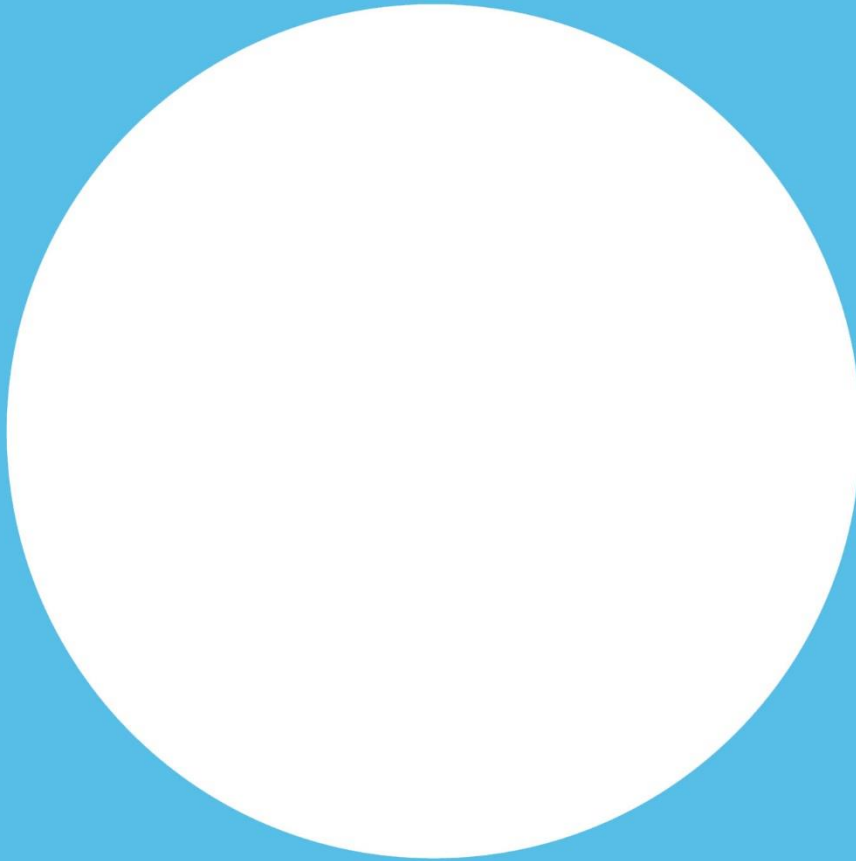


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Financial Indicators

Financial Sustainability Information Paper
(FSIP) No. 9

November 2024

Contents

About the LGA	2
Acknowledgement	2
1. Introduction.....	3
2. Background.....	3
2.1. What does legislation require?.....	4
3. SA Local Government Financial Indicators.....	5
3.1. What are the issues for councils?	5
3.2. Adjusted Ratios.....	6
Indicator 1: Operating Surplus Ratio.....	7
Rationale	8
Indicator 2: Net Financial liabilities Ratio	10
Rationale	11
Indicator 3: Asset Renewal Funding Ratio	13
Rationale	14

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About the LGA

At LGA South Australia, we're all about community.

Member-based and non-for-profit, our purpose is to help local government build stronger communities.

We do this in many ways. For one, we lead advocacy and discussions with state and federal government decision-makers and key stakeholders. We make sure the issues affecting members and local communities are heard, loud and clear.

We also help local government be at the top of their game. We provide training and networking opportunities, secure funds for local projects and work hard to reduce risk and save them money.

At the heart of it all, it's about our members and South Australian communities. Because we know if our local governments are thriving, then our communities are, too.

Learn more about LGA South Australia: lga.sa.gov.au

Acknowledgement

Development of this paper (historical and current versions) has benefited from contributions from the South Australian Local Government Financial Management Group (SALGFMG) and funding from the Local Government Research and Development Scheme.

1. 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. A complete list of the Financial Sustainability Information Papers (FSIP), including a glossary of terms and abbreviations, is provided at: [Financial Sustainability Resources | LGA South Australia](#).

The FSIP have undergone various revisions to take account of legislative changes and other developments. The FSIP are addressed to, and written primarily for, the benefit of council Members and staff.

This paper was last reviewed in November 2024.

2. Background

Financial statements, prepared under Australian Accounting Standards, contain a wealth of information. 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 those statements. 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 the people who rely on this financial information 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 Government¹ ('the Inquiry') 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 South Australian councils.

This paper promotes an approach whereby each Council would suggest target ranges for adoption by councils. There is discretion for each council to determine locally appropriate

¹ Refer to Rising to the Challenge: Towards Financially Sustainable Local Government in South Australia available via [Financial Sustainability Information Papers | LGA South Australia](#)

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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).

As part of its formal functions under section 126 of the Local Government Act, the council Audit and Risk Committee can be used to provide advice regarding trends in the financial sustainability indicators over time, including in relation to the setting of appropriate target ranges.

Amendments to the Local Government Act arising from the passage of the *Statutes Amendment (Local Government Review) Act 2021*, in particular changes relating to section 122 – Strategic Management Plans², has seen the introduction of the Strategic Management Plan (SMP) Advice Scheme which, establishes a 'designated authority', currently the Essential Services Commission of SA (ESCOSA), to review and provide 'advice' on the effectiveness and robustness of councils' strategic management planning processes and financial sustainability.

As part of their deliberations, ESCOSA will consider what the financial indicator results are suggesting about the long-term financial sustainability of a council and whether the council has a plan to maintain and/or improve the result (i.e., if council is operating outside of suggested or adopted target ranges what is the plan over time to bring the results back within the target ranges).

2.1. What does legislation require?

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

- operating surplus ratio;
- net financial liabilities ratio; and
- asset renewal funding ratio.

The financial indicators must be reflected in the council's:

- long-term financial plan (LTFP) (estimates and adopted target ranges to be included for each year)³;
- annual budget⁴;

² [Local Government Act 1999](#), s. 122(1c) to (1k), (9)

³ [Local Government \(Financial Management\) Regulations 2011](#) (SA), r. 5(1)(c)

⁴ [Local Government \(Financial Management\) Regulations 2011](#) (SA), r. 7(d)

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- mid-year review of the annual budget⁵; and
- report on annual financial results⁶.

In these documents, councils are effectively required to evaluate past and current performance and project the future impact of strategies under consideration on the financial indicators. Best practice would suggest that for any budget reviews the three ratios would also be updated and reported.

The Local Government Act requires a council to state the measures (financial and non-financial) that are to be used to monitor and/or assess⁷ the performance of the council over the relevant period, when preparing and adopting relevant plans (i.e., strategic management plans and annual business plan).

Section 122(4a)(a) of the Local Government sets out the requirements for the review of council long term financial plan/strategic management plans. When conducting such a review, council must consider a report from the chief executive officer (CEO) on the sustainability of the council's LTFP performance and position, which best practice suggests would include performance against the financial indicators.

3. SA Local Government Financial Indicators

Although the indicators provide an overall 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 historical and projected from a council's long-term financial plan in decision-making and when reviewing financial performance. Looking at one year's data or 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.⁸

3.1. What are the issues for councils?

All councils are required to use the financial indicators referenced in this paper to guide future decision-making.

⁵ [Local Government \(Financial Management\) Regulations 2011](#) (SA), r. 9(2)

⁶ [Local Government \(Financial Management\) Regulations 2011](#) (SA), r. 10(2)

⁷ [Local Government Act 1999](#) (SA), s. 122(1)(d) refers to 'monitor and assess'. [Local Government Act 1999](#) (SA), s. 123(2)(iii) refers to 'assess'.

⁸ See, for example, the latest [Financial Indicators report](#)

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Every council should set 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 levels⁹).

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 documented strategy of progressive improvement to achieve financial sustainability within a realistic time frame. The annual budget should also disclose projected performance using these financial indicators and associated targets established by the council.

3.2. Adjusted Ratios

From time to time, financial performance may be materially distorted by events, particularly timing differences on the revenue side, which can convey a false impression of the sustainability of Council's underlying operations.

A prime example is the prepayment of Federal Government financial assistance and local roads grants administered by the Local Government Grants Commission, out of future year allocations which has resulted in major distortions of councils' operating results, as these untied grants must be recognised upon receipt. The distortions that this approach creates and the effect on the interpretation of the financial reports should be clearly stated.

Another example is where the Federal Government has given grants to councils to stimulate the economy. Where council has discretion regarding what this money can be spent on, it is recorded as an operating grant, even if it is partly or wholly spent on the construction of assets. The recognition of this grant in this manner can materially distort the operating income.

Consequently, ratios that rely on amounts that contribute to the operating result - e.g., operating revenue and/or operating expenses - will be distorted, and the distortion may be material.

To present a true and fair view of its operations for the financial year, councils must disclose the adjusted operating surplus ratio and adjusted net financial liability ratio which exclude the effects of such distortions so that a more accurate picture of the underlying result of the council is presented.

Adjustments to the relevant ratios should only be made where the nature of the distortion is clearly explained in Note 1 of the Annual Financial Statements or when items are identified in Note 2 or Note 3 as individually significant items.

⁹ See [Financial Sustainability Information Paper](#) No. 26 - Service Ranges and Levels

Further information relating to the adjustments of the operating surplus ratio and the net financial liabilities ratio is provided in the Model Financial Statements.¹⁰

Indicator 1: Operating Surplus Ratio

(By what percentage does the operating income vary from operating expenses?)



Calculated as:

Operating surplus / (deficit)

(as transferred from the Statement of Comprehensive Income)

divided by:

Operating Revenue

(as transferred (Total Operating Income) from the Statement of Comprehensive Income)

Expressed as a percentage (one decimal place).

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 dependent 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 an operating surplus can occur only by ensuring in the future that income is increasing and/or that expenses are reducing (at least relative to income increases, either by reducing service levels or improving efficiency).

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 the level of service to its community.

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

¹⁰ The current edition of the Model Financial Statements is published on [the LGA's Financial Sustainability Resources](#) web page

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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 reducing any possible current debt in the first instance and then by increasing financial assets.

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.

It should be reiterated that a once off distortion such as the prepayment of Federal Government financial assistance, and local roads grants can convey a more favourable operating surplus ratio and this needs to be clearly explained through the use of the adjusted operating surplus ratio.

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, at a minimum, data for the reporting year would be reported. This ensures consistency among all councils and enables the LGA to continue to publish annual sector-wide information on financial indicators.

The Operating Surplus Ratio is by far the most important financial indicator for councils. It is essential that council members 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 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.



Target Range

Generally suggested target range for Indicator 1: Operating Surplus Ratio:

To achieve, on average over time, an operating surplus ratio of **between zero and 10%**.

Rationale

A target range for a positive operating surplus ratio over time shows that the council is ensuring each generation is paying for the services it receives. Consequently, the continual setting of a lower target would be hard to justify and would indicate the community is living beyond its means. A negative operating surplus ratio target (i.e., where a council is incurring

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an operating deficit) might be appropriate in the short-term to cater for fluctuations that occur in the normal course of business, for example 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. However, the focus should always be on ensuring the council works towards a positive operating surplus ratio over the long term and council should be looking for ways to either increase income and/or reduce its costs to achieve that objective.

Any council considering a negative operating surplus ratio target should clearly understand the reasons for, and implications of, this decision for its future ratepayers and should obtain independent professional advice of the financial ramifications of this approach.

A council should also consider the risks of budgeting for a near zero ratio over time. Financial sustainability is about a council's ability to meet planned long-term service and infrastructure levels and standards without unplanned increases in rates or disruptive cuts to services.

A council therefore needs to ensure it has the ability to be able to respond to unknown future impacts such as revaluation of assets, significant costs increase greater than assumptions, such as Consumer Price Index (CPI) and Local Government Price Index (LGPI) projected in its LTFP, without having future rates shock to be able to restore a positive operating surplus.

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 more than its operating expenses and could be considered to be overtaxing its community. 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 may now have impending major asset replacement which it has decided to finance through its operating surplus. Alternatively, past operating deficits may have resulted in levels of debt that require repayment.

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. When setting these targets, it is recommended that councils consider advice received from the Audit and

Risk Committees as they will have the appropriate experience to help support a well informed decision.

Indicator 2: Net Financial liabilities Ratio

(How significant is the net amount owed to others, compared with operating income?)



Calculated as

Total Liabilities (*from Statement of Financial Position*)
(excluding liabilities for equity accounted investments in Council businesses but including
Amounts in Advance and Lease Liabilities)

Less:

Current cash and cash equivalents (*from Statement of Financial Position*)
Current trade & other receivables (*from Statement of Financial Position*)
Current other financial assets (*from Statement of Financial Position*)
Non-current financial assets (*from Statement of Financial Position*)

Equals Net Financial Liabilities

divided by:

Total operating income (*subtotal on the Statement of Comprehensive Income*)

Expressed as a percentage (no decimal places).

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. For example, it would make no sense for individuals, when assessing their financial position, to consider one pile of bills and ignore others and disregard how much money they have in the bank. The same holds true for councils.¹¹

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

The net financial liabilities ratio effectively shows the percentage of a council's operating income that would be required if the council had to repay all its liabilities, including borrowings.

¹¹ See [Financial Sustainability Information Paper No. 10 - Debt](#)

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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.



Target Range

Generally suggested target range for Indicator 2: Net Financial Liabilities Ratio:

Net financial liabilities ratio is **between zero and 100%** of total operating income.

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 the circumstances. A target range should be set by a

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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(s).

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 (cash) 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).

Typically, councils that are experiencing high growth will have the requirement to cater for the increased population and will be investing in the construction of new infrastructure assets. In these circumstances, the council may possibly have a high net financial liabilities ratio of greater than 100% to help fund this expansion. The future growth in the population and rate base giving the council the ability to service the higher level of debt will be a factor in setting the maximum target.

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, compared 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 also choose to 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.

When reporting actual results against the target range, councils are also required to disclose the adjusted net financial liabilities ratio which excludes the effects of abnormal or timing differences of material operating revenue or expenditure, giving a more accurate picture of the actual underlying result of the council.

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. When setting net financial liabilities ratio targets, it is recommended that councils consider advice received from the Audit and Risk Committees as they will have the appropriate experience to help support a well informed decision and long term strategy.

Indicator 3: Asset Renewal Funding Ratio

(Are assets being renewed and replaced in an optimal way?)



Calculated as

Expenditure on renewal/replacement of assets (*Statement of Cash Flows*)

divided by:

Optimal level of such expenditure per Infrastructure & Asset Management Plan(s)

Expressed as a percentage (no decimal places).

The Asset Renewal Funding ratio indicates the extent to which existing non-financial assets (Infrastructure, property, plant and equipment) are being renewed and replaced to ensure council can cost effectively maintain services, compared with the asset renewal and replacement expenditure projections contained in a council's infrastructure and asset management plan (I&). 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&.

At their option, some councils may choose to calculate their asset renewal funding ratio in budgets, budget reviews and LTFPs over a rolling three or five year period, in addition to showing the ratio calculated on the standard financial year basis. A rolling average ratio allows for the impact of projects which are not completed in line with budget expectations due to a number of external influences and variables. For annual financial statements, at a minimum, data for the reporting year would be reported. This provides consistency across the sector and enables the LGA to publish annual sector-wide information on financial indicators.

If capital expenditure on renewing or replacing existing assets is at a level consistent with a soundly prepared I&, 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

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underspending on renewal and replacement over the medium term is likely to adversely impact the cost-effective achievement of preferred, affordable service levels and could 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 may be confronted with failed assets that require significant renewal and replacement expenditure that cannot be accommodated without sudden large rate increases.



Target Range

Suggested target for Indicator 3: Asset Renewal Funding Ratio

Capital outlays on renewing/replacing assets are, on average, **greater than 80% but less than 120% with a rolling average of 100%** of the level proposed in the Infrastructure and Asset Management Plan (I&).

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). It demonstrates a council's commitment to aligning their capital outlays to the funding forecasts in their I&s.

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. Despite a council's best intentions, it is understood that projects are not always completed on time due to a variety of external influences and there are often works in progress at year end. This means that a council can budget expenditure in alignment with its I& but often the actual ratio can be different due to the impact of works in progress. Therefore, practically the target should allow for that timing impact. This is also why a rolling average ratio can be useful. However, the capital works program should, in the first instance, be aligned to the adopted financial forecasts in the I&(s).

As noted previously, 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. When setting Asset renewal funding ratio targets, it is recommended that councils consider advice received from the Audit and Risk Committee as they will have the appropriate experience to help support a well informed decision.

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