



Financial Sustainability Program

Information Paper 12

Targets for Local Government Financial Indicators

March 2007



Introduction

The LGA's *Financial Sustainability Information Paper 9: 'Local Government Financial Indicators'* describes a set of standardised financial indicators applicable for all Councils. These indicators have been selected to help Council Members and staff understand the organisation's financial performance and health. Information Paper 9 is one of a number of information papers being developed as part of the LGA's Financial Sustainability Program and is designed to provide an overview of the value and nature of recommended financial indicators.

However, knowing the value of a particular indicator provides only limited usefulness. The result has much more meaning if it is considered in the context of a target or a target range set by the Council. A target, or target range, is a value or set of values that Council has adopted as its goal for each indicator.

For example if a family knows that its grocery bill was \$207 in a particular week this information alone is of limited use. If however the family budget aims for weekly grocery spending between \$180 and \$200 then spending \$207 in a particular week has more significance. Furthermore if the family observes that its weekly grocery bill is consistently exceeding its target range then it may lead to family decisions to cut back on some areas of discretionary grocery spending or to increase the family budget for weekly groceries at the expense of other spending areas.

The same rationale applies to Councils and their finances.

No two Councils are the same. Their strategic management plans will reflect the specific needs and preferences of their communities. The state of their infrastructure assets and any required rehabilitation, augmentation or replacement will vary. Their current and projected revenues, expenses, assets and liabilities will also vary and not necessarily proportionately to their population. For these reasons, and quite appropriately, some of the actual financial targets they set themselves may vary significantly from those of other Councils, even though all Councils need to ensure long-term financial sustainability.

This paper is intended to assist Councils in the development of financial targets. It should be read in conjunction with Information Paper 9 and other information papers on Financial Sustainability which highlight the increasing demands on Councils and the importance of efficiently managing the delivery of services. Information papers have been, or will soon be, prepared on the following topics:

- Financial Sustainability
- An Overview of Audit Mechanisms
- Audit Committees
- Scope of External Audits - 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
- Governance in Local Government
- Financial Governance and Management
- Revenue and Funding Policies
- A New Approach to Standards in Local Government
- A New Approach to State-Local Resourcing
- Depreciation

- Local Government Financial Indicators
- Debt Management
- Targets for Local Government Financial Indicators
- An Approach to Assessing Financial Sustainability for Local Government

A number of manuals, guidelines, templates, technical definitions, codes, standards and similar documents supporting this series of information papers are also being prepared by the LGA to provide practical assistance to Councils.

For an update on which information papers have now been completed or information about other documents and activities, including briefing and training sessions, please visit our website at: www.lga.sa.gov.au/goto/fsp.

What does legislation require?

Although Councils are not explicitly required to adopt targets for financial performance, amendments introduced to the Local Government Act in 2005 require a Council, when preparing and adopting its strategic management plans, to *“state the measures (financial and non-financial) that are to be used to monitor and assess the performance of the Council over the relevant period”* (refer Section 122 (1) (d)).

In helping Councils to meet this requirement the SA Local Government sector has established sector-wide indicators as described in Information Paper 9. The formal adoption by Councils of targets or target ranges for these indicators will enhance their accountability by enabling interested stakeholders to evaluate the level or nature of these targets and Councils' financial performance as measured by the indicators in the context of the targets and hence to ascertain the financial sustainability implications of past, current and projected financial performance.

Targets for SA Local Government Financial Indicators

The Financial Sustainability Inquiry recommended the adoption by the Local Government sector of a standard set of financial indicators. The seven indicators discussed below have been developed specifically to focus attention on factors that the Inquiry identified as key to securing a Council's long-term financial security. They are supported by the SA Local Government Financial Management Group and the LGA Financial Sustainability Advisory Committee and are intended to be recommended for adoption by the Local Government sector at the April 2007 LGA General Meeting. A summary description of the seven indicators is included at Attachment 1 to this paper however they are discussed in more detail in LGA Financial Sustainability Information Paper No 9. That paper, while including data on a hypothetical Council's and the overall SA Local Government sector's performance against the indicators, did not include consideration of what would constitute appropriate performance targets for them. This is discussed below.

<p>Indicator 1: Operating Surplus</p> <p>(the difference between day to day income and expenses for the period)</p>	<p>Proposed Target</p> <p>To achieve an operating breakeven position, or better, over any five year period.</p>
<p>Rationale</p> <p>The setting of a lower target would be hard to justify. An operating deficit may be appropriate in the short-term if a Council's community is widely and significantly adversely affected by economic conditions. As a long-term target an operating deficit could only be justified if the Council and its community had worked out, and accepted, where this course would lead them. That is, that the Council's stock of assets, net of liabilities, would progressively decline in value and that the Council may be unable to fund required rehabilitation or replacement in future without substantial rises in rates. This would not normally be acceptable but may be, for example, in cases where there has been very significant demographic or service preference change over time and assets are not intended to be replaced at the end of their economic life.</p> <p>Should a Council wish to target a very large operating surplus it needs to be equally clear about, and articulate, its reasons for doing so. This course of action will mean that the Council is setting rates and/or other fees and charges at levels well in excess of recorded costs and this has negative implications for its community in terms of intergenerational equity. There may nevertheless be compelling reasons for such a strategy. For example the Council may have run significant operating deficits in the past and have impending major asset replacement needs in excess of a prudent borrowing level. The Council may wish to build up financial assets or reduce existing liabilities to help it, in the future, fund this impending need.</p>	

<p>Indicator 2: Operating Surplus Ratio</p> <p>(the percentage by which the major controllable income source varies from day to day expenses)</p>	<p>Proposed Target</p> <p>To achieve an operating surplus ratio of between 0% and 15% over any five year period.</p>
<p>Rationale</p> <p>Should a Council wish to set a target above or below this range it should be mindful of comments appearing above in relation to Indicator 1.</p> <p>The setting of appropriate target ranges for the operating surplus and operating surplus ratio are the most important financial decisions a Council must make. It is essential that the elected Council and staff involved in making this decision are provided with sufficient information and training to fully understand all relevant issues and implications. If a Council consistently achieves modest operating surpluses and has soundly based projections showing that it can continue to do so in future, having regard to asset management and its community's service level needs, then it is financially sustainable. Favourable trend results measured against the other financial indicators described below will assist but not in themselves ensure that a Council operates sustainably.</p>	

<p>Indicator 3: Net Financial Liabilities</p> <p>(money owed to others less money held, invested or owed to Council)</p>	<p>Proposed Target</p> <p>Council's level of net financial liabilities is no greater than its annual operating revenue and not less than zero.</p>
<p>Rationale</p> <p>There is no right or wrong target level of net financial liabilities or of debt specifically. The range determined by a Council could be narrower or broader than that suggested above. Different Councils could appropriately have very different target ranges and each be equally responsible and financially sustainable depending on their circumstances. A target range should be set by a Council having regard to the target for its operating surplus ratio and needs identified in its Strategic, Long-term Financial and Infrastructure and Asset Management Plans.</p>	

<p>Indicator 4: Net Financial Liabilities Ratio</p> <p>(the significance of the net amount owed compared with income received)</p>	<p>Proposed Target</p> <p>Net financial liabilities ratio is greater than zero but less than 100% of total operating revenue.</p>
<p>Rationale</p> <p>The target for net financial liabilities should be normally greater than zero. If not then it is likely to imply that a Council is willing to place a higher priority on accumulating financial assets than applying funds generated from ratepayers to the provision of services and/or infrastructure renewal.</p> <p>It is suggested that in normal circumstances the target ceiling for net financial liabilities be generally no more than 100% of operating revenue to ensure the ratio remains within conventionally acceptable limits. A Council may choose to vary this maximum limit given its particular circumstances and risk profile and taking into account its Strategic, Long-term Financial and Infrastructure and Asset Management Plans. For example while the target should effectively provide a guide to influence revenue and expenditure decisions and a constraint on borrowing, it does make sense to borrow to fund the replacement of an asset at the end of its 'economic life' where funds are not available from other sources.</p> <p>Where a Council has not yet fully researched its likely medium to longer-term asset rehabilitation and replacement needs it may be appropriate to set a more modest ceiling until this information is available and its funding implications assessed.</p> <p>The breadth of the suggested range highlights the considerable discretion associated with sound management of net financial liabilities. 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.</p>	

<p>Indicator 5: Interest Cover Ratio</p> <p>(the level of income used to pay interest on loans)</p>	<p>Proposed Target</p> <p>Net interest is greater than 0% and less than 10% of operating revenue.</p>
<p>Rationale</p> <p>The above suggested target is considered a reasonable limit in most circumstances to ensure net interest costs can be met comfortably by operating revenues. A Council may choose to set different limits having regard to the factors discussed under Indicators 3 and 4 above.</p>	

<p>Indicator 6: Asset Sustainability Ratio</p> <p>(the extent to which assets are being replaced at the rate they are wearing out)</p>	<p>Proposed Target</p> <p>Option 1: Capital outlays on renewing/replacing assets net of proceeds from sale of replaced assets is greater than 90% but less than 110% of depreciation over a rolling 3 year period.</p> <p>Option 2: Capital outlays on renewing/replacing assets net of proceeds from sale of replaced assets is greater than 90% but less than 110% of the level proposed in the Infrastructure and Asset Management Plan (I&AMP) over a rolling 3 year period.</p>
<p>Rationale</p> <p>The achievement of the Option 1 target would mean that a Council is reasonably preserving the value of its stock of existing assets because renewal or replacement activity approximately matches the recorded consumption of its asset stock for the period. The achievement of the Option 2 target would mean that a Council is reasonably optimising the timing of renewal/replacement of its asset stock.</p> <p>If the Option 1 target is not achieved reasons for this should be investigated. It may be that a Council's asset replacement activity is not consistent with its I&AMP (which aims to optimise its financial sustainability). On the other hand it might be that a Council is spending an appropriate amount of funds on asset rehabilitation/replacement (in accordance with its I&AMP) to optimise financial sustainability even though this level of spending is not currently consistent with recorded depreciation levels. Which of these possibilities is the correct explanation is likely to be able to be ascertained from reference to asset replacement needs identified in the I&AMP.</p> <p>Failure to achieve the Option 2 target will almost certainly mean that a Council is not optimising its financial sustainability unless it has determined its asset renewal/replacement outlays for the period on more accurate and up-to-date technical data than on which the I&AMP was based.</p> <p>Where a Council is satisfied as to the rigour of its I&AMP it should adopt the Option 2 target over the Option 1 alternative. It should nevertheless still monitor and report performance using the Option 1 indicator and be in a position to explain its score and the implications thereof.</p>	

<p>Indicator 7: Asset Consumption Ratio</p> <p>(the average proportion of 'as new condition' left in assets)</p>	<p>Proposed Target</p> <p>The average proportion of 'as new condition' left in assets is greater than 40% and less than 80%.</p>
<p>Rationale</p> <p>A Council could theoretically be operating sustainably with sound financial and asset management performance and have an asset consumption ratio outside of the above suggested target range due to the age mix of its assets. This however is likely to be the exception rather than the rule.</p> <p>If a Council had an asset consumption ratio lower than 40% it indicates that, on average, its overall asset stock is relatively aged. It would need to pay particular attention to asset management and replacement issues and ensure future needs have been carefully assessed and are reflected in its I&AMP. A ratio higher than 80% would signal that its overall asset stock is relatively new and therefore probably requires modest maintenance and little replacement. In such circumstances it is important that a Council still operate sustainably and avoid the temptation to acquire additional assets or raise service standards just because it has a strong positive net cashflow. It needs to aim to continually reduce its net financial liabilities ratio to position itself to accommodate funding much higher asset replacement needs in future (it may be appropriate for its net financial liabilities ratio to be, or become, negative in these circumstances).</p> <p>As the ratio changes a Council should be confident that its asset management strategies are addressing renewal/replacement needs in a timely manner. This will ensure that there are no negative impacts on its ongoing financial sustainability and that its stock of assets will be able to continue to meet its community's service provision needs.</p>	

What are the issues for Councils?

Every Council should develop targets or review existing ones for the proposed sector-wide financial indicators discussed in this paper to guide future decision-making. Councils should publish information about their performance against these targets in the interests of greater accountability to their communities.

A Council's Long-term Financial Plan also should highlight projected performance against its financial targets and if necessary the plan should be revised to ensure achievement of the targets over an appropriate period. The annual budget also should disclose the Council's projected performance against its financial targets.

If Councils choose targets other than those suggested in this paper for their Operating Surplus and Operating Surplus Ratios then they need to understand the likely implications for ongoing financial sustainability of their decisions and make explicit their rationale. The same applies for a different Asset Sustainability Ratio target based on a Council's I& (i.e. Option 2) than recommended above.

For the other indicators discussed in this paper there is more discretion in choosing targets, given that the impact on financial sustainability will vary depending on each Council's circumstances. A Council needs to consider this and other local factors when determining appropriate targets for these indicators.

Each Council also needs to consider whether any of its policies warrant subsequent revision (e.g. rating, service levels and debt management) to support achievement of its financial targets.

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Attachment 1: Summary Description of the Recommended Financial Indicators

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.

A Council's long-term financial sustainability is dependant upon ensuring that, on average over time, its expenses are less than revenues. If a Council is not generating an operating surplus in most periods then it is unlikely to be operating sustainably. The longer this occurs the more severe will be the future consequences. This is most likely to come to a head when existing major assets fail. The Council would then need to choose between the unpalatable options of large rate rises, not replacing assets or making other potentially disruptive service cuts and effectively providing its community with a lower standard of service.

Indicator 2: Operating Surplus Ratio

(by what percentage does the major controllable income source vary from day to day expenses)

The operating surplus (deficit), expressed as a percentage of general and other rates net of rebates and excluding revenue from the NRM levy, is the Operating Surplus Ratio.

Indicator 3: Net Financial Liabilities

(what is owed to others less (net of) money you already have or is owed to you)

Net financial liabilities equals total liabilities less financial assets.

A Council's indebtedness should be managed to ensure that its liabilities and associated costs can be met without the prospect of disruptive service cuts and/or excessive rate increases (ie without impinging on its financial sustainability). For a more detailed discussion of debt related matters, refer to LGA *Financial Sustainability Information Paper 10: 'Debt Management'*.

Indicator 4: Net Financial Liabilities Ratio

(how significant is the net amount owed compared with income)

This ratio indicates the extent to which net financial liabilities of a Council can be met by its operating revenue.

As per Indicator 3 above there is no optimal single number or even narrow range for this indicator. It very much depends on a Council's current and projected future circumstances and aspirations. 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.

Indicator 5: Interest Cover Ratio

(how much income is used in paying interest on loans)

This ratio indicates the extent to which a Council's operating revenues are committed to meet net 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

(are assets being replaced at the rate they are wearing out)

This ratio can be measured in two ways. The first indicates whether a Council is renewing or replacing existing non-financial assets at the same rate as its overall stock of assets is wearing out. It is calculated by measuring capital expenditure on renewal or replacement of assets relative to the recorded rate of depreciation of assets for the same period.

Where a Council already has a soundly based Infrastructure & Asset Management Plan (I&) a more meaningful asset sustainability ratio would be calculated by measuring the actual level of capital expenditure on renewal and replacement (or proposed in the Budget or Long-term Financial Plan) with the optimal level identified in the I&.

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.

It highlights the aged condition of a Council's stock of physical assets and the potential magnitude of capital outlays required in future to preserve their service potential. If a Council is responsibly maintaining, renewing and replacing its assets in accordance with a well prepared I&, then the fact that its ratio may be relatively low and/or declining should not be a cause for concern - providing it is operating sustainably.

If a Council has been operating sustainably over the longer term and has not invested excessively in additional (or in enhancements to its existing) depreciable assets then it is likely that its financial assets will have grown in value to offset the decline in value of its physical assets. These financial assets can be used to fund replacement of the aged assets when it is optimal to do so.

Attachment 2: Glossary of Accounting Terms Used in this Paper in the Context of the Recommended Financial Indicators

Depreciable Assets are non-current assets having a limited useful life.

Financial Assets include cash, investments, loans to community groups, receivables and prepayments. Equity held in a Council business normally is regarded as a financial asset but is excluded for the purpose of calculating indicators based on financial assets in this paper. Also, inventories and land held for resale are not regarded as financial assets.

Financial Sustainability is where planned long-term service and infrastructure levels and standards are met without unplanned and disruptive increases in rates or cuts to services.

Net Financial Liabilities equals total liabilities less financial assets, where financial assets for this purpose includes cash, investments, loans to community groups, receivables and prepayments, but excludes equity held in Council businesses, inventories and land held for resale.

Net Interest Expenses equals interest expenses less investment income.

Non-financial or Physical Assets means infrastructure, land, buildings, plant, equipment, furniture and fittings, library books and inventories.

Operating Deficit is where operating revenues less operating expenses is negative and operating income is therefore not sufficient to cover all operating expenses.

Operating Expenses are operating expenses including depreciation but excluding losses on disposal or revaluation of non-financial assets.

Operating Revenues are operating revenues shown in the Income Statement but exclude profit on disposal of non-financial assets and amounts received specifically for new/upgraded infrastructure and other assets, e.g. from a developer. For ratios calculated where the denominator specified is total operating revenue, Natural Resource Management (NRM) levy revenue is excluded. For the purpose of calculating the **Interest Cover Ratio** investment income also is excluded from the denominator.

Operating Surplus is where operating revenues less operating expenses is positive and operating revenue is therefore sufficient to cover all operating expenses.

Rates Revenue is general and other rates net of the impact of rate rebates and excluding revenue from the NRM levy.