Financial Performance

A QUICK REFERENCE GUIDE FOR ELECTED OFFICIALS AND STAFF

AUDAX AT FIDELIS

QUEENSLAND TREASURY CORPORATION

This booklet is a quick reference guide to help you:

- understand the purpose and use of financial ratios reported on in local government, and
- ask the right questions of council staff to ensure you have the information you need to make informed decisions about your council's financial position.

Why is understanding financial ratios important?

As an elected member, you are responsible for the financial performance of your council.

Communities expect their assets to be well looked after, their money to be well managed and their future interests to be protected.

Each year, you and your colleagues will agree on a budget, a corporate plan and other policies that will explain how you intend to collect and spend the money needed to deliver community services and run your council. You should also have a long-term financial forecast—over a minimum of 10 years.

This elected members' guide has been developed to provide you with common sense advice, help explain the financial performance of your council and guide your decision making.

How does your council add up?

The financial performance indicators detailed in this guide will tell you how well your council is traveling compared to benchmark.

Your council is required by law to report on certain financial indicators. It is your role as an elected member to know what to look for. The additional ratios in this handout will give you a more complete picture.

Good financial management requires work. You should regularly assess your council's financial performance and make decisions as required.

The best advice is to set a long-term strategy; such a strategy will guide you and help with consistency in decision making. Rushed decisions are not usually the best decisions—the more information you have, the better.

Key local government performance indicators

Measure	Performance indicator	Calculation and definition	Target benchmark
Assets	Asset sustainability ratio	**Capital expenditure on replacement assets ÷ depreciation expense.** This is an approximation of the extent to which the infrastructure assets managed by council are being replaced as their service potential is used up.	Greater than 90%
Surplus/ profit	Operating surplus ratio	**Operating result as a percentage of operating revenue.** Indicates the extent to which revenues cover operational expenses only or are also available for capital funding. A positive ratio means that the surplus can be used for capital expenditures or debt repayments.	Between 0% and 10%
	Council-controlled revenue ratio	**Net rates, levies and charges and fees and charges/ total operating revenue.** Council's financial flexibility improves the higher the level of its council-controlled revenue. Greater reliance on external funding sources such as operating subsidies, donations and contributions reduces financial flexibility.	Higher the percentage = greater independance & flexibilty to influence future results
Level of debt	Total debt service cover ratio	**(Operating result (excluding capital items) + depreciation and amortisation + gross interest expense)/(gross interest expense + prior year current interest bearing liabilities).** Indicates the ability to repay loan funds. A low cover indicates constrained financial flexibility and limited capacity to manage unforeseen financial shocks.	Greater than 2 times
	Net financial liability ratio	**(Total liabilities – current assets) ÷ operating revenues.** Indicates that net financial debt can be serviced by operating revenues. A ratio greater than zero implies that liabilities exceed current assets.	Not greater than 60%
Liquidity	Cash expense ratio	**Current year's cash ÷ ((operating expenses – depreciation – finance costs) ÷ 12).** Indicates the number of months council can continue paying its immediate expenses without additional cash flows.	Greater than 3 months

Financial statements

What	Balance Sheet
Shows	What you own, what you owe and the community's net worth. It is a snapshot at a point in time of your council's financial position.
Look for	Equity—this is the net worth of your council.

What	Income Statement (Profit & Loss)
Shows	How much you earned and the costs incurred. It shows over a period of time whether your council has made or lost value.
Look for	Profit or (loss)

What	Cash Flow Statement
Shows	Where the cash came from, where the cash went and what is left at the end of the year.
Look for	Changes in cash over time.

Remember: an operating profit or surplus does not always equal an increase in cash.

Asset sustainability ratio

Statutory ratio

This ratio helps to show whether your council is replacing assets as their service potential is used up. Some assets are absolutely essential—think roads, bridges, water treatment facilities. Your community needs to continue to have access to these assets—the asset sustainability ratio helps to identify whether your council will be able to continue to provide these services to your community.

FORMULA

$$\frac{\text{Capital expenditure on replacement of assets}}{\text{Depreciation expense}}$$

EXAMPLE

$$\frac{\text{Only replacing \$50 worth of assets}}{\text{Using up \$100 worth of assets}} = 50\%$$

IN OTHER WORDS

$$\frac{\text{Money spent on renewing assets}}{\text{The decline in value of using the assets}}$$

TARGET

A percentage greater than 90%

Caution: If your ratio averages less than 90% over time, your council is at risk of not being able to continue to provide services.

Drivers: To maintain service quality for your community, key assets need to be replaced.

Sensible actions	Questionable actions
Maintain a good asset maintenance plan	Delay replacing deteriorating assets
Stick to your plan	Increase the asset life by artificial means
Analyse variances by comparing actuals to budget	Acquire low-cost or poor-quality replacements
Be smart in the acquisition of assets	Don’t have a quality asset management plan
Be prudent and recognise business needs	Major delays in maintenance OR not replacing deteriorating assets
Adhere to the agreed asset management plan	Disregard whole-of-life costs in the business case or no business case produced

Operating surplus ratio

Statutory ratio

This ratio shows whether your council has the ability to cover its operating costs from operating revenues. Like all businesses, it costs money to run a council, and you need to be sure that you have sufficient revenue to meet your operating costs.

FORMULA

$$\frac{\text{(Operating result excluding capital items)}}{\text{Operating revenue}}$$

EXAMPLE

$$\frac{\text{Loss of \$10}}{\text{Revenue of \$100}} = 10\%$$

IN OTHER WORDS

$$\frac{\text{Surplus/(Deficit) from council operations}}{\text{Revenue generated from council operations}}$$

TARGET

Between 0 & 10%

Caution: If your ratio is negative, your council is not covering its costs, whereas a ratio greater than 10% means that your community members may be paying too much.

Drivers: To fund services and replace assets you should aim to, at least, break-even.

Sensible actions	Questionable actions
Aim for more than break-even to allow for a buffer	Have break-even targets that allow little flexibility
Stick to your budget	Ignore your budget
Analyse variances by comparing actuals to budget	Cut discretionary costs, such as training, maintenance etc
Investigate the reasons for differences in your budget	Cut costs with no justification
Correctly price services so the right quantity of services goes to the right places	Cut costs to break-even and looking for short-term solutions
Incur an efficient level and type of costs	Increase rates and charges to cover inefficient costs

Net financial liabilities ratio

Statutory ratio

This ratio explains the level of debt your council has compared to its operating revenues. Borrowing money to fund the construction of assets may be appropriate and ensures that the cost of those assets is shared equally by community members that will benefit from the asset over the long term. Your community expects that if council does borrow money it does so within its means and does not over-extend itself.

FORMULA

$$\frac{\text{(Total liabilities less current assets)}}{\text{Operating revenue}}$$

EXAMPLE

$$\frac{\text{Council owes \$110 less cash of \$10}}{\text{Revenue of \$100}} = 100\%$$

IN OTHER WORDS

$$\frac{\text{What the council owes in net terms}}{\text{Revenue generated by council}}$$

TARGET

Less than 60%

Caution: Higher than 60% and your council may have borrowed too much.

Drivers: Community benefits resulting from the investment need to be greater than the costs.

Sensible actions	Questionable actions
Use moderate levels of debt for productive purposes	Maintain high levels of debt or have a policy of no debt
Recognise the benefits of debt to the community can be greater than the cost of debt	Use debt where the cost of the debt is higher than the community benefits gained through its use
Aim for beneficial debt and be able to service it	Amass debt you are not able to service
Recognise revenue increases required if the community wants added services	Increase revenues unreasonably to repay debt
Maintain some financial flexibility	Consume all financial flexibility
Stick to the plan/budget	Ignore the plan/budget

Total debt service cover ratio

Recommended ratio

This ratio simply explains the ability of your council to meet its loan repayments. Read in parallel with the net financial liabilities ratio this ratio will help explain the size of your debt obligations compared with your ability to pay for that debt. Your community expects that council will be able to make its repayments.

FORMULA

$$\frac{\text{(Operating result (excluding capital items) + depreciation and amortisation + gross interest expense)}}{\text{(Gross interest expense plus principal repayments for prior 12 months)}}$$

EXAMPLE

$$\frac{\text{Operating cash flow includes interest paid \$50 for the year}}{\text{Principal and interest payable of \$100 last year}} = 0.5 \text{ times}$$

IN OTHER WORDS

$$\frac{\text{Cash flow generated from operating activities}}{\text{Amount of loan repayments you have to pay this year}}$$

TARGET

Greater than 2

Caution: Lower than 2 and your council risks not being able to make loan repayments; a high number may indicate that you are using today's cash (collected through inflated rates and charges) to pay for long-life assets, which is not ideal.

Drivers: Need to be able to service debt regardless of the size of the debt.

Sensible actions	Questionable actions
Manage council’s cash flow	Budget poorly/don’t manage council’s cash flow
Borrow sensible amounts with an appropriate repayment schedule	Over spend
Check the operation cash flow regularly	Prioritise ‘wants’ over ‘needs’ and aiming to acquire everything immediately
Seek a more reasonable repayment schedule or go without	Forget ‘cash is king’
Have a strong indicator due to low debt relative to cash flow	Have a strong indicator due to a poor/inappropriate repayment schedule
Stick to the plan—if the community values the asset/service, they will fund it and service the debt	Don’t stick to the plan—this is POOR governance and not what the community wants

Cash expense ratio

Recommended ratio

This ratio provides a guide as to the ability for your council to pay its costs within the short term. Like all businesses, your council needs to have access to money to meet its obligations. Your community expects that your council has properly planned for when payments associated with council activities are due.

FORMULA

$$\frac{\text{Current cash balance}}{\text{(Operating expenses less depreciation less finance costs)} \div 12}$$

EXAMPLE

$$\frac{\text{Cash at bank \$100}}{\text{(Expenses of \$220 less depreciation \$20)} \div 12} = 6 \text{ months}$$

IN OTHER WORDS

$$\frac{\text{Cash at bank}}{\text{Expected cash operating costs for one month}}$$

TARGET

3 months

Caution: Less than 3 months and council may experience a liquidity problem. You may not have the cash available to meet costs. Too large a number may mean lost opportunities to earn a greater community benefit by using the cash to provide services or infrastructure the community values.

Drivers: For simple transactional purposes you need to maintain a certain level of cash.

Sensible actions	Questionable actions
Maintain moderate levels of cash for shocks	Maintain insufficient cash for shocks
Recognise smaller councils need to hold higher levels of cash	Maintain too much cash and become lazy and inefficient
Take budgeting seriously with robust cash flow forecasting	Budget poorly
Be prudent and efficient to reduce expenses and improve ratio	Cut discretionary expenses to improve ratio
Stick to the plan/budget	Ignore the plan/budget
Be aware of interrelationships with other ratios	Ignore interrelationships with other ratios

Council-controlled operating revenue ratio

Recommended ratio

This ratio provides an assessment of your council's financial flexibility. Not all revenues are in council's direct control but, as a rule of thumb, the more you control, the more flexibility you have and the lower the potential risks in terms of external shocks.

FORMULA

$$\frac{\text{Net rates, levies and charges and fees and charges}}{\text{Operating revenue}}$$

EXAMPLE

$$\frac{\text{Rates, utilities and charges etc of \$80}}{\text{Operating revenue of \$100}} = 80\%$$

IN OTHER WORDS

$$\frac{\text{Revenue where council sets the price and controls}}{\text{Total operating revenue received by council}}$$

TARGET

Higher the percentage = greater independance and flexibility to influence future results

Caution: Less than the suggested targets means a lower level of financial flexibility and implies that a more conservative management style is necessary.

Drivers: Need to consider, in the funding mix, how much revenue council can control.

Sensible actions	Questionable actions
Consider additional profitable commercial operations that may increase council-controlled revenues at acceptable risk levels	Unreasonably increase charges to increase level of council-controlled revenue
Recognise the differences in operations between smaller and larger councils	Operate the same as a large council even if you are a small council
Recognise small councils should have less debt, and greater cash holdings than benchmark and should aim for operating surpluses	Believe all councils should have the same debt, cash and surplus
Seek available grant income if it fits your future planning	Forego grant income to artificially increase the proportion of council-controlled revenues.
Be aware of interrelationships with other ratios	Ignore interrelationships with other ratios
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Self test

What do you think about this council?

Indicator	Target Benchmark	2013	2012	2011	Your analysis
Asset Sustainability Ratio	Greater than 90%	95%	85%	70%	
Operating Surplus Ratio	Between 0% and 10%	4%	2%	1%	
Financial Liability Ratio	Not greater than 60%	103%	83%	52%	
Total Debt Service Cover Ratio	Greater than 2 times	2.1	2.4	2.8	
Cash Expense Ratio	Greater than 3 months	7	8	8	

These ratios should be considered in light of council's level of council-controlled revenues.

QTC provides training courses on many aspects of financial management tailored to your council. These courses are facilitated by highly qualified professionals with extensive experience working with local governments and can assist you to take the first step on this important journey.

Councils interested in learning more about QTC's financial management training options can contact QTC on 07 3842 4600 or through your QTC Client Account Manager.

AUDAX AT FIDELIS

QUEENSLAND
TREASURY
CORPORATION

GPO Box 1096
Brisbane Q Australia 4001

Telephone: +61 7 3842 4600
Facsimile: +61 7 3221 4122

www.clients.qtc.com.au