



SHIRE OF WAGIN

PERIOD OF AUDIT: YEAR ENDED 30 JUNE 2019

REPORT ADDRESSING A SIGNIFICANT ADVERSE TREND IN THE FINANCIAL POSITION 2018/2019 – OPERATING SURPLUS RATIO

Report on Other Legal and Regulatory Requirements - Shire of Wagin's 2018/2019 Independent Audit Report from the Office of Auditor General (OAG).

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

- (1) In my opinion, the following material matter indicates a significant adverse trend in the financial position of the Shire:

The Operating Surplus Ratio has been below the Department of Local Government, Sport and Cultural Industries basic standard for the past 3 years. The financial ratios are reported in Note 29 of the annual financial report.

Background / Comment

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 2018-19 identified a significant adverse trend in the financial position of the Shire, **see above**. 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.

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. The report must then be forwarded to the Minister of Local Government and published on the Shire's website.

Operating Surplus Ratio

Operating Surplus Ratio =

(Operating Revenue MINUS Operating Expense)

Own Source Operating Revenue

The purpose of this ratio is a measure of a local governments' 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.



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FINANCIAL RATIOS

	Standard	2019 Actual	2018 Actual	2017 Actual
Current ratio	1.00	3.76	2.73	2.21
Asset consumption ratio	0.50	0.98	0.99	0.96
Asset renewal funding ratio	0.75	3.63	1.16	0.40
Asset sustainability ratio	0.90	1.32	4.94	1.63
Debt service cover ratio	2.00	13.38	11.30	14.71
Operating surplus ratio	0.01	(0.32)	0.03	0.26
Own source revenue coverage ratio	0.40	0.53	0.62	0.46

Staff have reviewed the Shire's 2018/2019 Financial Ratio's above and have discovered in fact the Operating Surplus Ratio is only below the Department's standard for one year being 2018/2019 and it was above the standard for the previous two years.

Through the OAG's, contract auditor, Marius van der Merwe of Butler Settineri, has received the following confirmation from the OAG:

- **The audit report for 2019 indeed is incorrect, in that it states that "...the Operating Surplus Ratio has been below the Department of Local Government, Sports and Cultural Industries basic standard for the past 3 years."**

However, the OAG has also stated that the Operating Surplus Ratio is under the benchmark for the last financial year (2019) and is in a declining trend for the last three years.

As such, in discussing this with the OAG, the matter would still have been reported as a significant adverse trend in the financial position of the Shire.

Therefore, should the audit report for the Shire have been changed, the only change would have been the reference to the three years under the benchmark – it would still be a matter raised in the audit report and it will still be referenced as a significant adverse trend.

It is the opinion of management that the determination of the OAG in deeming the Operating Surplus Ratio standard in having a *Significant Adverse Trend* is overstated. Whilst it is acknowledged that the ratio has been trending down for the past three years, it has only actually fallen below standard in the 2018/19 financial year. This could more accurately reported as an *Adverse Trend*, rather than a *Significantly Adverse Trend*.

Management and Council place high priority on ensuring the financial sustainability of the Shire, as evidenced by the efforts applied to long term financial planning, carefully balancing community priorities and diligently applying the financial resources of the Shire of Wagin, within strict budgetary frameworks.

There is concern that the reporting of the Operating Surplus Ratio as sustaining a *Significant Adverse Trend* (when arguably it is not) will convey to third parties, a negative perception that



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the financial position of the Shire is in serious decline. This of course is not the case. The Shire has met the financial ratio benchmarks in all the other six ratios and has only fallen below the benchmark for one year in the Operating Surplus Ratio.

The relevance, methodology and application of the Operating Surplus Ratio, whilst outside the parameters of this report, need to be assessed and examined at some stage to ensure that the ratio provides a meaningful assessment of the financial health and sustainability of a local government entity.

The fact that a “one size fits all” benchmark is applied to local government generally is problematic when there are wide disparities between large metropolitan councils with substantial rating capacity and with little or no dependence on Federal Financial Assistance Grants to small rural and remote councils with comparatively very limited rating capacities and with heavy reliance on Financial Assistance Grants. It is suspected that an examination of the Operating Surplus Ratio of councils across the Statewide spectrum would bear out the fact that the smaller rural and remote Councils are facing challenges in meeting the standard with respect to this ratio. The other factor that seemingly can influence the Operating Surplus Ratio equation is that of depreciation, to the extent that even though a local government may be living well within its means by balancing operational expenditure with operational income, depreciation (which is a non cash item) can skew the ratio into negative territory.

Further work needs to be done to ensure that ratios are relevant, meaningful; and convey to stakeholders the accurate position (in practical terms) of the financial health and sustainability of their respective Councils.

Operating Surplus Ratio Analysis

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.

Depreciation expense is a significant factor in this ratio as it is included in operating expenses. The requirement to revalue road assets on a regular basis, and attribute an appropriate level of depreciation, has been a challenge for local governments. Council's road infrastructure assets has increased some \$47,000,000 through the revaluation process, this has significantly increased Council's operating expenses, albeit on a non-cash basis. Unfortunately, this non-cash expense is still factored in this ratio calculation and is the major reason for the declining trend.

Management will look at the current systems in place to more accurately account for road asset depreciation expense in an effort to arrest this declining trend for this ratio.

Management has been informed to have the OAG correct the Audit report it is a difficult and long-winded process, however future Audit Report's will take into account the above error.



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There is still an obligation to report this to the Minister, which this report will do, however the Shire of Wagin acknowledges that the Operating Surplus Ratio has **not** been below the Department of Local Government, Sports and Cultural Industries basic standard for the past 3 years, however it notes the Ratio is on the decline.

Management's Comments and Actions

Through this Report, Council acknowledges and formally advises the Minister of Local Government the Shire's 2018/2019 Independent Audit is incorrect, in that it states that "...the Operating Surplus Ratio has been below the Department of Local Government, Sports and Cultural Industries basic standard for the past 3 years"

With regard to the material matter specified in the report, that the adverse trend stated is incorrect as it is based on the Operating Surplus Ratio has been below the Department of Local Government, Sports and Cultural Industries basic standard for the past 3 years (is has in fact been under the standard benchmark for only the 2018/19 financial year).

Council and Management acknowledges the Shire's Operating Surplus Ratio has fallen below the designated standard in the 2018/19 financial year and advises that steps will be taken as far as practicable, to remedy this adverse trend.

4257 OFFICER RECOMMENDATION & COUNCIL DECISION

Moved: Cr. S M Chilcott

Seconded: Cr. G R Ball

1 That the revised report to the Minister addressing the significant adverse trend in the financial position of the Shire in the 2018/2019 Audit Report with regards to the Operating Surplus Ratio be received and endorsed by Council.

2 Authorises the report to be forwarded to the Minister for Local Government and be published on the Shire's website.

Carried 10/0

Bill Atkinson
Acting Chief Executive Officer

29th April 2020