statement of recommended practice
SORP-4
indicators of financial condition

This Statement is to be read in conjunction with the Introduction to Statements of Recommended Practice.

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PURPOSE AND SCOPE

1 This Statement of Recommended Practice (SORP) 1 provides guidance to governments that choose to report supplementary information on **financial condition**.

2 The ability of governments to report indicators of financial condition may vary. Some governments may choose to report certain indicators initially, but over time, and as experience is gained, additional indicators may be reported.

3 Some governments may choose to provide this information in special purpose reports or in other public reports such as the annual report. Information about indicators of financial condition could accompany the financial statements, 2 although it is not a requirement. [Former footnote 2 of paragraph SORP-4.3, amended by 2022-2023 remaining annual improvements, retained in Archived Pronouncements.]

4 It may be useful to read this SORP in conjunction with FINANCIAL STATEMENT DISCUSSION & ANALYSIS, SORP-1, and PUBLIC PERFORMANCE REPORTING, SORP-2.

5 The main objective of reporting on financial condition is to expand on and explain information contained in financial statements by assessing a government's financial condition not only on the basis of its financial position and changes in financial position, but also in the context of its overall economic and fiscal environment.

6 In addition, reporting on financial condition has the following objectives:

(a) helps users identify current foreseeable risks and trends;

(b) enlightens users about a government's fiscal stewardship;

(c) offers insights into the short- and long-term implications of policy decisions;

(d) illustrates a government's financial ability to maintain the level and quality of its services and to finance new programs;

(e) illustrates a government's ability to meet its financial obligations, both short- and long-term;

(f) enhances an understanding of government policy and operating decisions; and

(g) provides a basis for comparison, where appropriate, with other similar jurisdictions.

DEFINITION OF FINANCIAL CONDITION

7 Financial condition is a broad, complex concept with both short- and long-term implications that describes a government's financial health in the context of the overall economic and financial environment.

8 Financial condition is a government's financial health as assessed by its ability to meet its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees and others.

RESPONSIBILITY FOR PREPARATION

9 **The report on financial condition should include a statement acknowledging the preparer's responsibility for its contents.**

10 Responsibility for reporting on financial condition rests with the preparer and this would be clearly communicated to the users. The report would include an acknowledgment of the preparer's responsibility for its content.

REFERENCE TO FINANCIAL STATEMENTS

11 The report on financial condition should be clearly referenced to the related financial statements.

12 When indicators of a government's financial condition are based on the information reported in the financial statements, they supplement and complement a user's understanding of both the financial statements and financial condition. Therefore, the relevant financial statements need to be clearly identified.

QUALITATIVE CHARACTERISTICS

13 **The information provided in the report on financial condition should embody the basic characteristics of understandability, relevance, reliability, and comparability.**

14 The qualitative characteristics are essential to the communication and utility of information contained in a government's report. While these characteristics are usually discussed in terms of financial statements, they are equally applicable when reporting on financial condition. Further guidance related to their application in other reporting formats is provided in FINANCIAL STATEMENT DISCUSSION & ANALYSIS, SORP-1, and PUBLIC PERFORMANCE REPORTING, SORP-2.

15 When financial and non-financial data are translated into charts or graphs, comparisons between numbers become more obvious and data relationships are easier to understand. However, given the absence of general guidelines for preparing graphs and charts, there is a potential for misleading representations, so caution and professional judgment would be applied when assessing how the information is provided.

16 Reporting on financial condition involves more than simply publishing lists of ratios or graphs. Non-financial data (for example, key financial policies) and other information that helps users understand the elements of financial condition need to be described.

17 The report on financial condition needs to help users interpret the meaning and significance of financial condition indicators and provide contextual information that illuminates how earlier decisions and policies affect financial condition.

ASSESSMENT OF FINANCIAL CONDITION

18 **An assessment of a government's financial condition needs to consider, at a minimum, the elements of sustainability, flexibility and vulnerability.**

19 There may be other elements that a government may choose to discuss, given their importance to specific stakeholder interests or jurisdictional circumstances.

20 Describing financial condition using the elements of sustainability, flexibility and vulnerability, at a minimum, provides a framework to support a variety of strategic and policy discussions. It also helps reduce the risk that the inherently subjective process of assessing financial condition excludes key data that could materially influence a user's perception of a government's financial performance.

21 Assessing and concluding on financial condition will vary according to several unique factors including, but not limited to, the level of government, the scale/scope of services provided, service standards and financial management policies.

Sustainability

22 Sustainability is the degree to which a government can maintain its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees and others without increasing the debt or **tax burden** relative to the economy within which it operates.

23 Sustainability is an important element to include in an assessment of financial condition because it describes a government's ability to manage its financial and service commitments and debt burden. It also describes the impact that the level of debt could have on service provision. For example, a government whose net debt grows at a faster rate than the **gross domestic product** (GDP) increases the risk that service levels cannot be sustained.

Flexibility

24 Flexibility is the degree to which a government can change its debt or tax burden on the economy within which it operates to meet its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees and others.

25 Flexibility provides insights into how a government manages its finances. A government that increases its current borrowing reduces its future flexibility to respond when adverse economic circumstances develop. Similarly, increasing taxation or user fees reduces its ability to do so in the future as a government approaches the limit that citizens and businesses are willing to bear.

Vulnerability

26 Vulnerability is the degree to which a government is dependent on sources of funding outside its control or influence or is exposed to risks that could impair its ability to meet its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees and others.

27 Vulnerability is an important element of financial condition because it provides insights into a government's reliance on funding sources outside its direct control or influence and its exposure to risks. A government whose vulnerability is relatively low has greater control over its financial condition.

INDICATORS OF FINANCIAL CONDITION

28 **For each element of financial condition, the report on indicators of financial condition should include government-specific indicators and government-related indicators.**

29 It may be useful to also include economy-wide information when discussing financial condition.

30 Describing financial condition involves multiple types of data. There is no single, "bottom line" indicator that adequately describes financial condition. Data from a government's financial statements, supplemented with other data, are necessary to create a plausible, evidence-based understanding of financial condition. This means that there would be three types of data:

(a) government-specific indicators — indicators about government finances derived from its financial statements;

(b) government-related indicators — indicators about government finances derived from a combination of information from its financial statements and from the economy within which the government operates; and

(c) economy-wide information — data about the economy within which the government operates that has a direct impact on the financial condition of the government.

Government-specific indicators

31 Financial statements for a government as a whole are prepared to provide an understandable overview of the full nature and extent of the financial affairs and resources which a government controls. Therefore, a government's report would include indicators of financial condition based on all organizations within the government.

32 Linking the indicators of financial condition to the financial statements has the following benefits:

(a) it provides users with contextual data that illuminates the relationships between information reported in the financial statements and helps them understand these relationships;

(b) it ties the information about financial condition to the financial statement date to give users a snapshot view of financial condition; and

(c) it facilitates comparability in reporting across governments, where applicable.

Government-related indicators

33 Other indicators relevant to understanding a government's financial condition include quantitative data that describes the economic environment in which the government operates. When combined with information from the financial statements, such data provides context to connect a government's financial results with broader aspects of the economy in which it operates.

34 Presenting information about a government's financial condition on a per capita or per household basis may be useful. However, it is important that there be a direct relationship between the information from the financial statements and the denominator (for example, between health care costs and population).

Economy-wide information

35 Information reflecting the overall economy helps users assess the impact of government policies and provides a base against which to evaluate a government's indicators. When a government chooses to include economy-wide information, it may be able to identify some economy-wide indicators to include in its report. It must be made clear that these indicators are affected by many factors in the overall economy, many of which are beyond the influence or control of a government.

APPLICABILITY OF INDICATORS

36 There are fundamental differences between local governments and sovereign governments in the scale, scope and type of services provided, and in the sources of revenue available to fund them. Despite these differences, there can still be indicators common to both levels of government. What may be different is the denominator being used to calculate an indicator. For example, economy-based indicators that provide a measure of the economic activity within a particular jurisdiction are often relevant in discussing financial condition. For sovereign governments, this denominator would be GDP. At the local government level, an equivalent denominator would be the taxable assessment. The taxable assessment is a good proxy measure of economic activity within a local jurisdiction.

37 The factors to consider below provide general guidance on determining which indicators of financial condition would be reported. Choosing which indicators of financial condition to report also requires the application of professional judgment, taking into consideration the specific circumstances of a government's jurisdiction.

38 Factors to consider when a government chooses which indicators to report are as follows:

(a) the indicator supports the assessment of financial condition as described in paragraph 18;

(b) the indicator meets the objectives for reporting on financial condition as described in paragraphs 5-6; and

(c) the indicator meets the qualitative characteristics of reporting as described in paragraph 13.

39 Focusing on a few critical indicators for each element of financial condition is important to provide sufficient information for a user to assess financial condition but not to overwhelm the user with excessive detail. It also enhances the usefulness of the report on indicators of financial condition by providing a concise and focused picture.

40 The set of indicators listed in paragraphs 41, 49 and 56 meet the criteria set out in paragraphs 38-39. Those reporting on financial condition may need to supplement or adapt this set of indicators, where necessary, to address their unique jurisdictional issues.

SUSTAINABILITY INDICATORS

41 **Indicators for assessing sustainability over time could include:**

(a) assets-to-liabilities;

(b) financial assets-to-liabilities;

(c) net debt-to-total annual revenue;

(d) expense by function-to-total expenses;

(e) net debt-to-GDP or taxable assessment; [3]

(f) accumulated deficit [4] **-to-GDP or taxable assessment; and**

(g) total expenses-to-GDP or taxable assessment.

Government-specific indicators

42 The "assets-to-liabilities" indicator reports the ratio of a government's financial and non-financial assets to its liabilities. This indicator supports a discussion about sustainability by illustrating the extent to which a government finances its operations by issuing debt. A ratio higher than one indicates that a government has accumulated surplus and has assets greater than debt. A ratio of less than one indicates that debt is greater than assets and that the government has been financing its operations by issuing debt. A trend in this direction may not be sustainable.

43 The "financial assets-to-liabilities" indicator reports the ratio of a government's financial assets to its liabilities. A result lower than one indicates liabilities exceed financial assets (net debt) and future revenues will be required to pay for past transactions and events. A result higher than one indicates financial assets exceed liabilities (net financial assets) and financial resources are on hand that can finance future operations. A trend showing increases in net debt or reductions in net financial assets may not be sustainable.

44 The "net debt-to-total annual revenue" indicator measures government net debt as a percentage of total revenues. Net debt provides a measure of the future revenue required to pay for past transactions and events. A ratio that is increasing would indicate that more time to eliminate net debt will be necessary. A trend in this direction may not be sustainable.

45 The "expense by function-to-total expenses" indicator provides a summary of the major areas of government spending as a proportion of the total expenses. Functions are broken down into separate components such as health, education and transportation, illustrating the trend of government spending in particular program areas over time. A program area that grows at a much faster rate than total expenses may have an impact on the sustainability of other programs.

Government-related indicators

46 The "net debt-to-GDP or taxable assessment" indicator measures a government's net debt — the difference between its liabilities and financial assets — as a proportion of the GDP or the taxable assessment. It shows the relationship between a government's net debt and the activity in the economy. If the ratio declines, government debt is becoming less onerous on the economy. A stable net debt-to-GDP or the taxable assessment ratio indicates a government's overall fiscal policies have been sustainable, to the extent that the rate of economic growth in the economy within which it operates is the same as the growth in net debt. If the ratio rises, government net debt is becoming more onerous on the economy, which may not be sustainable. This may prompt a government to decide whether to increase taxes, reduce program expenses relative to interest charges or increase borrowing further to service the debt.

47 The "accumulated deficit-to-GDP or taxable assessment" indicator measures the sum of the current and all prior years' operating results expressed as a percentage of the GDP or the taxable assessment. The accumulated deficit represents the extent to which annual revenues have been insufficient to cover the annual costs of providing services. An accumulated deficit that is growing at a rate faster than the growth in the economy within which it operates may not be sustainable.

48 The "total expenses-to-GDP or taxable assessment" indicator provides the trend of government spending over time in relation to the growth in the economy. A trend that shows total expense is growing at a faster rate than the growth in the economy may not be sustainable.

FLEXIBILITY INDICATORS

49 **Indicators for assessing flexibility over time could include:**

(a) public debt charges-to-revenues;

(b) net book value of capital assets-to-cost of capital assets; and

(c) own-source revenues-to-GDP or taxable assessment.

Government-specific indicators

50 The "public debt charges-to-revenues" indicator measures public debt charges as a percentage of revenues. It illustrates the extent to which past borrowing decisions present a constraint on a government's ability to meet its financial and service commitments in the current period. Specifically, the more government uses revenues to meet the interest costs on past borrowing, the less will be available for program spending.

51 The public debt charges-to-revenues indicator is important because, when this indicator increases for an extended period of time and assuming relatively stable interest rates, it means that the government has consistently chosen borrowing over increases in taxation or user fees to meet its financial and service commitments. This will eventually have an effect on its flexibility because once a government borrows, its first commitment must be to service its debt. Failing to do so would impair its future ability to borrow or to roll over its existing debt.

52 The "net book value of capital assets-to-cost of capital assets" indicator is important because it reports the extent to which the estimated useful lives of a government's tangible capital assets are available to provide its products and services. If a government's scale, scope and level of services remain unchanged or grow, its asset base could eventually impair flexibility because of the impending future costs of capital asset repair or replacement. Further information regarding assessing the physical condition of tangible capital assets can be found in ASSESSMENT OF TANGIBLE CAPITAL ASSETS, SORP-3.

Government-related indicators

53 The "own-source revenues-to-GDP" (sovereign governments) indicator is important because it shows the extent to which a government is taking income out of the economy in its jurisdiction, either through taxation or user charges.

54 The "own-source revenues-to-taxable assessment" (local governments) indicator is important because it shows the ratio of a local government's own-source revenues to its tax base. A change in the size of a local government's taxable assessment or a change in the rate of growth in assessment in relation to changes in own-source revenues could influence flexibility.

55 Over time, increases in these ratios suggest reduced flexibility. However, evaluating the extent to which flexibility is diminished by changes in these indicators is difficult. A government that has a lower own-source revenues-to-GDP or own-source revenues-to-taxable assessment figure compared to another does not necessarily have room to raise taxes or increase user fees. When combined with data about the willingness of taxpayers within a jurisdiction to change the level of taxation or user fees they are willing to pay, these indicators provide information that helps a government determine the extent to which it can access own-source revenues in the future.

VULNERABILITY INDICATORS

56 **Indicators for assessing vulnerability over time could include:**

(a) government transfers-to-total revenues; and

(b) foreign currency debt-to-net debt.

Government-specific indicators

57 The purpose of reporting "government transfers-to-total revenues" is to show the proportion of revenues that provincial or local governments receive from other governments. This indicator offers a perspective on the degree of vulnerability a government faces as a result of its dependence on another level of government for revenues.

58 An increasing dependence on another level of government for revenues means that the receiving government is increasingly vulnerable to the fiscal decisions of another. Reduced dependence on government transfers may reduce vulnerability but it could also impair sustainability if a government's own tax base has to replace the revenues lost from a reduction in transfer payments. A government that reduces its dependence on government transfers and correspondingly reduces its spending may avoid impairing its sustainability, but it could produce dissatisfaction among constituents.

59 The purpose of reporting "foreign currency debt-to-net debt" is to measure the amount of a government's foreign currency debt relative to its net debt. This helps illustrate the degree of potential vulnerability a government has to currency fluctuations. A government that uses hedging to manage its foreign exchange risk would include a general description of the nature of the hedges undertaken, its method for assessing effectiveness and the Canadian dollar amount of the hedged foreign currency debt.

60 When assessing vulnerability, it is important that a government consider the risks to which it is exposed, the economy within which it operates and whether additional indicators would be useful. The risk exposures of a government and its risk management strategies will be unique to each jurisdiction and some factors to consider for identifying risk can be found in FINANCIAL STATEMENT DISCUSSION & ANALYSIS, SORP-1, paragraphs 40-47.

REPORTING

61 **The report on financial condition should compare and analyze indicators of financial condition derived from actual results with historical trends and planned indicators** 5 **for the period.**

62 The report would include a comparison between planned and actual indicators with explanations of significant differences. The explanation of variances would include a description of influencing factors within a government's control as well as those factors that the government could not control but nonetheless had an impact on its financial condition.

63 Where differences between planned and actual indicators of financial condition exist, the report would focus on those factors that varied from the assumptions used to create the plan and had a significant impact on financial condition. Such disclosures provide users with a better appreciation of the challenges that were faced and help clarify why some plans proved more difficult to achieve or results were better than expected.

64 **The report on financial condition should provide a trend analysis including at least five years worth of historical trend data and current period results.**

65 Comparative information can include a trend analysis where the actual results for the current period are compared against the actual results for prior periods. Trend data over multiple periods provides information that enhances discussions about the eventual consequences of policy decisions.

66 Including at least five years worth of historical trend data would help put short-term anomalies into context and present results that may reflect the actions of more than one government. Governments that choose to report less than five years worth of trend data would include an explanation for selecting the shorter period.

67 When a change of methodology or measurement scale is deemed to be appropriate, disclosure of the effects of the change is necessary to maintain comparability. Where possible, prior period assessments would be restated for consistent comparison; otherwise, differences between current and previously reported assessments must be clearly articulated.

68 When comparative information is restated to reflect consistency with current period results, a government would explain the effect of changes made to the methodologies, measurement and reporting of financial condition or indicators of financial condition. Such explanations would provide a description of the nature and extent of the restatements and the reason(s) for the change(s).

69 **When a government chooses to provide comparisons with other jurisdictions, it would ensure comparisons are based on consistent data, consistent indicator definitions and other factors relevant for ensuring comparability.**

70 Where available and appropriate, comparison with other similar organizations can be informative, as long as significant differences in measures, data definitions, and circumstances are noted.

71 Comparisons with other jurisdictions are inherently difficult to make. Factors a government could consider when determining appropriate comparators include, but are not limited to, the following:

(a) the scale and scope of services available from the comparators are similar;

(b) revenue sources and financing policies are consistent;

(c) the key factors influencing a comparator's financial condition are similar; and

(d) the comparisons enhance the user's understanding of a government's financial condition.

72 Reporting comparisons with other jurisdictions would include a discussion about the rationale for selecting the comparators and the basis upon which comparisons were made. Such comparisons would be useful when they offer insights into the actual or potential financial implications of decisions about government services and service levels.

73 **An overall assessment of a government's financial condition should be provided based on whether the elements of financial condition have improved or worsened over time and the extent of its ability to achieve planned indicators. The assessment would be supplemented by a discussion of:**

- **(a) the reasons for changes in each of the elements of financial condition over time;**
- **(b) an analysis of significant events that occurred within a government's economic environment, presented in the context of their impact on financial condition; and**
- **(c) other information useful for understanding financial condition.**

74 An overall assessment would provide a concise description and explanation of the significant events and conditions that influenced financial condition. It would include any major changes that occurred during the year, major unplanned events, and any significant amounts related to assets, liabilities, revenues and expenses. A distinction between normal ongoing programs and infrequent or unusual events may be appropriate.

75 This information would help users interpret the meaning and significance of the financial condition assessment and provides the context to understand the effects financial condition has on the government.

76 Other relevant information included in the report on indicators of financial condition, or through a reference to a companion document/website link, includes:

- (a) a description of the key assumptions used to prepare the assessment of financial condition and whether any assumptions are susceptible to change;
- (b) an explanation of the changes made to past assumptions used in previous assessments of financial condition;
- (c) information about the effect of a change in the underlying assumptions used to prepare the assessment of financial condition;
- (d) the sensitivity of the assessment of financial condition to changes in the assumptions used and the reason(s) for the sensitivity;
- (e) sources for the economic data used in any of the indicators reported; 6
- (f) sources for the planned indicators reported (for example, where the planned information had been publicly made, in the budget, in the throne speech or some other publicly available document);
- (g) the methodologies applied in calculating indicators where there may be alternatives; and
- (h) an explanation of what has been done to ensure the reliability of the information used in the financial condition assessment.

GLOSSARY

Financial condition is a government's financial health as assessed by its ability to meet its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees and others.

Gross domestic product (GDP) is the total value of all goods and services produced within Canada or within a specific jurisdiction during a given year. It is a measure of the income generated by production within Canada or a specific jurisdiction.

Tax burden refers to the value of economic resources withdrawn from citizens and businesses through taxation or user fees.

Footnotes

1. Throughout this SORP, terms that appear in **bold type** are defined in the Glossary.

2. For purposes of this SORP, the term "financial statements" refers to the financial reports prepared by a government that present the financial position and changes in financial position of the reporting entity. Refer to Figure 3.1 in Chapter 3 of the Conceptual Framework, where financial statements are identified as an important type of financial report.

3. When "GDP or taxable assessment" is referred to as the denominator for a particular indicator, sovereign governments would apply the GDP denominator and local governments would apply the taxable assessment denominator (see also paragraph 36).

4. The term "accumulated deficit" has been used but in some cases this may be an "accumulated surplus".

5. Planned indicators refers to indicators that are publicly available and could include, for example, planned indicators found in budget documents or targets that reflect short-, medium- and long-term goals to be achieved.

6. Where alternative methods for calculating economic data are available (for example, income-based or expenditure-based GDP), the report would indicate which method was used.