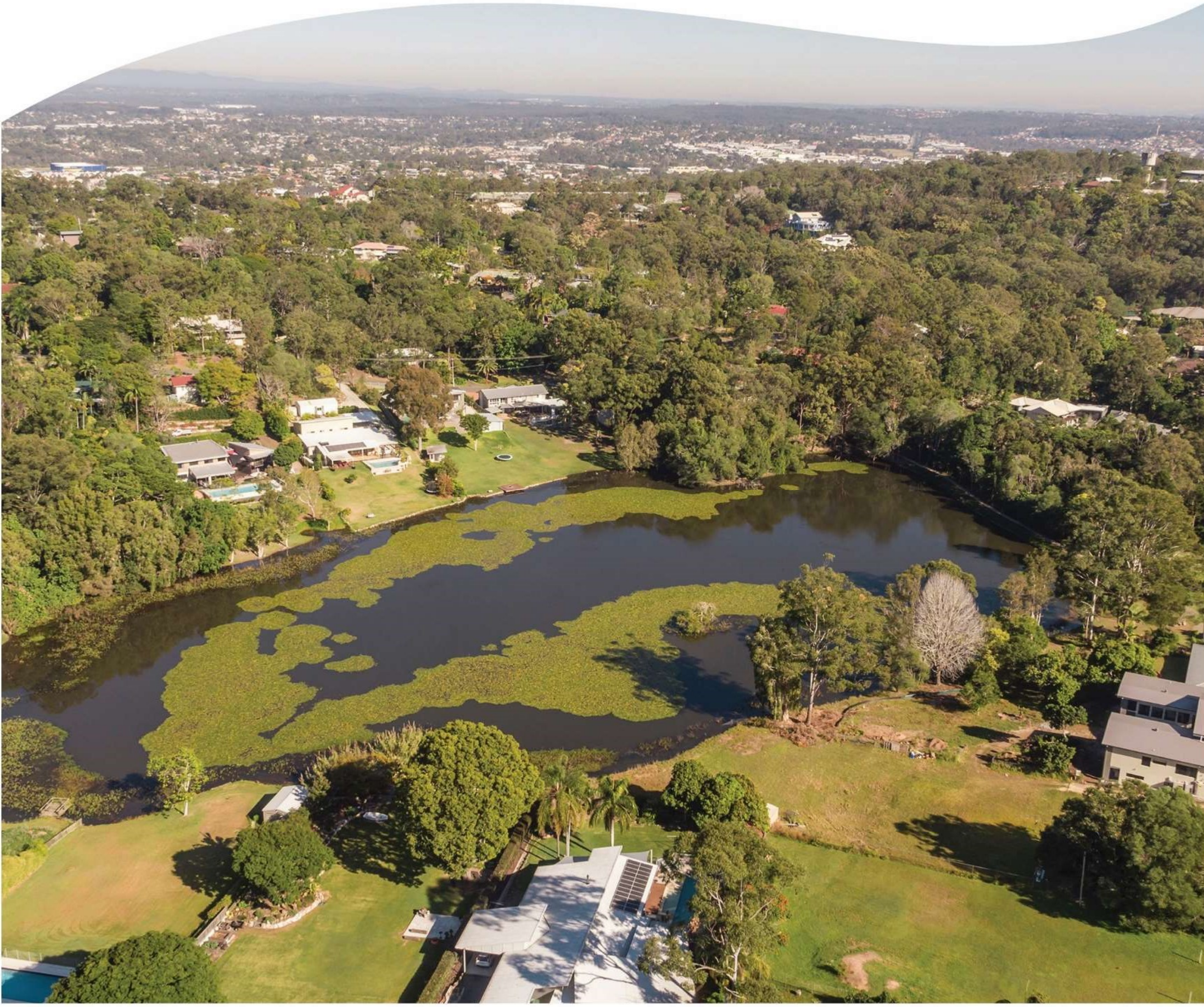
Financial Risk Management Framework



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Financial Risk Management Framework

Introduction

Logan City Council has a framework of plans, strategies, policies and procedures in place which reflect Council's compliance with its legislative obligations and provide governance assurance to all of Council's stakeholders. Together, they form the governance framework for Council.

This Financial Risk Management Framework document supports Council's governance framework by providing a written record of:

(a) risks that Council is exposed to through Council's operations that are relevant to financial management

(b) control measures adopted to manage these risks

(c) the duties of employees responsible for carrying out an activity relating to financial management.

1. Scope

Section 164(1) of the *Local Government Regulation 2012* states that a local government must keep a written record stating the following:

(a) the risks the local government's operations are exposed to, to the extent they are relevant to financial management

(b) the control measures adopted to manage the risks.

This framework provides practical steps to address these requirements.

2. Financial Risk Management Framework Principles

2.1. Financial management principles

Financial management principles shall be developed in support of priorities tabled in Council's corporate plan. Management principles shall ensure that:

(a) Council is financially sustainable and long-term financial sustainability is achieved

(b) Infrastructure is effectively and efficiently provided, developed, maintained, and disposed

(c) Budgets and other financial information are reported in a consistent and accurate manner

(d) Council has a considered position on service delivery, and its roles and responsibilities in relation to each of its services

(e) Council has a considered position on the funding of services and has suitable resources to enable it to evaluate the strategic benefit of all its services

(f) An equitable, transparent, and accountable rating system is in place

(g) Achievement of Council's strategic objectives is facilitated through effective management of borrowings and financial assets

(h) There are systems and procedures in place that improve the efficiency and effectiveness of Council services in order to:

  (i) recognise and manage risk

  (ii) encourage enhanced performance

(i) The integrity of financial systems and reports are safeguarded.

2.2. Financial management risk strategies

The following strategies shall be developed and maintained in support of financial management principles.

Principle 1: Council is financially sustainable and long-term financial sustainability is achieved

(a) The long-term financial plan adopted by Council focuses on achieving, at least, a break-even operating result:

  (i) Council shall adopt a long-term Financial Plan, for a period of at least 10 years, which ensures that each year's projected operating revenue is sufficient to meet that year's operating expenses, unless Council has formally resolved that it is financially prudent for it not to do so

  (ii) There are clear links between Council's Strategic Management Plans (including the long-term financial plan), its annual business plan and its annual budget

  (iii) An observable process shall be implemented that links the ongoing development of each of the following documents:

    A. corporate plan

    B. long-term financial plan

    C. Assets Management Plan (the results of which are reflected in the long-term financial plan)

    D. annual business plan

    E. annual budget

  (iv) The long-term financial plan is to include four standard financial reports:

    A. income statement

    B. balance sheet

    C. cash flow statement

    D. key financial performance measures/indicators including at least those in requirement 1(c) below

(b) Council shall report on key sustainability measures/indicators

(c) Council shall provide explanatory material in its annual report on the following measures/indicators of financial sustainability including commentary on variations from targets:

   (i) asset consumption ratio

   (ii) asset sustainability ratio

   (iii) asset renewal funding ratio

   (iv) leverage ratio

   (v) operating surplus ratio

   (vi) operating cash ratio

   (vii) unrestricted cash expense cover ratio

   (viii) council controlled revenue ratio

   (ix) population growth ratio.

Principle 2: infrastructure is effectively and efficiently managed

(a) Council has a clear understanding of infrastructure condition, maintenance, refurbishment, and replacement needs:

   (i) Council shall undertake regular assessment of infrastructure assets, including their condition, maintenance, refurbishment, and replacement needs

(b) Council shall be able to clearly demonstrate the link between infrastructure assets and service delivery:

   (i) Council shall undertake regular assessment of infrastructure requirements to support current and future service delivery to be compared with Council's stock of infrastructure in order to plan for future development requirements

(c) Council undertakes regular review of the Assets Management Plan:

   (i) Council shall review its Total Asset Management Plan at least annually

(d) Council ensures that annual capital expenditure programs for renewal and replacement of assets closely match the infrastructure and asset management plan:

   (i) The asset sustainability ratio (capital expenditure/optimal level of capital expenditure) for the previous year's expenditure shall be 100% (plus or minus 10%) indicating that optimum levels of capital expenditure are being undertaken to maintain service delivery

(e) Council must record accurate infrastructure asset values and depreciation costs. Council shall ensure that:

   (i) Its assets are revalued annually by at least applying a suitable price escalator with a more rigorous review of asset valuations (conducted on a 'fair value' accounting basis) occurring at intervals of no more than 5 years

(ii) Useful lives for each of its asset classes are regularly reviewed and informed by the Total Assets Management Plan and having due regard to the useful lives of similar assets of other councils

(f) 'Unit rates' have been developed from documented costing policies

(g) Infrastructure assets are recognised under the following categories:

(i) Capital renewal - renewing an asset to extend its serviceability but not providing a higher level of service (e.g. resealing a road)

(ii) Capital upgrade - renewing the asset to provide a higher level of service - e.g. sealing an unsealed road

(iii) Capital expansion - providing a new asset - e.g. extending a footpath to an area where one did not exist previously

(iv) Maintenance - does not upgrade or renew the asset, but enables an asset to deliver its defined level of service over its planned lifespan - e.g. repair potholes.

Principle 3: budgets and other financial information are reported on in a consistent and accurate fashion

(a) Budgets and financial reports are prepared on an accrual basis:

(i) Council shall adopt all budgets and financial reports on an accrual basis consistent with accounting treatments in annual financial statements

(b) Summary budget information is presented in a uniform and comparable basis:

(i) Council shall present summary information on its annual budget in a format set out in its budget manual

(ii) This shall include information on key financial performance and position measures/indicators.

Principle 4: Council has a considered position on levels of service, and its roles and responsibilities in relation to each of its services

(a) There is a framework for the assessment of provision of services:

(i) Council shall have a framework on the provision of services and its roles and responsibilities in relation to those services

(ii) Know the cost of providing existing levels of service:

A. Council shall have a system which produces clear information on the cost of current council levels of service, including fully attributed lifecycle cost/ benefit analysis

(iii) Determine the cost of providing an additional service:

A. Any new service proposed shall undergo a rigorous cost/benefit analysis and must align to strategic priorities.

Principle 5: Council has a considered position on the funding of services and has suitable resources to enable it to evaluate the strategic benefit of all its services

(a) Council has a funding framework:

- (i) Council has adopted a funding framework that clearly sets out Council's funding strategies for the major categories of its services

(b) Council funds are obtained and used in a strategic and appropriate manner:

- (i) Council is able to assess the operational and strategic revenue and cost implications of service delivery decisions.

Principle 6: an equitable, transparent, and accountable rating system is in place:

(a) The impact of changes in the distribution of the burden of rates is fully understood, and consideration is given to moderate any significant adverse impacts on individual ratepayers:

- (i) Modelling shall be undertaken of the rating options for all issues which have a significant impact on the distribution of the burden of rates and presented as a report to Council before the annual rating decisions are made
- (ii) The link between the long-term financial plan and annual budget and rating decisions can be clearly demonstrated:
  - A. The impact of the outcomes of the long-term financial plan shall be taken account of in consideration of rating options in 6 (a) (i)
- (iii) Revenue to be raised through rates is reported in a consistent and transparent manner:
  - A. Council shall publish rates information in a manner described in Council's budget.

Principle 7: achievement of Council's strategic objectives is facilitated through the effective management of borrowings and financial assets.

(a) Council actively manages its borrowings:

- (i) Council shall undertake the following actions in relation to borrowings:
  - A. Forecast and monitor long term capital expenditure programs that are required to be funded by loan funds
  - B. Limit external loan funds required for new capital works to:
    - new or upgrade capital projects
    - new capital projects that provide a return to Council
  - C. The term for new borrowings shall not exceed the estimate useful life of the asset
  - D. Obtain borrowings from the Queensland Treasury Corporation (QTC) only
  - E. The annual extent of new borrowings shall be approved by Council through the debt framework and as part of the annual budget process

F. A 10 year external borrowing schedule shall be provided in Council's debt framework and updated annually

(b) Council actively manages its financial assets and financial liabilities:

(i) Council shall manage financial risk elements encompassed in the risk types listed below:

A. Credit risk - Credit risk exposure refers to the situation where Council may incur financial loss as a result of another party to a financial instrument not discharging their obligations (e.g. unpaid rates)

B. Liquidity risk - Liquidity risk refers to the situation where Council may encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset

C. Interest rate risk - Interest rate risk is the risk of a loss due to a variation in interest rates on investments or borrowings

D. Commodity price risk – Commodity price risk is the risk that movement in the price of a commodity, in particular derivatives and carbon offsets, leads to a change in revenues and expenses

(c) Council shall undertake the following steps to minimise financial risks:

(i) <u>Credit risk</u>

A. Develop a collection framework for overdue rates and accounts receivable

B. Undertake disposal of property where rates remain unpaid as provided for in the *Local Government Act 2009*. Rates are levied quarterly in advance and are secured against the property under s.74 of the *Local Government Regulation 2012*

C. Limit investment of surplus funds to "authorised investments" as defined in the *Statutory Bodies Financial Arrangement Act 1982* as amended or direct investments with licensed banks limited by credit rating and type as specified in Council's investment policy.

(ii) <u>Liquidity risk</u>

A. Ensure that Council's long-term financial plan caters for the repayment of Council borrowings and ensure that sufficient funds are available to fund planned expenditures

(iii) <u>Interest rate risk</u>

A. The source of Council borrowing is restricted to the Queensland Treasury Corporation

B. Council's Treasury function shall manage cash allocation on a daily basis to maximise Council return and minimise risk exposure

(iv) Commodity Price Risk

A. Strategies such as diversification of investments will be implemented to limit exposure to price fluctuations.

(v) Derivatives and management of financial risk:

A. Council may enter into a derivative transaction only if it is prescribed to do so under the SBFA Regulation (schedule 8) and the Treasurer has provided approval in accordance with the Statutory Bodies Financial Arrangements Act 1982

B. The general approval is subject to the following conditions:

- Having a risk management framework for derivative transactions
- Conducting all derivative transactions under the General Approval of QTC
- The derivative transaction must be for the purpose of hedging foreign exchange or interest rate risks that arise in the normal course of business
- The transaction must be related to either foreign currency, or interest rates on a current or future borrowing position

C. For foreign currency derivative transactions:

- For any transaction when QTC SCPS is used, there is no restriction on the term and value limit of the derivative transaction; and
- For any transactions when the SCPS is not used, the underlying transaction being hedged must be below a limit of AUD $25m per transaction and the term of the derivative transaction must be less than 2 years and 1 month.

D. For interest rate derivative transactions:

- The value hedged by the derivative transaction must not exceed the proposed loan amount, and
- The term of the derivative transaction must not exceed 2 years and 1 month.

E. The overall appropriateness of any derivative transaction will be considered including the need to use derivatives, and the organisation's capacity to put in place the appropriate management, control and accountability systems.

F. The appropriate expertise held by council employees will be assessed and the roles and responsibilities of stakeholders will be documented.

G. This framework is to be reviewed with reference to the Financial Accountability Handbook.

Principle 8.1: there are systems and procedures in place that improve the efficiency and effectiveness of Council's recognition and management of risk.

(a) Council has an established risk management framework

(b) Council shall at least every 2 years undertake a review of strategic financial risks and have a plan to manage them

(c) Council has an established prudential management framework:

  (i) Council annually certifies compliance with the following legislative requirements of the *Local Government Act 2009* (the Act) and the *Local Government Regulation 2012* (the Regulation):

    A. Maintain a register of delegations per section 260 (Local government delegations register) of the Act, which has been reviewed by Council at least once per year

    B. Prepare and adopt policies on contracts and tenders (Procurement Policy) as described in part 3, division 2 of the Regulation

    C. Develop and adopt a 5 year corporate plan per section 166 of the Regulation

    D. Have a budget and annual operational plan per part 2, division 3 of the Regulation

    E. Ensure that appropriate policies, practices, and procedures of internal controls are implemented and maintained

    F. Have an Audit Committee, appoint an internal auditor and undertake an internal audit annually per section 207 of the Regulation

    G. Review the performance of investments annually as part of the budget process

    H. Ensure that all borrowings are approved by Council through the budget process

    I. Ensure that all expenditure not approved as part of the budget is subject to separate Council approval

    J. Council shall maintain a strong system of internal control:

    - The system of internal control shall be documented and shall identify individuals responsible for its maintenance and implementation

    - All material financial risks shall be identified and presented to Council along with how they are to be managed.

Principle 8.2: there are systems and procedures in place that encourage enhanced performance

(a) Clear, useful, and measurable key performance measures and indicators shall be used to evaluate performance:

  (i) A suite of key performance measures/indicators shall be established and adopted by Council

(b) Key performance measures/indicators shall include sustainability measures/indicators listed under principle 1

(c) The key performance measures/indicators to evaluate performance shall be publicly available:

 (i) Council's annual report shall include explanatory information about its performance, including variations from targets, using the measures/indicators pursuant to item 8.2 (a)(i)

(d) A transparent process shall be maintained for improving the effectiveness and efficiency of Council operations

(e) A transparent and rigorous process shall be implemented for the ongoing assessment of the efficiency and effectiveness of Council's operations and shall be reported in Council's annual report.

Principle 9: the integrity of financial systems and reports are safeguarded

(a) The Audit Committee shall have a clearly defined charter that sets out the composition, roles, and responsibilities of Councils Audit Committee

(b) Council shall be able to demonstrate the independence of the external audit role

(c) There shall be a clearly defined external audit framework which includes:

 (i) the appointment and removal of the external auditor

 (ii) the performance of the external auditor

 (iii) auditor independence

 (iv) provision of non-audit related services

 (v) external audit responsibility

 (vi) audit delivery and reporting

(d) There shall be an active internal audit program supported by appropriate framework

(e) There is a clearly defined internal audit framework which includes:

 (i) the preparation of the internal audit plan and program

 (ii) an internal audit charter and objective

 (iii) internal audit scope and operating principles

 (iv) independence

 (v) access to information and confidentiality

 (vi) relationships with departmental managers and employees

 (vii) reporting requirements and the role of the Audit Committee in relation to internal audit.

Management responsibility

Council management shall develop relevant processes and procedures identifying officers responsible for the carrying out of activities and controls in support of this framework.

3. Definitions

The following definitions apply to this framework.

Term	Definition
Asset consumption ratio	The asset consumption ratio approximates the extent to which Council's infrastructure assets have been consumed to what it would cost to build a new asset with the same benefit to the community. The minimum target of 60% indicates that a Councils assets are being broadly consumed in line with their estimate lives. The higher the percentage, the older the average asset age and the sooner expected replacement.
Asset sustainability ratio	The asset sustainability ratio approximates the extent to which the infrastructure assets managed by a council are being replaced as they reach the end of their useful lives. An asset sustainability ratio close to 100% suggests that a Council is spending enough on the renewal of its assets to compensate for the deterioration in its asset base as loosely proxied by its reported depreciation.
Asset renewal funding ratio	The asset renewal funding ratio measures the ability of a council to fund its projected asset renewal/replacements in the future. Ideally, the asset renewal funding ratio should be as close to 100% as possible, as this indicates that a council is appropriately funding and delivering the entirety of its required capital program as outlined in the Total Assets Management Plan.
Leverage ratio	The leverage ratio is an indicator of a Council's ability to repay its existing debt. It measures the relative size of the Council's debt to operating performance. A higher leverage ratio indicates an increasingly limited capacity to support additional borrowings due to already high debt levels and/or decreasing operational performance, whilst a lower ratio indicates the opposite.
Operating surplus ratio	Expresses operating surplus as a percentage of operating revenue. This measure provides an indicator of the extent to which operating revenues generated covers operational expense. Any operating surplus would be available for capital funding or other purposes. An operating surplus ratio above 0% is an indication that council is managing its finances within its existing funding envelope and generating surplus funds for capital funding or other purposes.

Term	Definition
	A negative ratio indicates that current period revenues are insufficient to meet current year expenditures and that the shortfall is funded either through capital contributions or an erosion of Council capital.
Operating cash ratio	The operating cash ratio is a measure of Council's ability to cover its core operational expenses and generate a cash surplus excluding depreciation, amortisation, and finance costs. A positive operating cash ratio indicates that Council is generating surplus cash from its core operations which indicates that council has the ability to self-fund its capital expenditure requirements.
Unrestricted cash expense cover ratio	The unrestricted cash expense cover ratio is an indicator of the unconstrained liquidity available to a council to meet ongoing and emergent financial demands which is a key component to solvency. It represents the number of months a council can continue operating based on current monthly expenses.
Council controlled revenue ratio	Council controlled revenue is an indicator of Council's financial flexibility, ability to influences its operating income, and capacity to respond to unexpected financial shocks. A higher Council-controlled revenue ratio indicates a stronger ability to generating operating revenue without relying on external sources.
Population growth ratio	Population growth is a key driver of a Council's operating income, service needs and infrastructure requirements into the future. A growing council population indicates a greater capacity to generate its own source revenue through rates as well as statutory charges.