Advisory

Relationships Aotearoa Incorporated
Report to the Board of Governance

Strictly Private and Confidential

26 March 2015
Draft

pwc

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This is a draft report

Our work is not complete and, as a result, this draft report may not represent our final findings or conclusions. Amongst other things, the following matters remain outstanding:

- Our internal review procedures are not yet completed.

Important notice

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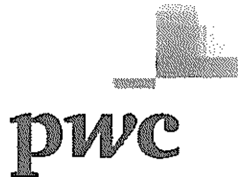
4. This report should also be read in conjunction with the important notice and restrictions set out in our Engagement Letter and Appendix 1.



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The Board of Governance of Relationships Aotearoa Incorporated
Level 8
203-209 Willis Street
Wellington 6140
Attention: Lesley Haines

Dear Lesley

We report on Relationships Aotearoa Incorporated ("the Entity") in accordance with our engagement letter dated 4 March 2015 (see Appendix 1).

This report has been prepared for the Board of Governance of Relationships Aotearoa Incorporated ("the Board") and provides analysis and comment on the recent financial performance of the Entity, together with a review of the Entity's forecasts. In addition, we provide an overview of the options available to the Board going forward.

This is a draft report. Our work is not complete and the comments in this draft report are therefore subject to amendment or withdrawal. Our definitive findings and conclusions will be those set out in the final report.

We draw your attention to the important notice and restrictions set out in our engagement letter and the scope and process of our work, set out in Appendix 2. Please note also that our engagement with the Entity is considered a one off assignment and we are accordingly not deemed to have a continuing professional relationship with the Entity.

Save as described in the agreement or as expressly agreed by us in writing, we accept no liability (including for negligence) to anyone else or for any other purpose in connection with this report, and it may not be provided to anyone else.

Yours faithfully

John Fisk
Partner
PricewaterhouseCoopers

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At a glance

PwC view

- Financial performance for the year to 30 June 2015 is likely to result in a deficit of $1,499k based on current expenditure levels and known revenue reductions.
- This deficit will result in almost total erosion of the Entity's equity of $1,522k available at the commencement of FY15.

1 Overview

PwC has been engaged by the Board to provide advice in respect of the recent financial underperformance of Relationships Aotearoa Incorporated.

- The Entity has recently been working through an operational restructuring, and has had a number of changes at senior management level over the last 2 years.
- There are a number of issues with regard to management information, and communication with Board. The current CFO has made a number of improvements to the finance function, although there remains significant work to do.
- The original FY15 budget has been disregarded by the CFO, who has created a new FY15 "reforecast".

2 FY15 performance

Actual performance for the year to Feb 2015 is $244k below forecast resulting in a current deficit of $1,120k.

- This reduction is predominantly driven by reduced Corrections Community Probation revenue together with reduced Ministry of Justice revenue, and offset slightly be reduced expenses in respect of project costs and personnel costs.

Management has estimated FY15 performance to improve somewhat as a result of an expected surplus over the remaining four months of the year, resulting in a forecast deficit of $873k.

However, following a review of the reforecast we expect further revenue reductions of $475k, together with estimated cost over-runs of $151k for remainder of the year resulting in an adjusted forecast deficit of $1,499k.

The table below shows the year to February 2015 actual results versus forecast, together with the FY15 reforecast versus the FY15 adjusted forecast.

Relationships Aotearoa Incorporated
Profit and Loss Statement Summary

($'000's)	Feb-15 YTD FCast	Feb-15 YTD Actual	FY15 Mgmt FCast	FY15 Adjusted FCast
Revenue	6,008.6	5,718.3	9,185.4	8,710.4
Expenses	6,884.6	6,838.3	10,058.5	10,209.5
Surplus / (Deficit)	**(876.1)**	**(1,120.0)**	**(873.1)**	**(1,499.1)**

3 FY16 forecast performance

Management has commenced the FY16 budgeting process by creating a very high level estimate of FY16 performance based on FY15 forecasts with adjustments overlaid.

- Management's FY16 estimate shows a further deficit of $804k. While revenue is expected to decrease from FY15 levels, this is more than offset by reduced personnel costs, cost savings proposed by Management, and costs incurred in FY15 that don't recur in FY16.

4 Equity

Based on the adjusted forecast deficit of $1,499k for FY15, the estimated equity balance reduces from a starting balance at 1 July 2014 of $1,522k to a forecast $22k at the end of FY15.

On the basis of this assumption the equity balance is then expected to reduce further to a $782k deficit by the end of FY16.

At a glance

PwC views

- The options available to the Board need to be assessed contemporaneously and not in isolation.
- Given the forecasts show that the Entity may become insolvent some time early in FY16, the Board of RA needs to take further advice to determine whether it is prepared to take a measured risk in assessing these options for viability.
- If the Board is not prepared to undertake that assessment then the only feasible option remaining is to call a meeting of members with a view to winding up the Entity.

Options available to the Board to revive the business.

During our review we have identified seven possible options available to the Board which may revive the business. These are as follows:

1. Negotiate new contractual terms with key suppliers particularly MSD
2. Terminate unprofitable contracts
3. Increase non-Government funding streams
4. Continue with on-going restructuring and cost cutting within the business
5. Seek funding / subscriptions from members
6. Reconcile what expenditure in FY15 can be capitalised
7. Merger with another provider

None of these options are mutually exclusive of each other and should be assessed and implemented contemporaneously to determine their possible viability.

However, before doing so, the Board must consider whether it is prepared to take the risk of continuing to trade over the next 3-6 months given the entity will likely become insolvent early in FY16 based on current forecasts.

Wind-up of the Entity.

If the Board feels is cannot investigate and implement any of the options noted earlier then its remaining option will be to call a meeting of members and wind up the Entity.

Next Steps.

The Board will need to consider the analysis, options and recommendations noted within this report. In that respect we look forward to discussing these matters with you at your Special Board Meeting on 27 March 2015.

In particular the Board will need to formulate a plan to address the issues and we would be happy to assist further in that regard.

Time being of the essence, we would note that whatever course of action the Board chooses we would expect a decision be made by mid-April 2015 at the latest.

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Background and Introduction

Overview

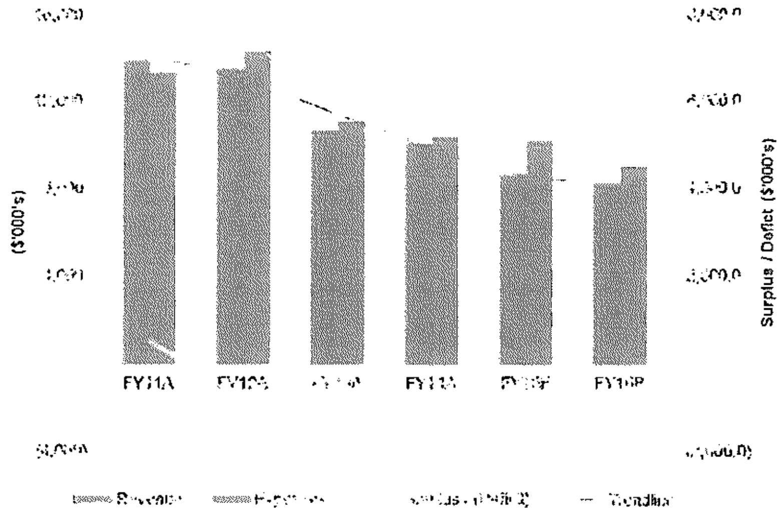
As we will outline throughout this report, FY15 has been a difficult year for RA and a culmination of deteriorating financial performance and operations of the last 3-5 years.

The trends illustrated in the chart opposite shows this to the extent of a revenue line which has declined from $13.9m to an adjusted forecast $8.7m (37%) from 2011 to 2015. Revenue is expected to decline further in FY16, to $8.3m. In some respects the final out turn for FY15 could be seen as a "perfect storm" although in saying that the indications have been manifest for some time.

While Management has made a concerted effort to realign costs as a result of declining revenue, these cost reductions have not taken effect quickly enough. As a high level estimate we believe it has historically taken around 6 months for costs to realign with revenue, after which time revenue drops further resulting in the requirement to continually realign costs. This is illustrated to a degree in the graph opposite, which shows that since FY12 expenses have continued to be greater than revenue.

The impact of this "lag" is that the FY15 deficit will be significant and the initial forecast for FY16 shows a continued deterioration in financial position to the extent that equity will be completely eroded. At some time in early FY16 the Entity will likely become insolvent unless urgent remedial actions can be taken.

Our report outlines these issues in more detail and concludes with a series of options and recommendations for the Board to consider.



The Board has engaged PwC to provide advice regarding the financial performance of the Entity.

Overview

As a result of sustained financial underperformance of the Entity both prior to and during FY15, the Board of Governance ("the Board") has requested PwC provides advice in respect of this.

- Our work has focussed on the year to date financial performance, the forecast performance for the remainder of FY15, the forecast performance for FY16, areas for cost reduction or revenue enhancement, and the options available to the Board.
- While the composition of the Board has remained relatively consistent over the last few years, we do note that Lesley Haines took over the role of Chairperson approximately 7-8 weeks ago. The previous Chairperson has remained on the Board.
- Over the last two years the Entity has experienced a number of reasonably significant changes. These are briefly summarised as follows:
  - There have been a number of changes in senior staff positions over the last 24 months, including a new CEO, a number of changes to the CFO position and finance function, and removal of a layer of Management which now results in regional managers reporting directly to the CEO.
  - In addition to the Management changes described above, there has been a significant restructuring of the practice staff in order to reduce the number of contractors utilised by the business, which in turn has reduced personnel costs.
  - A new IT system has been installed by the Entity. This should allow the Entity to better understand the productivity of its counsellors, and will result in a stronger layer of control.

The Finance Function

- With the CFO's contract due to end in June 2015 it is essential that plans are put in place to ensure continued oversight of the finance function of the Entity. In our view there are two options available in this regard:
  - The first option is to recruit a permanent CFO as a replacement. Given the likely timeframes involved in recruiting for senior management positions, if this course of action is to be taken we would recommend the recruitment process is commenced without delay.
  - The second option is for the Entity to outsource its finance function. While we are not in a position to estimate the likely costs of this, it may prove to be significantly cheaper and more effective than employing a permanent CFO in the Entity.
- The CFO is assisted by a financial accountant who appears to have a significant workload, covering both a financial accountant and management accountant roles. Outsourcing of the finance function as described above could take some of the workload away from this staff member.
- Outside of the finance function there appears to be a very low level of financial literacy within the organisation. The three "Regional Managers" have no financial background, which has resulted in added challenges for the CEO and CFO with the business planning process.
- Where possible, the finance team needs to work to improve financial literacy of the wider management group of the Entity.

We have concerns over the quality and accuracy of Management's monthly reporting to the Board. In particular, we feel the monthly management accounts do not provide a true picture of performance.

Board Reporting

During the course of our work it has become apparent that there have been a number of issues in respect of effective communication from Management to the Board. Because of these factors the Board has had difficulty formulating an informed and timely view of the financial performance and position of the Entity.

- During the first half of FY15 Management did not present monthly management accounts to the Board until approximately 8 weeks after month end. We understand the timing of the presentation of management accounts has reduced significantly to around 10 working days during January and February.
  - In addition to the timeframe taken to produce management accounts, the level and quality of information provided to the Board is of concern.
  - We understand there are often errors in the management accounts, often as simple as totals not adding correctly.
  - Management has no dashboard reporting system or effective reporting of KPIs to the Board. In part this is a result of Management not having access to this information itself.
  - Management needs to improve the explanations of actual performance when reporting to the Board. In addition, it should be generating a monthly out turn forecast that is updated on a monthly basis, reflecting actual results.
  - A relatively significant operational restructuring of the Entity has been carried out by the CEO, however, there does not appear to be detailed and concrete information showing the costs of this restructuring, the benefits it brings and whether it has actually been a success.
- While we are aware that the Board has encountered a number of issues in regard to the quality of information provided, we do believe Management is improving the quality and timeliness of the financial information, although this is certainly work in progress.
- In our view the monthly management accounts do not currently show an accurate picture of the Entity's performance at month's end. In part this is because of the recognition and subsequent release of the "income in advance" line in the balance sheet. With revenue recognised on a flat line basis for a number of contracts in the profit and loss statement, the true level of revenue earned could either be greater or less than the reported amount.
- An accurate picture of revenue will only be presented at year end, once a revenue "wash-up" adjustment has been made, and when the accounts have been audited. In part this can be demonstrated by the fact Management had a "wash-up" of revenue in the February management accounts which resulted in a significant revenue adjustment (as discussed later in the report).
- While we do not believe the management accounts show a clear picture of the revenue generated by the entity, we do believe the expenses lines to be relatively accurate, although we do stress that we have not conducted an audit of external contractor costs.

The Entity's FY15 budget was discarded following a number of errors being identified. Management are currently in the early stages of the FY16 budgeting process.

The Budgeting Process

- The original FY15 budget was completed by the previous CFO and showed a forecast deficit of $100k. The previous CFO departed prior to the commencement of the 2015 financial year and was replaced by a contract CFO, who is engaged until June 2015.
- Following a number of errors being identified in the original FY15 budget in November 2014 the Board requested a full and urgent review of the FY15 budget, which ultimately has resulted in the budget being discarded.
- To replace the FY15 budget the CFO created a "reforecast" document, showing a forecast deficit of $873k for FY15. In addition. a number of changes were made to the forecasting process, including the decision to recognise the timing of revenue differently to the methods used previously for a number of larger contracts, including contracts with the MSD. This includes flat phasing the MSD revenue on a monthly basis, with a view to having a "wash-up" at year end. In our view this appears to be a sensible approach given the volatility of month to month revenue.
- Given the lack of any budget in place, the Board has removed all delegated authorities for purchases or obligations over $2,000. We support this course of action in light of the financial and budget environment currently in place. However, we feel there is still an inadequate level of fiscal responsibility at some levels of the Entity and would recommend the Board continues to withhold delegations until a new budget is in place, and until budget managers have ownership of their budget areas. Having ownership of a budget is crucial for delegations to work effectively.

Financial performance for the year to February 2015 is $244k below Management's reforecast. This is largely driven by reduced Ministry of Justice and Corrections revenue and one-off costs.

The table opposite shows the performance of the Entity for the eight months to the end of February 2015, together with Management's reforecast for the same period.

- Year to date revenue is $290k below the reforecast amount. While the majority of revenue lines are tracking in line with forecast, Corrections Community Probation and Ministry of Justice revenue are below forecast. These variances are driven by the following:
  - Corrections Community Probation revenue is $82k below forecast. This is due to a reduction in the volume of referrals to the Entity, which in turn is a result of decreasing demand for counselling services through this avenue.
  - Ministry of Justice revenue is tracking $224k behind forecast. The contract with the Ministry of Justice is a transactional one, where the Entity is paid for the services delivered at a contracted rate. The reduction in revenue is due to reduced volumes as a result of changes to the way the Ministry purchases counselling services.
- Overall, Management has been able to reduce costs below reforecast levels. A reduction in project costs, together with reduced personnel costs and other expenses has been offset to some extent by increased IT and telecommunications costs and travel costs.
  - IT and telecommunications costs are higher than forecast due to an under-forecasting of line rental and tolls, together with increased costs associated with the tablets now in use by staff.

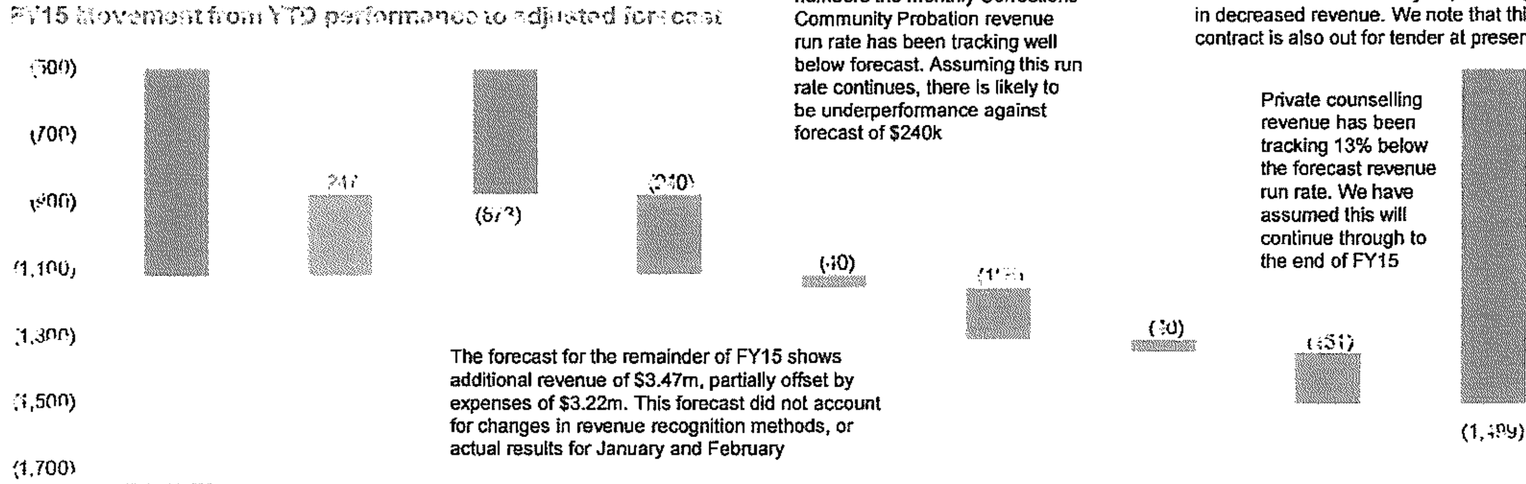
Relationships Aotearoa Incorporated
Profit and Loss Statement Summary

($'000's)	Feb-15 YTD FCast	Feb-15 YTD Actual	Variance	Variance (%)
Revenues				
Corrections Community Probation	507.1	425.4	(81.7)	(16.1%)
Child Youth and Family	170.1	170.1	0.0	0.0%
Ministry of Justice contracts	1,076.0	852.4	(223.6)	(20.8%)
Ministry of Social Development contracts	2,442.2	2,429.7	(12.5)	(0.5%)
Other counselling revenue	1,516.1	1,533.0	16.9	1.1%
Other income	105.4	112.4	7.0	6.6%
Grants revenue	191.7	195.2	3.6	1.9%
Total Revenues	**6,008.6**	**5,718.3**	**(290.3)**	**(4.8%)**
Expenses				
Rent, rates and electricity	651.3	653.0	(1.7)	(0.3%)
Personnel costs	4,490.6	4,468.9	21.8	0.5%
IT and telecommunications	322.4	354.1	(31.6)	(9.8%)
Travel	168.2	182.1	(13.9)	(8.3%)
Projects	801.7	753.9	47.8	6.0%
Other expenses	393.2	361.6	31.5	8.0%
Total Expenses	**6,827.4**	**6,773.6**	**53.8**	**0.8%**
Depreciation	57.2	64.7	(7.5)	(13.0%)
Net Profit / (Loss)	**(876.1)**	**(1,120.0)**	**(244.0)**	

- Management has conducted a recovery exercise during the year in order to continue to reduce expenditure. Management has not been able to isolate the recovery costs incurred during the year, which we would assume to be one off and not recurring, and has estimated full year, recurring savings of $311k achieved in FY15.

Management's reforecast shows a FY15 deficit of $0.9m. However, there are a number of adjustments that should be applied to this reforecast increasing the FY15 deficit to $1.5m.

- The chart below shows the movement from the actual year to date deficit of $1,120k, to Management's forecast FY15 deficit of $873k. Management has forecast a $247k surplus over the remaining 4 months of FY15.
- The chart also shows a number of adjustments we have overlaid on Management's forecast to provide an "Adjusted Forecast". This Adjusted Forecast shows an expected FY15 deficit of $1,499k. We note that the equity at the start of FY15 was $1,522k. As such we expect the equity balance in the Entity to reduce to approximately $23k by year end. However, there may be some further opportunities to supress expenditure and generate savings of c.$100k-$200k by the end of FY15.



The forecast for the remainder of FY15 shows additional revenue of $3.47m, partially offset by expenses of $3.22m. This forecast did not account for changes in revenue recognition methods, or actual results for January and February

Relationships Aotearoa Incorporated Profit and Loss Statement Summary ($'000's)	FY15 Mgmt F'cast	FY15 Adjusted F'Cast
Revenue	9,185.4	8,710.4
Expenses	10,058.5	10,209.5
Surplus / (Deficit)	(873.1)	(1,499.1)

The Nurturing the Future revenue stream for the entity has reduced to zero going forward, as a result of this entity ceasing to operate. Management is attempting to mitigate the impact of this by approaching MSD directly.

Net cost over-runs predominantly comprise additional telecommunications charges ($57k), higher personnel costs ($50k), travel costs ($15k) and depreciation ($27k).

Management are in the very early stages of preparing their FY16 Budget. They have used the FY15 reforecast as a baseline, adjusting for expected changes in revenue and expenditure in FY16.

Management is in the early stages of the budgeting process for FY16. Management has prepared a very high level budget estimate which is presented in the table opposite.

This budget estimate has been prepared using the FY15 reforecast as a baseline, and then overlaying adjustments for variances between the FY15 reforecast and Management's expectations for FY16. Given the lack of detail currently available in respect of the FY16 budget our review has been limited to a high level assessment of the appropriateness of the adjustments, as without a formal budget it is not possible to form a view on the achievability (or otherwise) of the expected deficit.

The high level FY16 budget estimate shows an expected budget deficit of $804k. Revenue in FY16 is expected to be $923k less than the FY15 re-forecast prepared by the CFO.

- Management are expecting philanthropic revenue to increase during FY16 by a net $150k following the appointment of a dedicated staff member to raise this funding. We comment on this later in our report.
- Ministry of Justice revenue is expected to decrease from prior year levels as the full year impact of the reduced new contract revenue is felt (the new contract has been in place since October FY15).
- EQC revenue is expected to decrease in FY16. Management has advised that the FY15 EQC revenue amount included a significant portion carried forward from FY14, but earned in FY15. This situation will not recur in FY16.
- Management has also carried forward $400k of adjustments made to FY15 revenue following our review of the FY15 reforecast. We note that this is lower than the $475k of revenue adjustments included on the previous page.

Relationships Aotearoa Incorporated
FY16 Budget Estimate

($'000's)	
FY15 reforecast revenue	**9,185.0**
Philanthropic revenue increase	150.0
FY16 Ministry of Justice revenue reduction	(185.0)
FY16 EQC revenue reduction	(488.0)
FY15 revenue adjustments carried forward	(400.0)
FY16 budget revenue	**8,262.0**
FY15 reforecast expenditure	**10,058.0**
One-off FY15 expenses	(143.0)
EQC cost reduction	(311.0)
Potential cost savings - as advised by management	(538.0)
FY16 budget expenditure	**9,066.0**
FY16 budget deficit	**(804.0)**

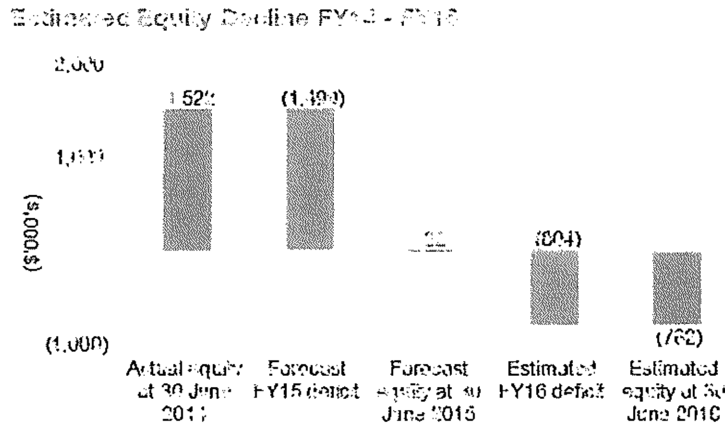
Management has estimated there will be $922k of cost reductions from the FY15 forecast to FY16.

- A number of one-off, non-recurring expenses incurred in FY15 and totalling $143k have been identified by Management, including restructuring costs, CEO road-shows, and IT installation costs.
- As a result of a reduction in EQC volumes being delivered Management has also deducted the a resulting decrease in costs of $311k from the FY16 estimate.
- In addition to the above, Management has identified $538k of potential cost savings, predominantly comprising reductions in staff numbers, reduced contractor costs and property lease savings.

Of particular concern to the Board and to Management will be the estimated decrease in the Entity's equity levels following a significant forecast deficit in FY15 and in FY16.

The chart opposite shows the estimated decline in equity from the balance of $1,522k in surplus as shown in the FY14 audited annual accounts to a forecast $782k equity deficit at the end of FY16.

- We note that for the purposes of this analysis we have excluded the impact of other potential movements in the balance sheet that would impact on the equity balance of the Entity. These may include the potential to capitalise some project expenditure incurred in FY15 either from baseline funding or CIR funding.
- The adjusted forecast for FY15 (discussed previously) shows an expected annual deficit of $1,499k, which in turn will reduce the Entity's equity balance to $22k at the end of FY15.
- When Management's estimated financial performance for FY16 is taken into account the equity balance drops to a $782k deficit as at the end of FY16. Again, this does not take into account the impact of other movements in the balance sheet.
- It is clear from the chart opposite that the Board and Management need to take significant action to stem the outflow of equity from the Entity.



The Entity does not produce a cash flow statement with the monthly management accounts, nor does it forecast cash flow as part of the budgeting process.

The Entity does not generate a formal cash flow forecast as part of its monthly management accounts, although it does produce a monthly balance sheet.

- The management accounts as at 28 February 2015 showed a closing cash balance of c.$2.2m. This is a decrease of $0.9m from the beginning of FY15. There is also an accounts receivable balance of $819k on the balance sheet at 28 February 2015.
- For the remaining four months of FY15, Management has forecast additional revenue of $206k from the Ministry of Justice, and a further c.$800k from a number of customers where revenue is generated on a transactional basis. A significant portion of the February accounts receivable will also be expected to be collected prior to the end of FY15.
- All other revenue forecast for the remaining four months of FY15 will simply be a reversal of a significant portion of the income received in advance balance (currently $2.2m) held as a liability on the balance sheet.
- While it is difficult to estimate the cash balance at the end of FY15 without a cash flow forecast or other relevant detail, we would estimate the closing cash balance to be between $600k and $800k, depending upon the performance of the entity, the collection of accounts receivable, and the phasing of accounts payable.
- Given Management's estimated budget for FY16, we would expect the Entity to require a cash injection at some point during FY16 if it is to remain solvent on a cash flow basis.

Furthermore, Management has not produced a balance sheet forecast as at 30 June 2015 as part of their forecasting process. However, we note the earlier prediction that total equity will be negligible at that time, and whilst the Entity may have a cash balance of up to $800k as well as accounts receivable at a level that cannot be determined, these current assets plus existing fixed assets will be offset by current liabilities of accounts payable and employee entitlements, and a remaining balance of income in advance which will largely be comprised of philanthropic funding.

Options and Recommendations

Introduction

At the time of our report, we consider RA to still be solvent on the basis that it has working capital to meet its current debts and its assets exceed liabilities. However, the high level forecasts for FY15 and FY16 show that it will continue to incur significant losses to the extent it will erode all remaining equity. Accordingly at some point in FY2016, likely to be towards the end of the first quarter / commencement of the second quarter it is likely RA will not have sufficient reserves to meet on-going operating expenses and liabilities and technically become insolvent. Unless therefore it can make immediate changes to financial performance and position then the Board will need to consider calling the appropriate meetings and seek resolutions from members to place the entity into liquidation.

Failing that option, we consider the following as possible means of reviving and sustaining the business of Relationships Aotearoa and returning it to profitability.

1. Negotiate new contractual terms with key suppliers particularly MSD
2. Terminate unprofitable contracts
3. Increase non-Government funding streams (e.g. philanthropic, public fund raising, private counselling fees)
4. Continue with on-going restructuring and cost cutting within the business
5. Seek funding / subscriptions from members
6. Reconcile what expenditure in FY15 can be capitalised
7. Merger with another provider

There may be other options available but we consider the aforementioned as the most feasible in the circumstances. In the event that any of the above cannot be successfully implemented then a wind down or formal liquidation of the business would seem inevitable.

We comment briefly on each of these options.

1. Negotiate new contractual terms with key suppliers, in particular MSD

This option would be the most straightforward in restoring the Company's revenue line to a level whereby it is able to meet the budgeted level of costs for FY16. This would mean a total increase in the contract values by c.$800k.

Our discussions with management indicate that the main contract requiring re-negotiations is the MSD contract which is currently set at an hourly rate of c.$95 as opposed to the Ministry of Justice ("MOJ") contract at c.$165 per hour. Accordingly negotiations would need to ensue to:

- Increase the hourly rate to a level commensurate with the MOJ contract; and / or
- Increase the total contract value by c.$800k as noted above; and / or
- Decrease the level of hours / case numbers to a level whereby the costs of delivery match the revenue and provide a satisfactory margin thereon

We understand that the CEO has been actively pursuing this option, however, consider that if these negotiations are to be successful then there would need to be a more active level of lobbying with the input of the Board.

Options and Recommendations

Nevertheless we consider it unlikely that MSD will agree to an increase in the hourly rate for the following reasons.

- During 2013 and 2014 RA received a considerable level of CIR funding (c.$1.3 million) and we would expect that there may be a reluctance now to provide additional one-off or permanent funding.
- MSD would need to find additional budget to accommodate this request. Budgets bids for FY16 will have already been submitted with reviews currently underway by the Treasury *et al* pending final cabinet decisions in April. It would not be possible to submit a further bid unless MSD already has some form of placeholder bid lodged or a level of contingency allowance against its previous budget or FY16 budget.
- We understand that MSD may wish to reduce, consolidate or rationalise contracts with existing counselling providers and accordingly MSD may simply see RA's inability to deliver at the existing price as a means of terminating the current contractual arrangements.

What we consider more likely to occur is for RA to renegotiate the volume of counselling hours, case number and / or reporting protocols and again this is something the CEO is trying to achieve. Where it may prove difficult is within MSD's long-standing desire to formalise a funding for outcomes framework and how then RA's delivery may become part of that framework.

Recommendation

We recommend the CEO, with the assistance of a Board member such as the Chairperson, should seek an urgent indication from MSD as to whether the current negotiations are likely to be successful and the contract capable of being changed in advance of FY16. If that is not possible then we would see RA as having no option but to advise MSD it cannot continue the existing contracted delivery arrangements (see below).

2. Terminate unprofitable contracts

There is no comprehensive activity based costing currently available upon which to make a detailed and accurate assessment of which contracts are profitable. However, there is a level of evidence which suggests that other than some of the user pays arrangements and the MOJ contracts, most other delivery arrangements, especially the MSD contract as noted above, represent a net cost to RA. Therefore if contract values or terms cannot be changed then they should be terminated and the organisation "right sized" to only deliver the profitable contracts.

We consider the difficulties in achieving this option will be as follows.

Options and Recommendations

- The impact it would have on counselling staff and contractors insofar as the remaining volumes and revenue they would derive would be unlikely to provide sufficient levels of sustainable income for them, meaning they would either terminate their arrangements with RA or increase their current prices to compensate for the loss of volume / income.
- Any such downsizing may then reduce the quality of service delivery, meaning RA could not meet qualitative metrics imposed under its remaining contracts.
- Downsizing of this nature will come at an immediate one-off cost through the need to remove overheads such as property costs, support services and the like. This may not be entirely possible, as there is no guarantee that the termination will reduce the current economies of scale and RA would still need to maintain presence in a number of its current regions and / or provide the same level of support services irrespective of reduced delivery volumes.
- If a reduction of overheads is possible then we would expect the one-off costs of achieving this to be significant (e.g. up to $300k) and note that RA does not necessarily have funds to accommodate that and may therefore need to access funding.

Recommendation

If the discussions with MSD are unsuccessful in achieving price increases and / or volume decreases, MSD should be advised that it is likely RA will need to discontinue service delivery under the existing contract terms. This may provide RA with some leverage to obtain additional funding or more favourable contractual terms.

However, we believe that MSD may well adopt an approach that if they can immediately contract with another large provider for service delivery, such as FairWay Resolution Limited, then it is likely to do so eliminating any leverage RA may have. If, however, MSD's only option is to contract with a number of smaller providers then it may take the view that the administrative and management costs, coupled with quality issues associated with such an option will be too high and that renegotiating with RA may simply be the better option.

Further urgent work should also be undertaken to determine the profitability of remaining contracts with a report prepared for the Board by the CFO with recommendations as to next steps.

Options and Recommendations

3. Increase non-Government funding streams (e.g. philanthropic, public fund raising, private counselling fees)

We understand that management is already considering a strategy and plans to raise the profile of RA in order to increase alternative funding streams. However, our discussions and initial analysis into this option indicate that it will not be easy to achieve. Furthermore, the current plans consider the need to employ a full time fundraiser and we question the benefits of that and whether the right person can be recruited, as we are aware that the currently capability and capacity in the marketplace is extremely limited.

RA also does not have the high profile brand associated with some of the other providers (e.g. Barnados or Presbyterian Social Support Services) and hence it will be difficult for it to launch any significant public fund raising initiatives. It may be able to increase levels of philanthropic funding but in all likelihood only from some of the existing providers such as NZ Lotteries Grants Board. Even then, such funding will be targeted against specific projects whereby all funds received will need to be spent directly on those projects and therefore not mitigate RA's projected operating deficit.

It is likely RA may also have reached saturation in respect of revenue from private counselling although it may be possible to implement a small price increase on these services albeit to a level which may not provide for any significant mitigation of the forecast FY16 deficit.

Recommendation

There are a number of fund-raising consultancy firms who could be sounded out to determine whether there are any merits in RA adopting a more aggressive public fund-raising profile. We consider that the employment of a full time staff member to undertake such a task is too great a risk for RA and represents an uncertain investment for an uncertain return.

Further analysis should be undertaken to determine whether current user pays prices can be increased.

4. Continue with on-going restructuring and cost cutting within the business

If the decision is made to continue with current operations at existing revenue and service delivery levels then it is absolutely essential that costs must reduce further and there needs to be a more integrated and defined plan for achieving this. Whilst there has been some evidence of cost-cutting as we have noted earlier in the report, we consider that the level of detail, milestones, reporting and measurement of those savings has not been optimal and that some of the implementation thereof has been *ad hoc*.

What is also of concern to us is that it has taken a directive of the Board to remove delegations in order to suppress spending. However, we still feel that there is not a sufficiently strong culture of fiscal responsibility when it comes to some areas of current (discretionary) expenditure or assessment of forward spend into FY15 in preparing the budget for that year. This means that if delegations are restored then budget holders do not own responsibility for that expenditure.

Options and Recommendations

Areas where we still see opportunity for reduced spending are as follows:

- Travel and accommodation
- IT and related costs
- Finance function costs
- Use of external contractors and consultants (not counselling related)
- Vehicle expenses
- Project implementation and management costs
- Property costs
- Administration and management salaries
- Other minor overheads

We would expect that there should still be at least 5%-10% savings in a number of these areas with an expectation set to achieve total savings in the order of $300k-$500k above what has already been targeted.

Recommendation

At the time of our report, RA had not yet completed a full budget for FY16 integrated into directorate and regional business plans. Our assessments of its FY16 prospects have been based on a high level forecast provided by the CFO which does not yet analyse costs on a line by line basis or have had the input of key management and link to FY16 business plans. RA must therefore immediately undertake a planning and budgetary session with key management and Board representation to determine a budget for FY16 which provides for a greater level of detail, integrity and buy-in than the current version.

5. Seek funding from members

At some time in the next month RA will need to engage with its membership base to advise them of the precarious financial position of the entity. That may either be at the next AGM or more likely at a Special General Meeting given the urgent need to resolve the issues.

Recommendation

We have had no interaction with RA's members and hence are unable to determine whether any of them have the means to provide financial support. However, RA's Constitution and Rules permit it to:

- Issue debentures or borrow by other means (Section 4 of the Constitution and Rules)
- Seek annual subscriptions from members (Section 6)
- Terminate the rights of members who fail to pay annual subscriptions (Section 6)

We recommend therefore that the Board and management seek high level legal advice as to whether it can in fact sufficiently levy members to assist with the financial position whilst it undertakes further restructuring. Subject to that advice, RA could then lobby those members to determine the likelihood of funding assistance before proceeding down the formalities of either calling meetings of members or issuing subscription notices.

Options and Recommendations

6. Reconcile what expenditure in FY15 can be capitalised

Throughout FY14 and FY15, RA has spent considerable sums on change management and quality improvement plans utlising either baseline or CIR funding. From what we understand, most of these costs have been expensed with very little expenditure capitalised to recognise assets purchased or created (e.g. IT systems).

Recommendation

RA should undertake its own analysis and then consult with its auditors to determine whether any of these costs can be capitalised. However, whilst this may improve the overall equity of the Entity and mitigate the FY15 deficit it will not improve the working capital position.

7. Merger with another provider

RA provides services for which there are a small number of larger providers and a large number of small providers. It is possible that one or more of the larger providers may be interested in consolidating their existing operations with those of RA.

The most likely of these we consider to be:

- Presbyterian Social Support Services
- FairWay Resolution Limited ("FairWay")
- Barnados
- Pegasus Health

The difficulty in achieving any such arrangement will be that any due diligence of RA's current operating and financial model will reveal the unprofitable nature of some services and unless these can be integrated into another provider's operations to achieve economies of scale and be delivered profitably then no provider will entertain such an arrangement.

Recommendation

We consider the most likely party that may consider such an arrangement will be FairWay and recommend that an approach be made to this organisation to determine its potential interest. Whilst we are not overly familiar with FairWay's operations, a number of the FairWay Board are well known to us and have an "entrepreneurial edge" to the way they have operated in the past and accordingly may see an opportunity to assist. We would be happy to assist with any approach that may be made.

8. Summary

We have outlined a number of options available to RA to revive its current financial and operational positions. None of these options are mutually exclusive of each other and should be assessed and implemented contemporaneously to determine their possible viability.

However, before doing so, the Board must consider whether it is prepared to take the risk of continuing to trade over the next 3-6 months given the current financial position and the initial indications that the forecasts for FY16 show the position will deteriorate further to the extent that by 2nd quarter FY16 the entity will likely be insolvent. Accordingly time will be of the essence in assessing the viability of any of these options.

If the Board does not have the appetite to investigate and implement any of these options then its only likely remaining option will be to call a meeting of members and wind up the entity.

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Contract

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Advisory

Relationships Aotearoa Incorporated
Report to the Board of Governance

Strictly Private and Confidential

26 March 2015
Draft

pwc

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From the Contents page – click on the title of the section or sub-section

From the contents listing on any section divider – click on the title of the sub-section

This is a draft report

Our work is not complete and, as a result, this draft report may not represent our final findings or conclusions. Amongst other things, the following matters remain outstanding:

- Our internal review procedures are not yet completed.

Important notice

Important message to any person not authorised to have access to this report.

Any person who is not an addressee of this report or who has not signed and returned to PwC a Release Letter is not authorised to have access to this report.

Should any unauthorised person obtain access to and read this report, by reading this report such person accepts and agrees to the following terms:

1. The reader of this report understands that the work performed by PwC was performed in accordance with instructions provided by our addressee client and was performed exclusively for our addressee client's sole benefit and use.
2. The reader of this report acknowledges that this report was prepared at the direction of our addressee client and may not include all procedures deemed necessary for the purposes of the reader.
3. The reader agrees that PwC, its partners, principals, employees and agents neither owe nor accept any duty or responsibility to it, whether in contract or in tort (including without limitation, negligence and breach of statutory duty), and shall not be liable in respect of any loss, damage or expense of whatsoever nature which is caused by any use the reader may choose to make of this report, or which is otherwise consequent upon the gaining of access to the report by the reader. Further, the reader agrees that this report is not to be referred to or quoted, in whole or in part, in any prospectus, registration statement, offering circular, public filing, loan, other agreement or document and not to distribute the report without PwC's prior written consent.
4. This report should also be read in conjunction with the important notice and restrictions set out in our Engagement Letter and Appendix 1.

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The Board of Governance of Relationships Aotearoa Incorporated
Level 8
203-209 Willis Street
Wellington 6140
Attention: Lesley Haines

Dear Lesley

We report on Relationships Aotearoa Incorporated ("the Entity") in accordance with our engagement letter dated 4 March 2015 (see Appendix 1).

This report has been prepared for the Board of Governance of Relationships Aotearoa Incorporated ("the Board") and provides analysis and comment on the recent financial performance of the Entity, together with a review of the Entity's forecasts. In addition, we provide an overview of the options available to the Board going forward.

This is a draft report. Our work is not complete and the comments in this draft report are therefore subject to amendment or withdrawal. Our definitive findings and conclusions will be those set out in the final report.

We draw your attention to the important notice and restrictions set out in our engagement letter and the scope and process of our work, set out in Appendix 2. Please note also that our engagement with the Entity is considered a one off assignment and we are accordingly not deemed to have a continuing professional relationship with the Entity.

Save as described in the agreement or as expressly agreed by us in writing, we accept no liability (including for negligence) to anyone else or for any other purpose in connection with this report, and it may not be provided to anyone else.

Yours faithfully

John Fisk
Partner
PricewaterhouseCoopers

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At a glance

PwC view

- Financial performance for the year to 30 June 2015 is likely to result in a deficit of $1,499k based on current expenditure levels and known revenue reductions.
- This deficit will result in almost total erosion of the Entity's equity of $1,522k available at the commencement of FY15.

1 Overview

PwC has been engaged by the Board to provide advice in respect of the recent financial underperformance of Relationships Aotearoa Incorporated.

- The Entity has recently been working through an operational restructuring, and has had a number of changes at senior management level over the last 2 years.
- There are a number of issues with regard to management information, and communication with Board. The current CFO has made a number of improvements to the finance function, although there remains significant work to do.
- The original FY15 budget has been disregarded by the CFO, who has created a new FY15 "reforecast".

2 FY15 performance

Actual performance for the year to Feb 2015 is $244k below forecast resulting in a current deficit of $1,120k.

- This reduction is predominantly driven by reduced Corrections Community Probation revenue together with reduced Ministry of Justice revenue, and offset slightly be reduced expenses in respect of project costs and personnel costs.

Management has estimated FY15 performance to improve somewhat as a result of an expected surplus over the remaining four months of the year, resulting in a forecast deficit of $873k.

However, following a review of the reforecast we expect further revenue reductions of $475k, together with estimated cost over-runs of $151k for remainder of the year resulting in an adjusted forecast deficit of $1,499k.

The table below shows the year to February 2015 actual results versus forecast, together with the FY15 reforecast versus the FY15 adjusted forecast.

Relationships Aotearoa Incorporated
Profit and Loss Statement Summary

($'000's)	Feb-15 YTD FCast	Feb-15 YTD Actual	FY15 Mgmt FCast	FY15 Adjusted FCast
Revenue	6,008.6	5,718.3	9,185.4	8,710.4
Expenses	6,884.6	6,838.3	10,058.5	10,209.5
Surplus / (Deficit)	**(876.1)**	**(1,120.0)**	**(873.1)**	**(1,499.1)**

3 FY16 forecast performance

Management has commenced the FY16 budgeting process by creating a very high level estimate of FY16 performance based on FY15 forecasts with adjustments overlaid.

- Management's FY16 estimate shows a further deficit of $804k. While revenue is expected to decrease from FY15 levels, this is more than offset by reduced personnel costs, cost savings proposed by Management, and costs incurred in FY15 that don't recur in FY16.

4 Equity

Based on the adjusted forecast deficit of $1,499k for FY15, the estimated equity balance reduces from a starting balance at 1 July 2014 of $1,522k to a forecast $22k at the end of FY15.

On the basis of this assumption the equity balance is then expected to reduce further to a $782k deficit by the end of FY16.

At a glance

PwC view

- The options available to the Board need to be assessed contemporaneously and not in isolation.
- Given the forecasts show that the Entity may become insolvent some time early in FY16, the Board of RA needs to take further advice to determine whether it is prepared to take a measured risk in assessing these options for viability.
- If the Board is not prepared to undertake that assessment then the only feasible option remaining is to call a meeting of members with a view to winding up the Entity.

Options available to the Board to revive the business.

During our review we have identified seven possible options available to the Board which may revive the business. These are as follows:

1. Negotiate new contractual terms with key suppliers particularly MSD
2. Terminate unprofitable contracts
3. Increase non-Government funding streams
4. Continue with on-going restructuring and cost cutting within the business
5. Seek funding / subscriptions from members
6. Reconcile what expenditure in FY15 can be capitalised
7. Merger with another provider

None of these options are mutually exclusive of each other and should be assessed and implemented contemporaneously to determine their possible viability.

However, before doing so, the Board must consider whether it is prepared to take the risk of continuing to trade over the next 3-6 months given the entity will likely become insolvent early in FY16 based on current forecasts.

Wind-up of the Entity.

If the Board feels is cannot investigate and implement any of the options noted earlier then its remaining option will be to call a meeting of members and wind up the Entity.

Next Steps.

The Board will need to consider the analysis, options and recommendations noted within this report. In that respect we look forward to discussing these matters with you at your Special Board Meeting on 27 March 2015.

In particular the Board will need to formulate a plan to address the issues and we would be happy to assist further in that regard.

Time being of the essence, we would note that whatever course of action the Board chooses we would expect a decision be made by mid-April 2015 at the latest.

Executive report

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Background and Introduction

Overview

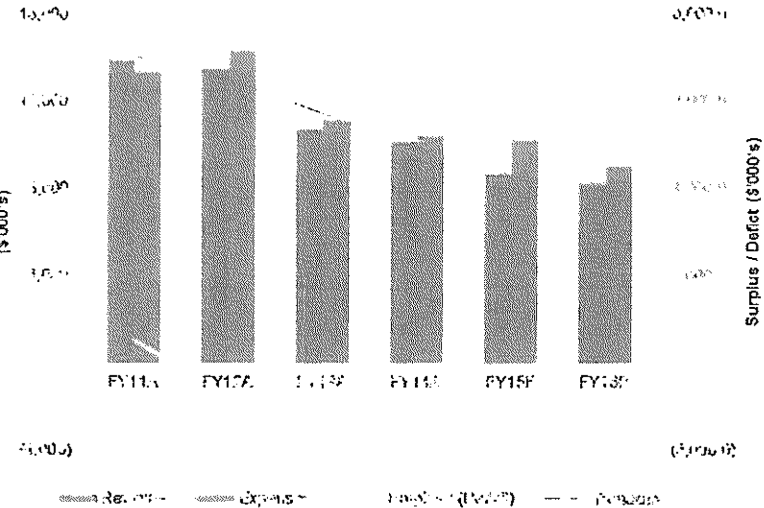
As we will outline throughout this report, FY15 has been a difficult year for RA and a culmination of deteriorating financial performance and operations of the last 3-5 years.

The trends illustrated in the chart opposite shows this to the extent of a revenue line which has declined from $13.9m to an adjusted forecast $8.7m (37%) from 2011 to 2015. Revenue is expected to decline further in FY16, to $8.3m. In some respects the final out turn for FY15 could be seen as a "perfect storm" although in saying that the indications have been manifest for some time.

While Management has made a concerted effort to realign costs as a result of declining revenue, these cost reductions have not taken effect quickly enough. As a high level estimate we believe it has historically taken around 6 months for costs to realign with revenue, after which time revenue drops further resulting in the requirement to continually realign costs. This is illustrated to a degree in the graph opposite, which shows that since FY12 expenses have continued to be greater than revenue.

The impact of this "lag" is that the FY15 deficit will be significant and the initial forecast for FY16 shows a continued deterioration in financial position to the extent that equity will be completely eroded. At some time in early FY16 the Entity will likely become insolvent unless urgent remedial actions can be taken.

Our report outlines these issues in more detail and concludes with a series of options and recommendations for the Board to consider.



The Board has engaged PwC to provide advice regarding the financial performance of the Entity.

Overview

As a result of sustained financial underperformance of the Entity both prior to and during FY15, the Board of Governance ("the Board") has requested PwC provides advice in respect of this.

- Our work has focussed on the year to date financial performance, the forecast performance for the remainder of FY15, the forecast performance for FY16, areas for cost-reduction or revenue enhancement, and the options available to the Board.
- While the composition of the Board has remained relatively consistent over the last few years, we do note that Lesley Haines took over the role of Chairperson approximately 7-8 weeks ago. The previous Chairperson has remained on the Board.
- Over the last two years the Entity has experienced a number of reasonably significant changes. These are briefly summarised as follows:
  - There have been a number of changes in senior staff positions over the last 24 months, including a new CEO, a number of changes to the CFO position and finance function, and removal of a layer of Management which now results in regional managers reporting directly to the CEO.
  - In addition to the Management changes described above, there has been a significant restructuring of the practice staff in order to reduce the number of contractors utilised by the business, which in turn has reduced personnel costs.
  - A new IT system has been installed by the Entity. This should allow the Entity to better understand the productivity of its counsellors, and will result in a stronger layer of control.

The Finance Function

- With the CFO's contract due to end in June 2015 it is essential that plans are put in place to ensure continued oversight of the finance function of the Entity. In our view there are two options available in this regard:
  - The first option is to recruit a permanent CFO as a replacement. Given the likely timeframes involved in recruiting for senior management positions, if this course of action is to be taken we would recommend the recruitment process is commenced without delay.
  - The second option is for the Entity to outsource its finance function. While we are not in a position to estimate the likely costs of this, it may prove to be significantly cheaper and more effective than employing a permanent CFO in the Entity.
- The CFO is assisted by a financial accountant who appears to have a significant workload, covering both a financial accountant and management accountant roles. Outsourcing of the finance function as described above could take some of the workload away from this staff member.
- Outside of the finance function there appears to be a very low level of financial literacy within the organisation. The three "Regional Managers" have no financial background, which has resulted in added challenges for the CEO and CFO with the business planning process.
- Where possible, the finance team needs to work to improve financial literacy of the wider management group of the Entity.