Report on adverse audit findings for the financial year ended 30th June 2018

Financial Ratio trends

Prepared by David Blurton – CEO

8th July 2019

Contents

Background

The Shire of Collie is required to prepare an audited Annual Financial Report each financial year under the Local Government Act 1995.

A legislative change introduced in 2017 passes the responsibility for local government audits to the Office of Auditor General (OAG) to oversee the audit of every local government in WA either through the OAG itself or through a certified agent. The costs of these audits are to be met by each individual Council, i.e. paid for by the ratepayer.

The Council's current auditor is AMD Chartered Accountants, who have a contract for audit services with the Council until 2021. AMD are experienced local government auditors and an accredited agent of the Office of Auditor General. AMD's 30 June 2018 audit report of the Shire of Collie is attached at appendix 1 of this document.

A key audit requirement of both the contract with AMD and new audit standards under the AOG is the responsibility for the auditor to identify any financial trends which it considers adverse and of concern. For the 30 June 2018 year, AMD has identified that the Shire of Collie meets four of the seven minimum standards for financial ratios (as set by the Department), with the following financial measures of sustainability being cause for concern;

- Operating Surplus ratio (the Department has noted that this measure has not met the basic standard for the last 3 years);
- Asset Sustainability ratio;
- Current ratio.

The audit report was considered at the Council's Audit Committee meeting on 29 November 2018 which was attended by AMD representative Mr Tim Partridge who spoke on the ratios in his report and answered several questions from the committee. Following acceptance by the Audit Committee the Annual Financial Report 2017-18 was adopted by the Council on 11 December 2018.

Following lodgement of the Annual Report to the Department, the Council received correspondence from the Department dated 28 June 2019 (refer Appendix 2), advising that the Shire of Collie has not fulfilled its obligations under section 7.12A(4) of the act, which states;

Section 7.12A(4) A local government;

(a) 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 these 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.

In the letter, the Council has been directed to meet the requirements of section 7.12A(4) as a matter of priority and has been given 60 days to comply.

Operating Surplus Ratio

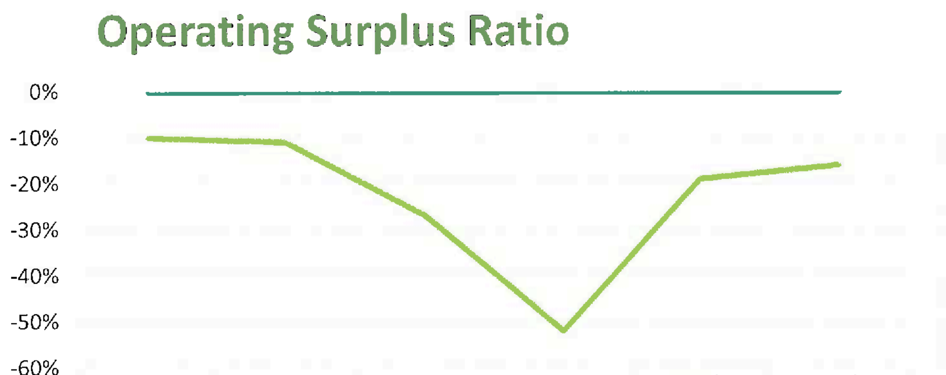
As per ***Local Government Operational Guidelines No18 – Financial Ratios*** published by the Department in 2015, The Operating Surplus Ratio measure is described as follows.

> *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.*

This measure identifies the Council's capacity to cover its operational costs and have additional funds available for other purposes including investment in capital projects. The Department considers a "basic" standard to be between 1% and 15% and an "advanced" standard with a measure of over 15%.

The ratios should be read for what they are, a very simplistic measure which does not take into consideration abnormal "one-off" items of income or expense from year to year or any reclassification of expenses from capital to operating as is required from time to time.

The Shire of Collie's operating Surplus ratio has traditionally been a negative result as indicated on the following graph. The 2015/16 year result is explained as a $1.59m reclassification of expenditure as operating expense and is related to the construction of the Collie Early Learning Centre which is not an asset owned by the Shire of Collie.



	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Operating Surplus Ratio	-10%	-11%	-27%	-52%	-19%	-16%
Benchmark	0%	0%	0%	0%	0%	0%

Over the years, Council and Management have made some policy adjustments with a view to improving this measure including;

- a review of all depreciation rates policy CS3.4 (now deleted);
- introduction of policy CS3.9 which capitalises infrastructure works and significant plant and machinery repairs over $10,000 in value which would otherwise be considered maintenance works (and expensed);
- a concerted effort to undertake more road construction projects in house, which assigns more internal plant, labour and overhead cost to capital rather than operating expenses.

In order to improve the Operating Surplus Ratio further, the Council has limited options available to it. The measure could be improved by increasing rates substantially, however this must be balanced with the community's capacity to pay particularly considering the current economic circumstances for Collie. The measure could also be improved by Council reviewing its major operating costs centres, including employment costs and contractors and materials however this will certainly adversely impact on the level of service which Council is able to deliver to the Collie community.

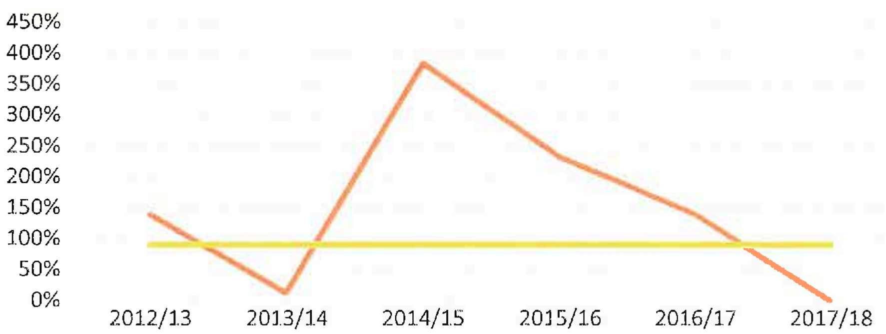
Staff recommend a detailed analysis of available options to improve the operating surplus ratio be undertaken as part of its long-term planning review during 2019/20.

Asset Sustainability Ratio

As per ***Local Government Operational Guidelines No18 – Financial Ratios*** published by the Department in 2015, The Asset Sustainability Ratio measure is described as follows.

> *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.*
>
> *Standard is met if the ratio can be measured and is 90% (or 0.90) Standard is improving if this ratio is between 90% and 110% (or 0.90 and 1.10).*

Asset Sustainability Ratio



	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Asset Sustainability Ratio	139%	12%	383%	232%	139%	1%
Benchmark	90%	90%	90%	90%	90%	90%

The asset sustainability ratio excludes expenditure on new assets and implies that the majority of Council's capital expenditure should be on renewing existing assets rather than creating new ones.

The Shire of Collie has met the Asset Sustainability Ratio required standard in four of the last six years as depicted in the above graph. The above graph includes expenditure at the Collie Motorplex of $3.1m in 2017/18 which represents the track extension project – stage 1. This may need reclassification as operating expenditure once stage 2 improvements are completed.

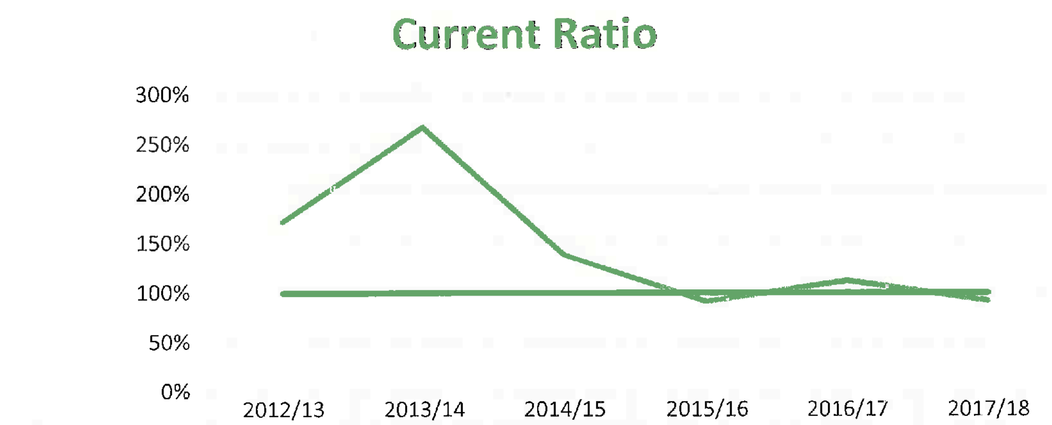
The Department should accept that anomalies such as the above example will often occur on a year to year basis and sustainability measures should be considered on trends of rolling averages over three years or five years rather than single years in isolation.

Staff recommend that in order for the Council to meet the minimum benchmark of 90% for the Asset Sustainability Ratio, consideration will need to be given to the composition of the Annual Infrastructure Program in its Annual Budget Processes and long term works program with a focus on renewal of existing assets rather than construction of new assets.

Current Ratio

As per ***Local Government Operational Guidelines No18 – Financial Ratios*** published by the Department in 2015, The Asset Sustainability Ratio measure is described as follows.

> *Liquidity refers to how quickly and cheaply an asset can be converted into cash. A local government's liquidity is measured by the 'Current Ratio'. This ratio provides information on the ability of a local government to meet its short-term financial obligations out of unrestricted current assets.*



	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Current Ratio	172%	267%	139%	91%	112%	92%
Benchmark	100%	100%	100%	100%	100%	100%

The Council's current ratio result for 17/18 of 92% has been raised as cause for concern by both AMD and the Department of Local Government, however as the above graph illustrates the Council has been in a relatively strong liquid position in the past six years.

Current ratio results are largely influenced by incomplete projects or carry forwards at the end of the financial year. This was the case in 12/13 and 13/14 where unspent Supertowns funds were held by the Council and the years 15/16 onwards represents a return to business as usual.

The Current ratio is also influenced by the current leave liability figure which has grown significantly in recent years for the Shire of Collie as more employees pass the 7-year service milestone. This triggers a full entitlement of long service leave for employees on a pro rata basis.

To improve this measure, the Council could consider reviewing the method in which it calculates the end of year surplus figure to industry best practice which includes the full entitlement of current leave instead of just the movement in current leave from year to year. However, this would cause a significant financial strain on the Council in the year which the new method was adopted as it would effectively require a deficit carried forward starting position. The Council can consider this further as well as other options to improve liquidity as part of a review of its long-term financial plan in 2019/20.

Staff Does not consider the Current ratio to be cause for concern, however Council should review its methodology for calculating current assets and liabilities as well as its end of year surplus figure as part of its long term financial plan review in 2019/20.

Other Recommendations

In addition to the above recommendations for the Council to consider, the following suggestions are provided and may warrant further discussion.

- The State Government could play its part to improve the sustainability for local government in regional areas with changes to state policy. For example, the Council has long advocated for rates to be paid by companies who operate under state agreements within local communities. This matter has been on the State Council of WALGA agenda for some time with limited success being made on the matter with successive state governments. The Department of Local Government and Communities could take on an advocacy role with this issue on behalf of the sector.

- Concessional arrangements to provide more financial support to regional and remote communities could be considered as part of a methodology review by the WA Grants Commission for the distribution of Federal Assistance Grants. The funding allocation provided to localities recognised as regional centres under the current methodology should be reviewed in consideration of the financial impost on services and infrastructure generated by predominantly transient employees.

- The current assessment by the DLGC is a one size fits all approach. It is recommended that the Department consider reviewing what it considers an acceptable result in terms of the ratios from Regional and remote Councils. This could be determined by the band level of a local government as it is unreasonable to expect Councils with vastly different resource levels to return similar ratio results. Consideration should also be given to individual Council circumstances such as the limited amount of rateable land, population and growth rates and rateable property values as examples.

- The Departmental assessment process of adverse trends should Consider financial ratio data over a three year trend rather than singular years in isolation.

The requirement of section 7.12A to produce a report addressing the issues raised by the auditor were introduced by amendment in 2017 and anecdotally, it would appear to have taken at least 50% of the sector by surprise. The requirement to report remedial action as an outcome of an identified adverse trend is likely to at least in the short term be an annual process for the Shire of Collie.

Appendix 1 – AMD Audit Report 2017-18

Appendix 2 – Correspondence from the Department of Local Government, Sport and Cultural Industries dated 28th June 2019