



Financial Sustainability Program

Information Paper 1

Financial Sustainability

June, 2007
(Re-issued)



Introduction

This discussion paper is one of a number developed as a part of the Financial Sustainability Program and was updated in June 2007. It is designed as a thought starter. Manuals, codes, guidelines, technical definitions, standards and similar documents being prepared provide tools to assist Councils in more practical ways. This paper aims to assist in ensuring that all involved have a common understanding of the basic concepts.

The subject of this discussion paper is financial sustainability itself. It is therefore the most central of the papers and relevant to all areas encompassed in the program. The paper is largely based on the concepts behind the report of the Independent Inquiry into the Financial Sustainability of Local Government. Input by Access Economics and the SA Office of State/Local Government Relations is gratefully acknowledged.

There is little disagreement about the basic concepts in this paper.

The February 2006 version of this document was used as the basis of consultations around the State which led to the adoption by the LGA's March 2006 General Meeting of a formal definition of Financial Sustainability. This version has been updated to incorporate that definition and to incorporate key financial indicators endorsed by the LGA's General Meeting in April 2007.

The following information papers have already been, or soon will be, prepared by the LGA:

- Financial Sustainability
- An Overview of Audit Mechanisms
- Audit Committees
- Scope of External Audit – Audit Specification
- Efficiency & Economy Audits
- Infrastructure and Asset Management (Policy and Planning)
- Service Delivery Framework Including The Role of Shared Services
- Long-term Financial Plans
- Local Government Financial Indicators
- Debt Management
- Governance in Local Government
- Targets for Local Government Financial Indicators
- Model Framework for Council Annual Business Plans
- Model Work Program for Council Audit Committees
- Depreciation
- Revenue and Funding Policies
- A New Approach to Standards in Local Government
- A New Approach to State-Local Resourcing
- An Approach to Assessing Financial Sustainability for Local Government
- Financial Governance and Management

More about other documents and activities can be found on our website at: www.lga.sa.gov.au/goto/fsp.

What do we mean by 'sustainable'?

The word 'sustainable' has gained common usage in a variety of areas in recent years.

Primarily however it is in the area of environmental management that it is most understood. In this context we can easily understand for example that if we use up fossil fuels rapidly, our reliance on energy will not be sustainable unless alternatives are found – meaning that at some point (or points) in the future our current practices will need to change.

In general terms we use sustainable to mean that we can continue our current practices.

'Financial sustainability' therefore can be taken to address whether we can sustain our current practices in financial or economic terms. For Local Government, financial sustainability poses the question:

Can we continue the sort of revenue and expenditure patterns of recent years while maintaining the levels of service expected by the community?

For community members, financial sustainability is probably thought of as whether we can afford our current lifestyle - whether we can pay for rent, food and other expenses with the income we receive each year. For those of us who own homes, farms or businesses, we may think in longer terms as to whether we will be in a position to repay debts by the time we retire. This type of thinking is practical for individuals or families where long-term planning is probably in the order of 15-20 years however most of us probably plan on a shorter basis than that.

What does Financial Sustainability mean for Local Government?

The concepts most people use in their personal and business lives are basically the same as those that should be applied to Local Government but need some modification. This is because Councils are perpetual corporations which hold and manage community wealth and assets through generation after generation.

Councils provide the legal framework by which communities own infrastructure and assets and by which they act as a collective. Much Local Government infrastructure has a life of 30, 50 or in some cases well over 100 years. While individuals involved in Local Government may come and go, the corporation continues like State and Federal governments, perpetually.

The Independent Inquiry into the Financial Sustainability of Local Government highlighted that too many Councils have large infrastructure maintenance and renewal backlogs and as a result our communities are enjoying infrastructure which will, and is beginning to, fall apart – and which will be left for our children to fix up. The Inquiry noted the very high proportion of infrastructure we manage (more than \$10 billion in SA) compared with other governments and the private sector. It further suggested that if we retain the very low debt of most Councils, we will be trying to rebuild long-lasting infrastructure out of our current income rather than recovering the cost over the life of the infrastructure. The Inquiry considered that, in some circumstances, a deferral of infrastructure renewal and replacement is a worse 'sin' than borrowing to finance such renewal/replacement.

As a result quite different thinking is called for. Leaders, administrators and communities must not only think about the state of infrastructure and assets we leave to our children, but to our grandchildren and great grandchildren.

These issues are often referred to as 'intergenerational equity'.

Another way of describing this is to say that communities have been, under our stewardship across the State, living off their assets rather than paying their way. We have been wearing out vital infrastructure and putting off until the next generation the challenges of renewal, while we improve current service levels.

In making corrections, we need to ensure however that the next generation does contribute appropriately for the infrastructure it uses up.

A better balance would see vital infrastructure renewed with costs shared by future generations while ensuring they are not paying for services used by today's generation.

The Inquiry suggested that most of the challenges facing Councils result from short-term thinking which fails to seriously address the long-term nature of infrastructure and the ongoing responsibilities communities give their Councils. It also noted that we are not profiling the indicators which tell us and others how we are performing on these issues.

Defining Financial Sustainability

The Inquiry noted that there was no generally accepted definition of 'financial sustainability' in SA Local Government and referred – given the common 'perpetual' nature of State and Federal governments - to several government definitions including the following Commonwealth definition:

“...a government's ability to manage its finances so it can meet its spending commitments, both now and in the future. It ensures future generations of taxpayers do not face an unmanageable bill for government services provided to the current generation.”

The Inquiry adopted a definition which clarifies the three essential elements of the above discussion: services; taxes; and impacts on future generations:

- ensuring the maintenance of a Council's high priority expenditure programs, both operating and capital;
- ensuring a reasonable degree of stability and predictability in the overall rate burden; and,
- promoting a fair sharing in the distribution of Council resources and the attendant taxation between current and future ratepayers.

It adopted the following terms to summarise these three elements:

- program sustainability;
- rate stability; and,
- intergenerational equity.

In another way, these elements can be seen as what the community expects from Councils:

- quality services;
- reasonable taxes to fund them; and,
- sound long-term financial management.

Following extensive consultation the LGA's 2006 General Meeting adopted the following definition of financial sustainability and this was subsequently adopted nationally by the Australian Local Government Association by resolution at its December 2006 National General Assembly:

A Council's long-term financial performance and position is sustainable where planned long-term service and infrastructure levels and standards are met without unplanned increases in rates or disruptive cuts to services.

There is no perfect definition but the definition above addresses the three key elements and is relatively short. Your Council may use the above definition or have its own wording, but it is useful to ensure there is an official and common view.

The Inquiry Board created some controversy in trying to build a picture of the financial position of Local Government in SA as a whole by doing a "desk audit" of individual Councils building on SA Local Government Grants Commission data. However the focus of most of the Inquiry's recommendations was on ensuring appropriate financial governance policies are in place rather than on comparisons between Councils. Indeed the Inquiry made the point that it was not convinced that many Councils which were rated as "sustainable" in the desk audit had the right policy and financial governance frameworks to keep them sustainable.

How do we signal/communicate financial sustainability?

One of the problems of the past was that there has been no common publication of data indicating how financially sustainable Councils are. In the absence of such data, the media and community tend to have focused on three elements:

- the sizes of our revenue, expenditure or debt levels;
- whether our budgets balance (in cash terms); and,
- our annual percentage increases in rates revenue.

All of these are short-term measures and were reflected in the confusion by some media about the Inquiry, suggesting there was some form of 'cash crisis' in Local Government, when the Inquiry's concerns related to long-term policy settings.

The only measure that points more to our long-term position is whether we have an infrastructure backlog – that is, infrastructure which has not been maintained or renewed appropriately. This depends on whether we have been spending enough on maintaining and renewing vital infrastructure assets like roads and drains, and not leaving an unfair burden on future generations to do so.

Councils communicate or signal important information to communities in a variety of ways. These include:

- information provided in reports for Council meetings;
- issues debated at Council meetings (including the budget);
- annual reports (including financial statements);
- media releases and statements by the Mayor/Chairperson or CEO;
- community newsletters, forums, meetings and on websites.

For the vast majority of Councils in the past, the above communication mechanisms have rarely highlighted key financial sustainability measures. As a result, in many Councils, current needs and demands of communities have been given priority over long-term sustainability which results from cost-effective management of asset stocks. Considering low growth of rates compared to other government taxes, cost shifting by other

governments and an aversion to debt, it is no wonder that many Councils have significant infrastructure backlogs and that their communities are relatively uninformed about this.

The way forward recommended by the Inquiry was for a Council's long-term financial sustainability to be assessed using a standard set of 4 key financial indicators. As a result of widespread consideration by Local Government and with informative input from the SA Local Government Financial Management Group a further three indicators were added to these and the seven adopted by the LGA's April 2007 General Meeting.

Two separate papers have been developed on the indicators, the first seeking to explain them in simple terms, and the second seeking to assist Councils to set targets for each of the indicators. The seven indicators are:

Indicator 1: Operating Surplus *(the difference between day to day income and expenses for the period)*

An operating surplus (deficit) arises when operating revenue exceeds (is less than) operating expenses for a period (usually a year). Just like any household or other organisation, a Council's long-term financial sustainability is dependant upon ensuring that, on average over time, its expenses are less than associated revenues. In essence this requires current day citizens to fully meet the cost of services provided for them by their Council.

Indicator 2: Operating Surplus Ratio *(the percentage by which the major controllable income source varies from day to day expenses)*

The operating surplus ratio is the operating surplus (deficit) expressed as a percentage of general and other rates net of (excluding) rate rebates and revenues from the NRM levy. A positive ratio indicates the percentage of total rates available to help fund proposed capital expenditure. If the relevant amount is not required for this purpose in a particular year, it can be held for future capital expenditure needs by either increasing financial assets or preferably, where possible, reducing debt in the meantime.

Indicator 3: Net Financial Liabilities *(money owed to others less money held, invested or owed to Council)*

Net financial liabilities equals total liabilities less financial assets. Often too much focus is placed on the level of a Council's borrowings. This number has little meaning without also considering the Council's available financial assets and other liabilities. There is no right or wrong target level of net financial liabilities.

Indicator 4: Net Financial Liabilities Ratio *(the significance of the net amount owed compared with income)*

This ratio indicates the extent to which net financial liabilities of a Council could be met by its operating revenue. Where the ratio is falling over time it indicates that the Council's capacity to meet its financial obligations from operating revenue is strengthening. Again, there is no optimal single number or even narrow range for this indicator. What is important is that a Council understands and is comfortable with its ratio and that it has been determined based on future community needs and long-term financial sustainability.

The following 3 indicators were adopted by the LGA in addition to the four key indicators recommended by the Inquiry (above).

Indicator 5: Interest Cover Ratio *(the level of income used to pay interest on loans)*

This ratio indicates the extent to which a Council's operating revenues are committed to interest expenses. As with all financial indicators associated with measuring indebtedness and its associated costs there is no right or wrong ratio. A Council simply needs to manage this ratio within a range acceptable to it, having regard to long-term financial sustainability and its suite of strategic management plans and financial management policies.

Indicator 6: Asset Sustainability Ratio *(the extent to which assets are being replaced at the rate they are wearing out)*

This ratio indicates whether a Council is renewing or replacing existing non-financial assets at the same rate that its overall stock of assets is wearing out.

Indicator 7: Asset Consumption Ratio *(the average proportion of 'as new condition' left in assets)*

This ratio shows the written down current value of a Council's depreciable assets relative to their 'as new' value in up to date prices. This ratio seeks to highlight the aged condition of a Council's stock of physical assets. If a Council is responsibly maintaining and renewing and replacing its assets in accordance with a well prepared plan, then the fact that its Asset Consumption Ratio may be relatively low and/or declining should not be a cause for concern - providing it is operating sustainability.

Financial Sustainability Information Paper 9 analyses these seven indicators in more detail with a hypothetical example. Information Paper 12 provides some guidance to Councils in setting targets within each of these indicator areas. These papers can be found on <http://www.lga.sa.gov.au/goto/fsp>.

Long-term financial plans of Councils can provide information on projected performance against each of these indicators. This information is particularly useful to assess the implications for financial sustainability of the Council's revenue and expenditure strategies and proposals.

The Inquiry was clear that we need to improve our Financial Governance – broadly the extent to which Council Members set short and long-term objectives in this area and are advised and supported to do so effectively.

What do we need to do?

The Independent Inquiry made 62 recommendations to Councils and the LGA to take the Local Government sector to best practice on financial sustainability. Understanding the issues better is a start. A significant number of the Inquiry recommendations relate to adopting and promoting indicators of financial sustainability, and the setting and pursuing of targets for them, as highlighted in the previous section.

Clearly we need to ensure that the range and standard of services Local Government provides to our communities is determined having regard to our long-term financial sustainability. This requires a particular focus on cost-effective provision, maintenance and renewal of assets we are responsible for. We need to give much greater profile in our mainstream communications to our targets for, and performance against, sustainability indicators. This information needs to feature more prominently in our primary communication tools – including information provided formally to Council meetings, in annual reports and in work with the media.

In short, we need to remind ourselves that in Local Government:

- we are making decisions as perpetual organisations for current and future generations;
- that the majority of our business, financial and management revolves around community infrastructure;
- many of us have significant infrastructure backlog issues which demand greater rates contributions and/or borrowings and possible reductions in 'lower priority' service areas if we are to get on top of them;
- this may mean we need to say 'no' to other governments or our communities in response to demands for involvement in issues beyond our current resources.

The above should be readily apparent to our communities and should be highlighted regularly, along with our plan to deal with these issues and how we are progressing.

We also need to remember that all Councils are not the same so the appropriate rates income, the appropriate expenditure on infrastructure and the appropriate level of net financial liabilities (including debts) will look different in a urban developed Council, compared with a rural Council, compared with a regional centre and compared with a fringe metropolitan high growth Council (and so on).

Some of the issues inherent in profiling sustainability indicators more prominently are quite complex: for example, determining appropriate rates of depreciation for a particular asset or class of assets that approximates actual rates of consumption bearing in mind that asset lives will be significantly affected by local factors (usage, environment, quality etc.). In some areas, such as infrastructure backlogs, new data will need to be collected and published. However none of the challenges ahead are insurmountable and many are relatively straightforward.

Notwithstanding differences between Councils, there are substantial issues on which we need to work together – in some instances, nationally, and we will all benefit from an approach in which we share the journey.

What does legislation require?

Amendments to the Local Government Act 1999 which followed the Independent Inquiry introduced the words "... sustainability of the council's financial performance and position ..." while the Act does not define 'financial sustainability'. It also provides under the heading 'objectives' that a Council must "...seek to ensure that council resources are used fairly, effectively and efficiently...".

The Act has required Councils to have strategic management plans and to report on those. By the end of 2008 all Councils will be required to have long-term financial management plans and infrastructure & asset management plans as a part of their suite of strategic management plans.

Councils are now required to have audit committees which are required, as a part of their roles, to provide input to any review of the Council's strategic management plans. Audit committees cannot include Council staff or the auditor and must include at least one person who is not a member of Council.

The Act requires that long-term financial plans be reviewed as soon as practicable each year after the adoption of the annual business plan. As a part of this review a Council CEO must prepare a report on the Council's financial sustainability.

So the current Act provides for a cycle of planning which embeds financial sustainability into the process. The Regulations now require Councils to disclose, in a consistent manner, actual and projected performance with respect to an operating surplus ratio, an asset sustainability ratio and a net financial liabilities ratio in their annual budget and long-term financial plan. Each year, the report from the CEO following the adoption of its annual business plan, will tell a Council how its long-term strategies and financial plans are affected by changed circumstances. Such reports are increasingly expected to use the indicators outlined in this paper as well reviewing targets, or target ranges, for each indicator.

What steps do we need to take?

This document is designed to assist in promoting a common basic understanding of financial sustainability issues for Local Government. Other checklists and documents have been and are being prepared to assist your Council in its next steps.

The LGA web page: <http://www.lga.sa.gov.au/goto/fsp> provides more information about the overall program including briefing and training sessions.

If you want to know more speak to your Chief Executive Officer, or other relevant Council officer, first and find out what approach your Council is taking to these issues. Seek their advice about next steps. If you want to understand more about the Inquiry the above web page provides a copy of the Inquiry's final report along with other relevant information.

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