



Local Excellence

Councils Working Together for Communities

Financial Sustainability

Information Paper 1

Financial Sustainability

Revised January 2012



Introduction

This Information Paper is one of a series of Information Papers about Financial Sustainability and Financial Governance in Local Government.

The series of Information Papers was originally published in 2006 to 2011 as part of the Financial Sustainability Program. The history of that program and a complete list of Information Papers and other resources, including a glossary of terms and abbreviations, is provided on the LGA's "Financial Sustainability" web page: <http://www.lga.sa.gov.au/goto/fsp>.

The entire series of Papers was revised in early 2012 to take account of legislative changes and other developments. These Papers are addressed to, and written primarily for the benefit of Council Members and staff, but they are also available as a resource for the general public and students of Local Government.

Financial Sustainability – the concept

The word 'sustainable' has gained common usage in a variety of areas since the 1990's. It is most often used in the context of environmental management. We can easily understand, for example, that fossil fuels such as oil and coal are finite resources. Therefore, considerable effort is devoted to seeking alternative renewable energy resources, along with energy-saving practices and technologies, to try to make our energy consumption practices sustainable. In general terms we use 'sustainable' to mean that we can continue our current practices.

'Financial sustainability' is a similar concept. 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 acquire and manage a stock of financial and physical assets (including renewing and disposing of individual items) in order to provide services for generation after generation of local residents and ratepayers.

Councils provide the legal framework by which communities own infrastructure and other 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 may come and go, Local Government continues like State and Federal governments, perpetually.

For Local Government, considering 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?

The 2005 [*Independent Inquiry into the Financial Sustainability of Local Government*](#) ("the Inquiry") found that too many Councils had large infrastructure maintenance and renewal backlogs and as a result our communities were enjoying infrastructure which would, and was

beginning to, fall apart – and which would be left for our children to fix up. [The Inquiry](#) noted the very high proportion of infrastructure that Local Governments managed compared with other governments and the private sector. (In 2005 the Inquiry noted it was valued at more than \$10 billion in SA. In 2010 Local Government infrastructure had a total estimated value of \$18 billion.)

[The Inquiry](#) suggested that if Councils continued to operate with very low levels of debt, then they would be trying to rebuild long-lasting infrastructure out of current revenue 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 was a worse 'sin' than borrowing to finance such renewal/replacement.

As a result quite different thinking was called for. Leaders, administrators and communities were urged to think not only about the state of infrastructure and other assets we would leave to our children, but what we would leave to our grandchildren and great grandchildren. This is often referred to as 'intergenerational equity'.

Another way of describing this is to say that communities were, under past stewardship, living off their assets rather than paying their way. We were on a path of wearing out vital infrastructure and putting off until the next generation the challenges of renewal.

[The Inquiry](#) suggested that most of the challenges facing Councils resulted from short-term thinking that failed to seriously address the long-term nature of infrastructure and the ongoing responsibilities communities give their Councils. It also noted that we had not been referring to financial indicators which could have told us and others how we had been performing on these issues.

Defining Financial Sustainability

[The Inquiry](#) noted that there was no generally accepted definition of 'financial sustainability' in SA Local Government. It referred to several government definitions including the following Commonwealth Government 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 clarified 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:

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.

This definition was subsequently adopted nationally by the [Australian Local Government Association](#) by resolution at its December 2006 National General Assembly.

This definition may not be perfect but it addresses the three key elements. 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.

How do we signal/communicate financial sustainability?

One of the problems of the past was that there had been no common publication of data indicating the extent to which Councils were financially sustainable. In the absence of such data, the media and community tended to focus on three elements:

- the sizes of our revenue, expenditure or, in particular, debt levels;
- whether our budgets balanced (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.

One measure that points 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;
- annual reports, annual business plans and long-term financial plans;
- media releases and statements by the Mayor/Chairperson or CEO;
- community newsletters, forums, meetings and on websites.

When engaging with a community, the written analysis around an annual business plan and a long-term financial plan is particularly important. It should facilitate community consultation on the likely changes to be made in service delivery, infrastructure spending and imposition of rates, to provide for or maintain financial sustainability in the longer term. In addition, the analysis should make a conscious attempt to ensure a linkage with the objectives and goals of the Council. This approach also should result in a clear understanding by the community of the Council's proposed direction.

Until recent years, Councils using these communication mechanisms had rarely highlighted key financial sustainability measures. As a result, current needs and demands of communities often were given priority over the Council's long-term sustainability.

The way forward recommended by [the Inquiry](#) was for a Council's long-term financial sustainability to be assessed using a standard set of key financial indicators.

The LGA's [General Meeting in 2007](#) endorsed the sector-wide use of seven financial indicators which many Councils then adopted. More recently, informed by a comprehensive review by the [SA Local Government Financial Management Group](#) and with encouragement by the [Australian Centre of Excellence for Local Government](#), all jurisdictions in Australia have agreed in principle to adopt three key financial indicators. These three indicators are applicable to Local Governments Australia-wide. The proposal is for the three indicators to cover each Council's:

- financial *performance*;
- financial *position*; and
- asset management performance.

Accordingly, these three indicators are known as:

1. Operating Surplus Ratio (the percentage by which the major controllable revenue source varies from operating expenses);
2. Net Financial Liabilities Ratio (the significance of the net amount owed compared with operating revenue); and
3. Asset Sustainability Ratio (the extent to which assets are being replaced, compared with what is needed to cost-effectively maintain service levels).

These indicators are explained in Information Paper No. 9 *Local Government Financial Indicators* at <http://www.lga.sa.gov.au/goto/fsp>.

Of the three, the most important is the "operating surplus ratio" which indicates whether a Council is living within its means. It indicates the extent to which a Council's major revenue source is more, or less than its operating expenses, including non-cash items such as depreciation of assets. A Council which has an operating deficit in one year should have a plan to achieve a breakeven position in future years.

Reporting on a smaller rather than larger number of indicators helps decision-makers and stakeholders more readily focus on and comprehend key outcomes and implications. Reporting on a smaller number of indicators also is consistent with the national frameworks for assessing financial sustainability endorsed by the former Local Government and Planning Ministers' Council. Precise details of how the three nationally-consistent indicators will be calculated had not been agreed by early 2012. However, it had been proposed that South Australian Councils would move towards a nationally consistent approach by using these three indicators in respect of financial material assembled covering 2012-13 and future financial years.¹

Notwithstanding the usefulness of financial indicators when communicating with ratepayers, the most critical measure of the financial sustainability of a Council is its annual operating result (i.e. the extent to which operating revenue is sufficient or insufficient to fund the cost of services). Any Council that incurs ongoing operating deficits should be quite clear about the

¹ In early 2012, it was intended that Councils were to have been consulted on this proposal as part of the development of the 2012 *Model Financial Statements*.

strategic implications of this on its future capabilities to sustain current service levels. It means that

- rates and charges that the community are paying are insufficient to cover the costs of providing existing levels of service;
- the Council effectively is running down its existing net assets; and
- in future, the Council must inevitably reduce service levels, improve efficiency and/or increase operating revenue (and the longer it delays remedial action, the more severe the consequences are likely to be).

What do we need to do?

[The Inquiry](#) made 62 recommendations to Councils and the LGA to achieve best practice on financial sustainability in the Local Government sector. Understanding the issues better is a start. A significant number of the Inquiry recommendations related to the need to improve our financial governance – particularly in respect of long-term financial and asset management planning.

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 business plans 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; and
- 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 Councils are all different so the appropriate rate revenue, the appropriate expenditure on infrastructure and the appropriate level of indebtedness will look different in an 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).

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". However the Act does not define financial sustainability. [The Act](#) provides in its section 8 list of "Objectives of a Council" that a Council must "...seek to ensure that council resources are used fairly, effectively and efficiently."

Section 8 of [the Act](#) also requires that a Council must "ensure the sustainability of the Council's long-term financial performance and position." This provision reinforces a key

message of the LGA's Financial Sustainability Program that collectively, Council Members are accountable for the financial sustainability of their Council.

[The Act](#) requires Councils to have strategic management plans (SMPs) and to report on those plans. [The Act](#) requires a Council's SMPs to address:

- the sustainability of the Council's financial performance and position;
- the maintenance, replacement or development needs for infrastructure within its area;
- proposals with respect to debt levels; and,
- identification of any anticipated or predicted changes that will have a significant effect upon the costs of the Council's activities/operations.²

All Councils are required to have a long-term financial management plan and an infrastructure and asset management plan as a part of their suite of strategic management plans.³ These plans are inextricably linked to the Council's annual business plan, because changes to one plan must affect the other.

In addition, each Council is required to have an Audit Committee. An Audit Committee is required, as a part of its role, to provide input to any review of the Council's SMPs. Therefore, an Audit Committee needs to review the sustainability of the Council's financial performance and position based on revenue and expenditure strategies and initiatives that are implicitly or explicitly proposed in such plans.

An Audit Committee cannot include any Council staff member or the auditor and must include at least one person who is not a Council Member.⁴

[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.⁵

Therefore, [the Act](#) provides for a cycle of planning which embeds financial sustainability into the process. Regulations⁶ require Councils to carry out a mid-year budget review, and at least two budget updates each year.⁷ The Regulations also require a Council to disclose, in a manner consistent with the Model Financial Statements, projected performance with respect to:

- an operating surplus ratio,
- a net financial liabilities ratio, and
- an asset sustainability ratio.

This disclosure must be made in both the annual budget and in the long-term financial plan. A Council's actual performance against these three indicators also is reported in the audited annual financial statements. Each year, the report from the CEO following the adoption of its

² Section 122 (1) (ab)

³ Section 122 (1a). See also Financial Sustainability Information Papers:

- No. 6: *Infrastructure and Asset Management Plans*; and
- No. 8 *Long-Term Financial Plans*

at <http://www.lga.sa.gov.au/goto/fsp>

⁴ See Financial Sustainability Information Paper No. 3: *Audit Committees*: at

<http://www.lga.sa.gov.au/goto/fsp>

⁵ Section 122 (4a)(a)

⁶ The [Local Government \(Financial Management\) Regulations 2011](#)

⁷ See Financial Sustainability Information Paper No. 25: *Monitoring Council Budget Performance* at

<http://www.lga.sa.gov.au/goto/fsp>

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.

Overall, the legislative framework requires a Council to continually review its actual financial performance against plans it has established. This is designed to ensure that a Council adheres to its plans and remains firmly focussed on achieving and/or maintaining financial sustainability.

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 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. If you want to know more, speak to your Chief Executive Officer, or other relevant Council officers 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 2005 Inquiry](#), then links to the Inquiry's final report along with other relevant information can also be found at: <http://www.lga.sa.gov.au/goto/fsp>.

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