



LOCAL GOVERNMENT
ASSOCIATION OF
QUEENSLAND INC.

Methodology and Framework

Best Practice Simplified Internal and External Reporting for Local Governments in Queensland

Prepared for the

Local Government Association of Queensland

March 2002

BDO *Kendalls*



1. METHODOLOGY AND FRAMEWORK

1.1. Key Points

- An organisation's level of risk will determine the focus of its performance indicators.
- Councils as a tax raising authority have lower financial risk than many other entities. Their performance indicators will have a bias towards social

1.2. Framework

In the landmark publication "The Leading Company: Growth, Learning and Longevity in Business" Arie de Geus outlines the criteria for organisations to be successful in the long-term. He notes that "we can see that money must play an important role in a company's survival and evolution. With money, a company can buy resources (and time) which allow it to evolve more rapidly. In addition, people who see companies as machines for earning money measure the success of a company's evolution by the extent to which it can make more money than its competitors." He then outlines the possibility that leaving too little money in the organisation could reduce the survival chances of the company, and looks at the research on the criteria for survival organisations. His conclusion is that 'long-lived organisations have a conservative approach to financing. They were rigidly careful about their borrowing and investment capital.' Any organisation's survival therefore is not only related to performance of its objectives, but also the risks it takes in creating its operating capacity.

The following KPI framework model was developed by David Spearritt and further researched by Assoc. Prof. Chew Ng for the Public Sector Accounting Centre of Excellence, CPA Australia.

The starting point of this model is to regard an organisation as an investment by its stakeholders and to assess that investment in terms of the risk and return profile of the organisation. In relation to risk, independent entities which have to raise their own funds have a higher risk than those which are funded through a Government or Council budget. Along this continuum, entities that are funded from a government budget (such as a government department) have low financial risk, followed by independent entities such as a government or local Council which have taxing powers. Organisations which generate revenue in a monopoly market have more risk than a

taxing authority but less risk than a firm operating in a competitive market. Entities which have tax raising powers have a different risk profile from those which have to generate their revenue in a competitive market. In relation to return, the main variable is whether the entity has been established to provide a social return to the community, or a financial return to its shareholder. These factors create different issues for monitoring and assessing the performance of the organisation, as shown in the following diagram.

FIGURE 1: REPORTING FOCUS OF AN ENTITY

FINANCIAL RETURNS

Internal Business Units	Tax/Revenue Office	Monopoly GOE's/ Commercialised Business Units	Private or Private Sector Firm in competitive market
<i>Financial performance, Financial risk</i>	<i>Financial performance</i>	<i>Financial Performance, Financial Risks</i>	<i>Financial Performance, Financial risks</i>
Government Departments	Taxing raising Authority	Statutory Authorities/Boards	Not-for-Profit Organisation
<i>Community objectives performance, contribution to operating capacity</i>	<i>Community objectives performance, Operating Capacity, Financial risk</i>	<i>Financial risk, Community objectives performance, Operating capacity</i>	<i>Financial risk, Community objectives performance, Operating capacity</i>

COMMUNITY RETURNS

Local governments are often comprised of a number of these types of entities. For example Ipswich City Council is a tax raising authority which has a number of departments with community objectives, several internal business units with financial objectives, the Finance Department which levies rates, a monopoly business units in the form of Ipswich Water. The Council also owns a private company Global Info-links operating in a competitive environment and controls the Ipswich Arts Foundation which is a not-for-profit organisation. Each of these entities has internal and external financial reporting requirements.

Council and government departments are characterised by having low financial risk and a focus on social returns. Therefore, performance indicators amongst this group need to focus primarily on the achievement of community objectives. Financial risk

issues will largely be secondary and mainly be used to ensure that liabilities are not unnecessarily incurred impacting on their owner government or Council. Financial performance issues are usually not paramount except for the obvious need to remain within budgetary allocations. However, Councils need to develop their operating capacity to deliver services which satisfy community objectives.

Tax raising authorities similarly need to monitor achievement of community objectives. However monitoring financial risk, for example, levels of debt is necessary to ensure continuing viability of an independent entity, and to ensure that debt levels do not cause future increases in taxes and rates. Financial performance is usually related to the extent to which the operating results affect the operating capacity of the organisation. In the widely referenced Brisbane City Council publication 'Accounting Concepts for Accountability in Local Government' the Council applied the physical concept of capital whereby:

'Capital is understood to be operating capability provided by the resources (assets) of the entity. Profit, therefore, is considered to be the total gain arising during a period, which could be distributed in full whilst still maintaining capital, in the sense of the operating capability, at the level which existed at the beginning of the period.'

Under this concept of capital, the entity viewpoint of financial reporting is applicable. This holds that the objectives of the entity are to continue to carry out particular functions. 'These may include profit-making through specific business activities for my hands of, ... the supply of services including the custodianship of public assets'. But from those viewpoint, 'the primary requirement is to maintain the ability of the entity to carry out the functions which are its *raison d'être* and it is there for all concerned with maintaining the physical operating capacity which will enable it to do so.' From this perspective, financial performance is related to improvements in the physical operating capacity of the Council.

Statutory authorities, for example in government control markets, usually have a number of community objectives which need to be achieved. However since revenue is predominantly from trading activities, the level of risk is higher and there is a need for appropriate monitoring of activities. Such entities usually also have some financial objectives.

Not-for-profit organisations are financially independent and usually operate in a non-monopoly trading environment. Therefore financial risks need to be closely monitored. However, their prime reason for existence is to achieve community objectives and therefore these need to be monitored. Financial performance monitoring is also required since these organisations need to generate sufficient operating surplus to be able to achieve community objectives.

Internal business units are similar in nature to government departments with the key difference that they have financial performance requirements rather than community objectives. They have a lower level of financial risk than corporatised business units or government owned enterprises and therefore monitoring financial risk is a lower priority.

Government and Council revenue offices are primarily concerned with generating income through taxation measures. Therefore, these offices are focused on financial results rather than social performance or financial risks. However the organisation faces implicit community objectives to ensure that the cost of collecting tax revenue is minimised including inconvenience to the taxpayer.

Government business enterprises usually are primarily focused on achieving financial results. The owning government or Council may require community objectives in the form of Community Service Obligations, however a government or Council normally funds. Since these organisations have a high level of financial independence financial risk issues need to be closely monitored.

Public and private firms operating in fully competitive environments will be primarily focused on achieving financial performance and minimising financial risks. The emphasis of this report is on the whole of council as an independent taxing authority. However, the KPI framework of an entity model allows the issues to be transported to other sectors for indicators that are common.

1.3. Types of Indicators

From the above analysis it can be seen that key indicators comprise three main categories: financial performance, social objective performance, and financial risk. In the private sector financial performance indicators have been developed over a long period of time. These centre on profitability indicators such as earnings before interest and tax (EBIT), and are supplemented by number of analytical measures to assess the source and sustainability of profitability. In the public sector, as we have noted, financial performance is related to changes in the physical operating capacity of the organisation.

Community performance indicators will necessarily be different for each organisation which these are applicable to. In each case these need to be directly derived from the defined objectives of the organisation. However, some generic indicators have been included in this study, such as 'value for money' measures.

Financial risk indicators are normally grouped into two main categories based on the time perspective. Short-term indicators monitor liquidity or the ability of the organisation to pay its bills, whereas the long-term indicators relate to long-term solvency issues such as the overall level of gearing or debt.

Operating capacity indicators cover a range of issues such as the level of capital investment and replacement, as well as revenue and expenditure issues.

1.4. Accountability and Management Cycle

Financial Management Cycle

Most organisations have a management cycle where resources are allocated through internal processes to produce product or service outputs, aimed at achieving desired outcomes. Ideally there is a regular review process to adjust these factors and improve outcomes. This process is managed by the organisation's leadership through applying and developing strategies, structure, and culture by means of organisational policies and procedures.

FIGURE 2: ORGANISATIONAL MANAGEMENT CYCLE¹



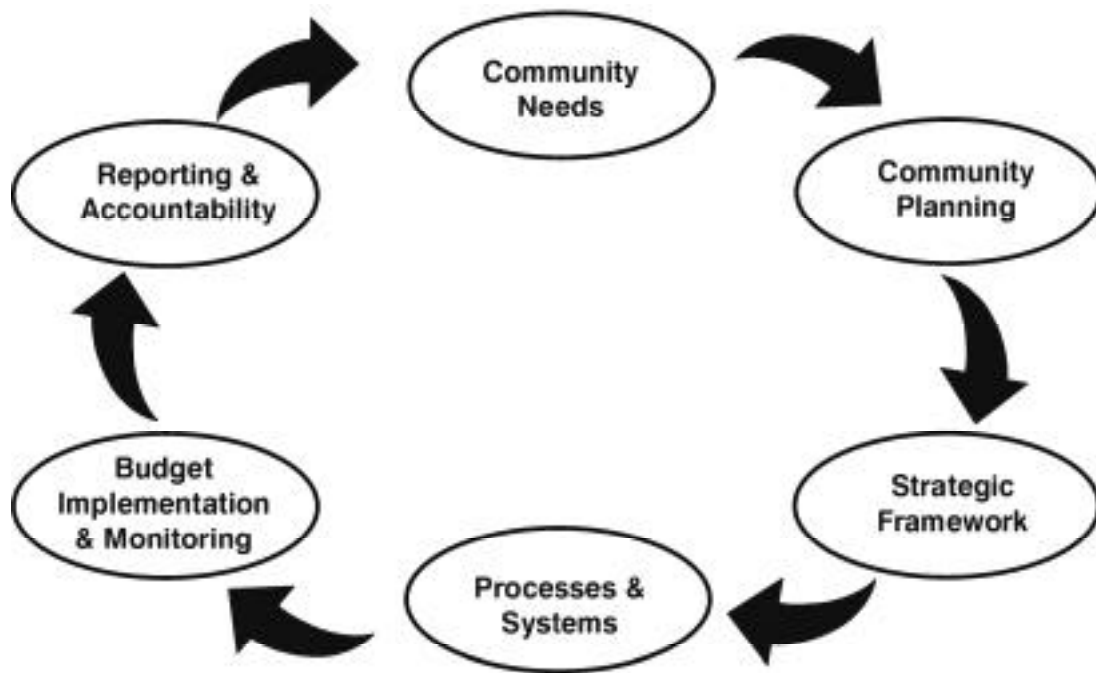
A similar process operates for the financial management cycle. At the beginning of this cycle strategies are formulated, budgets developed and monitored, with

¹ Developed by David Spearritt and Alex Taylor

accountability reports on the outcomes. This model is outlined in the following diagram. Ideally the organisational and financial management cycles are synchronised.

Each point in this cycle management requires different information. At the strategy development stage, management needs strategic information such as long-term forecasts and models, comparative benchmarks, economic parameters, and information on new and emerging issues which need to be addressed to meet community needs. As the budget is being developed information is required on the resourcing impacts on service levels and on the progressive budget balance. During the financial year, strategic indicators become less important and focus on monitoring adherence to the budget planning an achievement of the desired outcomes. During the implementation of the budget ongoing work is required to ensure productivity improvements occur and the community is receiving value for money. At the end of this cycle management is required to report on its performance in accountability reports such as the annual report and the audited financial statements.

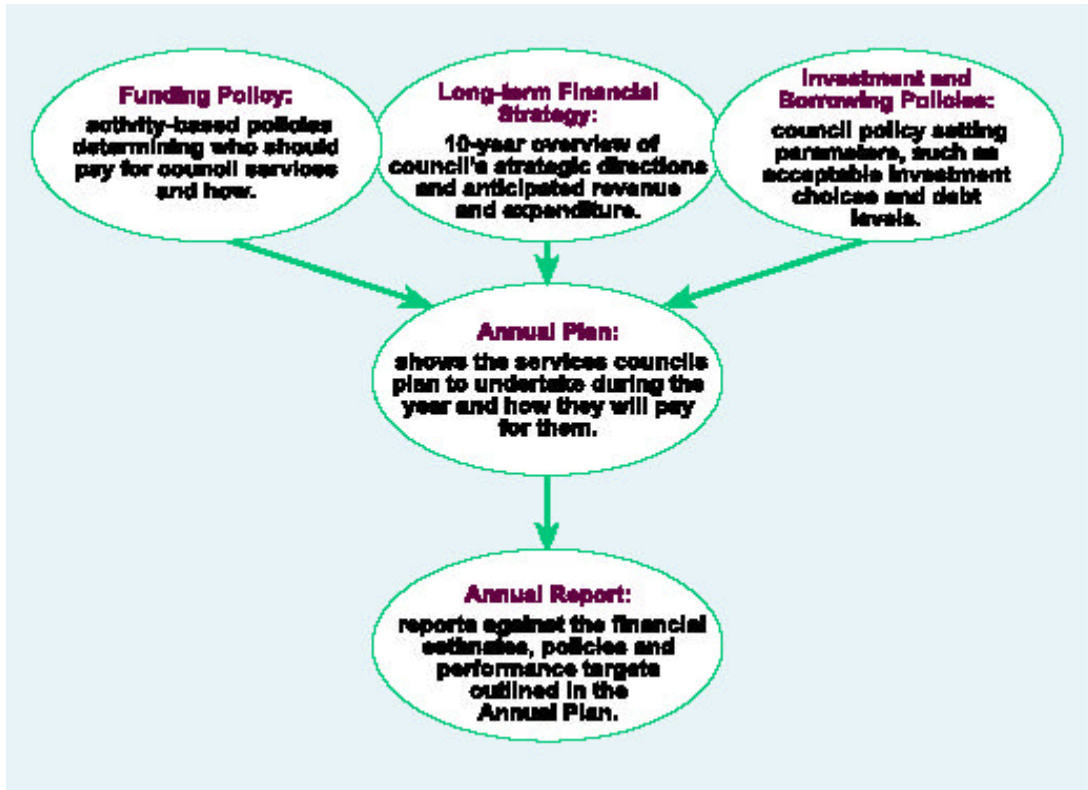
FIGURE 3: FINANCIAL MANAGEMENT CYCLE²



The following diagram outlines the New Zealand approach to financial management, which is similar to that outlined above but not shown as an annual cycle.

² Developed by David Spearritt and Alex Taylor

FIGURE 4: NEW ZEALAND APPROACH TO FINANCIAL MANAGEMENT



1.5. Methodology

The Methodology applied in this project will be to review the documentation literature throughout Australia and the world, both in terms of conceptual theory and practical case studies, with the emphasis on the last 10 years. Research will be conducted in three areas namely the external reporting, internal reporting, and performance management reporting. In order to determine this practice, the examples uncovered will be assessed against the risk return framework outlined above (with particular reference to community objectives, financial risk, and operating capacity issues) and the accountability and management cycle. In each area, the research will penalise developments in both the issues reported on as well as reporting techniques. From this conclusions will be developed and recommendations presented.