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LOCAL GOVERNMENT FINANCIAL INDICATOR

Accompanying Guide - March 2025

Contents

[Introduction 3](#_Toc192499385)

[1.0 Design and Calculation of the Local Government Financial Indicator 4](#_Toc192499386)

[1.1 LGFI design 4](#_Toc192499387)

[1.2 LGFI calculation 5](#_Toc192499388)

[1.2.1 Overview 5](#_Toc192499389)

[1.2.2 Setting of ratio thresholds 6](#_Toc192499390)

[1.2.3 Ratio score mapping 7](#_Toc192499391)

[1.2.4 Ratio weighting 8](#_Toc192499392)

[1.2.5 Data 8](#_Toc192499393)

[1.2.6 Missing ratios 8](#_Toc192499394)

[1.2.7 Example LGFI calculation 9](#_Toc192499395)

[2.0 Additional outputs for interpretation 9](#_Toc192499396)

[2.1 Comparison selector 9](#_Toc192499397)

[2.2 Bar graphs 9](#_Toc192499398)

[Appendix 1: Rationale for the exclusion of asset ratios 11](#_Toc192499399)

[Appendix 2: Basis for calculation of LGFI ratios 12](#_Toc192499400)

# Introduction

The new Local Government Financial Indicator (LGFI) is the result of several years of work and is a replacement to the previously reported Financial Health Indicator (FHI). The need for a review was determined based on sector feedback and changes to local government accounting requirements.

The LGFI has been designed to provide community members, stakeholders and the Department of Local Government, Sport and Cultural Industries (DLGSC) with at-a-glance insights to local government financial performance. It will allow local governments (LGs) and community members to have greater insights into local government performance against the four key financial ratios, allow for interpretation of results, the ability to track change over time, solicit and gain feedback from local government on ratio/financial performance and compare local government results against each other.

It must be noted however, that unlike the FHI, the LGFI does NOT attempt to assess a local government’s financial sustainability (its financial capacity to fund maintenance and asset renewal as infrastructure reaches the end of useful life). It was agreed when developing the new LGFI, that the LGFI would exclude ratios seeking to measure asset renewal and replacement. This results in an inability of the LGFI to assess sustainability which is deemed to be a key element to determining the financial health of an LG.

This document is provided as a guide, outlining the detail underpinning the project and process and the underpinning calculations for the LGFI.

# 1.0 Design and Calculation of the Local Government Financial Indicator

## 1.1 LGFI design

The new LGFI was developed by the Western Australian Treasury Corporation (WATC) on behalf of the DLGSC. The design was led by a steering panel consisting of DLGSC, WATC, the WA Local Government Association, LG Professionals WA, Ron Back and Associates and a representative cohort of local governments (collectively, the Steering Group).

The Steering Panel determined that the LGFI should be calculated based on the four ratios on which the WALGA Financial Ratios Working Group had previously reached agreement as being the desired basis for evaluation of LG financial performance. These four ratios are:

1. Current ratio;
2. Debt service coverage ratio;
3. Operating surplus ratio; and
4. Net liabilities ratio.

The four ratios provide point-in-time insights to a local government’s ability to:

* meet its short term financial obligations (Liquidity);
* fund its longer term financial obligations (Solvency); and
* access funding (either internal or external) to deliver services and maintain infrastructure (Financial Flexibility).

**Table 1:** LGFI Ratios

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **#** | **Ratio Name** | **Ratio Use** | **Numerator/ Denominator** | **Formula** |
| **1** | **Current Ratio** | Measurement of an LG’s liquidity and its ability to meet its short-term financial obligations. | Numerator | Current Assets |
| Denominator | Current Liabilities |
| **2** | **Debt Service Coverage Ratio** | Measurement of an LG’s ability to service its debt (including lease obligations). | Numerator | Adjusted Operating Surplus w/exclusions |
| Denominator | Debt Service Costs |
| **3** | **Operating Surplus Ratio** | An indicator of the extent to which revenue raised by an LG not only covers operational expenses but also provides for capital funding, debt repayment and transfers to reserves. | Numerator | Adjusted Operating Surplus |
| Denominator | Adjusted Operating Revenue (2) |
| **4** | **Net Liabilities Ratio** | An indicator of the extent to which the net financial liabilities of an LG can be serviced by its operating revenues. Potential indicator of an LG’s capacity to access new/additional debt to meet future capital funding requirements. | Numerator | Net Financial Liabilities |
| Denominator | Adjusted Operating Revenue (1) |

Further information on the inputs for the ratio formulas is included in the appendix.

## 1.2 LGFI calculation

### 1.2.1 Overview

The ratios are recorded for an LG on a financial year basis and are used in the calculation of a corresponding annual LGFI result.

* Four component ratios are calculated for each LG every financial year;
* Each ratio is then converted into a numerical score between 1 and 10, depending on where the ratio lies on a linear scale featuring floor, benchmark and cap thresholds (noting that a floor and cap threshold are used to ensure that no LG can be scored worse than one nor better than 10 for any ratio);
* Each ratio score is then multiplied by a weighting factor (which collectively sum to one) reflective of the relative importance of that ratio in contrast to the other three;
* The weight-adjusted four ratio scores are then summed and the product is multiplied by a scaling factor of 10 to provide a final annual LGFI score in a range between 10 and 100; and
* The benchmark LGFI score is 70.

**Figure 1:** LGFI Methodology

### 1.2.2 Setting of ratio thresholds

The collective opinion of the Steering Panel and the WALGA Financial Ratios Working Group was canvassed when deliberating the settings for ratio thresholds, in order to ensure that the adopted thresholds reflect the expert opinion of LG financial professionals.

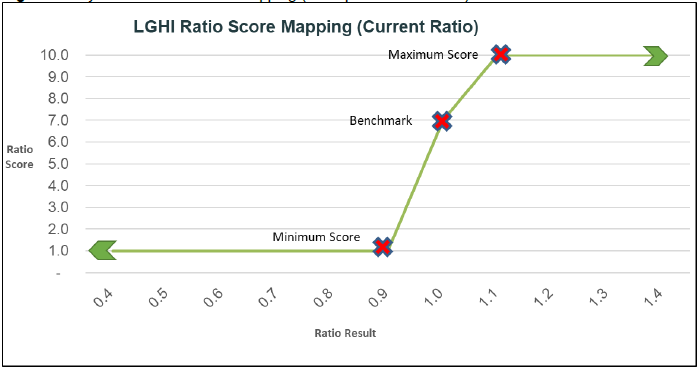
* For each ratio, three thresholds were set which in essence reflect collective opinion regarding what constitutes a good (“High”) result, a pass (“Benchmark”) result and a sub-standard (“Low”) result.
* In the overall construct of the three thresholds for each ratio, focus was not placed on trying to “fit” ratio results for the LG cohort to a normal (or Bell Curve) distribution profile – rather, the intent was to set meaningful and appropriate thresholds.
* The “High” result threshold was selected with a view to enabling visibility / early warning of those LGs whose ratio scores – while still above the benchmark – might be starting on a downward trend.

### 1.2.3 Ratio score mapping

Ratio values are then converted to ratio scores using a mapping scale developed in consultation with the steering committee.

The ratio value mapping function adopted for the LGFI (similar to that of the FHI) is piecewise-linear, implying that scoring is asymmetric either side of a benchmark, as illustrated in the example below:

**Figure 1:** LGFI Ratio Score Mapping (Current Ratio)



The adoption of an asymmetric scoring system enables the proposed LGFI – similar to the previous FHI – to limit the range of scores above the Benchmark, so that LGs are not unduly rewarded for exceeding what is considered by expert consensus opinion to be an acceptable score.

The only variance between the proposed LGFI scoring system and that of the FHI is the adjustment of the scoring range: the LGFI has adopted a range of 1-10, whereas the FHI used a range of 0-10. The Steering Committee felt that the substitution of a minimum score of 1 was preferred from a perception standpoint.

### 1.2.4 Ratio weighting

Each mapped ratio score is then weighted by multiplying the ratio score by a weighting indicator developed in consultation with the steering committee in order to better reflect the relative importance of each ratio’s contribution to an aggregate LGFI score.

**Table 2:** LGFI Ratio Thresholds, Scores and Weights

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Ratio** | **Ratio Thresholds** | | | **Ratio Scores** | | | **Ratio Weighting** |
|  | **Low**  **Threshold** | **Benchmark**  **(“Pass”) Threshold** | **High**  **Threshold** | **Minimum Score** | **Benchmark (“Pass”) Score** | **Maximum**  **Score** | **Expert Consensus Weighting** |
| **Current** | 0.90:1.00 | 1.00:1.00 | 1.10:1.00 | 1.0 | 7.0 | 10.0 | 10% |
| **Debt Service Coverage** | 1.00:1.00 | 2.00:1.00 | 5.00:1.00 | 1.0 | 7.0 | 10.0 | 20% |
| **Operating Surplus** | -0.85:1.00 | 0.00:1.00 | 0.15:1.00 | 1.0 | 7.0 | 10.0 | 40% |
| **Net Financial Liability** | 0.60:1.00 | 0.30:1.00 | 0.00:1.00 | 1.0 | 7.0 | 10.0 | 30% |
|  | | | | | | | **100%** |

### 1.2.5 Data

Data to calculate the financial ratios and the LGFI displayed on the MyCouncil website has been based on financial information held within local governments accounting systems.

Workbooks pre-populated with financial data were provided to local governments in order to validate the accuracy of data used to compile the LGFI. This process afforded local governments with the opportunity to amend data (if applicable), and to provide commentary on ratio outcomes to assist community stakeholder comprehension.

### 1.2.6 Missing ratios

Where data is not available to calculate one or more of the four ratios, a total LGFI score will not be calculated.

The exception is the Debt Service Coverage ratio:

* Where a local government has no debt and has an operating surplus, an adjusted ratio score of 10 (high score) will be applied to this ratio.
* Where a local government has no reported debt, but has an operating deficit, an adjusted ratio score of 1 (low score) will be applied to this ratio.

### 1.2.7 Example LGFI calculation

By way of recap, the LGFI calculation methodology is summarised below:

1. Identify ratio values for each of the four LGFI ratios for an LG in any given year.
2. Map each ratio value to the LGFI scoring system to determine a standardised ratio score (between one and ten).
3. Multiply each ratio score by its respective LGFI weight.
4. Sum the weighted scores to produce a total weighted score.
5. Multiply the total weighted score by the scaling factor (10) to arrive at a final LGFI score (between 10 and 100) for the LG for the year in question.

Table 3 below provides an illustration of the calculation of an LGFI score for a given year for a hypothetical LG, using sample ratio values.

**Table 3:** Example LGFI Calculation

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Ratio** | **Ratio Value** | **Ratio Score** | **Ratio Weight** | **Weighted Score** |
| **Current** | 3.14 | 10.00 | 10% | 1.00 |
| **Debt Service Coverage** | 4.30 | 9.25 | 20% | 1.85 |
| **Operating Surplus** | 0.03 | 7.00 | 40% | 2.80 |
| **Net Financial Liability** | -0.32 | 10.00 | 30% | 3.00 |
| Total | | | **100%** | **8.65** |
| Scaling Factor | | | | 10 |
| LGFI Score | | | | **86.5** |

# 2.0 Additional outputs for interpretation

The MyCouncil website continues to be the primary option to access, view and interpret local government financial and demographic data in a central point.

This includes the publication of the LGFI, which will replace the existing FHI data on the MyCouncil web site.

## 2.1 Comparison selector

On the MyCouncil website, users are able to select a primary LG and a secondary LG to allow the user to compare key data between local governments.

## 2.2 Bar graphs

Once all four financial ratios have been scored for LGs, the scores for a single financial year will be plotted in a series of vertical bar graphs on the MyCouncil website.

The LGFI will be shown on one bar graph, with the individual ratios also plotted on individual graphs (example below).

**Figure 3:** Example bar charts of LGFI Ratios and the LGFI Score for an LG

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These plots allow MyCouncil users to visually assess aspects of a local government performance across multiple years for each of the four LGFI ratios as well as the overall LGFI score.

Included in each graph is:

* a benchmark score, which shows if a local government for any given year is performing above or below the expectation for that measure; and
* Local governments will be invited to also provide comments / insights for each ratio graph and the LGFI graph, which will be displayed on the MyCouncil web site.

It is intended that future capabilities will allow for benchmarking of local governments against alternate cohort scores (such as local government tiers or Salaries and Allowance Tribunal bands).

## Appendix 1: Rationale for the exclusion of asset ratios

The former FHI incorporated the following three asset-related ratios in an attempt to gauge the extent to which LGs are renewing or refreshing capital assets as and when the latter reach the end of their useful life:

1. Asset consumption ratio;
2. Asset renewal funding ratio; and
3. Asset sustainability ratio.

There are acknowledged limitations to the use of asset-related ratios as indicators of financial sustainability:

* Timing issue - depreciation expense (which is used as a proxy for required capital renewal expenditure) is relatively constant from year to year, while in any given year actual capital expenditure on asset renewal may differ materially.
* Calculation issue – the capital expenditure components of asset ratios do not take into account funds earmarked by LGs as reserves which may build up over time and eventually be used to fund asset renewal activity, since such funds are typically held as unrestricted funds by an LG and accordingly cannot be readily identified from LG financial statements for ratio calculation purposes.

The consequence of the above limitations is that an LG’s asset ratios can materially fluctuate from year to year based on point-in-time activity (with associated impact on FHI scores) and thus only have relevance when viewed over an extended time period.

Given the decision to remove any measure of asset sustainability – a core tenant of financial health – from the LGFI, the Steering Committee acknowledged that the LGFI cannot be deemed to provide a comprehensive insight to the financial health of a local government.

Accordingly, WATC and the Steering Committee recommend excluding the term “Health” from the new indicator. The new name, “Local Government Financial Indicator” (**LGFI**) better reflects the fact that the new resulting indicator collectively provides an historic insight to the relative performance of an LG across the four financial reporting metrics which a representative group of LG financial professionals have deemed to be core indicators of LG financial performance.

## Appendix 2: Basis for calculation of LGFI ratios

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **#** | **Ratio Name** | **Numerator/ Denominator** | **Formula Elements** | **Basis for calculation** |
| **1** | **Current Ratio** | Numerator | Current Assets | Per Statement of Financial Position (SoFP) |
| Denominator | Current Liabilities | Per Statement of Financial Position (SoFP) |
| **2** | **Debt Service Coverage Ratio** | Numerator | Adjusted Operating Surplus w/exclusions | [Adjusted Operating Revenue (1) = Operating Revenues plus Federal Assistance Grants adjustment (see below)]  **Less**  [Adjusted Operating Expenses = Operating Expenses less (i) Depreciation Expense (ii) Interest Expense] |
| Denominator | Debt Service Costs | [Debt Service Costs = Includes principal repayments (excluding refinancing loans) and Interest, including lease interest and repayments] |
| **3** | **Operating Surplus Ratio** | Numerator | Adjusted Operating Surplus | [Adjusted Operating Revenue (2) = Adjusted Operating Revenue (1) plus non-operating grants/contributions for asset renewal]  **Less**  [Operating Expenses = Sum of (i) employee costs, (ii) materials & contracts, (iii) depreciation on non-current assets, (iv) insurance (v) utility charges (vi) interest expense (to be amended to finance costs) and (vii) other expenditure] |
| Denominator | Adjusted Operating Revenue (2) | Adjusted Operating Revenues (1) (see above)  **Plus**  [non-operating grants/contributions for asset renewal] |
| **4** | **Net Liabilities Ratio** | Numerator | Net Financial Liabilities | [Total Liabilities = Per SoFP less liabilities for equity-accounted investments but including amounts in advance and Lease Liabilities]  **Less**  [Financial Assets = Sum of (i) current cash & cash equivalents, (ii) current trade & other receivables, (iii) current other financial assets, (iv) non-current trade & other receivables and (v) non-current financial assets] |
| Denominator | Adjusted Operating Revenue (1) | [Operating Revenues = Sum of (i) rates, (ii) service charges (iii) grants, subsidies and contributions (iv) fees and charges (v) interest and earnings and (vi) other revenue]  **Plus**  [Federal Assistance Grants adjustment = Prior year Federal Assistance Grant less current year advance] |

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