



Report on Adverse Trends in Financial Position

Extract from the minutes of the Audit Committee Meeting held on 9 March 2022

6.4 2020-21 Significant Adverse Trend – Operating Surplus Ratio & Asset Sustainability Ratio

LOCATION:	N/A
APPLICANT:	N/A
AUTHOR:	M King – Manager of Financial Reporting
AUTHORISING OFFICER:	V Fordham Lamont - CEO
DATE:	4 March 2022
DISCLOSURE OF INTEREST:	N/A

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 three consecutive years and therefore has been included in this year's audit report.

The asset sustainability ratio has been below the recommended standard for three 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 2020-21 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 three years. This matter was also raised in the 2018/19 and 2019/20 audit reports. The 2020/21 audit report also recognised the Asset Sustainability Ratio has been below the DLGSCI standard for the past three years.

The 2020/21 audit report also states that the Shire does not have a current and up to date asset management plan and long term financial plan which has resulted in the asset renewal funding ratio being unable to be determined.

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 five financial years, including the figure for the 2020/21 financial year:

	2016/17	2017/18	2018/19	2019/20	2020/21
Operating surplus ratio	0.06	-0.14	-0.73	-0.33	-0.51

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 2020/21 was \$2,128,074 (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 including those received from Roads to Recovery (Federal) and Regional Road Group (State) were \$1,020,169. 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.

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	2020/21
Asset sustainability ratio	1.65	1.13	1.24	0.84	1.09	0.84	0.74	0.33	0.52

The average ratio based on the past five years is 0.70. Average ratio over 9 years is 0.93.

The allocation of available funds to new or upgraded infrastructure/buildings/roads as part of the annual capital program will influence this ratio negatively. In 2020/21 upgrade expenditure was \$348,049 (23% of capital expenditure) and included the construction of a new chalet and Growden Place expenditure. Sealing a previously unsealed road is an example of an upgrade.

Bridge depreciation of \$499,841 is recognised. This is not expected to be offset by renewal expenditure on an annual basis unless funding is also received.

The Shire has a current Long Term Financial Plan however this requires review to meet departmental guidelines. The Asset Management Plans require updating.

CONSULTATION:

The report has been prepared in consultation with other local governments. The majority of local governments cannot meet the recommended ratio standards.

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 Plan and budgeting process.

The review of Asset Management Plan and Long Term Financial Plan will require resources.

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.

VOTING REQUIREMENTS:

Simple majority

OFFICER RECOMMENDATION – (ITEM 6.1.2)

That the Audit Committee recommends that Council:

1. Notes the significant adverse trends in the financial position of the Shire, as identified in the Auditor General's Independent Auditor's Report for 2020-21, stating that the Operating Surplus Ratio and the Asset Sustainability Ratio are below the Office of Auditor General and Department of Local Government, Sport and Cultural Industries standard and that the Shire of West Arthur monitor through the long term financial planning and budgeting process.
2. Acknowledge the comments made relating to the Asset Management Plan and Long Term Financial Plan and direct the CEO to prepare current plans for adoption by Council by the end of the current financial year.
3. Authorises a copy of this report to be forwarded to the Minister for Local Government and be published on the Shire's official website.

Moved: Cr Neil Manuel

Seconded: Cr Karen Harrington

CARRIED: 3/0

Extract from the minutes of the Ordinary Meeting of Council held on 15 March 2022

Officer Recommendation:

That Council accepts the minutes of the Audit Committee Meeting held on 9 March 2022 and endorses the recommendations therein.

Moved: Cr Lubcke

Seconded: Cr South

CARRIED 6/0



Auditor General

INDEPENDENT AUDITOR'S REPORT 2021 Shire of West Arthur

To the Councillors of the Shire of West Arthur

Report on the audit of the annual financial report

Opinion

I have audited the financial report of the Shire of West Arthur (Shire) which comprises:

- the Statement of Financial Position at 30 June 2021, the Statement of Comprehensive Income by Nature or Type, Statement of Comprehensive Income by Program, Statement of Changes in Equity, Statement of Cash Flows and Rate Setting Statement for the year then ended
- Notes comprising a summary of significant accounting policies and other explanatory information
- the Statement by the Chief Executive Officer.

In my opinion the financial report of the Shire of West Arthur:

- is based on proper accounts and records
- fairly represents, in all material respects, the results of the operations of the Shire for the year ended 30 June 2021 and its financial position at the end of that period in accordance with the *Local Government Act 1995* (the Act) and, to the extent that they are not inconsistent with the Act, Australian Accounting Standards.

Basis for opinion

I conducted my audit in accordance with Australian Auditing Standards. My responsibilities under those standards are further described in the Auditor's responsibilities section below. I am independent of the Shire in accordance with the *Auditor General Act 2006* and the relevant ethical requirements of the Accounting Professional & Ethical Standards Board's APES 110 *Code of Ethics for Professional Accountants (including Independence Standards)* (the Code) that are relevant to my audit of the financial report. I have also fulfilled my other ethical responsibilities in accordance with the Code. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion.

Responsibilities of the Chief Executive Officer and Council for the financial report

The Chief Executive Officer (CEO) of the Shire is responsible for the preparation and fair presentation of the financial report in accordance with the requirements of the Act, the Regulations and Australian Accounting Standards. The CEO is also responsible for managing internal control (as required by the CEO) to ensure the financial report is free from material misstatement, whether due to fraud or error.

In preparing the financial report, the CEO is responsible for assessing the Shire's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the State Government has made decisions affecting the continued existence of the Shire.

The Council is responsible for overseeing the Shire's financial reporting process.

Auditor's responsibility for the audit of the financial report

As required by the *Auditor General Act 2006*, my responsibility is to express an opinion on the financial report. The objectives of my audit are to obtain reasonable assurance about whether the financial report as a whole is free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes my opinion. Reasonable assurance is a high level of assurance but is not a guarantee that an audit conducted in accordance with Australian Auditing Standards will always detect a material misstatement when it exists.

Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial report. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

A further description of my responsibilities for the audit of the financial report is located on the Auditing and Assurance Standards Board website. This description forms part of my auditor's report and can be found at https://www.auasb.gov.au/auditors_responsibilities/ar4.pdf.

Report on other legal and regulatory requirements

In accordance with the Local Government (Audit) Regulations 1996 I report that:

- (i) In my opinion, the following material matters indicate a significant adverse trend in the financial position of the Shire:
 - a) The Operating Surplus Ratio and Asset Sustainability Ratio as reported in Note 28 of the annual financial report are below the Department of Local Government, Sport and Cultural Industries standard for the last three financial years.
- (ii) The following material matters indicating non-compliance with Part 6 of the Act, the Regulations or applicable financial controls of any other relevant written law were identified during the course of my audit:
 - a) Management does not have a current and up to date asset management plan and long-term financial plan. As a result the Asset Renewal Funding Ratio in the annual financial report as required by section 50(1)(c) of the Local Government (Financial Management) Regulations 1996 is not able to be supported by verifiable information or reasonable assumptions.
- (iii) All required information and explanations were obtained by me.
- (iv) All audit procedures were satisfactorily completed.
- (v) In my opinion, the Asset Consumption Ratio included in the financial report was supported by verifiable information and reasonable assumptions.

Other information

The other information is the information in the entity's annual report for the year ended 30 June 2021, but not the financial report and my auditor's report. The CEO is responsible for the preparation and the Council for overseeing the other information.

My opinion does not cover the other information and, accordingly, I do not express any form of assurance conclusion thereon.

Matters relating to the electronic publication of the audited financial report

This auditor's report relates to the financial report of the Shire of West Arthur for the year ended 30 June 2021 included on the Shire's website. The Shire's management is responsible for the integrity of the Shire's website. This audit does not provide assurance on the integrity of the Shire's website. The auditor's report refers only to the financial report described above. It does not provide an opinion on any other information which may have been hyperlinked to/from this financial report. If users of the financial report are concerned with the inherent risks arising from publication on a website, they are advised to refer to the hard copy of the audited financial report to confirm the information contained in this website version of the financial report.

A handwritten signature in black ink, appearing to read 'N Raniga'.

Nayna Raniga
Acting Senior Director Financial Audit
Delegate of the Auditor General for Western Australia
Perth, Western Australia
2 March 2022