Financial Decision-Making and Transparency

Workbook & Reference Guide

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> Elected Member Skills and Knowledge Check

Financial Decision-Making and Transparency

1 point for each (one has 2 points) = 20 total for section
(check relevant boxes below)

Do you (know)

- ☐ How to consider if a council financial decision is prudent?
- ☐ That the LTP sets out the major direction and significant projects over the next ten years?
- ☐ That the Annual Plan budget for one year must only have variations compared with the LTP for that year?
- ☐ The current level of debt (and/or investments) compared with the projected level of debt (projected levels of investments)?
- ☐ When setting rates that each rate must be listed in the funding impact statement and comply with the Local Government (Rating) Act 2002 and that those rates must be consistent with Council's revenue & financing policy?
- ☐ What is the purpose of your Audit and Risk Committee?

Can you (do)

- ☐ Explain how Council's financial strategy sets the limits on rates and debt and how this impacts on the council view of being prudent?
- ☐ Identify within the LTP the significant projects and the impacts on rates and debt?
- ☐ Explain the variations between the LTP and Annual Plan?
- ☐ Identify the interest cost (or investment revenue) associated with your council's debt (or investments)?
- ☐ Identity the type of rates the council uses?
- ☐ Can you explain to the community how your council's financial strategy influences decisions?

Have you (done)

- ☐ Influenced the development of your council's financial strategy?
- ☐ Introduced or overseen a new project into either the LTP or Annual Plan that impacts either the rates or debt of Council?
- ☐ Adopted an Annual Plan that is consistent with the LTP or adopted an Annual Plan which has variations to LTP which required public consultation?
- ☐ Adopted the treasury policy (including liability management policy and investment policy?
- ☐ Modified an existing rate or introduced a new rate?
- ☐ Are you an active member of the A&R committee?

The next question is worth TWO points

- ☐ Does your council explain how your community's rates are decided and used?

Total __ / 20

> Introduction

Meet Bruce, EquiP Facilitator

Bruce Robertson works with many local authorities, including being an independent member of Audit and Risk Committees for Auckland City Council, Bay of Plenty Regional Council, Environment Southland, Far North District Council, Southland District Council, Thames-Coromandel District Council and Waipa District Council.

Much of his consultancy work intersects the key local government disciplines of financial, asset and strategic management. In his prior role as Assistant Auditor-General he oversaw the audit of the last four LTP rounds and reported extensively at sector level on the quality of forecasting and planning. Bruce is a Fellow Chartered Accountant and has a Bachelor of Commerce and Arts.

The Essentials

One of the challenges for councillors is the need to constantly upgrade their technical skills and knowledge to enable them to make well informed contributions as governors.

EquiP's focussed digital modules and workshops will help elected members to grow their governance and related skills. These modules, based on the *Elected Member Skills and Knowledge Check,* will allow councils to provide a nationally consistent set of induction training modules on generic topics.

This Financial Decision-Making and Transparency module is one of the ten digital modules developed by EquiP.

Each of the 10 video modules come with a set of questions and exercises to help participants and their councils to test the development of their knowledge and skills. Local governance support staff can oversee and sign off each module completion.

Purpose

- To enable councils to provide a nationally consistent set of induction training modules on general topics.
- To build and measure technical skills and knowledge across all elected members.
- To assist all elected members to be able to make informed decisions and contributions to effective council strategy and plans.

Four key areas of focus

- The first key things you need to know as a councillor
- The top 5 big issues for local government
- What (and who) to ask
- The most likely challenges you'll come up against

Bruce Robertson, EquiP Facilitator

The ten topics

- Governance 101
- Financial Decision-Making and Transparency (this one)
- Asset Management and Infrastructure
- Quality Decision Making
- Political Acumen
- Cultural Awareness
- Strategic Thinking
- Ethics, Values, Integrity and Trust

+ Technical topics

- Standing Orders
- Conflicts of Interest

Financial Decision-Making and Transparency - purpose

To demonstrate the importance of prudent financial decision-making and transparency for our communities.

Financial Decision-Making and Transparency - learning outcomes

By the end of this module you will be able to:

- decide if a council financial decision is prudent
- identify the purpose of the council's Long Term Plan (LTP) and Annual Plans
- explain how the council's financial strategy sets limits on rates and debts
- clarify the purpose of your Audit and Risk Committee.

Tips for watching the videos and using this workbook

Note that the video is in two parts and the workbook covers both parts. **Video Part 1** provides background and context and **Part 2** gets into more detail.

Financial Governance is a large topic and probably the one that people find the hardest. So pace yourself and take your time. Work your way through the scenario and accompanying questions and then you'll be ready to take a closer look at your own council's financial statements. Remember, you don't have to be an expert. So ask plenty of questions of the experts around you and the more you practice, the more comfortable you will become with the decision-making process.

> What is governance?

Governance is about being part of the conversation that sets the direction of your organisation.

Direction setting is done via you and your governance group's strategy development. To do this well requires:

- participating respectfully – developing trust and confidence;
- listening actively – understanding other points of view;
- seeking input from management and the general public - consulting; and
- being accountable – being transparent and honest.

Your role as a councillor is further complicated by the role being a representative one as well as a governance one.

It's worth remembering that it's impossible to please all of the people all of the time; therefore good governance and/or leadership is about being prepared to make some tough decisions.

EquiP's Five Foundations of Governance Excellence

1. Leader of community aspirations, direction and strategy
2. Collaborative culture, working to collective strengths while valuing individuals' input
3. Taking collective action for your community
4. Action and accountability as a good corporate citizen
5. Commitment to continuous improvement and personal development

Explanation:

Leader

As a leader of community aspirations, direction and strategy you have an advocacy role as well as an influencing role. You are contributing to the design of how community aspirations will be met, and with that settled; you are an advocate of those aspirations and the path that has been agreed to meet them. There may be a step in between if you are doing a consultation process – at which stage you are seeking input on a proposal rather than a decision. So your challenge is to listen to feedback rather than to try and justify the proposal. That bit comes when the proposal has become an agreed course of action.

Collaborative culture

The councils who work best for their communities are those who work collaboratively, enjoy high levels of trust, confidence and respect amongst themselves and with senior management.

Collective action

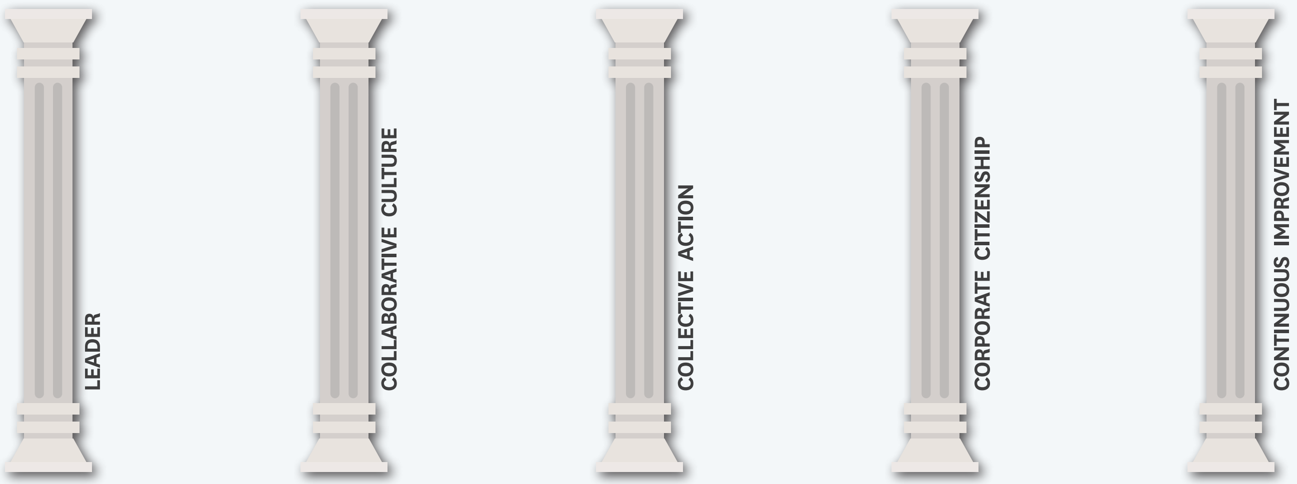
Taking collective action is about understanding the notion of collective responsibility. There will be times when you may not agree with the final decision that has been made – but the notion of collective responsibility requires that you accept the decision and work with it in the wider interests of the community.

Corporate citizenship

Good corporate citizenship entails being ethical, meeting your legal responsibilities, and being financially prudent.

Continuous improvement

This is about regularly evaluating your own performance as well as the performance of the council as a whole. There are plenty of tools to do this. Contact **equip.pd@lgnz.co.nz** to get started!



> Part One

Getting started

It's important to recognise that:

- most of the decisions you will make as a councillor have financial implications
- there is generally a cost, and therefore a requirement to fund, any decision outcome
- your community expects you to be accountable for those costs.

Remember what Dr Mike says. These concepts are new to most people. So, no question is a "dumb" question. Plus, there is plenty of support for you to upskill, as well as learning from others around the council table. (Later, check the back page to find out what accrual and depreciation is).

Why is this topic important?

- Council finances are an enabler of the goals of the council.
- Prudently marshalling your financial resources enables you to achieve your community aspirations.

Connecting the dots

See the EquiP Five Foundations on the Governance (previous) page of this workbook.

How financial decision-making relates to EquiPs Five Foundations:

- Managing council finances is part of having a leadership discipline, and recognises that you need to be accountable and transparent.
- You will bring different views and experiences to financial decision-making; being able to collaborate and committed to a consensus is important for your community to have trust and confidence.
- Good leaders learn, and continue to learn, through their experiences.

Do you know?

Five key issues:

1. How to consider if a council financial decision is prudent?
2. That the LTP sets out the major direction and significant projects over the next ten years?
3. That the Annual Plan budget for one year must only have variations compared with the LTP for that year?
4. The current level of debt (and/or investments) compared with the projected level of debt (projected levels of investments)?
5. What the purpose of your Audit and Risk Committee is?

Important legislation

Local Government finances are driven by statutes and regulations.

Key sections of the LGA you should read:

- start with Part 6
- particularly focus on sections 100 – 103 for financial management
- sections 93 – 99 concentrate on planning and transparency.

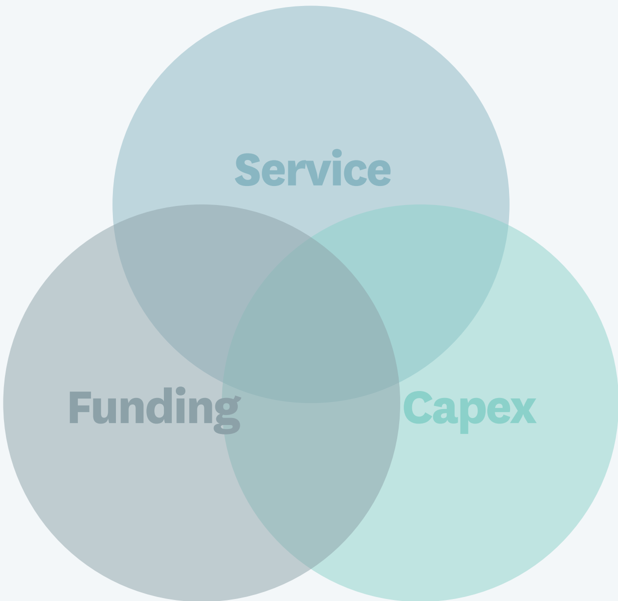
Other key legislation relates to the Local Government (Rating) Act.

This legislation sets out:

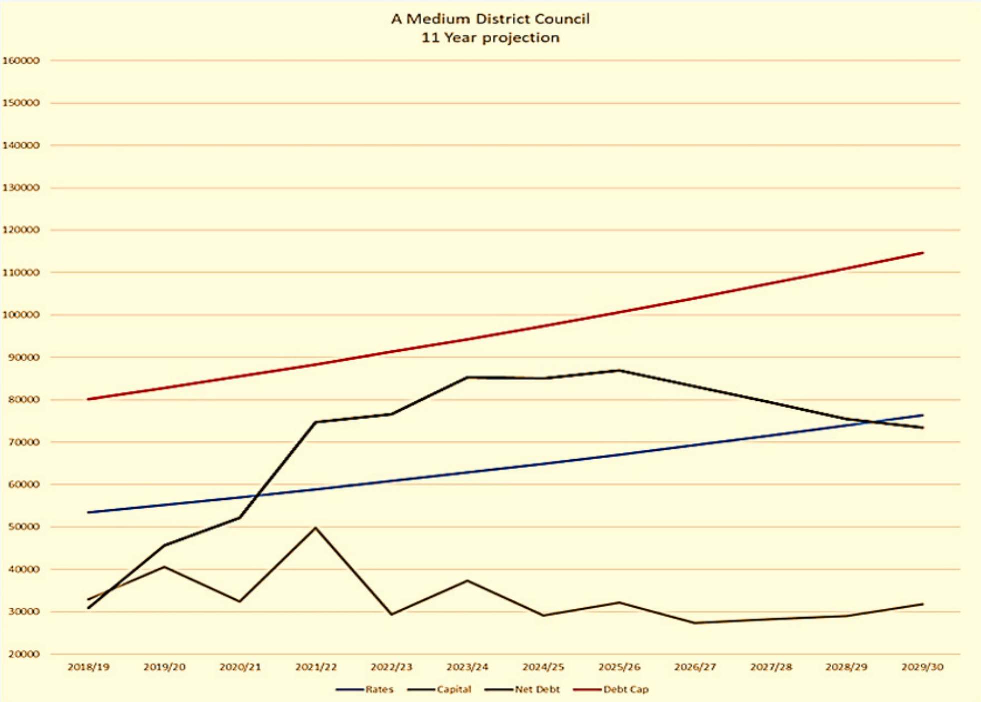
- what and who must pay rates
- what type of rates you can set
- how you set and collect rates

Long-Term Plan

The long term-plan is a key place were financial decision-making comes into play in the following areas:



The Financial Strategy



This graph gives you a visual idea of how a financial strategy can look over a ten (or eleven in this case) year period. It demonstrates how decisions reflect and impact your overall financial strategy.

The top line is the debt cap – the most you are allowed to borrow as a council. It needs to be the highest line on the graph – because if you go over that line at any point, your council is effectively exceeding its debt cap.

The line below that, is your actual debt.

The next line is the rates line which, in this case, is showing a steady rate increase slightly above rate inflation. That is the decision this council has made.

The last line is the capital work programme, year on year, which indicates when money needs to be spent. So for example, a sudden increase in capital work may also require an increase in rates to ensure your debt doesn't breach your debt cap.

Asset management and infrastructure plans also impact this capital work programme.

The graph demonstrates how multiple financial decisions are made and impact your overall financial picture. Some financial decisions will have a greater impact on this graph – such as parks – because there is no corresponding revenue. On the other hand, if a council wanted to increase the number of building inspectors, for example, this could be covered more directly by charging (or increasing the charge) for this service.

When developing a financial strategy, the key is to keep it simple, and high-level. It makes sense to think of things like long-term plans at the high-level rather than the individual details-level. But by policy setting at a higher-level, bigger picture decisions can be made. For example, think about what the total impact on the ratepayer will be. So, rather than whether the sewerage rates will go up and the water rates will go down, what will the overall (or net) impact be on the ratepayer.

Three key financial statements are the revenue and financing statement (often called the statement of comprehensive income now), the statement of cash flows and the balance sheet. For example, your rates line in the graph above comes from the statement of comprehensive income, your capital work programme is your main moving part in your statement of cash flows, and the debt line comes from, and is the main moving part in, your balance sheet.

A key thing to note is that the level of service your council provides impacts the lines on our graph. The higher the level of service, the higher the cost, and therefore potentially debt and/or rates, required to meet that higher cost in order to provide the higher level of service.

> Part Two

Is the financial decision prudent?

- There is no 'black and white' rule that exists as to what is prudent.
- It is a matter of judgement (by the council) and a matter of public accountability.
- How can I decide if it is prudent?
    - ask experienced people
    - follow the legislation
    - follow the regulations
    - use your common sense
    - ask good questions of your primary advisors.

Prudence – further discussion

Mike suggests a primary question: 'Is it a wise and a sensible decision that I'm about to make?' Is this service, for example, going to meet the needs of communities today and in to the future (e.g. taking into account an ageing population). For example, if the proposal isn't going to be suitable (it will fail) in five years' time, that might not be a prudent decision. Next, how are you going to pay for it (if council decides to go ahead)? Rates? Charges? Some other form? And asking 'Is the mix a prudent mix?'.

Dave suggests that every decision has a consequence – and the important thing is to understand the consequence. That is, if you want to spend more money, you need to be able to find more money. For example, it could mean a rates rise, debt increases (and operating costs through interest costs) or user charges – all of which have their challenges. So it is the consequences of doing versus not doing. The impact on the level of service of not doing something is just as important as assessing the consequence of doing it (whatever it is).

Bruce describes prudence as the financial ability to develop, maintain and continue to deliver services at the desired level (sometimes dictated by the law), affordably over the long term. In other words, it is a balancing act.

The Financial Management Legislation

101 Financial management

(1) A local authority must manage its revenues, expenses, assets, liabilities, investments, and general financial dealings prudently and in a manner that promotes the current and future interests of the community.

(2) A local authority must make adequate and effective provision in its long-term plan and in its annual plan (where applicable) to meet the expenditure needs of the local authority identified in that long-term plan and annual plan.

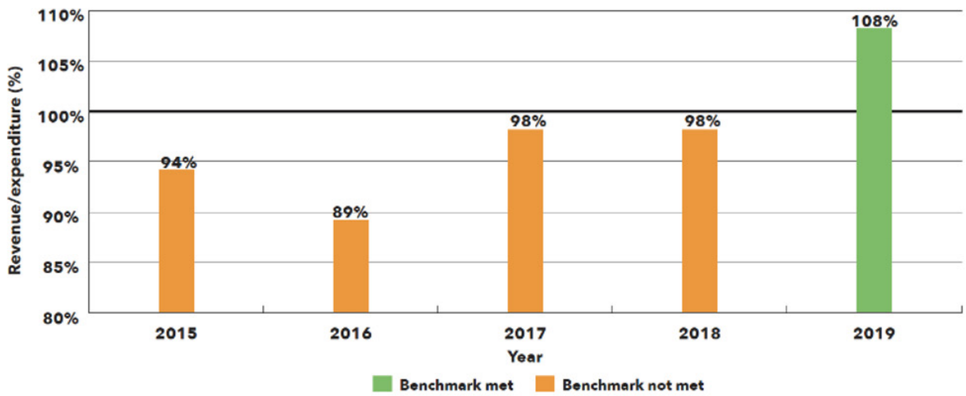
The Regulations

The regulations require specific disclosures within your planning documents. Arguably, they require a council to show the implications of their decisions. There are about eight tests that they provide. An example council (below) shows what two of the benchmarks mean for this council.

The first is the 'balanced budget benchmark' which relates to the need for council to make relevant provision for its costs (e.g. if you need $100 million, you can raise $100 million). In this example, the council hasn't reached that test until 2019. This council would need to understand why this is the case – i.e. why it was prudent – and in this case it would be because the council expected to exceed the 100% mark in 2019.

BALANCED BUDGET BENCHMARK

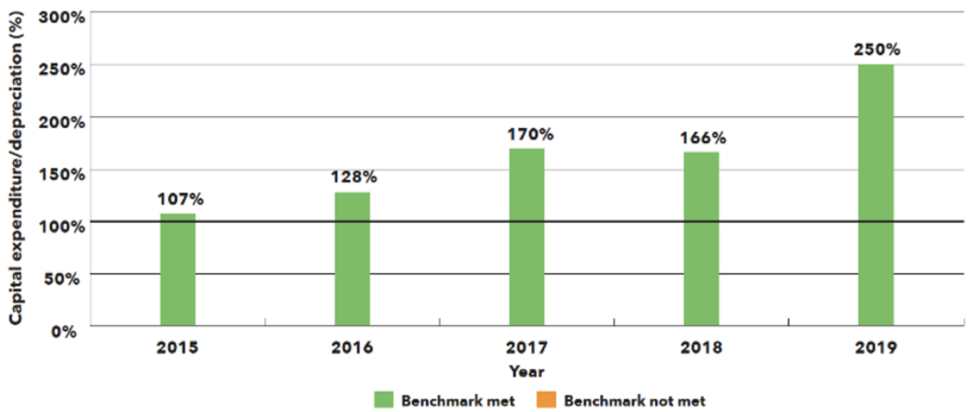
The following graph displays the Council's revenue (excluding development contributions, financial contributions, vested assets, gains on derivative financial instruments, and revaluations of property, plant, or equipment) as a proportion of operating expenses (excluding losses on derivative financial instruments and revaluations of property, plant, or equipment). The Council meets this benchmark if its revenue equals or is greater than its operating expenses.



The second benchmark below is the 'essential services benchmark'. This relates to the idea that your capital expenditure, driven by your asset management plans, would be at a level at least sufficient to maintain your assets. The 100% which is equating your capex to the level of depreciation. The argument for prudence is that if your capital spend equates to, or is in excess of, your depreciation level, you are being prudent. The regulations require as you prepare an annual plan or report that you indicate where you need to be and what you need to achieve. In the below example, the council has an increasing spend relative to depreciation. It would appear that this council is intending to maintain its asset base.

ESSENTIAL SERVICES BENCHMARK

The following graph displays the council's capital expenditure on network services as a proportion of depreciation on network services. The Council meets this benchmark if its capital expenditure on network services equals or is greater than depreciation on network services.



Annual Plan budget variations

- The Long Term Plan is the centrepiece of planning, but annually you set rates in the Annual Plan.
- The Annual Plan defines what the year ahead will look like – and fits into the Long Term Plan.
- The Annual Plan includes a reassessment of anticipated revenues and expenditures, and if they are now out of date or inaccurate, you will need to vary your plan in the Annual Plan.
- If the Annual Plan, including the variations, is not significantly different to the Long Term Plan, you can go ahead and adopt the Annual Plan and set your rates.
- But if the variation is significant, you need to consult with your community.
- Whether the changes are significant is an area of judgment – your Significance and Engagement Policy will help you decide whether you need to consult.

Levels of Debt

- Regular reporting will help you know whether your assumptions and predictions around level of debt are on track.
- You can then track and compare your budget position with your actual position – including your levels of debt.
- Ask where you will be at year end and why.

Setting rates

- Setting rates must be consistent with your Revenue and Finance Policy – the principles for setting rates are stated there.
- There is a legal process to setting rates.
- The process for setting rates must be transparent in planning documents.
- The type and level of rates must be explained.
- The planning process is important.
- Setting rates informs part of your prudent financial management.

Being transparent

Being a willing participant and reporting to your community is an important part of being an elected member and being transparent.

The annual report

- Is a reflection of what you achieved against what you planned to achieve or where you planned to be (and why there is a difference).
    - Financial – what money did we raise, how was it spent and what position does that leave us in?
    - Non-financial – what levels of service (including capital) did we deliver?
- It is subject to independent review by the auditor.

Purpose of the Audit and Risk Committee

Two primary functions:

1. Reviews the risks and processes in place to manage the risks.
2. Oversees the development, delivery and quality of a council's formal reporting on performance.

Best practice is that a committee includes one or more independent members.

Questions to ask/final thoughts

- It pays to get involved in the annual plan process. Most councils will start the process early in the New Year. The first decision is whether the plan is significantly different and consequently whether public consultation is required.
- Debt levels - in local government, your assets can't be 'realised' (i.e. you can't sell them easily) so you need to consider ability to repay debt rather than the usual bank lending criteria.
- What types of rates can be set? Examples include:
    - A general rate – i.e. based on the value of the property (e.g. land value or capital value),
    - Targeted rates – e.g. a uniform charge, or based on land/capital/annual value. You can target a rate to a group of people or a particular service.
    - A differential rate is essentially saying different parts of the community will pay different rates – e.g. residential, commercial and farming communities may pay different rates.
- What is funding depreciation? (And do I need to?). This issue is based on a financial measure that - if you go through your statement of income and expenditure - the final number will be zero or positive. This gives you an indication that you are "not going backwards" in your balance sheet.

> Check what you know

Check what you know so far. But don't panic if you don't know some of the answers - they are on the following page, so no peeking for now!

1. Scenario

Please refer to the Whakatane DC 2018-28 Long Term Plan, which comes with this workbook.

Whakatane is a mid-sized territorial local authority situated in the Eastern Bay of Plenty. Well known for its long sunshine hours, along with its neighbours, Opotiki and Kawerau DCs, it has a developing and vigorous local economy. Its district contains some great natural features including its hinterland including 2 major rivers. The District has a number of rural communities and a range of socio-economic conditions. Maori make up 46% of its resident population.

It is a Council committed to developing good practice and delivering for its communities.
Spend a few minutes familarising yourself with the document including a focus on their Key priorities for the coming 10 years (refer pages 14 through 29).

a) What principles are they using to ensure their financial strategy (direction) is prudent?

b) Will these principles in your judgement enable the council to be prudent?

c) How can the community affect your financial strategy?

d) Review the LTP – can you identify the significant projects and their impact on rates and debt?

e) Other than the first year of the LTP in the case of the Whakatane LTP that is the 2018/2019 financial year, a council is required to adopt an annual plan and set rates based on that plan. Why is it necessary when an LTP has been adopted and why could the rates set be different from that anticipated in the LTP?

f) Can you identify the interest cost associated with the Council's debt?

g) What type of rates does Whakatane set? Where would you find a definition of those type of rates?

> Check what you got!

Here are some suggested answers.

1. Scenario

a) What principles are they using to ensure their financial strategy (direction) is prudent?

Refer to objectives I – V. They are:

- I - Ensuring resource is available to sustainably manage assets and services
- II - Retaining capacity to add value to our services and facilities
- III - Maintaining rates at an affordable level
- IV - Maintaining overall debt at around or just above current levels
- V - Managing our finances responsibly and minimizing financial risk

b) Will these principles in your judgement enable the council to be prudent?

Prudence is ultimately a matter of elected member judgement. These principles are reasonable in their own right. However, they must be matched against the factors and pressures the Council must manage in the coming years. For example, principles IV and V represent real restrictions on the level of funding available for Council to undertake its activities. For example, at the moment their self-imposed debt limit under principle IV is $80m which ranges from 102 – 108% over the life of the LTP. Based on the accepted LGFA prudential limits of 175% of revenue, debt levels ranging form $129m to $136m could be accessed. The elected members thinking on this should be informed by the future challenges they face in coming years – these are outlined in the in the LTP and especially the "Key priorities for the coming 10 years" (refer pages 14 through 29).

c) How can the community affect your financial strategy?

The community has its input when Council consults the community on its draft LTP. It must take into account community comment before adopting the LTP, including setting its Financial Strategy. Feedback from the community and its influence is shown on page 16 of the LTP. Through the feedback process the Council has amended its draft Financial Strategy for rating the Murupara locality for its water and wastewater services and more generally the submission process has meant that overall rates have been set at an overall increase of 3.83% rather than the draft position of a 3.99% increase.

d) Review the LTP – can you identify the significant projects and their impact on rates and debt?

Refer pages 264 through 269 for a list of the major capital projects over the life of the plan. The list includes reference to how the projects are anticipated to be funded. The references are to percentages e.g. 'LOAN 50 RENEWAL 50' means it is intended funding comes 50% from debt funding which will have to be paid over coming financial periods (most likely from rates) and 50% from renewal reserves generated form rate income.

The rationale for the funding can be found in the Revenue and Financing Policy on pages 82 through 103.

e) Other than the first year of the LTP in the case of the Whakatane LTP that is the 2018/2019 financial year, a council is required to adopt an annual plan and set rates based on that plan. Why is it necessary when an LTP has been adopted and why could the rates set be different from that anticipated in the LTP?

The LTP is predicting the future. The Whakatane LTP was developed in the year preceding it coming into effect during the 2017/18 financial year. In reality this is nearly 3 years before he actual 2020/21 Annual Plan that you will be involved in. The Annual plan recognises the limitations of Council's ability to predict the future and the Annual Plan, while based on the 2018-28 LTP, enables a council to update those forecast LTP numbers with new information. Often that may be different to those predictions made up to 3 years earlier.

f) Can you identify the interest cost associated with the Council's debt?

The LTP discloses the anticipated cost of debt in its prospective Statement of Comprehensive Revenue and Expenses on page 234. This shows an anticipated cost of debt in the first year of the LTP (2018/19) of $2.572m. Given an anticipated level of external debt of $55m, this represents a raw interest rate of 4.6%.

Another helpful measure is disclosed on page 230 which show interest costs as a proportion rates revenue, given this is the primary source of funding interest costs. This matches the % (interest/total rate revenue) against an industry norm of 12%.

The annual report will also separately disclose the actual numbers for the financial year it is reporting on.

Note that the debt cap referred to is total debt (not just external debt).

g) What type of rates does Whakatane set? Where would you find a definition of those type of rates?

The primary source of understanding what rates Whakatane District Council uses is contained in their Revenue and Financing Policy (pages 82 through 103). The policy discloses their approach, why they use that approach, and the rates used to fund that activity (along with other sources of revenue, where relevant).

The other important source of understanding the type of rates used is the Funding Impact Statement on pages 271 through 275. This describes the actual rate to be set and the amount of funding each rate is anticipated to provide. Further on pages 276/77 indicates what a sample of representative properties throughout the district is anticipated to pay as a result of the LTP.

LGNZ can provide more advice on the technical nature of rate types and their use. The primary source (and very readable) is the Rating Act 2002.

> Can you do?

Now that you've had a practice, take a look at your own council's key documents – including the LTP, Annual Plan and the financial statements. Consider the following questions. Obviously we won't be able to tell you about your own council, so ask a colleague with some financial governance experience if you have any further questions about your own council's plans and financial statements.

1. **How would you describe your own council's financial strategy?**

2. **Do you think it is prudent?**

3. **How has/does your community affect your financial strategy?**

4. **What are your significant projects in the asset management plan, and how is your council planning to fund them?**

5. **How does your Annual Plan fit into your LTP?**

6. **What is your council's debt cap and current level of debt?**

7. **Can you find what the interest cost of your debt is?**

8. **How does your council currently set rates?**

> Wrap Up

More about Financial Decision-Making and Transparency

Two Definitions

Earlier in this video, Dr Mike emphasised that local government finances are different to traditional commercial finance. He also mentioned two areas that often trip new councillors up when it comes to financial governance. We wanted to give you a quick 'heads up' on what those terms meant.

Accrual accounting

< First, Dr Mike mentioned that we use 'accruals' in accounting. This means that the entry for a revenue or cost is recorded at the time they were incurred (happened) rather than when the actual money changed hands. In a practical sense this means that if your council built a new fence in February, but the tradesperson forgot to send the invoice until April, the entry for the cost of building the fence would show in February's reports – not April's. >

Depreciation

< Dr Mike also mentioned the term depreciation. Depreciation is used in accounting to reflect the fact that an asset (usually) loses value over time. For example, if your council purchased a brand new digger to look after your local parks, you would expect that at first, it would be worth the full amount that was paid for it. But over time, if you were to sell that same digger, you'd expect to get less and less each year. Depreciation accounts for this by reducing the value of the asset in the balance sheet over time, to a truer value of your assets to ensure they aren't overstated. It is also useful from a tax and accounting perspective because depreciation is treated as an expense and councils are required to balance their budget, unless it is prudent not to do so, revenue must be set at a level sufficient to cover that expense on an annual basis. >

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EquiP is LGNZ's Centre of Excellence. We deliver tailored services, best practice guidance, business solutions, and governance and management support to strengthen the local government sector.