

Risk Framework

Financial Sustainability



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Risk Framework – Financial Sustainability

Overview

The Department of State Development, Infrastructure, Local Government and Planning (the Department) has released the Financial Management (Sustainability) Guideline (the Guideline), which applies to all Queensland local governments from 1 July 2023.

This *Risk Framework – Financial Sustainability* supports the *Guideline* by outlining the principles underlying how the Department will monitor council financial sustainability, as presented in the measures reported by councils, the relative risk tolerance for each measure in the Guideline, and how measures can be interpreted in conjunction with each other.

Under the Local Government Regulation 2012 and City of Brisbane Regulation 2012, the Queensland Audit Office (QAO) is responsible for auditing council financial statements including the current year financial sustainability statement. The QAO's audit report on the sustainability ratios confirms the arithmetical accuracy of these ratios in accordance with the *Guideline*.

Principles

The Department's approach to assessing financial sustainability risk is informed by the measures outlined in the *Guideline* and reported by councils according to the following underlying principles:

Sustainability is more than financial ratios

Financial sustainability risks need to be considered holistically in combination with other key elements of council sustainability such as asset management, governance, compliance, and the broader operating environment as outlined in the Department's published *Sustainability Framework for Queensland Local Governments*.

Similarly, individual measures only tell a small part of the sustainability story and should be interpreted and assessed in conjunction with other relevant metrics to create a better understanding of council performance and sustainability. A poor result in one measure may be offset by success in another or may alternatively confirm risks identified by other metrics.

Sustainability is a long-term objective

Achieving sustainability takes time and concerted effort, and the Department recognises that there will be times when councils may experience sustainability pressures (such as natural disasters) which may affect short-term results but are able to be managed by a local government over the longer term. Assessments of financial sustainability risk should be considered in this context.

Some measures in the *Guideline* (such as the Unrestricted Cash Expense Cover Ratio) are shorter-term in nature and are recognised through application of their associated benchmarks to the single-year result. Assessments of financial sustainability risk by the Department will take the time-based importance of each measure into account.

Not all risks are created equal

The *Guideline* requires the calculation and reporting of up to nine financial sustainability measures by councils. Of these, the two financial capacity measures (Council-Controlled Revenue and Population Growth) are considered contextual ratios and support understanding by stakeholders of key operating pressures which may be affecting councils' performance.

The Asset Renewal Funding Ratio is also considered a contextual measure due to its forecast-based and therefore un-auditable nature. For councils in Tier 6 to Tier 8, the Operating Surplus Ratio is also contextual in recognition of their low level of self-generated revenue and high reliance on external funding, which reduces the relative importance of this metric for those councils compared to other measures in the *Guideline*.

Of the remaining measures in the *Guideline* (which apply to all Tiers), the Department considers some to be of higher importance from a risk perspective relative to others, as outlined in the **Risk Tolerances** section below, due to the potentially larger adverse consequences of a council falling below its assigned benchmark for that measure in the shorter term. The

Department will consider councils which do not meet the benchmarks for these measures as having a higher level of financial sustainability risk compared to other ratios.

Compare like with like

The Department's *Guideline* groups councils into Tiers for sustainability reporting purposes in recognition that councils have differing financial and non-financial circumstances and challenges. These differing circumstances and challenges mean financial sustainability risk may look different for different Tiers.

When assessing financial sustainability risk for councils, the Department will refer to the relevant Tier's targets as well as other comparative information to assist it in determining the potential level of exposure and possible responses.

Incentivise positive behaviours and avoid perverse outcomes

In updating the *Guideline*, the Department is seeking to establish a sustainability reporting framework which encourages council leaders to understand the drivers of long-term sustainability and pursue positive outcomes rather than "manage to the measure".

The Department's approach to assessing council financial sustainability risk recognises that sustainability is a constantly evolving concept that cannot be reduced to a single number or rating, but rather is informed by a range of factors which extend beyond what is contained in the *Guideline*.

As part of its ongoing role administering the Queensland local government sector, the Department uses all information at its disposal to identify potential sustainability risks across a range of areas and work with individual councils to address them.

Risk Tolerances

As outlined above, the Department considers that the measures outlined in the *Guideline* pose differing levels of financial sustainability risk to councils should their associated targets not be met. The table below outlines the relative risk tolerance for each measure (not including contextual measures).

Type	Measure	Target Risk Tolerance		Commentary
		Tier 1 – 4	Tier 5 - 8	
Financial Capacity	Council-Controlled Revenue	Contextual	Contextual	N/A
	Population Growth	Contextual	Contextual	N/A
Operating Performance	Operating Surplus Ratio	Lower	Higher	Tier 1 – 4: A lower risk reflects the expectation that these councils should be consistently generating operating surpluses given their larger population bases. Tier 5 – 8: A higher risk tolerance recognises the impacts of third-party capital funding which may offset a council's operating deficits.
	Operating Cash Ratio	Lower	Lower	All councils: A lower risk tolerance recognises the importance of a council being able to fund its core operations. Councils with negative operating cash ratios over time are at a higher risk of future liquidity issues.
Liquidity	Unrestricted Cash Expense Cover Ratio	Lower	Lower	All councils: A lower risk tolerance recognises the importance of a council being able to meet its financial obligations as and when they fall due. Councils with unrestricted cash expense cover ratios approaching zero are at a significantly greater risk of solvency concerns in the short term.

Asset Management	Asset Sustainability Ratio	Higher	Moderate	Tier 1 – 4 councils: A higher risk tolerance recognises the impact capital expenditure on new assets can have on this measure in larger councils (vs expenditure on asset renewals). Tier 5 – 8 councils: A moderate risk tolerance recognises that these councils should be prioritising capital expenditure that focuses on the renewal and replacement of existing assets over time.
	Asset Consumption Ratio	Moderate	Moderate	All councils: A moderate risk tolerance recognises the expectation that a council will adequately manage and maintain its asset base over time while also acknowledging different community needs and service levels.
	Asset Renewal Funding Ratio	Contextual	Contextual	N/A
Debt Servicing	Leverage Ratio	Lower	Lower	All councils: A lower risk tolerance for all councils recognises the importance of a council being able to meet its debt servicing obligations as and when they fall due. Councils which struggle to repay their debts affect the State's creditworthiness and are at a high risk of solvency issues.

Interpretation

Interpreting measures in combination

Individual financial sustainability measures in the Guideline provide information about an element of council sustainability but may not tell the full story when considered in isolation. Examples of measures which can be considered together to provide a more comprehensive interpretation include:

1. **Operating Surplus Ratio and Operating Cash Ratio** – where a council reports a low or negative operating result, this may pose less of a sustainability risk where the council's operating cash ratio remains positive as it indicates that the council is still able to fund its core business operations. This is especially the case for smaller councils (Tier 5 and below).
2. **Operating Cash Ratio and Unrestricted Cash Cover Ratio** – where a council reports a negative operating cash in combination with a low unrestricted cash cover ratio, this indicates a high risk of liquidity and solvency concerns as the council may have challenges meeting its financial commitments in the short to medium term.
3. **Asset Sustainability Ratio and Asset Consumption Ratio** – where a council reports a lower asset consumption ratio over time, this may represent less of a sustainability risk where the council's asset sustainability ratio is within or above the required target as it indicates that council is meeting its asset renewal needs over time.
4. **Unrestricted Cash Expense Cover Ratio and Leverage Ratio** – where a council reports a low unrestricted cash expense cover ratio at the same time as a leverage ratio which is high and/or above the target, this is an indicator of a limited ability to fund additional capital expenditure through either working capital or borrowings, resulting in increased sustainability and service delivery risks.
5. **Leverage Ratio and Asset Sustainability Ratio** – where a council reports a high or above-target leverage ratio in conjunction with a lower asset sustainability ratio, this is an indicator of reduced capacity to fund ability capital expenditure through borrowings and may present higher sustainability risks to the council. These indicators are especially important for growing councils which may need to rely on external funding to support their increasing infrastructure needs.

Interpreting measures within different Tiers

Interpreting the sustainability measures varies from tier to tier, having regard for the differing operational circumstances and sustainability drivers that impact Queensland councils.

Risk tables with relative targets and weightings to support assessments for each Tier can be found in **Appendix A**.

Tiers	Interpreting within Tiers
Tier 1 & 2	Councils with large population bases should be expected to generate consistent operating surpluses (increasing the significance of this ratio). For growing councils, the leverage ratio also takes on additional significance due to their greater infrastructure investment funding needs, while the relative importance of the asset sustainability ratio declines due to the higher proportion of capital expenditure on new assets (which reduces the ratio result).
Tier 3 & 4	Like Tiers 1 and 2, these councils have relative higher levels of council-controlled revenue and should be able to generate consistent operating surpluses. For growing councils, the significance of the asset sustainability ratio result also reduces due to the influx of new assets.
Tiers 5, 6 & 7	These councils are generally smaller and more remote and have a greater reliance on external funding due to their limited revenue-raising ability. The operating cash ratio increases in importance due to the need for these councils to ensure ongoing funding of their core business, while the unrestricted cash cover also has greater significance as these councils need to ensure an adequate cash buffer regardless of the peaks and troughs of external funding cycles.
Tier 8	Indigenous councils have no ability to levy rates and are therefore highly dependent on external funding to maintain their operations. Like the previous Tiers, the operating cash ratio increases in importance due to the need for these councils to ensure ongoing funding of their core business. The unrestricted cash cover also has greater significance as these councils need to ensure an adequate cash buffer regardless of the peaks and troughs of external funding cycles.

Departmental Response

Triggers for further action

The individual risk assessment tables contained in **Appendix A** outline the spectrum of possible results for each financial measure contained in the Guideline, including what the department considers to be an indicator of High or Very High risk.

If a council reports any measure with a result of High or Very High risk, this will form the basis for further investigation by the department and the development of responses and tailored support to emerging challenges if needed.

Appendix A – Risk Assessment Tables

Tier 1

FINANCIAL CAPACITY		Council-Controlled Revenue*		
FINANCIAL CAPACITY		Population Growth*		
OPERATING PERFORMANCE		Operating Surplus Ratio		
< -5%	-5 to -2%	-2 to 0%	0 to 2%	> 2%
OPERATING PERFORMANCE		Operating Cash Ratio		
< 0%			0 to 20%	> 20%
LIQUIDITY		Unrestricted Cash Expense Cover Ratio		
< 2 months			2 to 4 months	> 4 months
ASSET MANAGEMENT		Asset Sustainability Ratio		
< 30%	30 to 40%	40 to 50%	50 to 90%	> 90%
ASSET MANAGEMENT		Asset Consumption Ratio		
<50%	50 to 55%	55 to 60%	60 to 80%	> 80%
ASSET MANAGEMENT		Asset Renewal Funding Ratio*		
DEBT SERVICING		Leverage Ratio^		
> 6 times	5.5 to 6 times	5 to 5.5 times	3 to 5 times	< 3 times

* Contextual – not assessed

^only assessed if council has debt

Tier 2

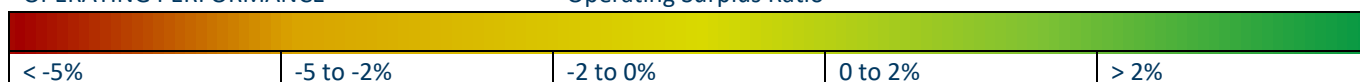
FINANCIAL CAPACITY Council-Controlled Revenue*



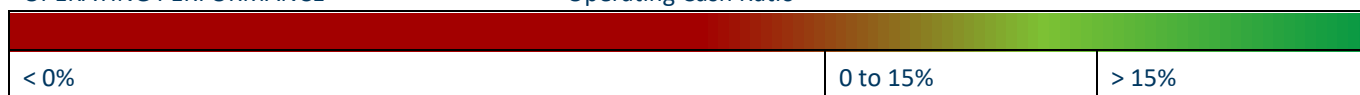
FINANCIAL CAPACITY Population Growth*



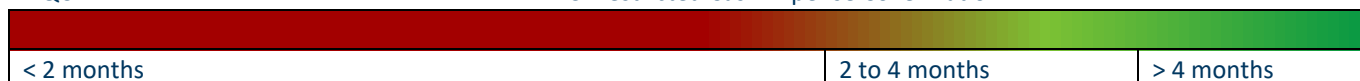
OPERATING PERFORMANCE Operating Surplus Ratio



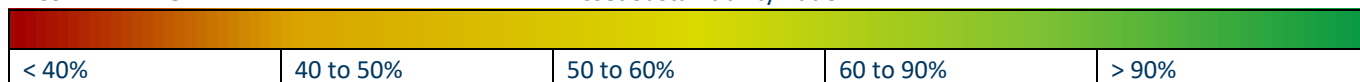
OPERATING PERFORMANCE Operating Cash Ratio



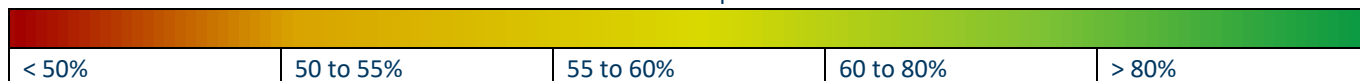
LIQUIDITY Unrestricted Cash Expense Cover Ratio



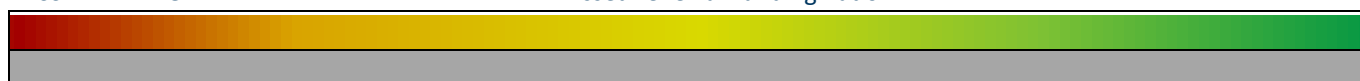
ASSET MANAGEMENT Asset Sustainability Ratio



ASSET MANAGEMENT Asset Consumption Ratio



ASSET MANAGEMENT Asset Renewal Funding Ratio*



DEBT SERVICING Leverage Ratio^



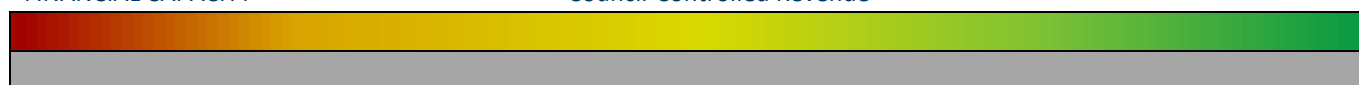
* Contextual – not assessed

^only assessed if council has debt

Tier 3

FINANCIAL CAPACITY

Council-Controlled Revenue*



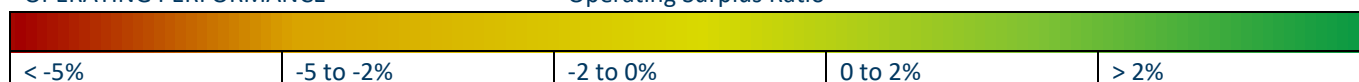
FINANCIAL CAPACITY

Population Growth*



OPERATING PERFORMANCE

Operating Surplus Ratio



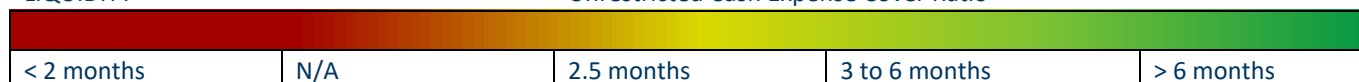
OPERATING PERFORMANCE

Operating Cash Ratio



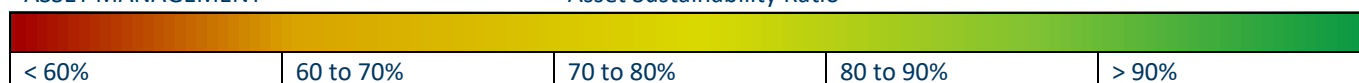
LIQUIDITY

Unrestricted Cash Expense Cover Ratio



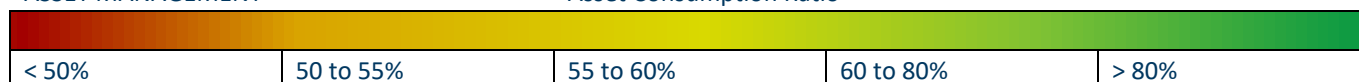
ASSET MANAGEMENT

Asset Sustainability Ratio



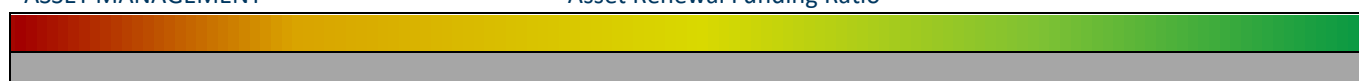
ASSET MANAGEMENT

Asset Consumption Ratio



ASSET MANAGEMENT

Asset Renewal Funding Ratio*



DEBT SERVICING

Leverage Ratio^



* Contextual – not assessed

^only assessed if council has debt

Tier 4

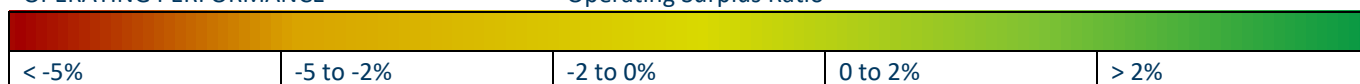
FINANCIAL CAPACITY Council-Controlled Revenue*



FINANCIAL CAPACITY Population Growth*



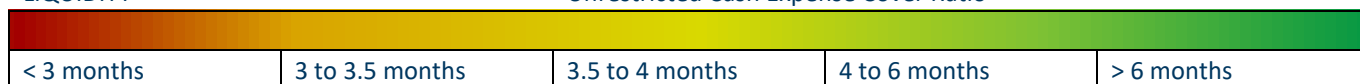
OPERATING PERFORMANCE Operating Surplus Ratio



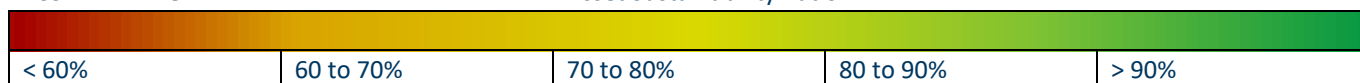
OPERATING PERFORMANCE Operating Cash Ratio



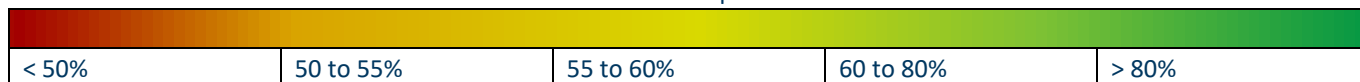
LIQUIDITY Unrestricted Cash Expense Cover Ratio



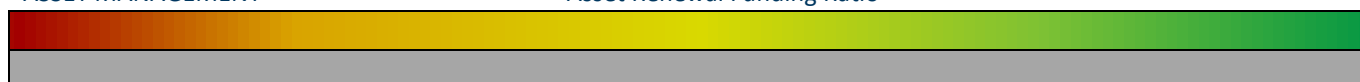
ASSET MANAGEMENT Asset Sustainability Ratio



ASSET MANAGEMENT Asset Consumption Ratio



ASSET MANAGEMENT Asset Renewal Funding Ratio*



DEBT SERVICING Leverage Ratio^



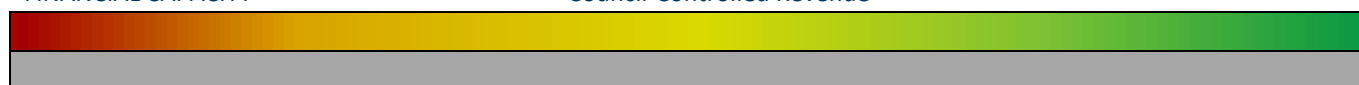
* Contextual – not assessed

^only assessed if council has debt

Tier 5

FINANCIAL CAPACITY

Council-Controlled Revenue*



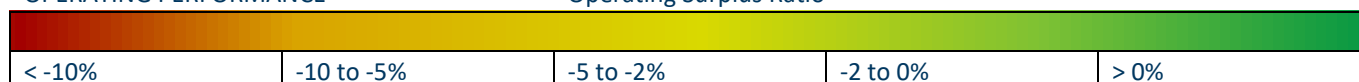
FINANCIAL CAPACITY

Population Growth*



OPERATING PERFORMANCE

Operating Surplus Ratio



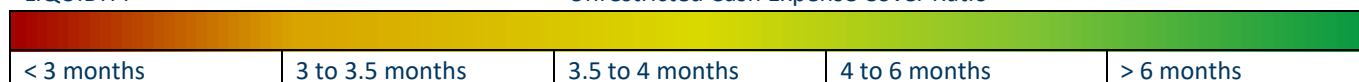
OPERATING PERFORMANCE

Operating Cash Ratio



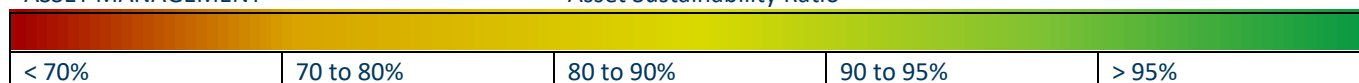
LIQUIDITY

Unrestricted Cash Expense Cover Ratio



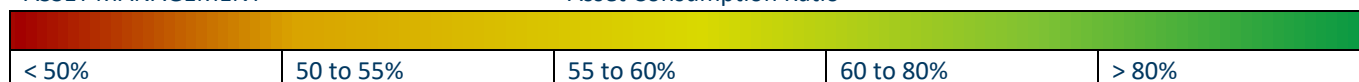
ASSET MANAGEMENT

Asset Sustainability Ratio



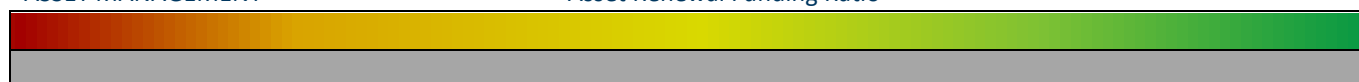
ASSET MANAGEMENT

Asset Consumption Ratio



ASSET MANAGEMENT

Asset Renewal Funding Ratio*



DEBT SERVICING

Leverage Ratio^



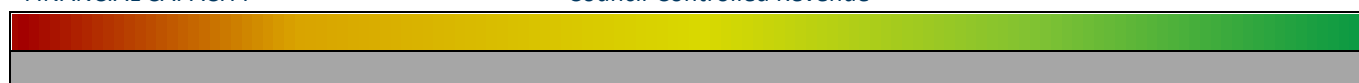
* Contextual – not assessed

^only assessed if council has debt

Tier 6

FINANCIAL CAPACITY

Council-Controlled Revenue*



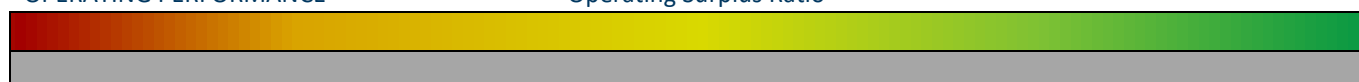
FINANCIAL CAPACITY

Population Growth*



OPERATING PERFORMANCE

Operating Surplus Ratio



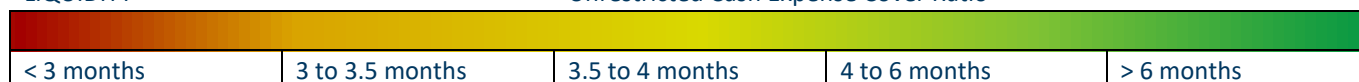
OPERATING PERFORMANCE

Operating Cash Ratio



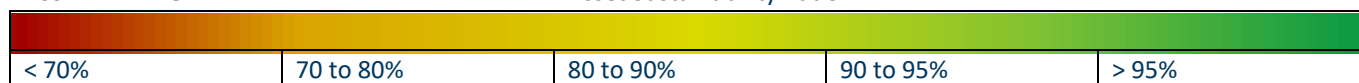
LIQUIDITY

Unrestricted Cash Expense Cover Ratio



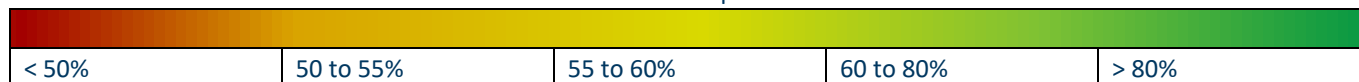
ASSET MANAGEMENT

Asset Sustainability Ratio



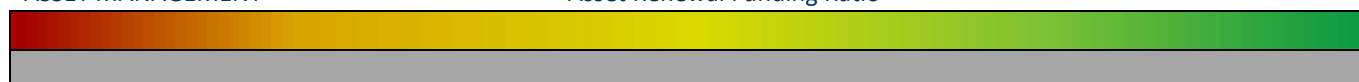
ASSET MANAGEMENT

Asset Consumption Ratio



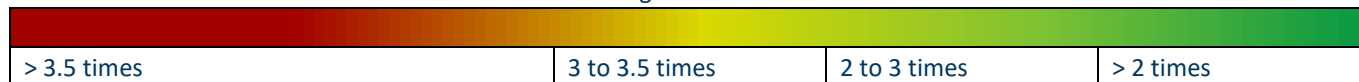
ASSET MANAGEMENT

Asset Renewal Funding Ratio*



DEBT SERVICING

Leverage Ratio^



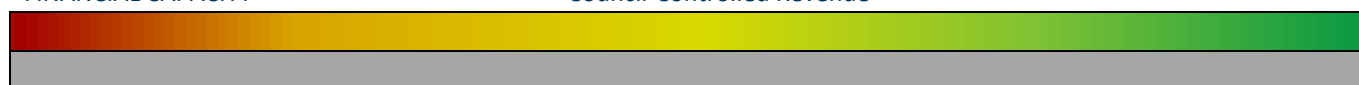
* Contextual – not assessed

^only assessed if council has debt

Tier 7

FINANCIAL CAPACITY

Council-Controlled Revenue*



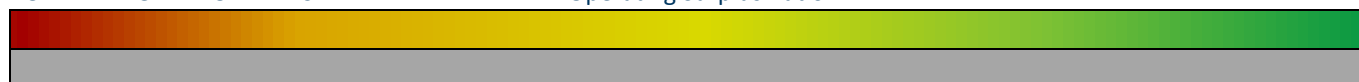
FINANCIAL CAPACITY

Population Growth*



OPERATING PERFORMANCE

Operating Surplus Ratio*



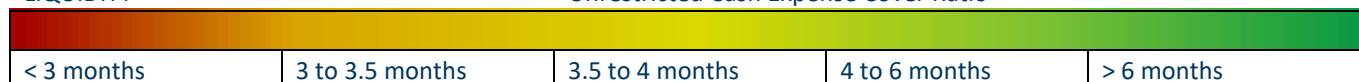
OPERATING PERFORMANCE

Operating Cash Ratio



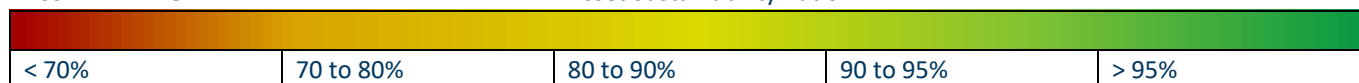
LIQUIDITY

Unrestricted Cash Expense Cover Ratio



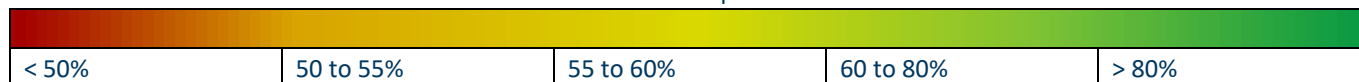
ASSET MANAGEMENT

Asset Sustainability Ratio



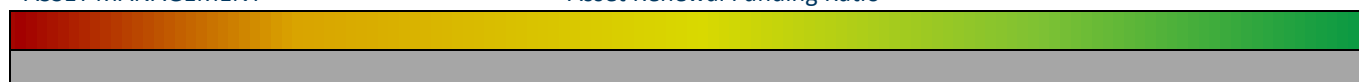
ASSET MANAGEMENT

Asset Consumption Ratio



ASSET MANAGEMENT

Asset Renewal Funding Ratio*



DEBT SERVICING

Leverage Ratio^



* Contextual – not assessed

^only assessed if council has debt

Tier 8

FINANCIAL CAPACITY		Council-Controlled Revenue*		
FINANCIAL CAPACITY		Population Growth*		
OPERATING PERFORMANCE		Operating Surplus Ratio*		
OPERATING PERFORMANCE		Operating Cash Ratio		
< 0%		0 to 5%		> 5%
LIQUIDITY		Unrestricted Cash Expense Cover Ratio		
< 3 months	3 to 3.5 months	3.5 to 4 months	4 to 6 months	> 6 months
ASSET MANAGEMENT		Asset Sustainability Ratio		
< 70%	70 to 80%	80 to 90%	90 to 95%	> 95%
ASSET MANAGEMENT		Asset Consumption Ratio		
< 50%	50 to 55%	55 to 60%	60 to 80%	> 80%
ASSET MANAGEMENT		Asset Renewal Funding Ratio*		
DEBT SERVICING		Leverage Ratio^		
> 3.5 times		3 to 3.5 times	2 to 3 times	> 2 times

* Contextual – not assessed

^only assessed if council has debt