



NOTES ON THE FINANCIAL HEALTH CHECK

1. INTRODUCTION

Local Government Managers Australia have sponsored a working party that has developed a "Financial Health Check" for NSW Councils. Coalface Software Solutions representatives have attended at four presentations relating to this, and exercise their constitutional right not to agree with certain aspects of the information they have received at these presentations.

The "Financial Health Check" is © LGMA and although Coalface is negotiating with the LGMA to enable us to incorporate the "Financial Health Check" within our product, we have not yet received such authorisation.

As a separate project, we have been researching Council Annual Financial Statements with a view to independently developing a series of financial indicators. Our research is currently incomplete, but the conclusions reached so far lead us to disagree with some of the information contained within the Financial Health Check.

At one stage, a draft of the "Financial Health Check" was posted on the NSW Local Government Financial Professionals web-site and our comments are based on its contents.

We have formed the opinion:

- that the "Financial Health Check" is **NOT** a suitable vehicle for comparisons **between Councils**
- that many of the indicators are **not inherently reliable**
- that a number of the benchmarks are **inappropriate and impracticable**
- that some key indicators, ascertainable from the Annual Financial Statements, are omitted.

We set out our reasons below.

2. REVENUE SOURCES

The "Financial Health Check" lists a summary of sources of Council's "ordinary revenue before capital" as values and percentages. We submit that this ignores three key factors - the definition of "ordinary revenue before capital", the likelihood of receiving similar amounts on an ongoing basis in future, and the extent to which such revenues are "discretionary".

2.1. Definition of "Ordinary Revenue before Capital"

During the course of our research, we have noted that 10 of 113 Councils apportion their Financial Assistance Grant - Revenue Sharing between *Operating* and *Capital* revenues. The basis of apportionment varies, most commonly but not always representing the local roads component of the grant. For these Councils, "ordinary revenue before capital" is lower than for other Councils even though the terms and conditions attaching to the use of the grant are identical in every case. We have made a submission to the Local Government Accounting Advisory Group (LGAAG) designed to overcome this problem¹ (discussed further below) but our submission has not yet been accepted.

1. *It is a problem only to the extent that it inhibits comparisons between Councils. It is NOT a problem in that it is a permissible interpretation under the NSW Code of Accounting Practice and Financial Reporting.*



2.2. Recurrence Effects

Councils receive many “one-off” grants from other levels of government, and the ability of a Council and its management to avail themselves of such amounts is often regarded as a measure of the efficiency of the local government. Under the current classification of such amounts between operating and capital, and grants, discretionary fees and contributions, there is nothing to indicate the likelihood of the receipt of similar amounts on an ongoing basis.

All amounts received from other levels of government are paid in accordance with that government’s political priorities, and can be subject to significant increases or decreases with little warning.

In December 2001 we made a submission to the LGAAG recommending that all amounts received from other levels of government be disclosed as such, and be further sub-classified between “recurrent” and “non-recurrent”, with a further sub-classification between “untied” and “special purpose” if required. This submission is posted on our web-site at www.coalface.com.au, and may be down-loaded by all interested persons.

We are of the view that information regarding the likelihood of receiving similar amounts into the future is of greater value to a user of the financial statements than the existing (highly subjective - see above) split between operating and capital, as is a far more valuable financial indicator.

2.3. Discretionary Revenues

Much of the revenue received by local government must be used for the purpose for which it is paid, or for functions where the costs relating to earning that revenue equate or exceed the amount of the revenue itself. Examples include all special purpose grants and many discretionary fees such as Aged Person Homes revenues, Child Care revenues and private works.

The few sources of discretionary revenues received by Council - funds that can be applied to any purpose that Council chooses - are of special significance.

The Financial Health Check neither identifies these revenues, or accords them any significance.

2.4. Comments included in the Financial Health Check

(a) “Over time shows the irregularity in flow of capital contributions.” With respect, the above information does not, because it is limited to **operating** revenues, not capital.

(b) “Shows the extent to which loans are secured against rates.” We have difficulty interpreting this comment. Until 1993 by law, and since then by convention¹, all local government borrowings have been secured against the future revenues of the Council, including rates. For the reasons given above, it is the discretionary revenue that effectively funds loan service costs.

2.5. Comparative Analysis

The worksheet provides for comparison of the current year and previous three years. The greater the number of years compared, the more clearly long term trends emerge.

2.6. Recommendations

We submit that the Financial Health Check should identify the discretionary revenues received by a Council and analyse the trends within this class as a group, and separately analyse the trends of other sources of revenue. Our investigations suggest that trends in discretionary revenue tend to vary relatively slowly over time, while trends in other revenues are considerably more volatile.

1. *The NSW Local Government Act 1993 permits the securing of loans against the property of Council.*



3. CASH/LIQUIDITY POSITION

The Financial Health Check reviews the Unrestricted Current Ratio (disclosed in Note 13) and the “Available Cash Position” in relation to “Available Cash Assets” (a new term) and “Unrestricted Available Cash Assets” both by value and as a percentage. “Available Cash Assets” is defined as “Cash Assets less Externally Restricted Cash Assets”. “Unrestricted Available Cash Assets” has the same meaning as “Unrestricted Cash” in Note 6.

3.1. Definition of Terms

Since the issue of Australian Accounting Standard AAS 36 (AASB 1040) the term “Cash Assets” has had a particular technical meaning. The term “Cash Assets” as used in the Financial Health Check refers to “Cash Assets and Investment Securities” and should either be corrected to read as such, or another term selected. (For an analysis of the definition of “Cash Assets” in the Australian Accounting Standards refer to “CashDefinition.pdf” which can be downloaded from our web-site www.coalface.com.au.)

In addition, AAS 36 defines “current assets” to exclude cash or cash equivalent assets that are restricted in their use beyond the current reporting period. The NSW Local Government Code of Accounting Practice and Financial Reporting (the Code) extends the definition of “current assets” to also exclude investment securities that are restricted beyond the current reporting period.

The Unrestricted Current Ratio reported in Note 13 to the accounts uses these definitions.

The definitions used in the Financial Health Check appear to be the former definitions, and would require the re-working of Notes 6 & 13 to calculate accurately.

3.2. Unrestricted Current Ratio

The changes in definition were first applied for the reporting period ended 30 June 2001, but appear to have been poorly understood and erratically applied by many Councils. It is not yet possible to identify distortions between the new and former definitions, and we accept this ratio with some reservations for this reason.

This ratio has **no significance** in the management of Council’s cash flow. Rates, Annual Charges and Untied Grants provide some 55% of gross Council revenues¹ and of this amount generally 75% is received in less than 15% of the working days of the year². The gross distortions that this introduces into a Council’s cash flow cannot be managed by any measure that includes components of Debtors and Inventories.

3.3. Available Cash Assets

We will adopt the term “Available Non-External Funds” and define it as *Current and Non-Current Cash Assets and Investment Securities net of External Restrictions*. Our definition does not make any adjustment for investment securities with a term exceeding 12 months. We believe that the distortion caused by this will be minimal because the Minister’s Order specifying permissible forms of investments strictly limits the ability of Councils to invest for terms exceeding 12 months.

We consider that this measure, expressed as a dollar amount, is of particular value. Subject to clarifying the definitional issues, we encourage its use by Councils.

3.4. Unrestricted Available Cash Assets or Unrestricted Cash

We submit that this is not a suitable measure whether expressed as a value or as a percentage of Total Cash Assets and Investment Securities.

1. Median value of a sample of 113 Councils for the 2000 reporting period.

2. FAGs grants are received on 17 August, 17 November, 17 February & 17 May in each year; the vast majority of rates notices payments are received in the last week of August, November, February & May.



An analysis of 30 Councils relating to the 2001 statements disclosed 18 where Unrestricted Cash was less than 10% of Total Cash Assets and Investment Securities. For these Councils, internal restrictions (i.e. reserves) averaged 90% of Available Non-External Funds as defined above. For the other Councils, internal restrictions averaged 54% of Available Non-External Funds. This suggests that the principal determinant in the amount of Unrestricted Cash is each Council's policy in relation to the creation of reserves.

Given that all Councils have a "wish list" that vastly exceeds their capacity to fund, some Councils choose to create reserves; some don't.

3.5. Comments included in the Financial Health Check

- (a) "Ratio will have more relevance from 2002 because of 12 month rule." We do not understand the significance of this comment.
- (b) "Relevance of s625 report." The section 625 report is the Investments Report required by legislation which discloses the total funds - externally and internally restricted, and unrestricted - invested by Council. We believe that the report should also disclose the reconciled bank balance, but this is not required by the legislation.
- (c) "This information mirrors Note 6 of the Local Government General Purpose Financial Reports." Only if the definitional issues considered above are addressed.

3.6. Acceptable Measures

These are expressed only in relation to the Unrestricted Current Ratio and by definition excludes special rate funds which are externally restricted. Current Ratios for special purpose funds for the provision of infrastructure - principally water and sewer - can have widely differing acceptable measures, depending on the age of the relevant infrastructure.

3.7. Comparative Analysis

The worksheet provides for the comparison of the current year and forward three years projections. We suggest that there is benefit in including the previous three years, and have doubts of the accuracy of most Councils' forward projections as a basis of future trends, particularly when general elections may result in significant changes in Council policy within the period of the projections.

4. OPERATING RESULT

Profitability is not as significant an indicator in government as in commercial operations. This is particularly recognised by the Canadian accounting standards which direct attention principally to the realisation of budget or management plan objectives. This approach does not suggest that a government can continually incur substantial surpluses or deficits - merely that profitability affects the financial health of a government organisation over a substantially longer time-frame than in commercial situations.

We can give an example of a Council where actual revenues exceeded budgeted revenues by 3.6% and actual expenditures were less than budgeted expenditures by 3.6%; the Operating Result was adrift by over M\$1.2 and changed from a deficit to surplus.¹

We suggest it is more appropriate to apply trend analysis techniques to discretionary and other revenue sources (as in section 2 above) and to expenditures separately, rather than to the Operating Result. The Operating Result should be disclosed as an arithmetical accident, but not analysed.

1. Budget revenues - M\$16.314, Actual revenues - M\$16.907
Budget expenditure - M\$17.153, Actual Expenditure - M\$16.538
Budget result - \$839,000 deficit, Actual result - \$369,000 surplus



Other factors impinging on the reliability of this indicator are the difference in treatment of identical grants referred to above, and the imprecision in depreciation expense, considered below. Although various comments refer to these factors, we consider the cumulative effect to be the invalidation of this indicator. At the very least, a clear warning should be located immediately adjacent to the indicator.

5. ASSET CONDITION MANAGEMENT

The effectiveness of this group of indicators relies heavily on the accuracy and completeness of the basic information from which they are calculated. A prominent characteristic of infrastructure is its long economic life, and its ability to provide some degree of service even at the expiry point of that life.

While we accept that the indicators appear to be appropriate, we set out below our reasons for believing that they should be closely accompanied by a clear qualification that comprehensive asset management recording procedures are still in their infancy, and that the quality of information on which the indicators are based will be improved over time.

5.1. The Revaluation Process

Prior to 1993 most construction and reconstruction expenditure was expensed and few, if any, formal records were retained of works undertaken or dates. Often the most reliable indicators were dates scratched into concrete, etc. Asset Management software was in its infancy, and computer disk capacities were a real inhibition to the storage of detailed data.

During the transitional period for the introduction of Australian Accounting Standard AAS 27, most NSW infrastructure assets were revalued in the 1995, 1996 and 1997 reporting periods. The resources allocated, and the diligence with which the work was carried out, varied significantly between Councils across the State. Update #3 to the Asset Accounting Manual was issued in January 1997 (update #4 in July 1999). These sources cannot be relied upon to ascertain the revaluation process used, because they were not issued until *after* most of the work was completed.

Because the whole concept of infrastructure valuation was so new and existing records so scanty, we suggest that it will take at least 5 revaluations to develop appropriate revaluation techniques and apply them consistently throughout the industry.

The revaluation process has now effectively ceased, with most Councils reverting to “deemed cost” following the introduction of Australian Accounting Standard AAS 38.¹ Many of the lessons previously learned will need to be re-learned when - if - the process re-starts. Regrettably, many Councils have ceased to maintain asset management systems implemented when it was anticipated that revaluation would be a regular feature of the accounting process.

Certainly the variations in the original and ongoing revaluation process render any indicator based on this information **totally unsuitable for comparisons between Councils.**

5.2. “AAS 38” Effects

At the commencement of AAS 38 - Revaluation of Non-Current Assets Councils were given the option of adopting deemed cost in accordance with para 10.4(a), or reversing previous revaluations in accordance with para 10.4(b). At least one Council adopted the para 10.4(b) procedure, and at least one Council has adopted *fair value basis* for its infrastructure assets.

These examples further emphasize the unsuitability of this measure **for comparisons between Councils.**

1. 29 of 30 Councils reverted to deemed cost at 1 July 2000.



5.3. Determining Asset Life

Because depreciation is the process of allocating the depreciable amount of an asset over its useful life, determining the asset life is integral to calculating the depreciation charge in any given year. For many infrastructure assets, only about 10% of the visual wear indicators become visible during the first 50% of the asset life. For relatively new assets, a series of observations at regular intervals will be necessary in order to determine exactly where the asset lies on the curve of wear, and hence to accurately estimate the remaining useful life. For many other infrastructure assets, gaining access to the asset in order to attempt an accurate assessment of its condition is difficult - underground sewer mains along property rear boundaries being just one example.

While depreciation charges are based upon the best available estimates, many of these estimates are recognised to be very speculative.¹

In recent years there have been technological advances that have resulted in the ability to defer the complete replacement of an asset, the lining of sewer mains being an example. No-one knows for how long the replacement of the re-lined sewer mains has been deferred. In another example relating to sewers, uPVC pipes are estimated to have a useful life of at least 70 years but the material was only invented in the 1970s and came into use in the 1980s, so no-one can yet know the actual useful life under operational conditions.

5.4. Maintenance Level Required to Achieve Useful Life

The obvious start point in determining this information is the maintenance effort that has previously been applied to the asset, and whether this has been sufficient to achieve the useful life. We doubt that this information is available in many Councils, and inevitably a process of estimation must be used. One problem commonly met is the broadly descriptive nature of many charts of accounts, where maintenance expenses and working expenses are commonly included within a single account.

There then remains the problems of determining the existing age of the asset and its useful life, both of which have been considered above.

5.5. Classification of Assets

The indicators are presented on the basis that two calculations are made covering all infrastructure assets and other assets. Infrastructure assets are generally paid for by Council and are the subject of day to day Council control. Assets not subject to Council control are excluded from the ambit of AAS 27. We suggest that the characteristics of certain groups of assets are sufficiently different as to warrant these indicators being calculated for a range of specific asset classifications.

(a) Buildings - many Councils own buildings that are subject to heritage or other preservation orders of various types - Sydney Town Hall would be a classic example. Asset renewal is clearly not an option in this instance, and is probably not a useful indicator for this group.

(b) Water & Sewer systems - it is our understanding that when significant parts of these systems are renewed, many other parts must also be renewed. For example, if an "upstream" pump is renewed, the "downstream" pump must also be renewed. This is clearly different from (say) footpaths, where a small section can be renewed without necessarily renewing adjacent sections.

We recommend that these indicators be individually calculated for each asset classification within the annual statements.

1. In the 2000 year, 2 Councils of 30 reported corrections of fundamental errors that related to the levels of depreciation charges previously made. In each case, the effect was to materially reduce depreciation charges made in prior years.



5.6. Acceptable Measures

For both the Asset Renewal and Asset Maintenance/Maintenance Required indicators, the acceptable measures are described as “1:1 - Green; <1:1 - Red”. For the reasons set out above, we suggest that the accuracy of the basic data from which the indicators are calculated does not justify the implication of precision.

We submit that the acceptable measures would be more appropriately displayed as <0.85:1 - Red; between 0.75:1 and 1:10 - Amber; >1:1 - Green subject to maintenance backlog. The overlap in the indicators is deliberate, and would be resolved only by trend analysis for that Council over a period of years, **not** by reference to other Councils.

6. DEBT AND DEBTOR MANAGEMENT

We suggest that this grouping is inappropriate as the first indicator specifically relates to liabilities and the others relate to assets. Debts owed by Council should form part of a separate section dedicated to “Debt and Inter-Generational Equity”; Debtor Management should also include a separate component addressing the promptness of completion and lodgement of grants and subsidy claims with other levels of government.

6.1. Debt and Inter-Generational Equity

The Debt Service Ratio indicator (in Note 13, expressed as a percentage) is the traditional calculation which suffers from distortion arising from short term fluctuations in revenue levels such as those caused by natural disaster restoration grants or other causes.¹ In our view, a more reliable indicator would use Discretionary Revenues as a divisor, as these are subject to fewer fluctuations. Both indicators are subject to distortions caused by the early retirement of borrowings.² However, using Discretionary Revenues as divisor accurately replicates the budget pressures imposed by a heavy loan repayment schedule.

Funds for the acquisition of infrastructure (e.g. water & sewer) can quite properly have debt service ratios well in excess of 50%. The Financial Health Check should insist that its indicator rates apply only to general purpose operations.

We question the measures that in the Financial Health Check are separately stated for developed and developing Councils. While there is no question that a developing Council is more likely to have a higher debt service ratio, this merely reflects the financial strain that is being experienced as part of the process of providing new and expanded services to residents. The financial health of the Council is under strain - and the debt service ratio reflects this. The debt service ratio must always be assessed in relation to a Council’s future ability to discharge its obligations, whether its area is developing or not.

Further, while there is no question that a NIL debt service ratio is a sign of relative financial strength, we seriously question whether a NIL debt service ratio is necessarily an indication that the financial *policies* of Council are *healthy*. This raises the question of inter-generational equity.

Inter-Generational Equity is inevitably influenced by individual political preferences, which we prefer to avoid. We cite the instance of a Council with \$4M debt, reserves of \$8M and unrestricted cash of \$3M³. This can be interpreted as \$7M in rates that has been levied upon its ratepayers, **and collected in cash**, that Council has not expended for their benefit. We suggest that this is an indication of distinctly *unhealthy* - or at least inappropriate - financial policies. All too often we have seen a change in the composition of the Council leading to a spending spree, resulting in a truly unhealthy financial position.

-
1. The reduction in the City of Sydney’s Debt Service Ratio from 6% in 1999 to 2% in 2000 can principally be attributed to revenues relating to preparations for the Olympic Games.
 2. Debt Service Ratio for one Council moved from 11.32% (1998) to 21.07% (1999) to 7.61% (2000) for this reason. It can easily be managed by explanation.
 3. The Council has a Debt Service Ratio of 5.23%



We interpret “health” as something more than absence of illness and submit that the Financial Health Check should also seek to encourage positive financial policies as has been attempted in relation to Asset Condition Management above. We suggest that indicators relating to inter-generational equity be developed.

6.2. Debtor Management

We support the indicators shown, and recognise that in some accounting systems obtaining statistics of gross billings will not necessarily be a straightforward process. We also suggest that an indicator relating to the collection of grants & subsidy claims should be included.

It has been suggested that for those Councils with water funds, the Rates Outstanding Percentage includes charges for excess water. We suggest that, if this is the case, the method of calculation of the percentage set out in part 5.14 of the Code is being mis-interpreted.

6.3. Acceptable Measures

- (a) Debt Service Ratio - for the reasons given above, we believe that a Debt Service Ratio of less than 2.5% should qualify for an “amber” warning.
- (b) Rates Outstanding - we do not accept the differentiation between urban and rural Councils. An analysis of the Rates Outstanding Percentage for a total of 38 Councils over 4 years suggests that the best practice percentage for both rural and urban Councils is identical. However, the range of values for a rural Council tends to be greater than for urban Councils. We attribute this to the fact that staffing levels in rural Councils are much lower than for urban (especially city) Councils, and a change in personnel tends to have a more significant effect on collection levels.

We submit that acceptable measures for all Councils would be <5% - green; 5% - 7% - amber; >7% - red, but that the clear notation be made that timing of excess water billings may change the acceptable levels.

6.4. Comparative Analysis

The comparison period shown is for the current year and three years forward projection. We doubt the accuracy of Council projections in this area, and it is far easier to project an acceptable measure as a target than it is to achieve that target. The comparison should be for the previous three years, current year and one year’s projection. The target level can be also be stated separately.

7. RE-VOTES OF EXPENDITURE

We understand that this term is intended to refer to *uncompleted works carried forward*. However, the term is also used for other purposes in other places and should be clearly stated.

A clear distinction must be made between uncompleted works carried forward that are funded by cash resources held as internally and externally restricted cash, and those that are not. Attention should also be drawn to the statutory requirements involved in the process.

We accept that the proposed indicators are suitable for “funded” works, and submit that indicators for “unfunded” works should be 0% - green, >0% - red.

8. ACCURACY / TIMELINESS OF FINANCIAL DATA / BUDGET / COMPLIANCE

8.1. “Financial Bottom Line”

This proposed criterion is entirely inappropriate for the reasons given in section 4 above.



8.2. Unqualified Audit Reports, Compliance with Statutory Deadline

The first of these criteria is of far less significance than in commercial areas. Generally, Council finance officers are very willing to correct errors and omissions, or faulty interpretations of Accounting Standards, the Code or legislation, identified by Auditors. In the result, most audit qualifications result from serious lapses in internal control, or from breach of statutory requirements. The most common breach of statutory requirement leading to a qualified report is failure to complete statements within the statutory period. Accordingly, these criteria substantially duplicate each other.

8.3. Timeliness of Reporting (1) - Management Reports

We have assumed that the "5 days" referred to is "5 working days", but it should be stated. This would only be able to be achieved where a Council has a full commitment costing system in place, and the values attributed to orders are accurate. It would also assume that the responsible staff are not required to attend industry seminars (as for example, the Financial Health Check workshop in Wagga Wagga on 3 May 2002), and that there are no Council meeting or employee leave commitments.

It does not recognise that the scale of many Councils does not justify the adoption of a full commitment costing system, and the need to process current creditors invoices before closing off the accounting month.

We suggest that it also fails to recognise the complexity of most Council ledger systems, which almost always exceed 1,000 individual accounts. Accordingly, the risk of incorrect allocation is very high, particularly where staff undertake similar tasks relating to different funding programs. Most responsible finance officers submit draft reports to individual managers inviting identification of errors before consolidating the reports for senior management.

It also fails to recognise that almost universally, individual managers have immediate access to progressive accounting reports on a specific project basis.

We submit that far more appropriate measures would be submission of drafts to individual managers within 7 working days, and to senior management within 14 working days of the month end.

8.4. Timeliness of Reporting (2) - Quarterly Statutory

The comments in 8.3 above also apply.

The criterion should be read down to reflect the date on which the quarterly reports are available for inclusion in the Council meeting papers, rather than as the date submitted to elected members, as the most common frequency of Council meetings is monthly.

8.5. Timeliness of Reporting (3) - Annual Statutory

We are of the opinion that this criterion is entirely inappropriate, and would deprecate any but the simplest Councils attempting to comply.

Most Councils need to incorporate financial information from sec 355 committees within their annual statements¹; many others are members of joint ventures and need to incorporate financial data in order to comply with AAS 14 or AAS 19 - obviously the joint venture statements need to be completed first.

Most rural Councils operate water supply or sewerage funds and have limited numbers of trained accounting staff. Most commonly, the responsible accounting officer also has direct or supervisory responsibility for the issue of rate notices - and rate notices must be issued by 31 July or the first rate instalment cannot be collected until 30 November.

We consider that completion of statutory reports by 15 August would be a clear indicator of best practice, and know of no significant advantage conferred by earlier completion.

1. One Council reports over 100 such committees.



8.6. Budgets Incorporate 3 Year Plan

This, of course, is a requirement of the legislation and in theory is applied by all Councils. The great variable is the extent to which the second year actually serves as a base for the following year, or whether it is merely a formulaic derivation from the current year plan. The criterion gives no basis for assessing this, nor do we know of one, and we therefore consider the item to be superfluous.

8.7. Rigour of Budget Review

Again, the criterion gives no basis for assessing the degree of rigour of budget reviews, nor do we know of any generally accepted method for making such an assessment. Either always answer “yes” or delete the criterion.

8.8. Formal Report on sign off of Statements

We support this criterion as a clear expression of good practice.

9. SUMMARY

We have set out our reasons for forming the opinion expressed in the introduction. We shall be pleased to provide further information, and to receive comments by email to davemax@ozemail.com.au. We reserve the right to review revise or even totally reverse our views following receipt of any comment or further information. Our own research into the financial aspects of NSW Local Government Councils is by no means complete and will continue.

We wholeheartedly support the expressed intention of the LGMA (NSW Division) when the original task force was established. There is certainly a need to identify the various items contained in the financial reports of Councils that provide indicators of their financial condition. The hope that some of those indicators will provide an adequate and accurate basis for comparison between different Councils is a valid goal. In turn, we hope that some of the contents of this paper will help towards achieving that goal.