Exposure Draft

C2 – Financial Performance Standards

Summary of Changes and Invitation to Comment

Standards and Certification
First Nations Financial Management Board

November 2017
Comments to the FMB must be received by December 15, 2017

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Executive Summary

Under the *First Nations Fiscal Management Act* ("the Act"), the First Nations Financial Management Board ("the FMB") is responsible for setting standards for First Nations in areas of Financial Administration Law, Financial Performance, Financial Management System and Local Revenue Financial Reporting. The Financial Performance Standards are the framework used by the FMB to assess First Nations' financial performance and ultimately, their eligibility for Financial Performance Certification. The Financial Performance Standards comprise a collection of seven ratios used to measure a First Nation's financial capacity, liquidity, fiscal balance, net debt service flexibility, management of capital investment, budgeting and collection of local revenues.

In order for the Financial Performance Standards to remain relevant, they must remain up to date and be responsive to feedback received from the FMB's stakeholders. The FMB recently completed a comprehensive review of its Financial Performance Standards with a particular focus on the ratios used in the assessment of financial performance. This Exposure Draft and the changes proposed herein are the result of this review. The majority of the changes impact the financial performance ratios. The Exposure Draft proposes to decrease the number of ratios used to measure a First Nation's compliance with the Financial Performance Standards from seven to six. Figure 1 below illustrates, at a very high level, those proposed changes to the ratios.

Figure 1 - Summary of proposed changes to the financial performance ratios

FISCAL GROWTH RATIO	LIQUIDITY TEST RATIO	CORE SURPLUS RATIO	ASSET MAINTENANCE RATIO	NET DEBT RATIO / INTEREST COVERAGE RATIO	BUDGET PERFORMANCE RATIO	PROPERTY TAX COLLECTION RATIO
MODIFIED	ELIMINATED	REPLACED	MODIFIED	MODIFIED	ELIMINATED	MODIFIED

The FMB seeks stakeholder input prior to introducing or significantly amending its standards. This input is critical in developing standards that are relevant to First Nations and responsive to their needs. The FMB welcomes comments on all aspects of this Exposure Draft. Comments on the proposals contained within this Exposure Draft are requested by December 15, 2017.

The FMB expects to issue a new set of Financial Performance Standards in the first half of 2018. The effective date for these new Standards will be announced at that time.

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First Nations First

Every First Nation has a past to preserve, a future to secure—a future filled with promise, where children thrive, communities grow and cultures prosper. The FMB exists to partner with First Nations in their pursuit of economic and social well-being. We provide First Nations with support and guidance to put sound, financial management systems in place. This opens the door for First Nations to borrow money on fair terms—money that gives them the freedom to pursue their own priorities, and secure their own futures.

Standards for First Nations

Under the First Nations Fiscal Management Act (the "Act") the FMB is responsible for setting standards and procedures for First Nations on areas of Financial Administration Law, Financial Performance, Financial Management System and Local Revenue Account Financial Reporting. The FMB has developed a set of standards designed specifically for First Nations – the first of their kind in Canada and the world. These standards are intended to allow First Nations to access best practices in the areas of financial management. Upon request, the FMB will independently evaluate and certify that a First Nation has met these standards.

The FMB's collection of standards consist of:

- ✓ Financial Administration Law Standards
  Standards to guide in the development of a Financial Administration Law

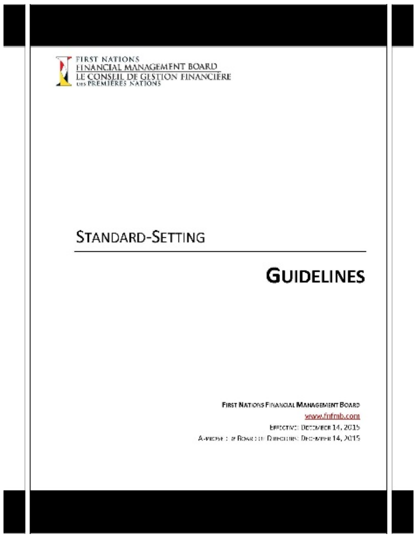
- ✓ Financial Management System Standards
  Standards, that when met, allow a First Nation to receive a Financial Management System Certificate

- ✓ Financial Performance Standards
  Standards, that when met, allow a First Nation to receive a Financial Performance Certificate

- ✓ Local Revenue Financial Reporting Standards
  Standards to assist in the preparation of separate local revenue financial statements

Standard Setting

The FMB is committed to being responsive to the needs of First Nations. In the context of setting and developing standards, this means listening to First Nations and understanding their first-hand experience working with and applying our standards.



FIRST NATIONS FINANCIAL MANAGEMENT BOARD
LE CONSEIL DE GESTION FINANCIÈRE DES PREMIÈRES NATIONS

STANDARD-SETTING

GUIDELINES

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To guide our efforts in this area, the FMB has published its own Standard Setting Guidelines. These Guidelines (available on our website) describe how the FMB will remain transparent in its standard setting activities and how First Nations and other stakeholders can participate in this process. The FMB depends on receiving feedback from users of its standards to ensure that they remain relevant and continue to meet the needs of First Nations.

This Exposure Draft document is intended to fulfill the commitments of transparency and responsiveness contained in our Standard Setting Guidelines.

Proposed changes to the Financial Performance Standards

Background

The FMB is proposing to amend its Financial Performance Standards. It has been almost seven years since the first edition of these standards were published. Table 1 below presents a history of the Financial Performance Standards since their initial publication in 2010. Since that time, the FMB has issued over 90 Financial Performance Certificates to First Nations across the country. Most of these First Nations have used their Certificate to become borrowing members of the First Nations Finance Authority in order to access long-term debenture financing. To ensure that these Financial Performance Standards remain relevant and responsive to the needs of First Nations, it is important that they be reviewed and updated as necessary.

Table 1 Financial Performance Standards history

Date	Standards Published	Highlights
September 15, 2010	C2 - Financial Performance Standards	First edition of the Financial Performance Standards which included the following financial performance ratios: 1. Fiscal Growth Ratio 2. Tax Collection Ratio 3. Core Surplus Ratio 4. Asset Maintenance Ratio 5. Net Debt Ratio 6. Budget Performance Ratio

Date	Standards Published	Highlights
November 1, 2010	C1 – Financial Performance Certification Procedures C2 – Financial Performance Standards	First edition of C1 – Financial Performance Certification Procedures Second edition of C2 - Financial Performance Standards
October to November 2011	C1 – Financial Performance Certification Procedures C2 – Financial Performance Standards	Second edition of C1 – Financial Performance Certification Procedures Third edition of C2 - Financial Performance Standards which included the following financial performance ratios: 1. Fiscal Growth Ratio 2. Liquidity Test Ratio (added) 3. Core Surplus Ratio 4. Asset Maintenance Ratio 5. Net Debt Ratio 6. Budget Performance Ratio 7. Tax Collection Ratio
April 1, 2014	C2 – Financial Performance Standards	Third edition of C1 – Financial Performance Certification Procedures which included some amendments to clarify and improve definitions. Fourth edition of C2 - Financial Performance Standards which included a small change to the threshold used to evaluate the Liquidity Test Ratio.
April 1, 2016	C2 – Financial Performance Standards	Fifth edition of C2 - Financial Performance Standards which included minor amendments to ensure the standards remained consistent with amendments to the *First Nations Fiscal Management Act*

In the years since the Financial Performance Standards were first published, the FMB has collected feedback from clients and stakeholders about the effectiveness of the ratios used in measuring financial performance. Complemented by the FMB's own observations in the course of its financial performance reviews, in 2016 it was determined that a comprehensive review of the Financial Performance Standards should be undertaken.

The FMB recently completed this comprehensive review, the objective of which was to refresh the financial performance ratios and other guidance within the Financial Performance Standards. The review involved benchmarking the ratios against leading and relevant credit assessment practices observed in the market. It is worth remembering that the FMB's Financial Performance Standards are used to determine if a Financial Performance Certificate can be issued to a First Nation, which in turn has the sole purpose of making the recipient First Nation eligible to become a borrowing member of the First Nations Finance Authority. It is therefore important that the standards being used to help First Nations gain access to this source of long-term pooled borrowing are meeting the needs of all Certificate users.

The changes presented in this Exposure Draft are based on the results of this comprehensive review.

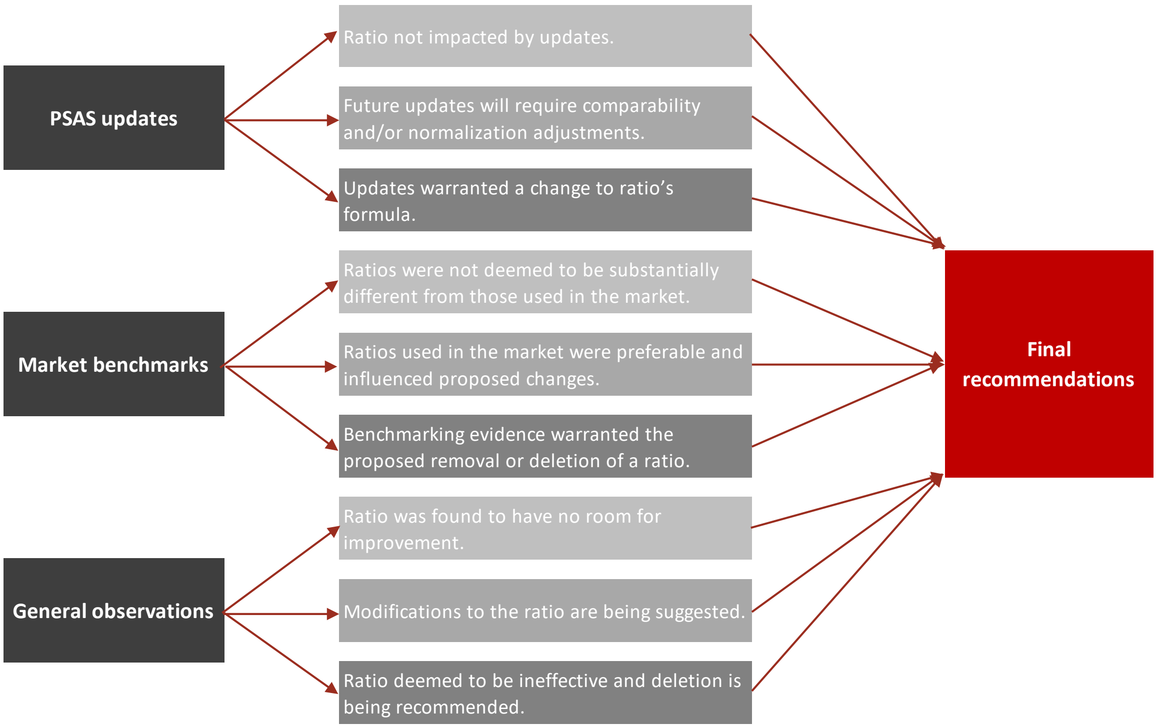
Review methodology

The analysis of the ratios contained within the Financial Performance Standards was conducted using a variety of inputs and frameworks:

- Examining recent and upcoming changes to Canadian Public Sector Accounting Standards ("PSAS") and their potential impact on the ratios. The financial statements of First Nations are required to be prepared in accordance with PSAS and the inputs used in the determination of the financial performance ratios are drawn almost exclusively from the financial statements. Although none of the changes were substantial enough to warrant a change to any of the ratios, several upcoming changes will warrant comparability and normalization adjustments and will impact how the ratios are interpreted.
- Benchmarking to ratings agency methodologies for municipalities and application of guidance contained within the Public Sector Accounting Board's Standard of Recommended Practice "Indicators of Financial Condition" to ensure that best practices are being followed. Comparisons between the frameworks and the Standards were made at both granular and holistic levels. Our findings influenced the modification or removal of several ratios.
- Examining observations collected from the FMB's own experience in completing financial performance reviews, as well as feedback received from stakeholders. The effectiveness and composition of ratios were critiqued by accounting professionals. Inputs, thresholds and mathematical formulae were all analyzed to ensure that suggested ratios come together to provide a holistic and robust framework.

Under each framework, the ratios were grouped into one of three categories depending on how much modification was required. The most significant of the three recommendations often formed our conclusions. This is illustrated in Figure 2 on the following page.

Figure 2



The recommendations for changes to the financial performance ratios were tested on a sample of First Nations drawn from the collection of financial performance reviews completed by the FMB. This sample included both First Nations who were able to meet the existing financial performance ratios and those who previously were not. The sample was used to test the impact of the proposed changes as well as benchmark the thresholds for achieving compliance with the ratios.

Summary of proposed changes

The changes proposed to the Financial Performance Standards in this Exposure Draft are significant. The majority of the changes impact the financial performance ratios used to determine compliance with the Financial Performance Standards. Currently the FMB uses a set of up to seven ratios to measure a First Nation's financial performance. With the proposed changes to the Standards, the number of ratios is reduced to five. Table 2 that follows contains a summary of the proposed changes to the financial performance ratios. A detailed explanation of the changes being proposed for each financial performance ratios follows.

Table 2 Summary of proposed changes to financial performance ratios

Ratio	Existing measure	Proposed measure
Fiscal Growth Ratio	Measures trends in revenue compared to trends in expense over the review period.	- Replace with a top-line measure of revenue growth trends over the review period. - New threshold for demonstrating compliance.

Ratio	Existing measure	Proposed measure
Liquidity Test Ratio	Measures current assets less current liabilities as a percentage of total average revenue.	- Eliminate this ratio from the Standards.
Core Surplus Ratio	Measures the weighted average over the five-year period of total revenues less total expenses and tangible capital purchases, plus amortization, tangible capital purchases funded by debt and changes in net working capital compared to a percentage of current year revenue.	- Replace with "Operating Margin Ratio" that measures operating margin as a percentage of total revenue over the five-year period. Operating margin is equal to total revenues less total expenses. - New threshold for demonstrating compliance.
Asset Maintenance Ratio	Total tangible capital expenditures as a percentage of total amortization expense over the five-year period.	- No change to the formula. - Lowering of the threshold for demonstrating compliance.
Net Debt Ratio	Total liabilities less total financial assets as a percentage of total revenues for the most recent year. Part of a two-part test that includes the Interest Coverage Ratio.	- Net Debt Ratio becomes a stand-alone standard. - No change to formula. - Tightening of the threshold for demonstrating compliance.
Interest Coverage Ratio	Net income before amortization and interest expense compared to interest expense. Part of a two-part test that includes the Net Debt Ratio.	- Replace with "Interest Expense Ratio" that measures interest expense as a percentage of total revenue. - Interest Expense Ratio becomes a stand-alone standard. - New threshold for demonstrating compliance.
Budget Performance Ratio	Difference between actual and budget for both total revenue and expense.	- Eliminate this ratio from the Standards.
Property Tax Collection Ratio	Property tax collected as a percentage of property tax levied.	- Rename the ratio to "Local Revenue Collection Ratio" - Strengthen definitions used to determine ratio inputs - Modification of the threshold for demonstrating compliance.

FISCAL GROWTH RATIO (“FGR”)

	Existing Ratio	Proposed Ratio
Formula	Measures trends in revenue compared to trends in expense over the review period.	Replace with a top-line measure of revenue growth trends over the review period.
Threshold	The First Nation demonstrates one of the following: a. its FGR is not lower than -5% **OR** b. if its FGR is lower than -5%, its adjusted FGR is not lower than -5%.	The First Nation demonstrates that its average FGR for the period under review is not lower than -5%.

Rationale for proposed changes

The purpose of the existing FGR is to assess a First Nation’s ability to sustain its financial capacity. The existing FGR measures the difference between the average compound annual revenue and expense growth rates expressed as a percentage. A growth rate of 0 or better indicates that revenue growth has outpaced expense growth and thus fiscal balance has been maintained. A growth rate of less than 0 indicates that expenditures are increasing faster than revenues which could indicate an unsustainable trend or structural deficit that can put fiscal stress on a First Nation’s ability to maintain financial capacity to meet government program and service requirements, infrastructure spending, or servicing debt.

The maintenance and growth of fiscal capacity remains an important measure for assessing the overall financial health of a First Nation, therefore while there are proposed changes to the FGR, the objective continues to be the measurement of the sustainability of a First Nation’s fiscal capacity. The Exposure Draft proposes to modify the FGR formula so that it is based solely on revenue. The shift to a top line measure is due in part to weaknesses observed in the existing formula. The existing formula picks up trends in expenses and revenues individually, not the trend in margin. The margin could be significantly negative, yet the First Nation could still pass if the margin were improving. Conversely, the margin could be large, yet seen as declining on a percentage basis.

The proposed new formula will measure the average trend in revenue growth over the period under review. An average revenue growth formula was tested and benchmarked against the other alternatives being considered and was found to be the most appropriate in the First Nations context.

Alternatives considered

Revenue growth per capita: Revenue per capita growth was considered as an alternative measure. Per capita measures, such as GDP per capita, are frequently used by ratings agencies in the government context for measuring economic growth and productivity. A revenue per capita formula was tested and benchmarked against the revenue growth formula being proposed and the results were found to be quite similar under both alternatives. On qualitative basis, revenue per capita in the First Nations context may not be as meaningful as it is for other levels of government. For example, a high revenue per capita is not necessarily an indicator of a healthy economy or a higher standard of living, but rather, could be a factor of geographical location. First Nations in the North with a higher cost-of-living would be expected to receive additional funding to cover these costs, which would in turn inflate the revenue per capita.

Compound revenue growth: Another alternative considered for the new FGR was compound revenue growth, which would take revenue from the most recent year and compare it to the least recent year. A compound revenue growth formula was tested and benchmarked against the average revenue growth formula being proposed. More variability was noted in the results under the compound revenue alternative. This is attributed to the variability in revenue that we see in the First Nations context. For example, a significant amount of one-time capital funding received in the least recent year under review would result in a negative trend in revenue over the review period, when in fact revenues could actually be consistent or increasing over the period. The average revenue growth formula better accounts for the potential variability in revenues.

LIQUIDITY TEST RATIO ("LTR")

	Existing Ratio	Proposed Ratio
Formula	Measures current assets less current liabilities as a percentage of total average revenue.	Eliminate this ratios from the Standards.
Threshold	The First Nation demonstrates that: a. its LTR for the most recent reported year is not lower than -10%, **<u>OR</u>** b. its average LTR for its five reported years is not lower than -10%	N/A

Rationale for proposed changes

The purpose of the existing LTR is to assess a First Nation's ability to meet short-term operating obligations. Positive working capital indicates strong liquidity. The higher the LTR value the greater the margin of safety in meeting short-term operating obligations. Negative working capital indicates weak liquidity and suggests that future revenues will be required to pay for past transactions and events. Sustained working capital deficits may impair the ability of a First Nation to manage its payments and thus maintain adequate levels of program and service delivery.

The Exposure Draft proposes to eliminate the LTR from the required standards. There are several reasons behind this proposal, one of which is its perceived redundancy with the Net Debt Ratio ("NDR"). The LTR and NDR are similar in that they measure a First Nation's ability to manage or meet their financial obligations – the LTR on a short-term basis and the NDR as an overall measure. The question was raised whether the measurement of a First Nation's ability to meet its short-term obligations is a necessary part of the certification process. To the extent that a First Nation breaches certain short-term debt capacity thresholds, liquidity becomes a more immediate concern to the First Nation in the context of its stewardship, but not necessarily in the context of its ability to obtain new long-term financing. For these reasons the LTR can be viewed as a redundant ratio when compared with the NDR ratio and the other proposed changes within the Exposure Draft.

The FMB has observed and has received feedback from stakeholders the LTR has been a barrier for certain First Nations with historical working capital deficits, who would otherwise meet the required standards if it were not for the LTR. A First Nation whose short-term liabilities include demand loans, lines of credit, bank overdrafts or similar financial instruments is at risk of not meeting the LTR due to the fact these short term liabilities would be considered current for the purpose of calculating the LTR. First Nations have historically not been able to access the global capital markets to obtain long-term fixed rate debt financing. First Nation in this situation are often looking to refinance their short-term obligations through the First Nations Finance Authority ("FNFA"). It is worth remembering that the sole purpose of a Financial Performance Certificate is to make the recipient First Nation eligible to become a borrowing member of the FNFA. It is therefore important that the standards are not perceived as compounding or reinforcing historical structural barriers that First Nations have faced when seeking access to capital.

The proposed elimination of the LTR is also a reflection of changes to PSAS since the inception of the Financial Performance Standards. When the Financial Performance Standards were initially developed First Nations' financial statements were required to show the breakdown between current assets and current liabilities. This distinction is no longer required in financial statements prepared in accordance with PSAS. As such, when the LTR is calculated by the FMB it frequently involves judgments about which assets and liabilities are current and non-current. Eliminating the LTR removes the subjectivity from the determination of compliance with the Finance Performance Standards.

CORE SURPLUS RATIO ("CSR")

	Existing Ratio	Proposed Ratio
Formula	Measures the weighted average over the five-year period of total revenues less total expenses adjusted for tangible capital purchases, tangible capital purchases funded by debt, amortization and changes in net working capital.	Replace with new ratio "Operating Margin Ratio" ("OMR") that measures average operating margin as a percentage of total revenue over the five-year period. Operating margin is equal to total revenues less total expenses.
Threshold	The First Nation demonstrates that its weighted average CSR exceeds such threshold as determined by multiplying the most recent year's revenue by negative 5%.	The First Nation demonstrates that its average OMR for the period under review is not lower than -5%.

Rationale for proposed changes

The purpose of the existing CSR is to assess a first nation's ability to sustain fiscal balance. The CSR measures the ability of a First Nation to sustain structural fiscal balance by determining the extent to which its operating cash flows have been sufficient to meet its cash operating activities, including capital spending. The CSR measures the first nation's cash management and ability to generate sufficient cash flows to maintain operations. The measure also indicates whether the First Nation is spending beyond its revenue base and thus exerting fiscal stress on its financial capacity. A cumulative positive CSR indicates fiscal balance has been maintained, whereas a pattern of operating deficits signals fiscal imbalance and a need to fund deficits by borrowing.

The Exposure Draft proposes to replace the existing CSR with a measure of 'Operating Margin', where operating margin is the difference between revenues and expenses. A number of the inputs used in the existing CSR are captured elsewhere in the financial performance ratios, such as the Net Debt Ratio and the Asset Maintenance Ratio, when it comes to understanding cash impacts related to the use of debt and prudence of capital expenditures. A focus on operating margin would better capture the First Nation's ability to achieve fiscal balance. We would expect that the margin would need to be maintained to produce the operating cash flow needed to satisfy capital expenditures and debt commitments. Therefore, the Exposure Draft proposes to use operating margin ratio instead as it would capture the essence of the First Nation's fiscal management. Several ratings agencies employ a similar operating margin ratio as part of their review of municipal entities' financial performance.

The shift to measuring operating margin also removes the subjectivity involved in calculating the existing CSR. One of the inputs to the CSR, tangible capital asset purchases funded by debt, is not a figure available in the financial statements. It has to be estimated or drawn from unaudited financial information. In addition, the existing formula does not adequately account for timing differences between when a tangible capital asset in acquired and when it is ultimately financed.

Alternatives considered

Average vs. weighted average: The analysis considered whether the overall OMR result should be based on a weighted average, as was used in the existing CSR, or an average of the period under review. For the purpose of ratios that measure revenues and expenses, the average was determined to be the preferred methodology. Average is better able to account for the variability observed in revenues and expenditures over a five-year review period.

ASSET MAINTENANCE RATIO ("AMR")		
	Existing Ratio	**Proposed Ratio**
Formula	Measures tangible capital expenditures as a percentage of total amortization expense over the five-year period.	No change to the formula.
Threshold	The First Nation demonstrates that: a. its AMR calculated on the average of the last 5 year's financial statements is at least 100%; **AND** b. its annual AMR for at least 3 out of the 5 reported years exceeds 100%.	The First Nation demonstrates that its average AMR for the period under review is at least 100%.

Rationale for proposed changes

The purpose of the existing AMR is to assess a first nation's ability to sustain its investment in its tangible capital assets other than land. The AMR measures the first nation's total tangible capital expenditures (other than for land) relative to the first nation's total amortization cost, expressed as a percentage. The AMR assesses whether the overall asset base is increasing, or being replenished, at a rate equal to, or higher than, the consumption of assets. The AMR is an indicator of the willingness of the First Nation to maintain the current level of investment in capital assets and provides a measure of the first nation's ability to execute a tangible capital assets maintenance plan. An AMR of less than 100% over extended years can create fiscal stress in the future. Delayed maintenance or replacement of capital assets may result in outdated assets which affect the first nation's ability to provide programs and services.

Investment in tangible capital assets remains an important measure for assessing the overall financial health of a First Nation. The Exposure Draft does not propose to make any changes to the formula used to calculate the AMR or to the requirement that the average AMR over the review period be at least 100%, as these continue to be adequate measures of investment in tangible capital assets. However, the Exposure Draft proposes to eliminate the requirement that the annual AMR for at least 3 out of 5 reported years exceed 100%. The FMB has observed, on numerous occasions, circumstances where a First Nation is not able to meet the 3 out of 5 year requirement even though their average AMR for the review period is well in excess of 100%. This 3 out of 5 year requirement potentially punishes First Nations for the timing of their capital asset expenditures which is often outside of their control. The First Nation may rely on government funding in order to replace or rehabilitate tangible capital assets, and as a result, the ability to incur expenditures at their discretion is often not realistic.

Alternatives considered

Exclusion of capital asset maintenance expenditures: The existing definition of tangible capital asset expenditures used in the calculation of the AMR allows for the inclusion of expenditures such as repairs and maintenance or renovation of existing tangible capital assets. An alternative definition where expenditures on maintenance of existing tangible capital assets were excluded was considered. The alternative definition was tested and compared to the AMR results using the existing definition. The average AMR result over the review period was significantly lower under the alternative. In addition, the results under the alternative definition were considered to be less meaningful given that they did not include the full picture of tangible capital asset maintenance and replacement activities.

Sustaining capital expenditures: An alternative formula for AMR was considered that would only measure "sustaining" capital expenditures. Sustaining capital expenditures are expenditures to replace existing tangible capital assets and are different from "growth" capital expenditures which are those expended on new tangible capital assets. Sustaining capital expenditures is a measure not found in financial statements, so additional information would have been required from the First Nation, which would increase time and resources, as well as reliance on unaudited information.

NET DEBT RATIO ("NDR")

	Existing Ratio	Proposed Ratio
Formula	Part of a two-part test including the NDR and the Interest Coverage Ratio ("ICR"). The NDR measures total liabilities less total financial assets as a percentage of total revenues for the most recent year. The ICR measures net income before interest and amortization, over interest expense.	NDR becomes stand-alone with no change to the NDR formula.
Threshold	The First Nation demonstrates that: a. its NDR for its most current reported year does not exceed 60%; OR b. its weighted average interest coverage is not lower than 1.5x.	The First Nation demonstrates that its weighted average NDR for the period under review does not exceed 30%.

Rationale for proposed changes

The purpose of the existing NDR is to assess a First Nation's ability to manage its overall level of debt. The NDR measures the size of the First Nation's net debt burden in relation to its revenues. The NDR indicates whether a first nation's debt load is sustainable or potentially restricting its financial flexibility to incur more debt. Net Debt is widely considered one of the most important measures of financial performance for governments, which is why financial statements prepared in accordance with PSAS highlight Net Debt as a balance on the statement of financial position. Ratios that measure debt capacity are commonly used by ratings agencies to evaluate how much an entity is leveraged.

In its existing form a First Nation is able to achieve compliance with the Net Debt Standard by either meeting the NDR threshold or if the NDR threshold is not met, then by meeting the secondary threshold of the ICR. The FMB has observed over the course of completing its financial performance reviews that the ICR has not been effective at screening First Nations with poor financial performance. The current interest coverage test is ineffective and is achieved in virtually all circumstances. Thus it is a rare occurrence for a First Nation to not meet one of the two ratio tests that make up the current NDR standard. This result is inconsistent with the factual observations accumulated by the FMB about those First Nations that have significant net debt and especially for those that also do not meet the existing LTR. The Exposure Draft proposes to resolve this concern by separating the NDR from the ICR and making each ratio a stand-alone requirement of the Financial Performance Standards.

The Exposure Draft does not propose to change the formula used to calculate the NDR, but does propose to amend the ratio to assess trends in Net Debt, whereas the existing ratio only looked at Net Debt for the most recent year. A trend analysis will demonstrate how a First Nation has managed their debt capacity over the review period. An increasing NDR indicates total debt is becoming more onerous on the First Nation that could lead to long-term sustainability concerns. A decreasing NDR indicates the first nation's capacity to incur more debt is strengthening. Further, this extension of the NDR over the entire period under review is imperative given the variability observed in First Nation revenues and the impact of timing on ratios that use statement of financial position balances.

Alternatives considered

Average vs. weighted average: The analysis considered whether the overall NDR result should be based on a weighted average or an average of the period under review. For the purpose of ratios that that are based on statement of financial position balances, the weighted average was determined to be the preferred methodology. The weighting proposed in the Exposure Draft gives more importance to the most recent year, which rewards First Nations who show improvement in Net Debt over the period under review.

INTEREST COVERAGE RATIO ("ICR")		
	Existing Ratio	**Proposed Ratio**
Formula	Part of a two-part test including the NDR and the ICR. The NDR measures total liabilities less total financial assets as a percentage of total revenues for the most recent year. The ICR measures net income before interest and amortization, over interest expense.	ICR becomes a stand-alone formula and is replaced by the "Interest Expense Ratio" ("IER"), that measures average interest expense as a percentage of total revenue over the five-year period.
Threshold	The First Nation demonstrates that: a. its NDR for its most current reported year does not exceed 60%; OR b. its weighted average interest coverage is not lower than 1.5x.	The First Nation demonstrates that its average IER for the period under review does not exceed 5%.

Rationale for proposed changes

The purpose of the existing ICR is to assess a First Nation's ability to manage the interest payments on its existing debt. The ICR measures operating cash flow available for interest payments. It is intended to complement the NDR, which assesses a First Nation's debt capacity.

As described above under the Net Debt Ratio, Net Debt is considered one of the most important measures of financial health of a First Nation. The combining of the NDR and the ICR in the existing Standards currently allows some First Nations with poor debt capacity to meet the Net Debt Standard. For this reason, it is being recommended that interest coverage become a separate, stand-alone measure from the NDR. The FMB has observed over the course of completing its financial performance reviews that the ICR, as an alternative threshold to the NDR, has not been effective at screening First Nations with poor financial performance. First Nations with high levels of net debt, who exceeded the 60% threshold for the NDR, were always able to meet the requirements of the Net Debt Standard by meeting the ICR. With the proposed separation from the NDR, this will no longer be a concern.

Further, the Exposure Draft is proposing to substitute the existing ICR with the Interest Expense Ratio ("IER"), which would measure interest expense as a percentage of total revenues. The proposed IER is similar to ratios currently employed by ratings agencies.

Alternatives considered

Average vs. weighted average: The analysis considered whether the overall IER result should be based on a weighted average, as was used in the existing ICR, or an average of the period under review. For the purpose of ratios that measure revenues and expenses, the average was determined to be the preferred methodology. Average is better able to account for the variability observed in revenues and expenditures over a five-year review period.

BUDGET PERFORMANCE RATIO ("BPR")

	Existing Ratio	Proposed Ratio
Formula	Measures the difference between actual and budget for both total revenue and expense.	Eliminate this ratio from the Standards.
Threshold	The First Nation demonstrates the following: a. its BPR calculated on the average of the last 5 year's revenues is within the range of +15% and - 15%; b. its BPR calculated on the average of the last 5 year's expenses is within the range of +15% and - 15%; and, c. its BPR calculated on the average of the last 5 year's surplus/deficit differential is within the range of + 15% and - 15%.	N/A

Rationale for proposed changes

The purpose of the existing BPR is to assess a First Nation's ability to manage within its budget. The BPR measures the ability of a First Nation to meet its budget expectations by measuring the extent of deviation of the actual performance from the budgeted performance. The BPR measure can illustrate the reasonableness of the budgetary assumptions and whether the current budgets can be relied on. Improper budgeting can undermine future financial flexibility, which can create fiscal problems and pose a significant challenge to maintaining credit strength. Proper budgeting can improve credit strength in good times and provide some assurance of maintaining credit strength in weaker times.

The Exposure Draft proposes to eliminate the BPR from the required standards. The FMB has observed over the course of completing its financial performance reviews that budget information is frequently incomplete or missing from the financial statements. Accurate budgeting is premised on the First Nation having a well-functioning financial management system in place, something that many First Nations are working to establish. To potentially punish First Nations that may be good stewards, but who lack a more formal budgeting process is misaligned with the FMB's capacity development mandate.

Additionally, First Nations may not have control over a number of the items in their budgets. For example, the timing and amount of funding received from other levels of government may be materially different than forecast. These observations raised questions about the relevance, measurability and achievability of the BPR, which are three of the FMB's key principles for Standards. For these reasons the Exposure Draft is recommending the removal of the BPR from the Financial Performance Standards.

PROPERTY TAX COLLECTION RATIO ("PTCR")

	Existing Ratio	Proposed Ratio
Formula	Measures property tax collected as a percentage of property tax levied.	Renamed to "Local Revenues Collection Ratio" ("LRCR"). Formula modified to include all forms of local revenues.
Threshold	The First Nation demonstrates that a. its PTCR calculated on the average of the last 5 year's information exceeds 95%, and, b. its annual PTCR for at least 3 out of the 5 reported years exceeds 95%.	The First Nation demonstrates that its LRCR calculated for the most recent year exceeds 95%.

Rationale for proposed changes

The purpose of the existing TCR is to assess a first nation's effectiveness in collecting the property tax revenues it is levying. This ratio is only applicable to First Nations who have enacted a local revenues law and are collection property taxes under the *First Nations Fiscal Management Act*.

The Exposure Draft proposes to rename the standard to the "Local Revenues Collection Ratio" in order to align with the nomenclature used in other FMB Standards and encompass all forms of local revenues. During the comprehensive review it was observed that there is potential ambiguity in the definitions for local revenues levied and collected. The Exposure Draft proposes to update and strengthen these definitions in order to ensure consistent application in the course of financial performance reviews. Uncollected taxes are proposed to be defined at those outstanding as at the date of the financial performance review (i.e. March 31st).

It is expected that one of the results of these proposed changes will be a shift in the inputs used to assess collection of local revenues. Levied and collected local revenues are not easily determined from the financial statements. Local revenues levied for a given year are available from the First Nation's Property Tax Expenditure Law. In order to determine uncollected local revenues, the FMB will need to rely on a local revenues aging schedule prepared by First Nations management. With the proposed change to the definition of uncollected it will be difficult to assess uncollected local revenues for any year beyond the most recent year under review. For this reason it is proposed that the LRCR will only be calculated for the most recent year. It is expected that with the recently effective *Local Revenue Financial Reporting Standards* that information on property taxes levied and collected will be available in the separate annual local revenues financial statements or separate note disclosures that are now required for First Nations collecting local revenues.

Other proposed changes

In addition to the proposed changes to the financial performance ratios, the Exposure Draft includes various other non-substantive changes to the Financial Performance Standards. These changes are editorial in nature and primarily serve to either clarify the wording in a standard or update the terminology used in the standards.

Timing of adoption of proposed changes

The FMB expects to issue the final C2 – Financial Performance Standards in the first quarter of the 2018 calendar year. The effective date for these new Standards will be communicated at that time. The FMB's Standard Setting Guidelines require that the effective date be set so that those applying the standard have sufficient time to prepare for the new requirements. Given that the changes proposed in the Exposure Draft will not impact First Nations who have achieved Financial Performance Certification under the FMB's existing Financial Performance Standards, and since the changes are intended to benefit prospective Financial Performance Certification clients, the FMB considers it reasonable to possibly waive the requirement of a transition period between issuance of the final Financial Performance Standards and the date they become effective.

Comments requested

As a matter of policy, the FMB seeks input from stakeholders prior to introducing or significantly amending its standards. This input is critical in developing standards that are relevant to stakeholders and responsive to their needs.

The FMB welcomes comments on all aspects of this Exposure Draft. Feedback sent to the FMB can lead to major changes to a final standard. It is just as important to know if stakeholders support a proposed standard as it is to know if there are any concerns about it. Any comments that express disagreement with the proposals should clearly explain the problem and if possible, include a suggested alternative.

Comments and responses to the following questions are requested <u>on or before</u> <u>December 15, 2017</u>.

1. Do you agree with the proposed changes to the Fiscal Growth Ratio?
2. Do you agree with the proposed elimination of the Liquidity Test Ratio?
3. Do you agree with the proposed changes to the Operating Margin Ratio (formerly the Core Surplus Ratio)?
4. Do you agree with the proposed changes to the Asset Maintenance Ratio?
5. Do you agree with the proposed changes to the Net Debt Ratio?
6. Do you agree with the proposed changes to the Interest Expense Ratio (formerly the Weighted Average Interest Coverage Ratio)?
7. Do you agree with the proposed elimination of the Budget Performance Ratio?

8. Do you agree with the proposed changes to the Local Revenue Collection Ratio (formerly the Property Tax Collection Ratio)?

9. Do you have any other comments on the FMB's proposed changes to the C2 – Financial Performance Standards?

For convenience, an online response form has been released with this document. Alternatively, written comments may be sent by email to: standards@fnfmb.com

C2 – Financial Performance Standards

The red-line version of the C2 – Financial Performance Standards showing the proposed changes from the April 1, 2016 version of the Standards can be downloaded separately from the Standard Setting page of the FMB's website.