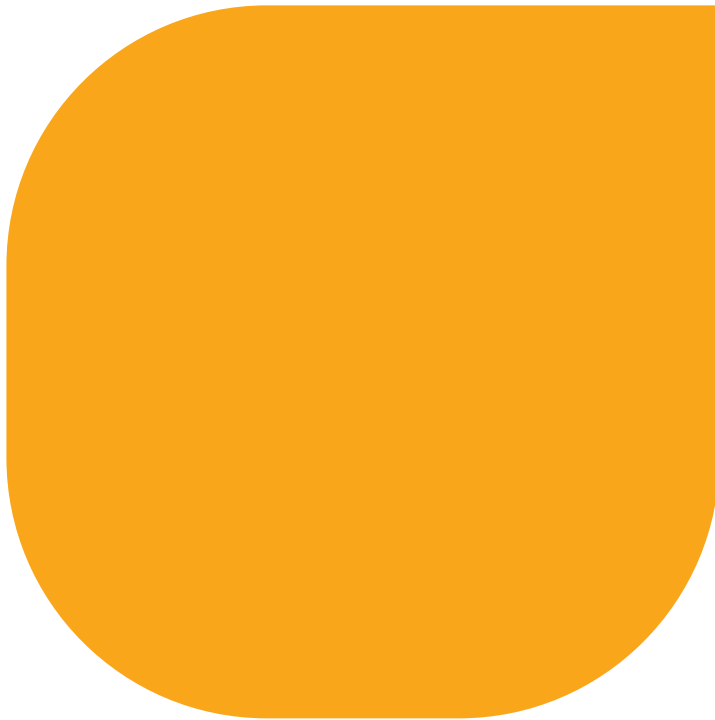
- > financial management and financial policies
- > detailed budget for the current year
- > tracking against current budget
- > approach to growth and funding
- > non housing activities undertaken by an agency

For agencies seeking to be registered as housing associations, we also require a financial plan setting out a planned development program that includes projections for housing life in the development program (may be 25 years or more).

Expectations of significant growth placed on housing associations, together with the financing of a proportion of this growth through external sources (including private debt) results in higher risk profiles than housing providers.

The level of data thus required from housing providers is less than housing associations. It is reduced even more for housing providers with no housing stock for which they are directly responsible for maintenance and upgrade.

Housing agencies are requested to submit financial performance reporting in electronic format.



The information collected in our financial performance report enables us to analyse agency viability. The financial performance report also allows agencies to carry out self analysis of financial performance and viability.

Agencies can:

- > be aware of information we use and how we use it
- > review ratios calculated automatically as data is entered in the online template
- > change assumptions, giving the agency an indication of the sensitivity of results to assumptions
- > provide comments to us to assist in the interpretation of the agency's performance.

5.2 Annual information requirements

Once an agency achieves registration financial viability is assessed annually. Agencies must submit audited financial statements, business plan and financial performance report within 28 days of their annual general meeting.

In addition, details of any significant variations to agency financial policy should be provided to us.

We review the business plan along side the audited financial statements and financial performance report, and make a judgement about agency viability.

6 What we look for – assessing viability

In assessing financial viability, we are concerned with both short term and longer term viability.

We largely assess the financial viability of housing agencies from information generated by the financial performance report, which demonstrates an agency's performance over the past three and next five financial years.

6.1 Assessing profitability and cash flow

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

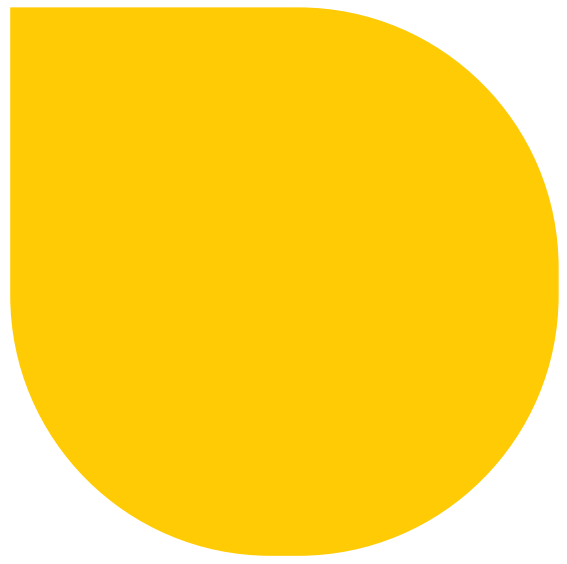
The ultimate financial basis of viability is adequate profitability and cash generation over the asset cycle together with the management of long term debt.

Although registered agencies are "not for profit" entities, the profitability of an agency is important from a number of perspectives, including to:

- > provide a "buffer" against future adverse circumstances
- > allow for the long term replacement/refurbishment of housing stock
- > fund growth.

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

Given the potential for significant discrepancies between accounting profit and cash flows, we also assess agency cash flow position in detail.



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

In analysing profitability and cash flow, we focus on:

- > **sustainability** – the extent to which historical cash flows and profits are sustainable, and not reliant on non-recurring items or capital grants
- > **growth** – the potential for growth and also the impact of growth on profitability and surpluses
- > **stability** – the extent to which cash flows and profits provide a stable base for growth and debt service.

Additionally, we focus on assessing the contribution of the agency's different operating areas to determine the extent to which cross subsidy occurs.

The assessment of profitability and cash flow ensures agency operations provide sufficient resources to enable growth, replacement of assets as required, and protection against adverse situations.

The financial performance report calculates a range of ratios and indicators on which we conduct trend and sensitivity analysis.

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

6.2 Assessing short term liquidity

Our assessment of agency short term financial viability is based on data submitted in the financial performance report.

We focus on whether the agency is able to meet short term commitments as they fall due.

We also consider whether organisational problems foreshadow financial concerns or might lead to loan covenants being breached.

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

6.3 Assessing capital structure

Capital structure refers to agency long term funding structure and reflects the sources of funding the agency has utilised to acquire fixed assets:

Agencies may be funded from a number of sources including:

- > external borrowings
- > capital grant contributions from Office of Housing (OoH)
- > donations of cash or assets from stakeholders in the provision of affordable housing;
- > asset contributions from parent or associated entities
- > cash contributions from parent or associated entities.

Undertaking external borrowings enable an agency to leverage the investment in affordable housing and potentially deliver greater growth in the level of affordable housing.

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

The optimal level of agency external borrowing is dependent upon the ability of an agency to service borrowings, and assets available as security to borrowers.

Our analysis of agency capital structure is focused upon the:

- > level and growth of external funding
- > covenants placed on borrowed funds
- > composition of external funding
- > ability of the agency to service external funding.

Longer term viability concerns the ability of housing agencies to meet all future financial obligations as fall due. Registered housing providers are not expected to assume significant levels of debt.

Growth for housing providers typically results from an opportune spot purchase of property supported by government capital grants, operating surplus and contributions from philanthropic organisations.

Therefore, our assessment of capital structure applies primarily to registered housing associations.

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

6.4 Overall financial assessment

In assessing overall agency financial viability, we consider:

- > **history and management**, the traditional and future clients of the agency, financial and management policies adopted by the agency and the agency's business risks and mitigation strategies
- > **operating environment**, the strategic response of management to factors operating within that environment, and the impact of those strategies on the scale of operation
- > **profitability**, in particular looking at operating margins and financial efficiency after removing the impact of capital grants and other one-off financial impacts
- > **cash flow dynamics**, and an agency's ability to meet its financial obligations
- > **capital structure and debt management**

Other information that affects our determination of agency financial viability includes agency's capacity to meet financial obligations. The following indicators give us an indication

an agency's willingness and ability to provide sufficient information on which to base a financial assessment.

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

Financial ratios quantify and highlight key financial relationships but have limitations.

They do not explain underlying causal factors and whether such factors might get better or worsen.

We consider financial data within the environmental context in which the agency operates, the quality and experience of management, the agency's strategic objectives, and the risks to achievement of those objectives.

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

Indicator type	Definition	Rationale
Unqualified accounts	Existence of an unqualified audit report	A qualified audit report may highlight potential concerns about agency financial management and viability. We investigate further and discuss results with agency and its auditor.
Timeliness of submission	Extent to which required information is submitted in a timely fashion	Extended delays in submission of information may indicate issues with respect to agency financial management and solvency.
Commentary on financials	Explanation of major variances, changes or events in most recently completed financial statements	Assists with analysis of the underlying viability of an agency, and allows us to more clearly understand agency financial statements

7 Informing our final assessment - other considerations

We inform our initial assessment of financial viability through examining an agency's current strategic approach to its operating environment.

Issues we consider are:

- > markets the agency works in
- > competition the association faces within markets (from within and without the sector)
- > where the agency fits within markets
- > how markets are likely to change over time.

To the extent the housing agency has either a group structure, or operates through geographic divisions or diversified activities, our analysis of the operating environment is broken down to that level.

All of these questions impact on the level, trend and stability or volatility of rental income and other revenues. These are key profit drivers with analysis of risk factors discussed above central to assessing environmental considerations.

When reviewing aspects of the external environment, we focus on actual or anticipated changes, whether from external forces or internal policy decisions.

Changes should be reflected in ratios that drive the business plan. If the environment is expected to change but ratios stay constant, there are prima facie grounds for doubting validity of business plan assumptions and projections.

Having considered relevant environmental factors, we look at management's strategic response:

- > what is the approved strategy? – such as diversification, growth through merger/stock transfer/new development, focus on regeneration, withdrawal from supported housing
- > does the agency have the capacity to deliver strategy?
- > is strategy consistent with financial forecasts?

The strategic decisions taken by the board impact on revenue generated by the agency. We evaluate management's business strategy, not only in the context of the environment, but also in terms of internal financial and operational capacity.

If, for example, management is focused on business growth, a comparison of growth in turnover, together with other lines in the forecasts, including growth in total assets, provides a balanced assessment.

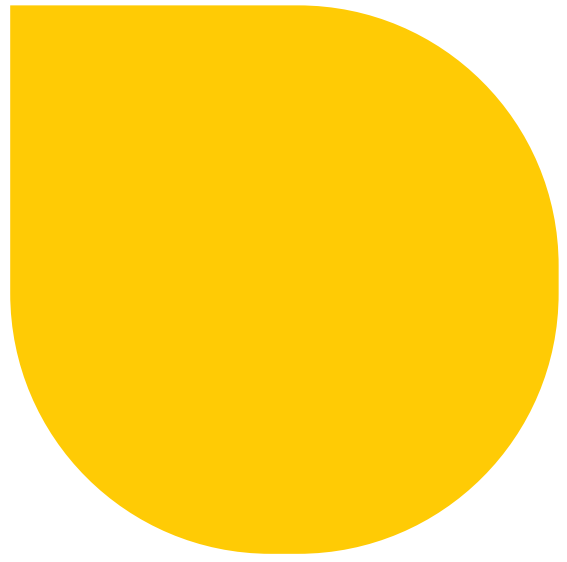
Revenue growth may be important for achieving an association's social and business objectives and increasing surpluses. Growth however has a negative impact on cash flows and on borrowings if only achieved via higher capital expenditure (net of grants).

We also compare growth with resources (both physical and human) employed to generate that growth.

In most housing agencies, which generate revenue from the provision of housing, growth in total assets reflects growth in the business. This may not be the case for agencies whose main activity is contract based rather than asset based, for example provision of tenancy management services. Care is taken when comparing asset growth with revenue growth on newly registered agencies.

Rent guarantees and OoH's expectations on rent restructuring are limiting factors on rent increases, and consequently turnover growth.

8 Managing group structures



In some cases, our assessment of financial viability may focus on more than one entity.

Registered housing agencies are not a homogenous group. Agencies may be a subsidiary of a larger parent company, have subsidiaries themselves, act as trustees, or be standalone entities.

Some agency annual financial reports are published as a group rather than individual agency level.

Based on case by case assessment of regulatory implications, we may therefore conduct detailed analysis at group level only. This means we request an association submits returns on a group basis as well as (or instead of) an agency specific basis. In such a case, we advise agencies of our requirements.

9 Using our findings

Results from our assessment are communicated to agencies in reports that we prepare.

At registration, our assessment of financial viability forms part of the report presented to a panel recommending registration.

For registered agencies, our assessment is primarily undertaken between December and February each year.

A comprehensive description of our analysis and findings is included in a financial viability report. We provide a copy of this report to the agency, and discuss with senior management and the governing body as appropriate.

A summary of findings and recommendations is included in the final report of the annual regulatory review, undertaken with each agency with the financial viability assessment.

10 Addressing issues from assessments

We take issues identified in assessments seriously, and seek to address these as quickly as possible.

Our first course of action is discussion with the registered agency is to ensure understanding of an issue is accurate and comprehensive.

We seek a collaborative approach to resolving an issue in a timely and logical manner, taking account of an agency's ability and willingness to remedy an issue. Mostly, we expect resolution to be achieved quickly and effectively.

Where an issue is more significant and/or the remedy strategic, we may seek specific undertakings that require action to be taken and included in the annual regulatory plan.

When unhappy with progress made by an agency in resolving an issue, we inform an agency and clarify expectations.

Where additional reporting by an agency on progress made is considered useful, we specify and implement this reporting requirement with the agency.

We may use intervention powers under the Act where we believe an agency is unwilling or unable to deal with significant issues in a satisfactory way.

Further information on powers and our use is available in the Intervention Guidelines published in the Victorian Government Gazette in August 2005. In addition, a document focusing on intervention will be part of our regulatory framework series.

Summary

Financial viability is a critically important aspect of our regulatory focus with housing agencies.

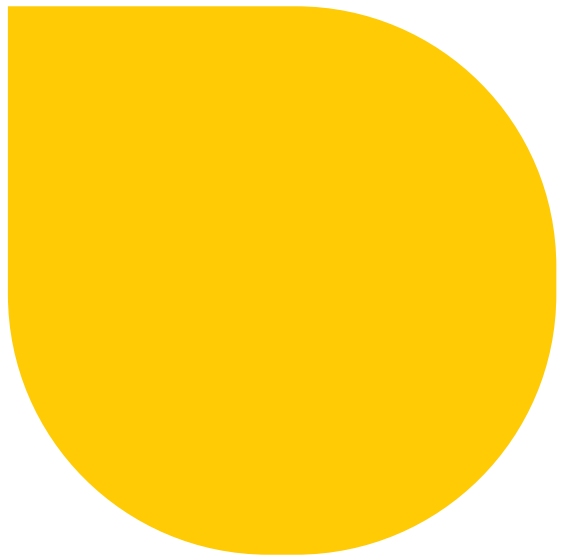
We have developed a thorough approach to assessing and monitoring an housing agency's financial viability.

This approach integrates closely and effectively with our overall approach to assessing and monitoring agency compliance and performance.

While not directly running an agency's business, we have a major legislative responsibility to ensure each registered agency remains well governed, well managed, and viable.

Such agencies generally provide better services and more positive outcomes for tenants, prospective tenants and other stakeholders, and continue to strengthen their capacity to manage, and where appropriate grow, affordable rental housing.

They also provide assurance to sources of investment funds and loans they use funds efficiently and effectively, and fully meet obligations associated with the provision of these funds.



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