



**Local Excellence**

Councils Working Together for Communities

*Financial Sustainability*

# Information Paper 23

# Financial Governance

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 Governance – the concepts

Financial governance describes the way a Council manages its financial affairs in pursuing its strategic and corporate objectives and ensuring appropriate high levels of accountability. It comprises the policies and practices by which a Council meets its responsibility to the community to achieve long-term financial sustainability.

It is critical that financial governance policies and practices are efficient, effective and transparent. Good financial governance enhances public confidence in Local Government and helps to ensure that a Council is in a position to make decisions that are properly responsive to the interests of its community.

## Legislative framework for financial governance

The principal provisions relating to financial governance in the [Local Government Act 1999](#) are:

- [Section 8—Objectives of a council](#)
- [Section 59—Roles of members of councils](#)
- [Section 80A—Training and development](#)
- [Section 122—Strategic management plans](#)
- [Section 123—Annual business plans and budgets](#)
- [Section 125—Internal control policies](#)
- [Section 126—Audit committee](#)
- [Section 130A—Other investigations](#)

The principal provisions relating to financial governance in the [Local Government \(Financial Management\) Regulations 2011](#) are:

- [Regulation 5 - Long-term financial plans](#)
- [Regulation 6 - Annual business plans](#)
- [Regulation 7 - Budgets](#)
- [Regulation 8 - Provision of subsidiary budgets to councils](#)
- [Regulation 9 - Review of budgets](#)
- [Regulation 10 - Report on financial results](#)
- [Regulation 11 - Accounting standards](#)
- [Regulation 14 - Certification of financial statements](#)

These provisions impose a range of requirements on Councils intended to support good financial governance. They point to two distinct roles for Council Members:

1. to represent and advocate for individuals and groups within their community;
2. as members of a governing body (with law making and taxing powers) serving to protect the organisation's long-term sustainability so that it can best serve the whole community and future generations.

To meet their responsibilities, all Council Members should participate in the deliberations (consideration, discussion, debate and decision making) relevant to financial governance.

It is beyond the scope of this paper to discuss each of the legislative provisions listed above. Instead this paper's focus is on characteristics of 'best practice' financial governance in a South Australian Local Government context. Some recommended practices described below are in addition to legislative obligations. Comments that 'Councils should...' or 'it is recommended' etc are not intended to mean that the action is a legislative requirement unless this is specifically stated.

### **Characteristics of best practice financial governance for Local Government:**

This information paper identifies 13 characteristics of best practice financial governance and encourages Councils to adopt financial governance processes that will ensure that they rate highly against these characteristics. The characteristics are described below under four theme areas.

1. Supporting sound financial decision making;
2. Ensuring affordable services to the community;
3. Guiding funding and financing; and
4. Facilitating performance monitoring and review.

## **Theme 1: Supporting sound financial decision making**

### ***1.1 Ongoing education and training such that all Council Members understand and fulfil their financial governance responsibilities***

Financial understanding and decision-making should not rest with one or two Council Members who have a background in financial matters. It is recommended that all South Australian Council Members and key staff embrace their financial management responsibilities and understand the importance and means of achieving financial sustainability.

All Council Members should be able to identify and comprehend the key messages contained in financial statements and Council meeting agenda financial reports, and feel confident in contributing to financial decision-making. For example, they need:

- to understand if their Council has an operating deficit, its relative magnitude, the ways it can be progressively eliminated and the likely implications if it isn't;
- to be able to assess whether the financial strategy and service level settings reflected in their long-term financial plan are sustainable;
- to know if their Council's level of indebtedness is reasonable and appropriate; and
- to be able to evaluate the affordability and long-term impact of committing to major new capital projects/services.

All Councils should ensure that training programs for both Council Members<sup>1</sup> and senior staff are regularly reviewed and address financial management training needs as appropriate.

The LGA has produced a wide-range of material, some of which is referenced in this paper, to assist Councils to improve their financial governance and sustainability. This material is available from the LGA website at [www.lga.sa.gov.au/goto/fsp](http://www.lga.sa.gov.au/goto/fsp). The LGA also regularly runs a variety of relevant training courses or can arrange tailored courses for specific needs.

### **1.2 Council's accounting policies and practices support decision-making and assessment of performance**

Councils need accurate costing information upon which to base:

- pricing and taxing decisions (both for aggregate revenue raising requirements and for equitably basing service charges such as for Community Wastewater Management Systems and waste collection);
- decisions about affordability of proposals for adding to stocks of assets and services;
- reviews of performance and means of service provision.

Accounting policies and practices should not only meet legislative obligations (including compliance with relevant Australian Accounting Standards<sup>2</sup>) but should go further where considered beneficial. For example, on average, depreciation represents about 22% of Councils' operating expenses. While Accounting Standards require assets to be regularly revalued<sup>3</sup> auditors usually interpret this to mean at least every 3 to 5 years. Councils may find it beneficial to revalue major classes of assets more frequently, including possibly annually adjusting by an appropriate indexation factor to ensure recorded depreciation expenses remain up to date.

For further information in regard to depreciation issues see LGA Financial Sustainability Information Paper 17: *'Depreciation and Related Issues'* at [www.lga.sa.gov.au/goto/fsp](http://www.lga.sa.gov.au/goto/fsp).

### **1.3 Budget and financial information presented for Council deliberation is at a strategic level, succinct and easy to follow.**

Financial information is often, unfortunately, presented in a format that is neither enticing nor easy to interpret by people who are not financial experts. This occurs in all sectors and industries, not just in Local Government. Too often there is a lot of detail that appears overwhelming to the reader and makes it hard to identify and focus on issues of key relevance to the governing body.

It is recommended for purposes of a Council's transparency that financial information is presented in a form that supports decision-making and public accountability. Is the Council on track to achieve its budgeted performance (service delivery) targets within the overall financial constraints it has set itself? If not, why and what needs to be done to correct the situation?

---

<sup>1</sup> Section 80A of the [Local Government Act 1999](#) requires all Councils to have a training and development policy for Council Members that aims to assist members in the performance of their functions and duties.

<sup>2</sup> See [Local Government \(Financial Management\) Regulations 2011](#), Regulation 11

<sup>3</sup> See paragraph 31 of [Australian Accounting Standard AASB 116](#)

Internal financial reporting that is used to manage a Council's finances should be based on accrual rather than cash accounting. Council budgets and reviews of budgets must be presented in a manner consistent with the *Model Financial Statements*,<sup>4</sup> which require the use of accrual accounting. Cash accounting can lead decision-makers to conclude that they can afford more than is the reality, by ignoring non-cash costs such as depreciation (arising from the using-up of assets).

#### **1.4 The annual budget is based on a sound Long-term Financial Plan**

Each Council must have a Long-term Financial Plan (LTFP) covering a period of *at least* ten years.<sup>5</sup> The financial starting point for the preparation of a Council's annual business plan<sup>6</sup> and resultant budget should be the content of the corresponding year (typically year 2) of a Council's LTFP, updated to take account of any relevant factors. In deliberations associated with development of the forthcoming budget the Council should be clear in its understanding regarding any differences in its proposed content compared with the content of its approved LTFP.

Preparation of a LTFP requires a Council to have identified future organisational and community needs and preferences and to consider forecast demographic and other likely operating environment changes and their implications.<sup>7</sup>

The development of a LTFP enables a Council to model various options and scenarios and determine affordable and appropriate service levels e.g. the impact on the achievement of responsible targets for financial indicators from alternative rating strategies or from adding to Council services.

A Council's LTFP should:

- be based on the objectives, strategies and actions documented in its strategic management plan;
- explicitly state its assumptions, revenue raising proposals and any significant changes in planned service levels;
- accommodate the financial resource requirements of its infrastructure and asset management plan;
- explicitly disclose projections for financial indicators against targets it has set.

## **Theme 2: Ensuring affordable services to the community**

### **2.1 The range and level of services provided is based on affordability and community needs and preferences and appropriate Local Government roles**

A Council's range and level of service provision should be driven by the outcomes of the periodic review of its strategic management plan (including associated community consultation). Communities need to be made aware of the revenue raising implications of any proposed additional services and/or the potential to raise the standards of existing services.

<sup>4</sup> See [Local Government \(Financial Management\) Regulations 2011](#), Regulations 7 and 9

<sup>5</sup> See [Local Government Act 1999](#) Section 122 (1a) and LGA Financial Sustainability Information Paper 8: 'Long-Term Financial Plans' at <http://www.lga.sa.gov.au/goto/fsp>

<sup>6</sup> See LGA Financial Sustainability Information Paper No. 13: 'Annual Business Plans' at <http://www.lga.sa.gov.au/goto/fsp>

<sup>7</sup> In the Council's strategic management plans: see [Local Government Act 1999](#) Section 122 (1) and (3)

Before making any commitment to increase services (including through the construction or acquisition of new assets) Councils should assess whether it is appropriate for Local Government to fund the activity under consideration. They should be especially wary of undertaking or contributing to roles more appropriately the responsibility of other spheres of government.

Demographic and preference changes may mean that services that were once popular now have less demand and new needs have arisen. When introducing new services (or services in different locations) Councils also need to consider whether existing services in some locations can be reduced. This could include identification of opportunities to dispose of under-utilised assets. Any decision to undertake major discretionary one-off projects or ongoing initiatives must be supported by a thorough benefit/cost analysis<sup>8</sup> and an understanding of any additional revenue raising requirements to ensure a Council's financial targets are not adversely affected.

## **2.2 Considerable effort is made to help the community understand Council's financial circumstances and performance**

All spheres of government have more demands and expectations placed on them than they are able to responsibly fund. If taxpayers believe that a government has plenty of money why wouldn't they want more?

Councils need to simply and clearly communicate their financial capacities and constraints and the costs of existing responsibilities and services, along with initiatives under consideration. They need to explain the consequences of trying to provide service levels beyond what is affordable on an ongoing basis. Where a Council does this well, it is far more likely that its community will accept the need for restraint in service expectations and/or increases in revenue. Most people want to receive value for money from their Local Government but would not want their Council to provide more services than is affordable and as a result incur financial problems that will have negative consequences for their community in future. Section 123 of the *Local Government Act 1999* requires that a Council consult with its community on its annual business plan (ABP). An ABP must include a summary of a Council's long-term objectives, an outline of its proposed activities to achieve those objectives, its financial requirements for the year and its rates structure and impacts on the community.

Councils should publish and promote their actual performance against their financial and service standard targets through a variety of communication mediums as a demonstration of their commitment to transparency and accountability. This information needs to be easily understandable and should explain steps being taken where reported performance is below target. A Council needs to be accountable to its community not only for its expenditure on delivery of services, but more importantly for the quality and efficiency of services it delivers and the outcomes it achieves.

## **2.3 The Infrastructure and Asset Management Plan (I&AMP) is based on affordable service levels and maintenance programs that minimise whole-of-life costs of assets**

Councils' activities are extremely asset-intensive relative to their operating revenue (and far more so than other spheres of government). Council Members in their 'governing

---

<sup>8</sup> See [Local Government Act 1999](#) Section 48, which requires a Council to have prudential management policies, practices and procedures for the assessment of projects.

body' role are effectively custodians of these assets on behalf of the community (both current and future generations).

It is important that Council Members have an understanding of:

- the aggregate value of assets they are effectively responsible for managing;
- the proportions of each type of asset in their Council's asset portfolio.

How well a Council manages its asset portfolio (achieving the right level and standard of assets relative to community need and capacity to pay, and ensuring that maintenance and rehabilitation/replacement is carried out when appropriate to minimise whole-of-life costs) will have paramount impact on its financial performance.

As Local Government responsibilities and services have grown over time, most Councils have under-funded asset maintenance. Under-funding asset maintenance is false economy. Assets will deteriorate prematurely and service capabilities designed into assets (at a cost) will not be realised. Sound asset management can save a Council considerable funds over time.

Each Council must have an I&AMP.<sup>9</sup> Service levels upon which an I&AMP is based should be consistent with a Council maintaining future financial sustainability. Within this over-arching constraint, an I&AMP should allow for timely and cost-effective asset maintenance programs and renewal/replacement of asset components. If expenditure needs to be reduced or deferred and a Council wishes to maintain its existing range and level of services then it should in the first instance consider deferring acquisition of new or upgraded assets rather than deferring maintenance or renewal of existing assets. If, having done this, funding is still insufficient, it may be cost effective to raise additional borrowings rather than defer essential maintenance/renewal (e.g. road reseal programs should be carried out whenever technically optimal to do so in order to prevent premature failure of pavements).

Preparation of an I&AMP and inputting its financial resource requirements into the LTFP enables Councils to ascertain funding (revenue raising) and financing (cash flow generation including from borrowings) necessary to carry out timely cost-effective maintenance/renewal/replacement regimes and determine the affordability of any proposals to acquire additional assets or upgrade existing stocks (e.g. the affordability of converting an unsealed road into a sealed road).

## **Theme 3: Guiding funding and financing**

### ***3.1 The rating strategy is equitable and generates sufficient revenue to meet financial sustainability needs***

For most Councils rates (including general and service rates and fixed and service charges) represent by far the largest source of their operating revenue (average of 68% across all Councils in 2009-10).<sup>10</sup> Councils have considerable flexibility as to both the quantum of rate revenue they raise and the basis on which it is raised.

---

<sup>9</sup> See [Local Government Act 1999](#) Section 122 (1a) and LGA Financial Sustainability Information Paper No. 6: *Infrastructure and Asset Management* at <http://www.lga.sa.gov.au/goto/fsp>

<sup>10</sup> Source: SA Local Government Grants Commission Database Report 2009-10

No-one likes paying more in government taxes and charges than they have to. Councils must balance their obligations and preferred service levels with the community's capacity and willingness to pay when determining how much rate revenue to raise. They also need to determine how to best achieve their revenue target and whether some classes of ratepayers should pay proportionately more or less than others relative to the value of their property (e.g. by applying a fixed charge and/or differential rates).

The Australian Bureau of Statistics publishes information on the average annual income levels for individuals by Council area and for South Australia collectively. Councils must also have regard to issues of consistency and comparability across other Local Government areas.<sup>11</sup> The SA Local Government Grants Commission provides to each Council, annual database reports showing comparative rating information across all Councils.

Councils are understandably sometimes reluctant to increase rates because of the likely impact on specific sections of the community. However, the flexibility of Local Government rating powers usually means it is possible for a Council that wished to generate more overall revenue, to structure its rating system to ensure an equitable impact while reasonably protecting particular classes (e.g. persons with low capacity to pay) from an unfair burden.

In summary Councils need to use their revenue raising powers responsibly. This means:

- raising sufficient revenue to ensure financial sustainability;
- keeping Council's rating system under review to ensure it has appropriate regard for:
  - changes in capacity to pay within sections of the community;
  - the extent of opportunity for access to, use of and benefit from Council services when structuring and setting taxing and charging regimes.

Further information regarding rating is available in LGA Financial Sustainability Information Paper 20: *Funding Policies and Strategies* and the [Council Rates page](#) on the LGA's web site.

### ***3.2 Debt is used responsibly and treasury management activities are undertaken in accord with a policy that minimises net interest costs relative to acceptable risk***

Many South Australian Councils have traditionally been averse to debt. Greater use of debt can actually improve financial performance (e.g. by using borrowings to cost-effectively finance the rehabilitation of assets and extend their lives and/or reduce future maintenance costs, where it is not practical to finance this work in other ways).

Where a Council achieves an operating breakeven result on average over time it will generate approximately sufficient funds to renew/replace assets when required. It will not however generate sufficient funds to also finance upgrades or additions to its stock of assets. It could accommodate this to some extent by generating operating surpluses but over reliance on this strategy will give rise to intergenerational inequity issues. In order to avoid this, usually borrowings will be needed, sooner or later (but not necessarily at the time the outlay arises) to finance outlays that increase the quality and quantity of assets held.

---

<sup>11</sup> See [Local Government Act 1999](#) Section 153(2).

Councils should not be concerned at having a large amount of debt, provided that their long-term financial plan and financial strategies are soundly based.

Irrespective of their actual level of debt, many Councils have potential to generate savings over the medium term and reduce their interest rate risk exposure by changing the timing and the nature of their borrowings.

In most instances there is no need for, and no point in, a Council borrowing money to meet cash outflows if at the same time it has funds invested which can be liquidated. Similarly, borrowings should not be raised for a fixed long term period if a Council expects to have surplus funds to invest (even for just a short period) in future. Having a significant proportion of borrowings at variable interest rates (rather than all at fixed rates of interest) will help minimise long-term interest costs in a risk averse manner and such borrowings can be repaid when surplus cash is available.

Further information regarding recommended treasury management strategies is provided in LGA Financial Sustainability Information Paper 15: *Treasury Management*.

Good financial governance necessitates the adoption of a formal treasury management policy. Such a policy should have regard to the content of Information Paper 15 and other relevant factors. Councils should regularly report on actual performance relative to the policy's targets and requirements.

## **Theme 4: Facilitating performance monitoring and review**

### **4.1 *Financial performance is managed using suitable financial indicators and targets***

Financial indicators can provide a sound, easily understood and transparent measure of financial performance if the range of indicators used is relevant and kept to the minimum necessary for the organisation's circumstances, and if appropriate targets are also set for these indicators.

LGA Financial Sustainability Information Paper 9: *Local Government Financial Indicators* describes the financial indicators that have been endorsed for general applicability by the South Australian Local Government sector, and possible target ranges for those indicators. Councils are required to disclose their projected performance relative to 3 of these indicators (operating surplus ratio, net financial liabilities ratio and asset sustainability ratio) in their budgets,<sup>12</sup> long-term financial plans,<sup>13</sup> and mid-year budget reviews,<sup>14</sup> and actual performance against all indicators in their annual financial statements.<sup>15</sup>

No individual, organisation or government can continue to carry on its business and financial affairs indefinitely with a large annual operating deficit. In a Local Government context the most likely consequence of sustaining ongoing deficits would be that a Council would find it difficult to generate the funds necessary to renew and replace

---

<sup>12</sup> See [Local Government \(Financial Management\) Regulations 2011](#) Regulation 7(d)

<sup>13</sup> See [Local Government \(Financial Management\) Regulations 2011](#) Regulation 5(c)

<sup>14</sup> See [Local Government \(Financial Management\) Regulations 2011](#) Regulation 9(2)

<sup>15</sup> See [Local Government \(Financial Management\) Regulations 2011](#) Regulation 13

assets as and when required to maintain existing service standards, without subsequent excessively large increases in rate revenue.

Significant ongoing operating deficits are inequitable. Effectively they mean that the current generation of ratepayers is paying considerably less than the cost of services it enjoys. This must have an adverse consequence for the generation that follows. The longer a Council delays addressing an operating deficit the more significant the impact, both in terms of lower service levels and higher overall costs (as it is likely to increasingly struggle to cost effectively maintain and renew its assets as required). Of course, unless there are good reasons for doing so, ongoing excessive operating surpluses would also be inequitable (because the current generation of ratepayers would be paying more than the cost of services it was enjoying).

A Council should set financial targets for each year of its long-term financial plan. More information to help Councils determine targets for the financial indicators relevant to their own circumstances is contained in LGA Financial Sustainability Information Paper 9: *'Local Government Financial Indicators'*.

#### **4.2 The efficiency and effectiveness of means of service delivery is regularly reviewed**

Councils are required to use their resources efficiently.<sup>16</sup> They should consider the relative merits of options such as using their own employees, contracting out and resource sharing where relevant and choose the means that is most appropriate for their circumstances.<sup>17</sup> Councils can initiate formal efficiency and economy audits<sup>18</sup> for this purpose but a better approach is to have a systemic program where key services are reviewed on a cyclic basis through internal audit or other ongoing arrangements.

#### **4.3 There is a process in place that helps ensure compliance with finance-related legislative obligations**

The *Local Government Act 1999* and the supporting *Local Government (Financial Management) Regulations 2011* impose a wide range of obligations on Councils in connection with rating, budget setting and management, internal financial controls, record keeping and financial reporting. A Council needs to be confident that it is fulfilling these requirements. Its external auditor may test compliance with some of these requirements in connection with the annual external audit but often the audit brief is not sufficiently comprehensive to cover all aspects.

Councils should, through their own resources or with the assistance of independent experts, periodically satisfy themselves that they are complying with all of their financial related legislative obligations. Such activities could be managed as part of an internal audit program or by independent review or as a specific project of an appropriate staff member. Non-compliance with these obligations may have an adverse effect on community confidence in a Council's administration of public monies.

---

<sup>16</sup> See [Local Government Act 1999](#) Section 8(h)

<sup>17</sup> See LGA Financial Sustainability Information Paper 7: *'Service Delivery Framework Including the role of Shared Services'* at <http://www.lga.sa.gov.au/goto/fsp>

<sup>18</sup> See [Local Government Act 1999](#) Section 130A and also LGA Financial Sustainability information Paper No. 5: *'Efficiency and Economy Audits'* at <http://www.lga.sa.gov.au/goto/fsp>

Although not its primary purpose, the LGA's "*Managing for the Future – Performance Assessment Tool*" that was made available to all Councils provided an assessment of how well a Council was meeting its legal obligations, at the time of the assessment.<sup>19</sup>

#### **4.4 Council's audit committee's activities and work program supports and promotes effective financial governance by the Council**

Each Council is required to have an Audit Committee.<sup>20</sup> The Audit Committee's roles include:

- proposing and contributing relevant information to a review of a Council's strategic management or annual business plans;
- reviewing the adequacy of a Council's accounting, internal control, reporting and other financial management systems and practices on a regular basis.<sup>21</sup>

A Council Audit Committee's work program should be structured to ensure it includes actions that enable it to review the appropriateness and effectiveness of the Council's financial governance systems and practices, and suggest improvements where the Committee considers that this is warranted.

Further information regarding Audit Committee work programs is documented in LGA Financial Sustainability Information Paper 3: '*Audit Committees*'.

### **What are the issues for Councils?**

Good financial governance is essential in order for Councils to well serve their communities. The better a Council's standards of financial governance the more likely it is that:

- it efficiently and effectively provides an appropriate range and level of services to residents and ratepayers;
- it fairly generates appropriate levels of revenue from different classes of ratepayers and users of services both currently and over longer periods; and
- financial related risks from undertaking its responsibilities and activities will be effectively managed.

In order to carry out their financial governance responsibilities Council Members as a governing body must:

- establish sound financial policies and targets;
- keep expenditure and efficiency and effectiveness of service delivery under review;
- monitor on-going financial results;
- ensure ongoing financial sustainability;
- ensure proper management of assets and resources.

Councils should rate their operations against each of the characteristics described in this information paper to monitor the strength of their financial governance processes.

### **Acknowledgements**

The contribution of John Comrie, of [JAC Comrie Pty Ltd](#), in the preparation of this paper is acknowledged. This project has been assisted by the [Local Government Research and Development Scheme](#).

---

<sup>19</sup> This tool was made available to Councils over the period October 2010 to March 2012. Each participating Council received a tailored 'Continuous Improvement Plan'.

<sup>20</sup> See [Local Government Act 1999](#) Section 126(1)

<sup>21</sup> See [Local Government Act 1999](#) Section 126 (4)