

*Financial Sustainability*  
**Information Paper 9**  
**Financial Indicators**

Revised May 2015



## 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: [www.lga.sa.gov.au/FSP](http://www.lga.sa.gov.au/FSP).

The entire series of Papers was revised in early 2012, and again in early 2015 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.

This Information Paper combines what were originally published as two separate Information Papers:

- No 9 – *Local Government Financial Indicators*; and
- No 12 – *Targets for Local Government Financial Indicators*.

The previous Information Paper No. 12 was discontinued in 2012 and its contents were merged into this Information Paper.

## Financial Indicators – background

Financial statements, prepared under Australian Accounting Standards, contain a wealth of information. Unfortunately their detail and format often mean it is hard for people without specific training (like accountants and auditors) to readily ascertain an entity's financial health and performance from this data. As a consequence, financial indicators and associated targets have been developed both in the public and private sectors to assist organisations and others who are interested in an entity's financial performance, to understand the messages that its financial statements contain.

For example, the South Australian Government sets targets for its key financial indicators to guide revenue and expenditure decisions and overall budget strategies. Corporate boards in both the public and private sectors do the same. Many of these people are not finance experts but they can readily ascertain the financial health of their organisations and the impact of decisions under consideration by reference to simple financial indicators.

The 2005 [Independent Inquiry into the Financial Sustainability of Local Government](#) recommended greater use of financial indicators by Councils. This prompted considerable work, much led by the [SA Local Government Financial Management Group](#) (SALGFMG) to develop and subsequently review a set of standardised financial indicators applicable to all Councils. More recently, with encouragement by the [Australian Centre of Excellence for Local Government](#) (ACELG), all jurisdictions in Australia have agreed, in principle, to adopt three nationally consistent financial indicators.

Going forward, the LGA is confident that the three indicators described in this paper will be agreed by all jurisdictions. The only change required for South Australian Councils is the existing denominator of the operating surplus ratio.

This paper promotes an approach whereby each Council would determine locally appropriate targets or target ranges for each indicator. Reporting actual results against targets helps the public assess the degree of accomplishment of a Council's objectives. If reported alone, indicators do not provide a basis or context for assessing performance.

The use of these financial indicators and associated targets determined by a Council are intended to act like a road map to assist Council Members and senior staff to steer their Council's financial performance and sustainability (and to enable the public to judge their success).

### **What does legislation require?**

The [Local Government \(Financial Management\) Regulations 2011](#) require a Council to use three specific indicators:

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

in the Council's:

- long-term financial plan;<sup>1</sup>
- annual budget;<sup>2</sup>
- mid-year review of the annual budget.<sup>3</sup>; and
- report on annual financial results<sup>4</sup>

[The Regulations](#) also require a Council's long-term financial plan to include target ranges adopted by the Council for each indicator.<sup>5</sup>

In these documents, Councils effectively are required to evaluate past performance and project the future impact of strategies under consideration against financial indicators.

Section 122(1)(d) of [the Local Government Act 1999](#) (the Act) requires 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*".

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<sup>1</sup> [Local Government \(Financial Management\) Regulations 2011](#) Regulation 5(1)(c)

<sup>2</sup> [Local Government \(Financial Management\) Regulations 2011](#) Regulation 7(d)

<sup>3</sup> [Local Government \(Financial Management\) Regulations 2011](#) Regulation 9(2)

<sup>4</sup> [Local Government \(Financial Management\) Regulations 2011](#) Regulation 10 (2)

<sup>5</sup> [Local Government \(Financial Management\) Regulations 2011](#) Regulation 5(1)(c)

## SA Local Government Financial Indicators

Most Councils have used and reported on various financial indicators over many years but until the 2005 [Independent Inquiry Into Local Government Financial Sustainability](#) ("the Inquiry") no consistent approach had evolved. Some commonly used indicators were developed during the cash accounting<sup>6</sup> era, or have been drawn from what is used in the corporate sector, and are less relevant in an accrual accounting<sup>7</sup> and Local Government environment. Councils have often also used a large number of indicators and the myriad of data generated has not necessarily helped to clarify focus on key issues concerning their financial performance and position.

The LGA's [General Meeting in 2007](#) endorsed the sector-wide use of a consistent set of seven financial indicators, which many Councils then adopted. Several years later, informed by a comprehensive review by the SALGFMG, it was agreed to focus on only three key financial indicators. Reporting on a smaller rather than a larger number of indicators helps decision-makers and stakeholders more readily focus on and comprehend key outcomes and implications.

Although the indicators provide a robust ready assessment of financial performance and sustainability, they need to be interpreted in the context of a Council's operating environment. They do not replace the need for sound judgement. It is particularly important to consider trend data, both historic and that projected from a Council's long-term financial plan in decision-making and in reviewing financial performance. Looking at one year's data or in movements between two or even three years in isolation could lead to misleading conclusions.

For each of its Annual General Meetings, the LGA assembles an update report providing the latest values, history and comparisons of the three indicators for the Local Government sector as a whole.<sup>8</sup>

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<sup>6</sup> Cash accounting recognises events as having occurred only when payments are made or received.

<sup>7</sup> Accrual accounting recognises revenues when they are earned and expenses as they are incurred.

<sup>8</sup> See, for example, the latest *Financial Indicators report* available at <http://www.lga.sa.gov.au/FSP>

## **Indicator 1: Operating Surplus Ratio** **(By what percentage does the operating income vary from operating expenses?)**

An operating surplus (or deficit) arises when operating income exceeds (or 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 income. In essence this requires current day citizens to fully meet the cost of services provided for them by their Council.

If a Council is not generating an operating surplus in most periods, then it is unlikely to be operating sustainably. It means that the cost of services provided to the community exceeds income generated. The change of an operating deficit into a operating surplus can occur only by ensuring in future that income is increasing and/or that expenses are reduced (at least relative to income increases, either by reducing service levels or improving productivity).

If a Council was operating with a significant deficit over several years and its strategic management and long-term financial plans did not provide clear proposals for this to be turned around then it would be inevitable that the Council would face major financial shocks in the future. The Council effectively would be in the same position as an individual or family living beyond their means. Sooner or later they would be caught by the consequences. For a Council the problem would likely come to a head when existing major assets failed. The Council would then need to choose between large rate rises or not replacing assets thereby effectively lowering its standards of service to its community.

The **operating surplus ratio** is the operating surplus (deficit) expressed as a percentage of operating income.

A positive ratio indicates the percentage of operating income 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.

A negative ratio indicates the percentage increase in operating income or the approximate decrease in operating expenses required to achieve a break-even operating result.

When preparing budgets, budget reviews and long-term financial plans, some Councils may choose to calculate an operating surplus ratio over a rolling three or five year period, in addition to showing the ratio calculated on the standard annual basis. For annual financial statements, as a minimum, data for the reporting year would be reported. This would at least ensure consistency among all Councils and enable the LGA to continue to publish annual sector-wide information on financial indicators.

This indicator is by far the most important financial indicator for Councils. If a Council consistently achieves a modest positive operating surplus ratio, 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.

**Generally suggested target range for Indicator 1: Operating Surplus Ratio:**  
To achieve, on average over time, an operating surplus ratio of between 0% and 10%

## Rationale

The setting of a lower target would be hard to justify. A negative operating surplus ratio target (i.e. where a Council is incurring an operating deficit) might be appropriate in the short-term to cater for fluctuations that occur in the normal course of business in the timing of substantial income and/or expenses or if a Council's community was widely and significantly adversely affected by economic conditions. Similarly an annually diminishing negative operating surplus ratio target might be an appropriate 'roadmap' to progressively achieve financial sustainability for a Council that had previously incurred large operating deficits.

Targeting a negative operating surplus ratio over a long-term could be justified only 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 would increasingly over time be unable to fund required rehabilitation or replacement of assets. 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 some assets are not intended to be replaced at the end of their economic life.

Should a Council wish to target a very large operating surplus ratio it needs to be equally clear about, and articulate, its reasons for doing so. This course of action would mean that the Council would be setting rates and/or other fees and charges at levels well in excess of its operating expenses. Accordingly, careful consideration needs to be given to the impact of large operating surpluses on 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 might wish to build up financial assets or reduce existing liabilities to help it, in the future, finance this impending need. Another example may be that a Council expects relatively consistent capital expenditure on new and upgraded assets over an extended period and has decided that it is appropriate to finance some of that capital expenditure from operating surpluses.

The setting of an appropriate target range for the operating surplus ratio is the most important financial decision that 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.

Like targets determined locally for other indicators described in this paper, a Council should set targets, or preferably target ranges, for its operating surplus ratio for each year of its long-term financial plan.

Again at their option, some Councils may also prefer to establish targets for this ratio in their budgets and long-term financial plans over a rolling three or five year period.

**Indicator 2: Net Financial Liabilities Ratio**  
**(How significant is the net amount owed to others, compared with operating income?)**

Net financial liabilities equals total liabilities less financial assets (excluding equity accounted investments in Council businesses).

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. It would make no sense for individuals, in assessing their financial positions, to look at one pile of bills and ignore others and disregard how much money they have in the bank. The same holds true for Councils.<sup>9</sup>

Net financial liabilities is a broader and more appropriate measure of indebtedness than the level of borrowings, because it includes items such as employee long-service leave entitlements and other amounts payable in future as well as taking account of a Council's cash holdings and invested monies.

Before considering an increase in its indebtedness, a Council needs to recognise that interest associated with borrowings will impact negatively on its operating result. However Councils with significant asset rehabilitation and replacement backlogs may find that their financial sustainability is improved if they raise borrowings to finance the works needed to address these backlogs. I.e. if the operational savings achieved from addressing these backlogs exceed the additional interest costs resulting from the borrowings raised, financial sustainability would be improved. For example, it may be a financially better option for a Council to borrow money to undertake the reseal of a deteriorating road sooner than originally planned and thus avoid having to fully reconstruct the road within a few years at a cost two or three times the cost of the timely reseal.

The **net financial liabilities ratio** is calculated by expressing net financial liabilities at the end of a financial year as a percentage of operating income for the year. If the ratio falls, over time, this indicates that the Council's capacity to meet its financial obligations from operating income is strengthening.

An increase in the net financial liabilities ratio will sometimes mean that a Council is incurring higher operating expenses (e.g. as a result of additional maintenance and depreciation costs associated with purchasing new assets). This will detract from the Council's overall operating result. Nevertheless a Council with a healthy operating surplus could quite appropriately decide to allow its net financial liabilities ratio to increase in order to provide additional services to its community through acquisition of additional assets without detracting from its financial sustainability.

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.

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<sup>9</sup> For more detailed discussion of this issue and other debt related matters highlighted elsewhere in this paper, refer to the LGA Financial Sustainability Information Paper No. 10 - *Debt* at [www.lga.sa.gov.au/FSP](http://www.lga.sa.gov.au/FSP)

**Generally suggested target range for Indicator 2: Net Financial Liabilities Ratio:**  
Net financial liabilities ratio is between zero and 100% of total operating income, but possibly higher in some circumstances.

## Rationale

There is no right or wrong target range for the net financial liabilities ratio. Different Councils (or the same Council at different points of time in its long-term financial plan) could appropriately have very different target ranges and each could be equally responsible and financially sustainable, depending upon their circumstances. A target range should be set by a Council having regard to the target for its operating surplus ratio and the needs that are identified in its long-term financial plan and its infrastructure and asset management plan.

The target ratio should normally be (especially over the medium to longer-term) greater than zero. If not, that is likely to imply that a Council places a higher priority on accumulating financial assets than applying funds generated from ratepayers to the provision of services including infrastructure renewal.

It is suggested that in normal circumstances the target ceiling for a net financial liabilities ratio be generally no more than 100% of operating income to ensure the ratio remains within conventionally prudent limits. However, a well-managed Council committed to sound financial strategies (particularly during a time of significant development) could comfortably allow a higher net financial liabilities ratio. Also, while any target ratio should effectively provide a guide to influence income and expenditure decisions and to constrain borrowing, it would make sense to borrow to fund the replacement of an asset at the end of its 'economic life' if funds were not available from other sources (and assuming that existing service levels were considered affordable).

All other things being equal, a Council that provides Community Wastewater Management System (CWMS) services is likely to need to have a higher level of net financial liabilities, as a result of financing needs associated with CWMS asset provision, relative to a Council that does not provide such services. This should not cause concern, because a CWMS has a separate associated income stream and associated rates or charges should be based on recovering full costs. A Council with a CWMS could choose to also establish a net financial liabilities ratio target exclusive of operating income and net financial liabilities associated with CWMS activity and report its performance against same.

If 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.

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.



**Indicator 3: Asset Sustainability Ratio<sup>10</sup>**  
**(Are assets being renewed and replaced in an optimal way?)**

This ratio indicates the extent to which existing non-financial assets are being renewed and replaced, compared with the asset renewal and replacement expenditure identified as warranted in a Council's infrastructure and asset management plan (I&AMP). It is calculated by measuring capital expenditure on renewal or replacement of assets for a period, divided by the optimal level of such expenditure proposed in a Council's I&AMP.

At their option, some Councils may choose to calculate their asset sustainability ratio in budgets, budget reviews and long-term financial plans over a rolling three or five year period, in addition to showing the ratio calculated on the standard basis. For annual financial statements, at a minimum, data for the reporting year would be reported. This would at least ensure consistency among all Councils and enable the LGA to continue to publish annual sector-wide information on financial indicators.

If capital expenditure on renewing or replacing existing assets is at a level consistent with proposed in a soundly prepared I&AMP that is based on long-run affordable service levels, then it is likely that a Council is reasonably optimising timing of asset renewal activity. Any material underspending on renewal and replacement over the medium term is likely to adversely impact on the cost-effective achievement of preferred, affordable service levels and could potentially progressively undermine a Council's financial sustainability. For example, additional maintenance costs associated with assets that have exceeded their economic life might be higher than costs that would be associated with renewal or replacement. Eventually a Council will be confronted with failed assets, and potentially significant renewal and replacement expenditure needs that cannot be accommodated without sudden large rate increases.

**Suggested target for Indicator 3: Asset Sustainability Ratio**

Capital outlays on renewing/replacing assets are greater than 90% but less than 110% of the level proposed in the Infrastructure and Asset Management Plan (I&AMP).

**Rationale**

Achievement of the suggested target would mean that a Council was reasonably optimising the timing of capital outlays on the renewal/replacement of assets (for its specified and preferred level of service from assets).

Failure to achieve the target would most likely mean that a Council was not optimising its financial sustainability and in order to do so may need to consider revising service levels.

Again at their option, some Councils may prefer to establish targets for this ratio in their budgets and long-term financial plans over a rolling three or five year period, in addition to showing targets on the standard basis.

<sup>10</sup> As part of the ACELG initiative to encourage three nationally consistent financial indicators, the name of the 'Asset Sustainability Ratio' might change in the future to 'Asset Renewal Funding Ratio'. Any such change would need to be reflected in a corresponding change to [the Regulations](#).

## What are the issues for Councils?

Councils should review their past practices in relation to the use of financial indicators. All Councils are encouraged to use the financial indicators recommended in this paper to guide future decision-making.

Every Council also should consider setting target ranges for aspired performance against these indicators and consider whether any of its policies warrant subsequent revision (e.g. policies on rating, and service levels<sup>11</sup>).

A Council's long-term financial plan should highlight projected performance using these indicators and include targets for each year of the plan. Where targeted performance is not being achieved, the plan should be restructured with incremental targets set based on a strategy of progressive improvement and achievement of appropriate ongoing targets by a reasonable point in time in future. The annual budget also should disclose projected performance using these financial indicators and associated targets established by the Council.

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<sup>11</sup> See LGA Financial Sustainability Information Paper No. 26: - *Service Ranges and Levels* at [www.lga.sa.gov.au/FSP](http://www.lga.sa.gov.au/FSP).