

## 9.1 – Significant Adverse Trend 2018 Audit Report

Submission To:	Governance, Audit & Community Services Committee
Location/Address:	Whole Shire
Name of Applicant:	Mark Hook, Chief Executive Officer
File Reference:	FM.AUD.1225
Author:	Mark Hook, Chief Executive Officer
Disclosure of any Interest:	Nil
Date of Report:	13 August 2019

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### Enclosure/Attachments:

Letter from the Department of Local Government.

### Summary:

The Governance, Audit and Community Services Committee is being requested to receive the report on the adverse trend of the following ratios raised in the 2017/2018 Annual Report.

1. Asset Sustainability Ratio
2. Operating Surplus Ratio
3. Own Source Revenue Ratio

### Background:

The CEO received the following letter from the Department of Local Government Sport and Cultural Industries regarding the 2017/2018 audit report on 5 July 2019.

The Department of Local Government, Sport and Cultural Industries (the Department) has received the Shire's 2017-18 Audit Report from Butler Settineri (Audit) Pty Ltd dated 19 December 2018.

The Audit Report identifies matters as significant in regard to adverse trends, qualified audits and other matters. The following matter is identified as significant by the auditor:

- Significant adverse trends in the financial position of the Shire: Asset Sustainability Ratio, Operating Surplus Ratio and Own Source Revenue Ratio below the Department standard.

Section 7.12A(4) of the *Local Government Act 1995* states that a local government must:

*prepare a report addressing any matters identified as significant by the auditor in the audit report, and stating what action the local government has taken or intends to take with respect to each of those matters; and*

*(b) give a copy of that report to the Minister within 3 months after the audit report is received by the local government.*

*Within 14 days after a local government gives a report to the Minister under subsection (4)(b), the CEO must publish a copy of the report on the local government's official website.*

To date it appears that a report has not been received and has not been published on the Shire's official website in accordance with Section 7.12A.

As a matter of priority the Shire must prepare a report for its Audit Committee and seek council's endorsement before forwarding a copy to the Department at [audits@dlqsc.wa.gov.au](mailto:audits@dlqsc.wa.gov.au)

As this report is now overdue, the Department requires the local government to remedy this non-compliance within the next 60 days from the date of this letter.

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**Comments:**

The Audit Committee is to consider the significant adverse trend in the Ratios identified in the 2018 Audit Report issued by the Office of Auditor General for the 2018 Annual Financial Statements.

The Ratio have been below the Department of Local Government, Sport and Cultural Industries standard for the last three years on both an adjusted and non-adjusted basis.

Local governments must prepare a report addressing the significant matters identified in the report and state what action the local government has taken or intends to take. This report must be provided to the Minister within three months of receiving the audit report. Within 14 days after the local government gives the report to the Minister, the CEO must publish a copy of the report on its official website.

Correspondence received from the Department dated 28 June 2019 has highlighted a non-compliance issue in relation to the report addressing what actions have been taken or are intended to be taken to address this ratio.

The Annual Financial Statements and Independent Audit Report was discussed at the Audit Committee Meeting held on 19 December 2018.

**Moved Cr Russell / Seconded Cr Lansdell**

That the Governance, Audit and Community Services Committee meeting adopts the Annual Audit and Management Reports provided by Butler Settineri for the year ended 30 June 2018.

**Carried 7 / 0**

The ratios in question were listed in the Annual Report on page 75.

NOTES TO AND FORMING PART OF THE FINANCIAL REPORT  
FOR THE YEAR ENDED 30TH JUNE 2018

27. FINANCIAL RATIOS

	2018	2017	2016
Current ratio	9.57	6.62	4.59
Asset sustainability ratio	0.53	0.33	0.44
Debt service cover ratio	36.75	50.25	3.45
Operating surplus ratio	(1.60)	(1.52)	(2.30)
Own source revenue coverage ratio	0.29	0.26	0.28

The above ratios are calculated as follows:

Current ratio	$\frac{\text{current assets minus restricted assets}}{\text{current liabilities minus liabilities associated with restricted assets}}$
Asset sustainability ratio	$\frac{\text{capital renewal and replacement expenditure}}{\text{depreciation expenses}}$
Debt service cover ratio	$\frac{\text{annual operating surplus before interest and depreciation}}{\text{principal and interest}}$
Operating surplus ratio	$\frac{\text{operating revenue minus operating expenses}}{\text{own source operating revenue}}$
Own source revenue coverage ratio	$\frac{\text{own source operating revenue}}{\text{operating expenses}}$

Notes:

Information relating to the asset consumption ratio and the asset renewal funding ratio can be found at Supplementary Ratio Information on Page 53 of this document.

Three of the ratios disclosed above were distorted by the early receipt of Financial Assistance Grants.

In addition, two of the ratios were impacted by revenue and expenses associated with flood damage re-instatement which is considered one-off in nature.

	2017/18	2016/17	2015/16
	\$	\$	\$
Amount of Financial Assistance Grant received during the year relating to the subsequent year.	797,202		
Amount of Financial Assistance Grant received in prior year relating to current year.		779,922	
Amount of reimbursement for flood damage received	103,965		
Expenditure on flood damage re-instatement	288,240		

If the events detailed above did not occur, the impacted ratios in the 2018, 2017 and 2016 columns above would be as follows:

	2018	2017	2016
Current ratio	8.72	3.21	5.24
Debt service cover ratio	33.04	27.92	11.48
Operating surplus ratio	(1.66)	(1.93)	(2.05)
Own source revenue coverage ratio	0.29	0.26	(0.28)

RATIO INFORMATION

The following information relates to those ratios which only require attestation they have been checked and are supported by verifiable information.

	2018	2017	2016
Asset consumption ratio	0.99	0.94	0.95
Asset renewal funding ratio	1.00	1.00	1.00

The above ratios are calculated as follows:

Asset consumption ratio	$\frac{\text{depreciated replacement costs of depreciable assets}}{\text{current replacement cost of depreciable assets}}$
Asset renewal funding ratio	$\frac{\text{NPV of planned capital renewal over 10 years}}{\text{NPV of required capital expenditure over 10 years}}$

Following is an Extract from the Auditors Report for 2017/2018.

*In accordance with the Local Government (audit) Regulations 1996, we also report that:*

- a) *Apart from the asset sustainability ratio, operating surplus ratio and own source revenue ratio that do not meet the minimum benchmark, there are no material matters that in our opinion indicate significant adverse trends in the financial position or the financial management practices of the Shire.*
- b) *The Shire substantially complied with Part 6 of the Local Government Act 1995 (as amended) and the Local Government (Financial Management) Regulations 1996 (as amended).*
- c) *In relation to the Supplementary Ratio Information presented on page 60 of this report we have reviewed the calculations as presented and nothing has come to*

our attention to suggest that they are not reasonably calculated and based on verifiable information.

d) All information and explanations required were obtained by us.

e) All audit procedures were satisfactorily completed in conducting our audit.

### Asset Sustainability Ratios

Following are the Shire of Wickepin Asset Sustainability Ratios 2016 to 2018.

	2018	2017	2016
Asset Sustainability Ratio	0.53	0.33	0.44

This ratio is an approximation of the extent to which assets managed by a local government are being replaced as these reach the end of their useful lives. It is calculated by measuring capital expenditure on **renewal** or **replacement** of assets, relative to depreciation expense. Expenditure on new or additional assets is excluded.

Depreciation expense represents an estimate of the extent to which the assets have been consumed during that period. Measuring assets at fair value is critical to the calculation of a valid depreciation expense value.

f) Asset Sustainability Ratio		Capital Renewal and Replacement Expenditure	
		Depreciation Expense	
	[23]	[24]	[25]
=	$\frac{660,185^* + 2,031,457 + 46,798 + 2,976,240}{6,907,407}$		$\frac{5,714,680}{6,907,407} = 82.7\%$ (or 0.827)
	[10]		

\*Note: while described as land and building in the rate setting statement, for the purpose of this example the expenditure is assumed to all relate to buildings.  
[Numbers drawn from rate setting statement]

The Departments Minimum bench marks are as follows:

1. Not Meeting Standards <0.90 Minimum 0.75
2. Standard 0.90
3. Improving 0.90 to 1.10 Max 1.20

As council standard for 2018 was 0.53 it is not meeting the Department's minimum standards of 0.75.

Currently the ratio is improving and council to meet this standard will need to increase its spending on the renewal of its current assets.

Another issue is with council's current asset management plan that requires the renewal years to be altered to meet council needs this would improve this ratio.

### Action required to meet this Ratio

Review current renewal expenditure and update existing Management Plans and look at current depreciation rates.

### Operating Surplus Ratio

Following are the Shire of Wickepin Operating Surplus Ratios 2016 to 2018:

	2018	2017	2016
Operating Surplus Ratio	(1.60)	(1.52)	(2.30)

A key indicator of a local government's financial performance is measured by the 'Operating Surplus Ratio'. If a local government consistently achieves a positive operating surplus ratio and has soundly based long term financial plans showing that it can continue to do so in future, having regard to asset management and the community's service level needs, then it is considered financially sustainable.

A positive ratio indicates the percentage of total own source revenue available to help fund proposed capital expenditure, transfer to cash reserves or to reduce debt.

A negative ratio indicates the percentage increase in total own source revenue (principally rates) that would have been required to achieve a break-even operating result.

Ratio Calculations are for the year 200Y			
<b>d) Operating Surplus Ratio</b>	$\frac{\text{(Operating Revenue MINUS Operating Expense)}}{\text{Own Source Operating Revenue}}$		
=	$\frac{((20,707,319+44,048) - (21,513,908))}{13,763,772}$	=	$\frac{-762,541}{13,763,772} = -5.5\%$ (or -0.055)
[Numbers drawn from statement of comprehensive income by nature or type and Own Source Operating Revenue same as in c) above]			

The Departments Minimum bench marks are as follows:

1. Not Meeting Standards <0.00 Minimum 0.00
2. Standard 0.01 to 0.15
3. Advanced >0.15

The ratio is well below the standard set by the Department for 2016, 2017 and 2018 due to the following factors.

The ratio excludes Financial Assistance Grants (FAG's). It has long been argued that Financial Assistance Grants are an integral component of revenue for local government and business models are predicated on the Receipt of FAG's grants. Removing this key source of operational revenue from the ratio calculation has a negative impact on the ratio and skews the result.

### Action required to meet this Ratio

The CEO can see no action to rectify this ratio as it would require a major increase of rates for the Shire of Wickepin to be non-reliant on grants.

The Chief Executive Officer believes council should request the Minister to instruct his departmental staff to review the ratio and consider reinstating Financial Assistance Grant revenue and other operational grant revenue such as ESL BFB and SES type operation grants in the ratio.

### Own Source Revenue Coverage Ratio

Following are the Shire of Wickepin Own Source Revenue Coverage Ratio 2016 to 2018:

	2018	2017	2016
Own Source Revenue Coverage	0.29	0.26	0.28

A local government's ability to cover its costs through its own taxing and revenue efforts is measured by the 'Own Source Revenue Coverage Ratio'.

c) Own Source Revenue Coverage Ratio					Own Source Operating Revenue	
					Operating Expense	
	[13]	[14]	[15]	[16]	[6]	[18]
=	(8,165,843+4,999,717+498,964+55,200+44,048)				=	13,763,772
	(21,365,583+98,325+50,000)					21,513,908
	[7]	[8]	[9]	[10]		[17]
	<b>0.64 (or 64%)</b>					
[Numbers drawn from statement of comprehensive income by nature or type]						

The Departments Minimum bench marks are as follows

1. Not Meeting Standards <0.40 Minimum 0.30
2. Standard 0.40 to 0.90
3. Advanced >0.90

There is no way the Shire of Wickepin will be able to meet this ratio as we do not have enough outside revenues other than rates and grants.

### Action required to meet this Ratio

The CEO can see no action to rectify this ratio as it would require a major increase of rates for the Shire of Wickepin to be non-reliant on grants.

### Statutory Environment:

#### **Local Government Act 1995**

#### **7.12A. Duties of local government with respect to audits**

- (3) A local government must —
  - (aa) examine an audit report received by the local government; and
  - (a) determine if any matters raised by the audit report, require action to be taken by the local government; and
  - (b) ensure that appropriate action is taken in respect of those matters.
- (4) A local government must —
  - (a) prepare a report addressing any matters identified as significant by the auditor in the audit report, and stating what action the local government has taken or intends to take with respect to each of those matters; and
  - (b) give a copy of that report to the Minister within 3 months after the audit report is received by the local government.
- (5) Within 14 days after a local government gives a report to the Minister under subsection (4)(b), the CEO must publish a copy of the report on the local government's official website.

**Policy Implications:** Nil

**Financial Implications:** Nil

**Strategic Implications:** Nil

**Recommendations:**

That the Governance, Audit and Community Services Committee accept the report and take the necessary actions outlined within the report.

**Voting Requirements:**

Simple majority.

**Moved Cr Martin / Seconded Cr Hyde**

That the Governance, Audit and Community Services Committee accept the report and take the following actions outlined within the report:

1. Review current renewal expenditure and update existing Management Plans and look at current depreciation rates.

Carried 7/0

**Moved Cr Martin / Seconded Cr Lansdell**

That the CEO raise the Significant Adverse Trend 2018 Audit Report at the next Central County Zone meeting.

Carried 7/0