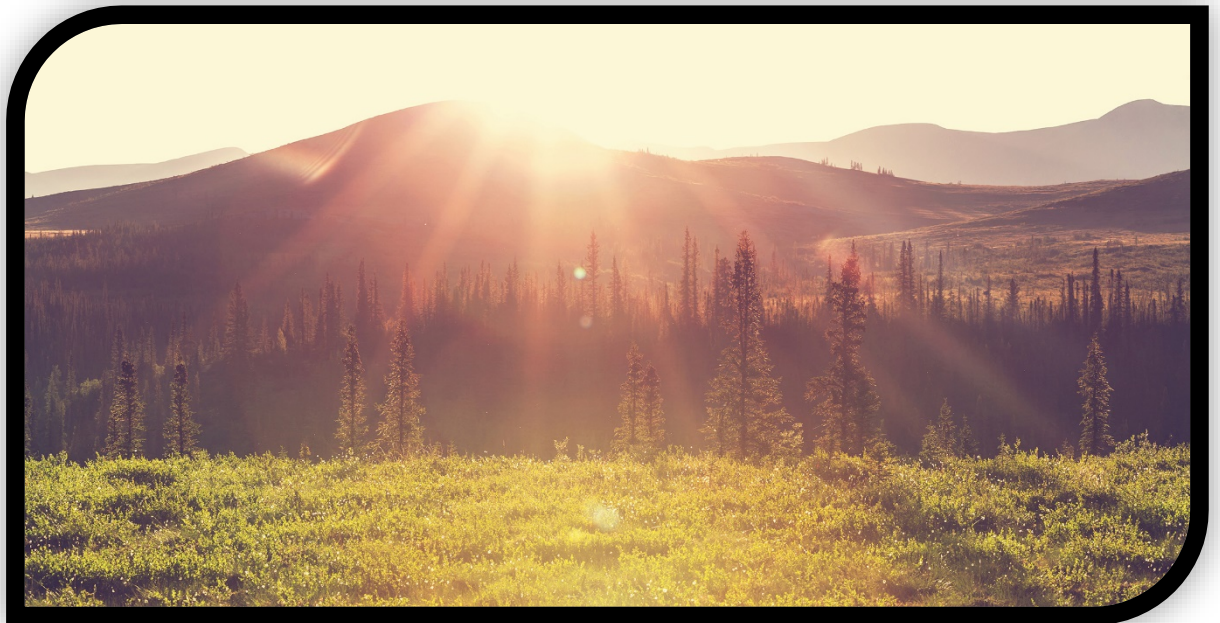




First Nations  
**FINANCIAL  
MANAGEMENT  
BOARD**

# C2 – Financial Performance Standards

*Basis for Conclusions*



Standards and Certification  
First Nations Financial Management Board  
February 22, 2018  
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## Foreword

The First Nations Financial Management Board (“the FMB”) issued its first edition of its Financial Performance Standards on September 15, 2010. Since that time four subsequent editions have been published. The only substantive change was in November 2011 when the Liquidity Test Ratio was first introduced. With so many external changes occurring within the First Nations accounting and financial reporting environment during this period, the FMB decided in 2016 to conduct an in-depth review of its Financial Performance Standards. The objective of this review was to make sure these Standards remain relevant to all users of a Financial Performance Certificate including First Nations and the First Nations Finance Authority. The outcome of this research was the publication of an Exposure Draft on November 15, 2017 containing a number of proposed changes to the Financial Performance Standards. The FMB sought feedback from First Nations, auditors and other stakeholders. A webinar was held on November 22, 2017 to inform participants of these changes and to obtain any further input as a new set of Standards was developed.

On February 22, 2018 a new edition of *C2 – Financial Performance Standards* was approved and issued by the FMB and became effective for all First Nations seeking a Financial Performance Certificate issued by the FMB. These standards will be what the FMB uses to conduct financial performance reviews for First Nations that have requested a Financial Performance Certificate from this date forward.

The primary objective of this Basis for Conclusions document is to set out how the FMB reached its conclusions in developing the new standards contained within the *C2 – Financial Performance Standards*. In addition, it sets out matters arising from comments received from stakeholders in response to the Exposure Draft and changes made to the *C2 – Financial Performance Standards* between the release of the Exposure Draft and their final publication.

This document is intended to assist the FMB’s current and future clients and stakeholders in understanding the rationale followed by the FMB when developing standards.

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## First Nations First

Every First Nation has a past to honour, and a future to secure – a future filled with promise, where children thrive, communities grow and cultures prosper. The FMB will provide the tools and guidance that will instill confidence in First Nations' financial management and reporting systems to support economic and community development.

## 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.



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 Basis for Conclusions document is intended to fulfill the commitments of transparency and responsiveness contained in our Standard Setting Guidelines.

## Amendments to the Financial Performance Standards

### Background

The project to amend the FMB's Financial Performance Standards began in 2016 and culminated with the approval of the new C2 – Financial Performance Standards on February 22, 2018. The FMB improves its Standards to remain relevant to the needs of First Nations and other First Nations Institutions. The changes to the Financial Performance Standards were needed to remain responsive to feedback from First Nations and to build on the FMB's extensive experience to date. The changes are expected to provide even greater opportunities for First Nations to access capital that is needed for on-reserve infrastructure and economic development.

A full history of the FMB's Financial Performance Standards and the FMB's review methodology leading up to the release of the Exposure Draft and the proposed Financial Performance Standards can be found in the Exposure Draft. The Exposure Draft can be downloaded separately from the Standard Setting page of the [FMB's website](#).

### Summary of amendments to the Financial Performance Ratios

The changes made to the Financial Performance Standards are significant. The majority of the changes impact the financial performance ratios used to evaluate compliance with the Financial Performance Standards. Previously the FMB used a set of seven ratios to measure a First Nation's financial performance. With the changes to the Standards, the number of ratios is reduced to six. Some of the previous ratios have been eliminated, while other have been modified or replaced. The thresholds used to demonstrate compliance with most ratios have also been updated. **The**

financial performance evaluation remains a point-in-time assessment that is based on information from the most recent five years of audited financial statements.

Figure 1 below summarizes the overall changes financial performance ratios. The sections that follow set out the changes to each individual financial performance ratio. The detailed rationale for the changes can be found in the Exposure Draft. The Exposure Draft can be downloaded separately from the Standard Setting page of the [FMB's website](#).

**Figure 1 – Summary of changes to financial performance ratios**

Ratio	Type of Change
Fiscal Growth Ratio	MODIFIED
Liquidity Test Ratio	ELIMINATED
Core Surplus Ratio	REPLACED
Operating Margin Ratio	NEW!
Asset Maintenance Ratio	MODIFIED
Net Debt Ratio	MODIFIED
Interest Expense Ratio	NEW!
Budget Performance Ratio	ELIMINATED
Local Revenue Collection Ratio	REPLACED

### Modification of the Fiscal Growth Ratio (“FGR”)

The purpose of the amended FGR is to evaluate the sustainability of a First Nation’s fiscal capacity. The new FGR is a top-line measure of revenue growth trends over the review period and replaces the previous measure of trends in revenue compared to trends in expense over the review period giving results that are more accurate and relevant to First Nations

**Figure 2 - Fiscal Growth Ratio**

<b>Previous FGR</b>	<ul style="list-style-type: none"> <li>Measured trends in revenue compared to trends in expense over the review period</li> <li>Threshold: FGR must not be lower than -5%</li> <li>Secondary calculation for Adjusted FGR if initial FGR is not met</li> </ul>
<b>Modified FGR</b>	<ul style="list-style-type: none"> <li>Replaced with a top-line measure of revenue growth trends over the review period</li> <li>Threshold: average FGR over the review period must not be lower than -5%</li> <li>No secondary option if FGR is not met</li> </ul>

### Elimination of the Liquidity Test Ratio (“LTR”)

One of the most important changes to the Financial Performance Standards was the elimination of the LTR from the financial performance requirements. The previous purpose of the LTR was to assess a First Nation’s ability to meet short-term operating obligations. It measured current assets

less current liabilities as a percentage of average revenue. The FMB's experience has indicated that this ratio has been a major barrier to First Nations with otherwise strong financial results, which happen to have short-term or demand financing. The removal of this ratio will give these First Nations to access becoming borrowing members of the First Nations Finance Authority and with the potential to refinance short-term loans. The removal of the LTR eliminates the previous redundancy with Net Debt Ratio in measuring ability to meet financial obligations. The removal of the LTR further eliminates judgment about current and non-current assets and liabilities, which are no longer classified as such on the statement of financial position for entities applying Public Sector Accounting Standards.

**Figure 3 – Liquidity Test Ratio**

<b>Previous LTR</b>	<ul style="list-style-type: none"><li>• Measured current assets less current liabilities as a percentage of average revenue</li><li>• Threshold: LTR for the most recent year must not be lower than -10%</li><li>• Secondary calculation for average LTR for the period if initial LTR is not met</li></ul>
<b>LTR Eliminated</b>	<ul style="list-style-type: none"><li>• Eliminated this ratio from the Standards</li></ul>

#### **Replacement of the Core Surplus Ratio (“CSR”) with the Operating Margin Ratio (“OMR”)**

The purpose of the new OMR is to evaluate the ability of the First Nation to achieve fiscal balance. It measures total revenues less total expenses as a percentage of total revenue and replaces the previous measure of adjusted annual surplus/deficit expressed as a percentage of revenue. The replacement of the CSR with the OMR eliminates previous redundancies with other ratios and results in a more accurate measure of achievement of fiscal balance. Several ratings agencies employ a similar operating margin ratio as part of their review of municipal entities' financial performance.

**Figure 4 – Core Surplus Ratio replaced by Operating Margin Ratio**

<b>Previous CSR</b>	<ul style="list-style-type: none"><li>• Measured the weighted average over the review period of annual surplus/deficit, adjusted for tangible capital purchases, tangible capital asset purchases financed with debt, amortization and changes in net working capital</li><li>• Threshold: Weighted average CSR must exceed -5% of most recent year's revenue</li></ul>
<b>Replaced by OMR</b>	<ul style="list-style-type: none"><li>• Replaced with “Operating Margin Ratio” that measures total revenues less total expenses as a percentage of total revenue</li><li>• Threshold: average OMR over the review period must not be lower than -5%</li></ul>

#### **Modification of Asset Maintenance Ratio (“AMR”)**

The purpose of the AMR is to evaluate the ability of the First Nation to sustain its investment in tangible capital assets. It measures total tangible capital expenditures, including maintenance, as a



percentage of total amortization expense. The modification to the ratio is not a change to the formula, but a lowering of the threshold required to demonstrate compliance. Previously the standard required the AMR in three out of five years to exceed one-hundred percent. The FMB's experience has indicated that this ratio has been a barrier to First Nations who were not able to meet the 3 out of 5 year requirement even though their average AMR for the review period was well in excess of one-hundred percent. The change removes elements potentially outside First Nation's control including timing of capital projects

Figure 5 - Asset Maintenance Ratio

<b>Previous AMR</b>	<ul style="list-style-type: none"><li>• Measured total tangible capital expenditures, including maintenance, as a percentage of total amortization expense</li><li>• Threshold: Average AMR for the review period is at least 100% <u>AND</u> annual AMR for at least 3 of the 5 years must exceed 100%</li></ul>
<b>Modified AMR</b>	<ul style="list-style-type: none"><li>• No change to the formula</li><li>• Threshold: Average AMR for the review period is at least 100%</li><li>• Eliminate requirement for 3 of 5 years exceeding 100%;</li></ul>

### Modification of the Net Debt Ratio ("NDR")

One of the most important changes to the Financial Performance Standards was the separation of the two components of the NDR: the NDR and the Interest Coverage Ratio (ICR). Under the previous standards the evaluation of the NDR was a two-part test that included the ICR. If a First Nation was not able to meet the sixty percent threshold for the NDR, then they were still able to meet the standard by having an ICR in excess of 1.5 times. The FMB observed that this method was ineffective at screening higher levels of net debt.

The NDR is now a stand-alone ratio, separate from the measure of interest expense. The purpose of the NDR is to evaluate a First Nation's ability to manage its overall level of debt and it measures total liabilities less financial assets expressed as a percentage of total revenues. There has been no change to the NDR formula, but the amendments include a lowering of the threshold from sixty percent to fifty percent.

Figure 6 - Net Debt Ratio

<b>Previous NDR</b>	<ul style="list-style-type: none"><li>• Measured financial assets less liabilities as a percentage of total revenues</li><li>• Part of a two-part test that includes the Interest Coverage Ratio (ICR)</li><li>• Threshold: NDR for the most recent does not exceed 60%</li><li>• Secondary calculation for weighted-average ICR if NDR is not met</li></ul>
<b>Modified NDR</b>	<ul style="list-style-type: none"><li>• NDR becomes a stand-alone ratio, separate from ICR</li><li>• No change to formula</li><li>• Threshold: Weighted average NDR for the review period does not exceed 50% <u>or</u> current period NDR does not exceed 50%</li></ul>



### New Interest Expense Ratio (“IER”)

As stated above under the Net Debt Ratio, the interest coverage portion of the previous NDR was split off from the measure of net debt into a standalone ratio, now called the Interest Expense Ratio. The purpose of the new IER is to evaluate a First Nation’s ability to manage the interest payments on its existing debt and it measures total interest as a percentage of total revenues. This new ratio aligns with similar ratios used by credit ratings agencies as part of their review of municipal entities’ financial performance.

Figure 7 – Interest Expense Ratio

<b>Previous ICR</b>	<ul style="list-style-type: none"><li>• Measured annual surplus/deficit before amortization and interest expense compared to total interest expense</li><li>• Part of a two-part test that includes the Net Debt Ratio</li><li>• Threshold: Weighted average ICR is not lower than 1.5x</li></ul>
<b>Replaced by IER</b>	<ul style="list-style-type: none"><li>• Replaced with “Interest Expense Ratio” that measures interest expense as a percentage of total revenue</li><li>• Interest Expense Ratio becomes a new stand-alone ratio</li><li>• Threshold: average IER over the 5-year period does not exceed 5%</li></ul>

### Elimination of the Budget Performance Ratio (“BPR”)

The purpose of the BPR was to assess a First Nation’s ability to manage within its budget. The FMB’s experience indicated that we were regularly calculating normalization adjustments on this ratio to account for the fact that many First Nations are not reporting consolidated budgets on a GAAP basis<sup>1</sup> and to take into account that First Nations are often subject to unpredictable cash flows (particularly those related to capital projects) from the federal government of Canada and other funders.

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 hold First Nations back that may be good stewards, but who lack a more formal budgeting process is misaligned with the FMB’s capacity development mandate. It is the FMB’s view that budget effectiveness is better evaluated in the context of a review of the First Nation’s Financial Management System.

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<sup>1</sup> GAAP, or generally accepted accounting principles, is considered to be Public Sector Accounting Standards. PS 1201, *Financial statement presentation*, contains this requirement for reporting budget information

Figure 8 – Budget Performance Ratio

<b>Previous BPR</b>	<ul style="list-style-type: none"><li>• Measured the difference between actual and budget for both total revenue and expense</li><li>• Threshold: Average BPR for revenues, expenses and annual surplus/deficit for the review period must be within the range of +/- 15%</li></ul>
<b>BPR Eliminated</b>	<ul style="list-style-type: none"><li>• Eliminated this ratio from the Standards</li></ul>

### Replacement of the Property Tax Collection Ratio (“PTCR”) with the Local Revenue Collection Ratio (“LRCR”)

The purpose of the PTCR and the LRCR is to assess a First Nation’s effectiveness in collecting any property tax revenues it is levying under the *First Nations Fiscal Management Act*. The LRCR measures local revenues collected as a percentage of local revenues levied for the most recent year. The change in the name of the ratio was needed to align it with nomenclature used under the *First Nations Fiscal Management Act* and other FMB Standards. Other changes were made to strengthen the definitions used in standards and to incorporate feedback received from the First Nations Tax Commission. In addition, the new LRCR only applies for First Nations who report at least \$100,000 of local revenues annually.

Figure 9 – Property Tax Collection Ratio replaced by Local Revenue Collection Ratio

<b>Previous PTCR</b>	<ul style="list-style-type: none"><li>• Measured property tax collected as a percentage of property tax levied</li><li>• Threshold: Average PTCR for the review period exceeds 95% <u>AND</u> annual PTCR for at least 3 of the 5 years exceeds 95%</li></ul>
<b>Replaced by LRCR</b>	<ul style="list-style-type: none"><li>• Renamed to “Local Revenue Collection Ratio” to align with FMA nomenclature</li><li>• Strengthens definitions used to determine ratio inputs</li><li>• Threshold: LRCR only applicable if local revenues are at least \$100,000 annually</li><li>• Threshold: LRCR for the most recent year is at least 95%</li></ul>

### Other changes to the Financial Performance Standards

In addition to the changes to the financial performance ratios various other non-substantive changes to the Financial Performance Standards have been made. 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.

### Summary of changes between the Exposure Draft and final Standards

Following the release of the Exposure Draft in October 2017 the FMB sought feedback from its stakeholders through an invitation to comment. Stakeholders were informed about the proposed changes to the Financial Performance Standards on the FMB’s Standard-Setting webpage, through email notifications and the FMB hosted a webinar outlining the proposed changes. The FMB also

sought targeted feedback from key stakeholders, the First Nations Finance Authority and the First Nations Tax Commission.

Feedback received during the comment period was incorporated into the final Financial Performance Standards. Table below

**Table 1 - Summary of comments received and responses**

<b>Feedback received</b>	<b>Response</b>
<b>Some of the terms and definitions used in the proposed Local Revenue Collection Ratio (LRCR) were unclear.</b>	Editorial changes were made to clarify terms and definitions used in the LRCR.
<b>Consider incorporating a minimum threshold for application of the Local Revenue Collection Ratio (LRCR).</b>	The LRCR includes a new \$100,000 threshold such that the LRCR will only be calculated and reported upon when a First Nation's local revenue meets or exceeds this amount. This will reduce the internal cost of conducting a financial performance review without reducing the usefulness of a Financial Performance Certificate.
<b>The effective date for the new Standards should be as soon as possible so that First Nations can start benefiting from the changes immediately.</b>	The FMB opted to waive the requirement of a transition period between issuance of the final Financial Performance Standards and the date they become effective given that the amendments to the Financial Performance Standards will not impact First Nations who have already achieved Financial Performance Certification under the FMB's existing Financial Performance Standards and that the changes are intended to benefit prospective Financial Performance Certification clients.

In addition to seeking stakeholder feedback, the FMB continued to assess the quantitative impact of the proposed changes to the financial performance ratios in the period between the release of the Exposure Draft and the development of the final Standards. The FMB extended its original quantitative analysis on which the proposals in the Exposure Draft were based to incorporate data collected from financial performance reviews completed by the FMB between October 2017 and January 2018. This new data pointed to a need to revisit the thresholds being proposed for the Net Debt Ratio, which was originally proposed at 30 percent. This threshold was re-assessed incorporating the new data and evaluating other alternative thresholds for the NDR between 30 and 60 percent. This new analysis resulted in two changes to the original proposal in the Exposure Draft: the threshold for the Net Debt Ratio was increased to 50 percent and an alternative threshold based on current year net debt was introduced for First Nations who do not meet the weighted average NDR, but where their current year NDR is within the new threshold (i.e. the NDR result for the most recent year is better than the weighted average). This allows First Nations who have demonstrated improvement in overall net debt not to be held back for previous periods of under-performance.

The FMB opted not to re-release an Exposure Draft of the changes made to the original Exposure Draft proposals. The majority of the changes made were non-substantive with the purpose of

clarify the wording in a standard or served to improve the relevance and achievability of the Standards. In addition, the FMB sought feedback from its key stakeholders who were in support of the changes.

### **Effective date of the new Financial Performance Standards**

A date of February 22, 2018 was set as the effective date of the new Financial Performance Standards and coincides with the approval of the Standards by FMB's Board of Directors. The FMB opted to waive the requirement of a transition period between issuance of the final Financial Performance Standards and the date they become effective given that the amendments to the Financial Performance Standards will not impact First Nations who have already achieved Financial Performance Certification under the FMB's existing Financial Performance Standards and that the changes are intended to benefit prospective Financial Performance Certification clients.

### **Who will be impacted by the new Financial Performance Standards?**

First Nations seeking Financial Performance Certification from the FMB on or after February 22, 2018 will need to demonstrate compliance with the amended Financial Performance Standards. First Nations with existing Financial Performance Certificates are not impacted by the changes.

### **C2 – Financial Performance Standards**

The red-line version of the *C2 – Financial Performance Standards* showing the changes from the April 1, 2016 version of the Standards, along with a separate version that shows the changes compared to the original Exposure Draft published on November 15, 2017, can be downloaded separately from the Standard Setting page of the [FMB's website](#).