AUDIT AND RISK MANAGEMENT COMMITTEE MEETING

MINUTES

SECTION 5.9(2)(a) LGA 1995

Committee Brief

1. ***Provide guidance and assistance to the local government -***
   a) ***as to the carrying out of its functions in relation to audits carried out under Part 7 of the Act; and***
   b) ***as to the development of a process to be used to select and appoint a person to be an auditor; and***
2. ***May provide guidance and assistance to the local government as to -***
   a) ***matters to be audited; and***
   b) ***the scope of audits; and***
   c) ***its functions under Part 6 of the Act; and***
   d) ***the carrying out of its functions relating to other audits and other matters related to financial management; and***
3. ***Is to review a report given to it by the CEO under Regulation 17(3) (the CEO's report) and is to -***
   a) ***report to the Council the results of that review; and***
   b) ***give a copy of the CEO's report to the Council.***

A meeting of the Audit and Risk Management Committee
was held in the Committee Room
Lowood Road, Mount Barker WA 6324,
at 9.00am Tuesday 15 August 2017.

Rob Stewart
CHIEF EXECUTIVE OFFICER

Committee Members
Cr K Clements, Cr L Handasyde, Cr J Moir and Cr C Pavlovich (Council 223/15)

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Membership
Cr K Clements
Cr L Handasyde
Cr J Moir
Cr C Pavlovich (Presiding Member)

Cr J Hamblin (Deputy for any member)

1 DECLARATION OF OPENING / ANNOUNCEMENT OF VISITORS

9.02am The Presiding Member declared the meeting open.

2 RECORD OF ATTENDANCE / APOLOGIES / LEAVE OF ABSENCE

Members Present

Cr C Pavlovich (Presiding Member)
Cr K Clements
Cr J Moir

Leave of Ansence

Cr L Handasyde

Staff

Mr R Stewart - Chief Executive Officer
Mr J Fathers - Deputy Chief Executive Officer

3 CONFIRMATION OF MINUTES

Moved Cr K Clements, seconded Cr J Moir:

That the Minutes of the Meeting of the Audit and Risk Management Committee, held on 28 March 2017 as circulated, be taken as read and adopted as a correct record.

CARRIED

4 DISCLOSURE OF INTEREST

Part 5 Division 6 Local Government Act 1995

Nil

5 REPORTS OF COMMITTEE MEMBERS AND OFFICERS

5.1 STATUTORY RATIOS - 2015/2016 ANNUAL REPORT

File Ref:	**N44235**
Attachments:	**Letter from Department of Local Government and Communities – 30 June 2017**
	Asset Management Improvement Program – March 2017
	Moore Stephens' management letter for the 2016/2017 annual report
Responsible Officer:	**Rob Stewart** **Chief Executive Officer**
Author:	**John Fathers** **Deputy Chief Executive Officer**
Proposed Meeting Date:	**15 August 2017**

PURPOSE

The purpose of this report is to determine a position in response to a request from the Department of Local Government and Communities to review the two financial and three asset ratios reporting below standard.

BACKGROUND

The Department of Local Government and Communities (now Department of Local Government, Sport and Cultural Industries) has written to the Shire President advising that, as part of its compliance framework monitoring role, various local government statutory reports and management letters are being reviewed to identify whether there are compliance issues or financial management weaknesses that should be addressed. The monitoring process has identified financial management issues which are drawn to the Shire's attention.

The Department has requested that the Council reviews, via its Audit Committee, the two financial and three asset ratios reporting below standard at 30 June 2016. The Council is asked to endorse strategies to ensure it has action plans in place to deliver continual improvement in the ratios currently below standard.

The Audit and Risk Committee has discussed these matters at length at its last two meetings with the auditor.

At its meeting held on 19 January 2016, the minutes note that Mr Russell Harrison from Lincolns Accounts and Business Advisors *'discussed the results of the statutory ratios, in particular the negative operating surplus ratio, which was not ideal, but as it excludes non-operating grants and is therefore of limited benefit. The Shire may choose to add information to its Annual Financial Report, such as modified ratios, aimed to provide more meaningful information.*

Recent discussions with the administration in this regard had been useful as they had led to discussion with other parties, such as the Department of Local Government and Communities, which is taking a keen interest in such ratios in terms of comparability and sustainability. The State Government is in fact looking at options for the Office of *the Auditor General taking on audits for local government which would be good in terms of stronger guidelines and audit consistency for local government.*

Mr Harrison recommended that the Shire continue to review its ratios in the Long Term Financial Plan and budget processes.'

At its most recent meeting with the new auditor David Tomasi, held on 6 December 2016, the minutes note that '*Mr Tomasi discussed the results of the statutory ratios, which were all either in the orange or red category and some trending downwards. It was recommended that the Council continue to monitor its performance in respect to ratios, and comparison to state and regional averages are useful.*

It was advised that increased depreciation on roads infrastructure was the major factor causing ratios to deteriorate. Work to verify depreciation and improve ratios will require improved data (and reduction in assumptions in the RAMM 2 database) and reviews of condition and remaining useful lives of assets.'

STATUTORY ENVIRONMENT

Regulation 50 of the Local Government (Financial Management) Regulations 1996 states in part, that:

'(1) The annual financial report is to include, for the financial year covered by the annual financial report and the 2 preceding financial years -

(a) the current ratio; and

(b) the asset consumption ratio; and

(c) the asset renewal funding ratio; and

(d) the asset sustainability ratio; and

(e) the debt service cover ratio; and

(f) the operating surplus ratio; and

(g) the own source revenue coverage ratio.'

FINANCIAL IMPLICATIONS

There are no financial implications for this report.

POLICY IMPLICATIONS

Policy implications do not apply for this report and it is the opinion of the author that policy development is not required.

STRATEGIC IMPLICATIONS

The Shire of Plantagenet Strategic Community Plan 2013-2023 provides at Outcome 4.1 (Effective governance and leadership) the following Strategy:

Strategy 4.1.6:

'Provide administrative support to the Shire for Governance functions.'

Accordingly, the recommended outcome for this report aligns with the Strategic Community Plan.

OFFICER COMMENT

Statutory Ratio Results

A copy of the auditor's (Moore Stephens) management letter for the 2016/2017 annual report is attached. The audit letter focuses on the Shire's current position with respect to the statutory financial ratios in Note 19. A comment in regard to the results is as follows:

The trend in regard to the ratios is shown in the table below:

Financial Ratios	Basic Standard	2013	2014	2015	2016
Current Ratio	>1.0	0.771	0.650	1.020	0.792
Asset Sustainability Ratio	0.9 to 1.1	0.928	1.178	0.487	0.491
Debt Service Cover Ratio	>2.0	6.857	4.250	6.921	3.562
Operating Surplus Ratio	0.01 to 0.15	-0.210	-0.258	-0.319	-0.590
Own Source Revenue Coverage Ratio	0.4 to 0.6	0.646	0.677	0.579	0.547
Asset Consumption Ratio	>0.5	0.122	0.188	0.620	0.466
Asset Renewal Funding Ratio	0.75 to 0.95	1.024	0.970	0.783	0.656

- Current Ratio $$\frac{\text{Current assets minus restricted assets}}{\text{Current liabilities minus liabilities associated with restricted assets}}$$

This ratio gives an indication of short term liquidity, or the ability to meet financial obligations when they fall due. The standard is met if the ratio is greater than 1. The Shire's 2016 result of 0.792 is lower than the standard of 1.0, due mainly to storm damage payments of almost $450,000.00 which had not been recouped. In comparing to the 2015 result, it should be noted that commonwealth financial assistance grants were prepaid in the previous year but not this year.

- Asset Sustainability Ratio $$\frac{\text{capital renewal and replacement expenditure}}{\text{depreciation expense}}$$

This ratio indicates that to what degree the Shire is replacing or renewing existing assets at the same rate that its overall asset stock is wearing out. The standard is met if the ratio is between 0.9 and 1.1.

- Debt Service Cover Ratio $$\frac{\text{annual operating surplus before interest and depreciation}}{\text{principal and interest}}$$

This ratio indicates an ability to service debt out of general purpose funds available for operations. A ratio greater than 2 is desirable at a basic level and an advanced standard is met if the ratio is greater than 5. The Shire's 2016 result of 3.562 is acceptable, acknowledging however that the Shire's debt load, including self supporting loans, needs careful attention.

- Operating Surplus Ratio $$\frac{\text{operating revenue minus operating expense}}{\text{own source operating revenue}}$$

This ratio indicates an ability to cover operational costs and have revenues available for capital funding or other purposes. A basic standard is met between 0.01 and 0.15. An advanced standard is met over 0.15. The Shire's 2016 result of (0.590) is well below ideal.

Accounting guidelines indicate that a sustained period of deficits will erode the local government's ability to maintain both its operational service level and asset base. This worsening situation is mainly due to increasing depreciation due to asset revaluations. To some degree, this ratio does not accurately represent the local government scenario, whereby a significant proportion of infrastructure renewal (expensed via depreciation) is met by capital grant income.

- Own Source Revenue Coverage Ratio $$\frac{\text{own source operating revenue}}{\text{operating expense}}$$

This ratio indicates an ability to cover costs through own source revenue efforts. A basic standard is met between 0.4 and 0.6. An intermediate standard is met between 0.6 and 0.9. An advanced standard is met over 0.9. Given that asset valuations and the depreciation figure that is thereby created have impacted on this ratio, the Shire's 2016 result of 0.547 is acceptable.

- Asset Consumption Ratio $$\frac{\text{depreciated replacement cost of assets}}{\text{current replacement cost of depreciable assets}}$$

This ratio measures the extent to which depreciable assets have been consumed by comparing their written down value to their replacement cost. The standard is met if the ratio is greater than 0.5. The standard is improving if the ratio is between 0.6 and 0.75. The Shire's 2016 result is 0.466.

- Asset Renewal Funding Ratio $$\frac{\text{NPV of planned capital renewals over 10 years}}{\text{NPV of required capital expenditure over 10 years}}$$

This ratio measures an ability to fund projected asset renewal and replacements in the future. The standard is met if the ratio is between 0.75 and 0.95. The standard is improving if the ratio is between 0.95 and 1.05. The Shire's 2016 result is 0.656 lower than desirable.

These final two ratios have only been audited to the extent that the values are accurately represented in the Shire's Asset Management Plan and LTFP. There has been no additional effort in auditing the veracity of those plans or the figures used to determine the ratios.

Comments on Statutory Ratios below Standard

Financial Ratios

The Current Ratio is a short term ratio and to a large extent reflects accurate budgeting and the aim of completing capital works projects within the budget period. A way of improving the ratio could be to adopt a surplus budget to achieve an unrestricted cash reserve. Given that the Council has an overdraft facility in place, this option is not preferred.

The auditor has stated that the ratio is impacted by the current portion of long term borrowings of $334,653.00 as at 30 June 2016, which is budgeted for payment over the next 12 months. In addition, the Shire's level of Annual Leave and Long Service Leave provisions have a significant impact on the Current Ratio.

In this regard, in response to a request from the then Department of Local Government at its meeting held on 27 May 2014, the Audit Committee resolved:

That the following approach being taken by the Chief Executive Officer in regard to the review of the Shire of Plantagenet's 2012/2013 Annual Report, undertaken by the Department of Local Government and Communities be noted and endorsed:

…

2. *The intention is to gradually build up the Employee Reserve to $100,000.00, the purpose of which is to fund sick, annual and long service leave entitlements for former staff called upon by other local governments and unplanned payments of annual leave and long service leave liabilities. For the purpose of future budgets and annual reports, it will be assumed that this reserve fund together with budgeted amounts will cover any predicted staff payouts of long service leave.*

In this context, it is recommended that the Department be advised that the Shire is taking action referred to above, but is otherwise not concerned with this result.

In regard to the Operating Surplus Ratio, the auditor indicates that the main reason this ratio is below target is an increase in operating expenditure associated mainly with increase in depreciation (the resultant effect of revaluation of infrastructure assets). All local governments are going through the revaluation exercise and presumably, most will reflect this trend. Ideally, future long term plans should achieve a reversal of this trend. This will involve work on, in particular verifying the remaining useful life (RUL) of infrastructure and ensuring depreciation rates are reliable.

Asset Ratios

The Asset Sustainability Ratio would not be considered within acceptable limits in the long term. This ratio needs to be considered in determining future asset management programs and more work needs to be done to verify infrastructure depreciation values.

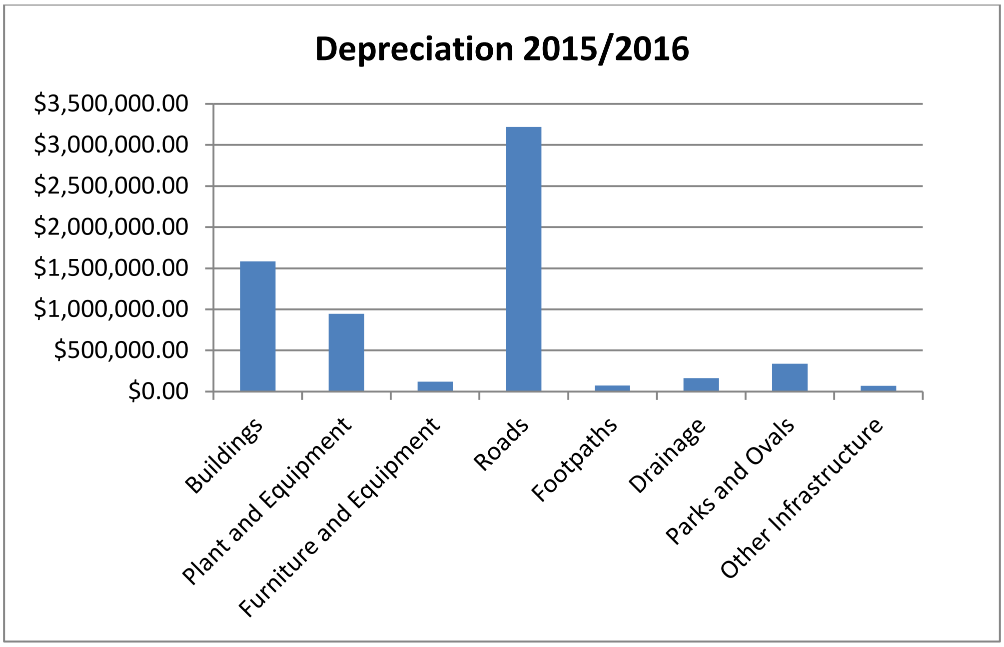
The Shire's 2016 result of 0.491 continues the trend whereby a relatively high proportion (25% in 2015/2016) of capital expenditure was associated with new or upgrade projects, such as $196,772.00 on the Administration Building, $50,937.00 on CCTV and $274,985.00 on parks and recreation ground improvements. The ratio also reflects the increased depreciation identified as a result of adjustments to asset fair values.

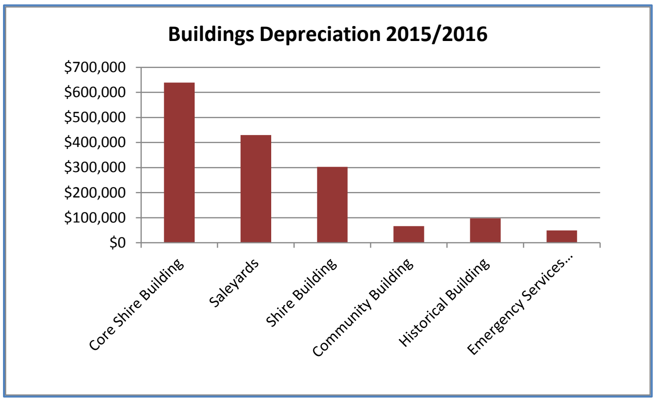
The figures used to calculate the Asset Consumption Ratio now reflect updated valuation and depreciation values across all assets and can be considered a more reliable measure than past values. This result would indicate that care needs to be exercised as the Shire is in danger of slipping into the level where it will have difficulty maintaining the 'aged' condition of its assets. As indicated by the auditor, the Council needs to update asset condition and RUL assessments, to ensure inputs to this ratio are based on reliable and verifiable data.

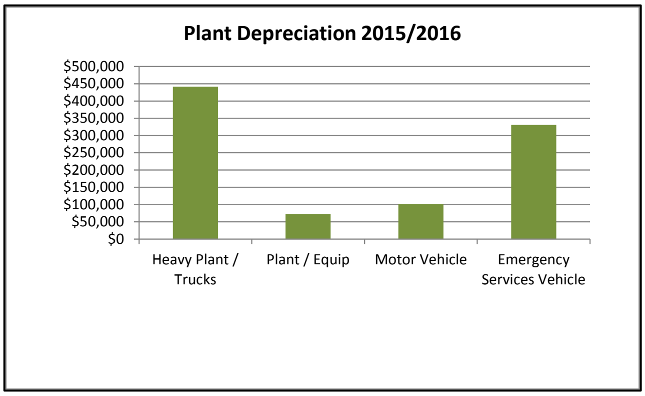
The Asset Renewal Funding Ratio also requires further work on the LTFP and Asset Management Plan to achieve a better level of confidence.

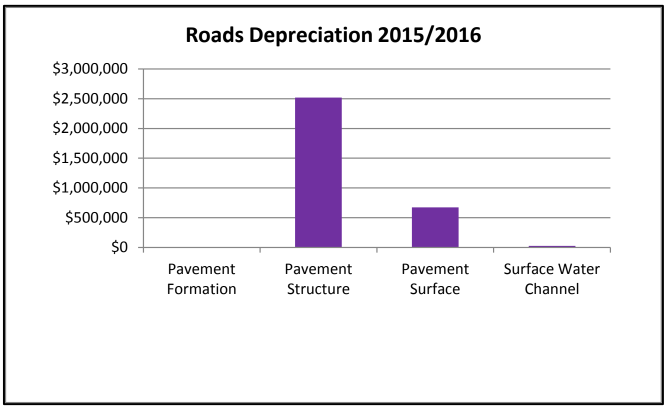
Actions Proposed to Improve Asset Ratios

The implementation of fair value accounting and the increase in depreciation associated with asset revaluations has brought attention to a number of issues with the data held by this and other councils which is used to calculate the ratios. Ratios that are below the standard set by the Department may be legitimately below standard or not depending on the veracity of data, however it is difficult to know one way or the other unless a lot of work is done to check the data. Valuation and depreciation data for most of the asset classes are relatively easy to verify and are low value compared to road infrastructure (see graph below), so the roads data is the priority for improvement.









The other graphs are provided for information, but highlight some interesting facts about the composition of depreciation. Firstly, in relation to buildings, the historical (museum) buildings and emergency services buildings combined make up 9.3% of the overall buildings depreciation. These are buildings that will either never be renewed or completely funded by Emergency Services Levy funds. Similarly, in relation to plant, the fire trucks make up 35.0% of the overall plant depreciation. These are plant that completely donated by the State Government and no renewal funding needs to apply. These things highlight the problem with focusing on global ratios, without drilling down on the detail.

The RAMM II database is the road infrastructure database rolled out across a majority of WA local governments in the last few years by WALGA. The database requires a degree of engineering expertise and resources that make it impossible for many small local governments to operate effectively in house. However, a number of different things are being worked on to improve the data in RAMM II within this Shire.

In 2016, the Shire agreed to take part in the National Asset Management Assessment Framework (NAMAF) and Asset Condition Rating Project (ACRP), an initiative of the then Department of Local Government and Communities to assist local governments to improve asset management processes. The contracted consultant, Opus International Consultants (Australia) Pty Ltd, has developed the attached Asset Management Improvement Plan in conjunction with Shire staff and it has sent it to the Department. This plan will take considerable time and effort to work through.

Councillors may recall that a sum of $42,000.00 was included in the draft budget for 2017/18 for a visual condition survey of the Shire’s road network and data entry into the RAMM II roads database. It was argued that work to verify depreciation and improve ratios will require improved data (and reduce the assumptions in the RAMM II database) and reviews of condition and remaining useful lives of assets. Also, an up to date database will also increase the functionality of RAMM II in providing road renewal forecasting reports. Unfortunately, due to other competing priorities, this allocation was not approved, although many councillors acknowledged this would need to be undertaken at some stage.

In the meantime, the Council has been liaising with its contractor that undertakes RAMM II database updates to discuss other ongoing improvements to the data and assumptions within the valuations and depreciation calculations. In particular, these relate to useful lives, unit costs and road formation of minor gravel roads.

It was noted that, if in-situ gravel is used to form the road and the intention of the Shire is to keep it like that, that is not bring in gravel in the future, then these roads should be recorded as ‘formed’ rather than ‘paved’. That would affect the depreciated cost since formation does not depreciate.

The Deputy CEO and the works crew have now analysed the Shire’s road network and specified which roads are actually ‘formed’ rather than ‘paved’. This data has been sent to the contractor and once the updates are undertaken, it is anticipated that this will have some beneficial impact on the depreciation and hence some of the ratios.

The development of a revised Long Term Financial Plan (LTFP) and Asset Management Plan is underway, however the problem faced is that, until condition and remaining useful life data in RAMM II can be verified, we are to some extent ‘flying blind’ in the question of are the ratios legitimately below standard or not.

The Moore Stephens consultancy arm (as opposed to its auditors) indicate that there is widespread issues across the sector with below standard ratios, and in fact recommend that, in some instances LTFPs use modified ratios that better reflect local government scenarios. Councillors may recall that former auditor, Russell Harrison pointed out that the negative operating surplus ratio was not ideal, but as it excludes non-operating grants is therefore of limited benefit. However, it is expected there would be a limit to which such arguments can be put to the Department.

A point to be made is that the Shire of Plantagenet has had a focus over an extended time period in allocating extensive resources to the maintenance and renewal of its road network. It is considered that the condition of the road network is good for a predominantly gravel road network. In addition, there has been considerable expenditure on new recreation facilities and other outdated buildings and infrastructure.

This would suggest that the data is the problem, not the assets. It is therefore recommended that the Department be advised that the Council is undertaking the initiatives mentioned above, but that the three asset ratios reporting below standard are likely to be mainly attributable to data integrity than legitimate financial management weaknesses. The Council will continue to work towards verifying data and maintaining assets at service levels that are appropriate and affordable by the community. It is anticipated that this effort will result in an improvement in the asset based ratios. Unfortunately, however, this improvement may not be realised until 2017/2018 and afterwards.

VOTING REQUIREMENTS

Simple Majority

OFFICER RECOMMENDATION

That in response to the request from the Department of Local Government, Sport and Cultural Industries to review the two financial and three asset ratios reporting below standard, the Department be advised that:

1. The Shire is taking action referred to in its letter dated 28 May 2014 in regard to the Employee Reserve, which will have a positive impact on the Current Ratio and is otherwise not concerned with the result of the Current Ratio as there are valid and mitigating reasons for the result.
2. In relation to the Asset Sustainability Ratio, the 2016 result of 0.491 reflects a relatively high proportion (25% in 2015/2016) of capital expenditure associated with new or upgrade projects, such as $196,772 on the Administration Building, $50,937.00 on CCTV and $274,985 on parks and recreation ground improvements which the Council has been undertaking over the last three years, whereas the Shire has now entered into a phase of renewal rather than new capital projects;
3. In relation to the other below standard ratios, the main reason these are below target is an increase in operating expenditure associated mainly with increase in depreciation (the resultant effect of revaluation of infrastructure assets);
4. The Shire is implementing an Asset Management Improvement Plan and undertaking other activities to verify the remaining useful life of infrastructure and ensure depreciation rates are reliable;

5. It will be recommended to the Council that the necessary allocation be included in the draft budget for 2018/19 for a visual condition survey of the Shire's road network and data entry into the RAMM II roads database to help in verifying depreciation and remaining useful lives of road assets;
6. It is the opinion of the Committee that the three asset ratios reporting below standard are likely to be mainly attributable to data integrity than legitimate financial management weaknesses; and
7. The Council will continue to work towards verifying data and maintaining assets at service levels that are appropriate and affordable by the community and it is anticipated that this effort will result in an improvement in the asset based ratios. Unfortunately, however, this improvement may not be realised until 2017/2018 and afterwards.

During discussion at the Audit and Risk Management Committee meeting held on 15 August 2017, some concerns were expressed about the recommended visual condition survey. The view was expressed that the Committee needs to be confident of the practical value and that a survey should be based on minimum standards for carrying out the assessment. The Committee agreed that the program should be staged and that the sealed roads should be the initial priority.

COMMITTEE DECISION

Moved Cr K Clements, seconded Cr J Moir:

That in response to the request from the Department of Local Government, Sport and Cultural Industries to review the two financial and three asset ratios reporting below standard, the Department be advised that:

1. **The Shire is taking action referred to in its letter dated 28 May 2014 in regard to the Employee Reserve, which will have a positive impact on the Current Ratio and is otherwise not concerned with the result of the Current Ratio as there are valid and mitigating reasons for the result.**
2. **In relation to the Asset Sustainability Ratio, the 2016 result of 0.491 reflects a relatively high proportion (25% in 2015/2016) of capital expenditure associated with new or upgrade projects, such as $196,772 on the Administration Building, $50,937.00 on CCTV and $274,985 on parks and recreation ground improvements which the Council has been undertaking over the last three years, whereas the Shire has now entered into a phase of renewal rather than new capital projects;**
3. **In relation to the other below standard ratios, the main reason these are below target is an increase in operating expenditure associated mainly with increase in depreciation (the resultant effect of revaluation of infrastructure assets);**
4. **The Shire is implementing an Asset Management Improvement Plan and undertaking other activities to verify the remaining useful life of infrastructure and ensure depreciation rates are reliable;**
5. **It will be recommended to the Council that the necessary allocation be included in the draft budget for 2018/19 for an initial visual condition survey of the Shire's sealed road network and data entry into the RAMM II roads database to help in verifying depreciation and remaining useful lives of road assets;**

6. **It is the opinion of the Committee that the three asset ratios reporting below standard are likely to be mainly attributable to data integrity than legitimate financial management weaknesses; and**
7. **The Council will continue to work towards verifying data and maintaining assets at service levels that are appropriate and affordable by the community and it is anticipated that this effort will result in an improvement in the asset based ratios. Unfortunately, however, this improvement may not be realised until 2017/2018 and afterwards.**

CARRIED

6 ORGANISATIONAL RISK MANAGEMENT

In line with a previous Committee request, this item is listed as a permanent fixture on the agenda. The current Organisational Risk Register is attached for information.

7 NEXT MEETING

7 November 2017.

8 CLOSURE OF MEETING

10.00am The Presiding Member declared the meeting closed.

CONFIRMED: PRESIDING MEMBER__________________DATE:______/_____/_____