Report on Adverse Trends in Financial Position

2019-20 SIGNIFICANT ADVERSE TREND – OPERATING SURPLUS RATIO & ASSET SUSTAINABILTY RATIO

SUMMARY:
If a significant matter is reported in an audit report, section 7.12A of the Local Government Act 1995 requires a response from the local government and a report to be prepared stating what action has been taken or is intended to be taken in respect to matters raised within the audit report. The operating surplus ratio of the Shire of West Arthur has been below the required level for two consecutive years and therefore has been included in this year's audit report.
The asset sustainability ratio has been below the recommended standard for two years and is also raised this year.

BACKGROUND:
In November 2017, proclamation of the *Local Government Amendment (Auditing) Act 2017* introduced a number of reforms to auditing laws. The legislation requires local governments to examine an audit report it receives and implement appropriate action in respect to the significant matters raised.

The Auditor General's Independent Auditor's Report for 2019-20 identified a significant adverse trend in the financial position of the Shire (attached). Specifically, that the Operating Surplus Ratio has been below the Department of Local Government, Sport and Cultural Industries ("the Department") standard for the past two years. This matter was also raised in the 2018/19 audit report. The 2019/20 audit report also recognised the Asset Sustainability Ratio has been below the DLGSCI standard for the past 2 years with the current year also being below the previous year.

Local governments must prepare a report addressing the significant matters identified in their audit report, which is to be considered by the local government's audit committee before being adopted by council.

Operating Surplus Ratio

$$\text{Operating Surplus Ratio} = \frac{\text{(Operating Revenue MINUS Operating Expense)}}{\text{Own Source Operating Revenue}}$$

The purpose of this ratio is a measure of a local government's ability to cover its operational costs and have revenues available for capital funding or other purposes. The Department has determined that a ratio below 0.01 (1%) is below the standard required. OAG standard is Zero.

The following table highlights the Shire's ratio as calculated for the last four financial years, including the figure for the 2019/20 financial year:

	2016/17	2017/18	2018/19	2019/20
Operating surplus ratio	0.06	-0.14	-0.73	-0.33

Own source operating revenue is made up of rates, fees and charges, interest income, profit on disposals of assets, reimbursements and recoveries, and other revenue. Small regional local governments are limited in their ability to increase own source revenue and are more reliant on grant funding for renewal of assets.

A significant expense recognised in operating expenditure and included in the ratio calculation is depreciation. The depreciation expense recognised in 2019/20 was $2,093,849 (including $499,841 bridge depreciation).

While the ratio recognises the depreciation on our fixed assets, the ratio does not recognise capital road or capital project funding and this income is specifically excluded from the ratio. Non-operating road grants from Roads to Recovery (Federal) and Regional Road Group (State) were $853,361. These capital grants are used to fund asset renewal as recognised in the depreciation expense.

The ratio reflects a reliance on sources of funding other than Council's own source funds such as rates, to be sustainable. To have an operating surplus ratio which does not meet the minimum requirements is typical of many local governments.

Council would need to increase income or decrease expenditure by a further $768,000 to meet the recommended standard this year.

The ratio will also be affected by the timing of the Federal Assistance Grants. A substantial prepayment of the FAGS grants has been prepaid in recent years however if not consistently prepaid will influence the ratio.

Asset Sustainability Ratio

$$\text{Asset Sustainability Ratio} = \frac{\text{Capital Renewal and Replacement Expenditure}}{\text{Depreciation}}$$

The purpose of this ratio is to measure the extent to which assets are being renewed/replaced compared to the amount consumed (depreciation). The interpretation of this ratio is much improved if it is calculated as an average over time as this reduces skewing caused by large scale intermittent investment in major infrastructure (such as buildings and road upgrade)

The OAG has determined that a ratio of below 0.8 (80%) is below the standard required.

	2012/13	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**	**2019/20**
Asset sustainability ratio	1.65	1.13	1.24	0.84	1.09	0.84	0.74	0.33

The average ratio based on the past five years is 0.77. Average ratio over 8 years is 0.98.

The expenditure on new infrastructure/buildings as part of the annual capital program will influence this ratio. The 2019/20 included $756,284 (49%) capital upgrade expenditure. Sealing a previously unsealed road is an example of an upgrade.

Bridge depreciation is recognised ($499,841) and this is not expected to be offset by renewal expenditure on an annual basis unless funding is also received.

Budgeted capital expenditure for 2020/21 would meet the expected standard.

CONSULTATION:
The report has been prepared in consultation with other local governments. The majority of local governments cannot meet the recommended standard.

STATUTORY ENVIRONMENT:
In November 2017, proclamation of the *Local Government Amendment (Auditing) Act 2017* introduced a number of reforms to auditing laws. The legislation requires local governments to examine an audit report it receives and implement appropriate action in respect to the significant matters raised.

POLICY IMPLICATIONS:
There are no policy implications.

FINANCIAL IMPLICATIONS:
The Operating Surplus Ratio is expected to be reported as having a significant adverse trend in the future. The ratio will continue to be monitored through the long term financial planning and budgeting process.

The Asset Sustainability ratio is also expected to be reported in some future years as having a significant adverse trend in the future however is dependent on the capital works program renewal/upgrade and grant funding for new capital projects received. This ratio will continue to be monitored through the long term financial planning and budgeting process.

STRATEGIC IMPLICATIONS:
This item aligns with the community's vision and aspirations as contained in the Shire of West Arthur Corporate Plan 2020 to 2024. Specifically, it relates to the following strategy(s):
5.2 Financial management and decision making will be transparent, accountable and in an accessible format for the public