Council

REPORT ON SIGNIFICANT ADVERSE TRENDS IN FINANCIAL POSITION 2019-2020

Report on Significant Adverse Trend

Meeting Date: 23 February 2021

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Shire of Plantagenet

REPORT ON SIGNIFICANT ADVERSE TREND

Pursuant to Section 7.12A(4) of the Local Government Act 1995

FEBRUARY 2021

1. Background

Under the Local Government Act 1995, the Shire of Plantagenet is required to prepare an audited Annual Financial Report each financial year.

The Shire's 2019/2020 audit report was received from the Shire's auditor, David Tomasi of Moore Australia Audit (WA) on 27 November 2020 and is attached to this document.

A key audit requirement requires the auditor to identify any financial trends which it considers adverse and of concern. For the 30 June 2020 year, the Auditor has raised the following significant matters.

'a) *In our opinion, the following matters indicate a significant adverse trend in the financial position of the Shire:*

   i. *The Asset Sustainability Ratio has been below the DLGSCI standard for all 3 years reported in the annual financial report.*

   ii. *The Operating Surplus Ratio has been below the DLGSCI standard for all 3 years reported in the annual financial report.* '

Section 7.12A(4) of the Local Government Act 1995 requires that a local government must:

'(a) *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 those 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.'*

Section 7.12A(5) further requires that:

'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.'

2. Details

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

Financial Ratios	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Asset Sustainability Ratio	1.18	0.49	0.49	0.68	0.48	0.60	0.76
Operating Surplus Ratio	-0.26	-0.32	-0.59	-0.29	-0.47	-0.18	-0.28

The **Asset Sustainability Ratio** is calculated as follows:

$$\frac{\text{capital renewal and replacement expenditure}}{\text{depreciation expense}}$$

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. A basic standard is met if the ratio is greater than 0.9 and the Standard is 'Advanced if the ratio is above 1.1.

The 2019/2020 Asset Sustainability Ratio of 0.763 is the highest result in the last five years and in the last three years, has trended upwards. The 2018/2019 was higher than the 2017/2018 figure of 0.484, but similar to the 2016/2017 result.

As expected, capital renewal expenditure trends upwards in the long term but can be reduced in years where the Shire spends comparatively more on new or upgraded assets.

This ratio is worsened in years where there is less than normal expenditure on 'renewal' items (due to more expenditure on 'new' and 'upgrade' projects). With much of our roadworks program, there is often an element of road / seal widening; such expenditure is excluded from this ratio.

The main reason for the improvement in this ratio in 2019/2020 was that the total depreciation amount was reduced from $6.06 million in 2018/2019 to $5.29 million in 2019/2020, as part of the efforts to verify condition and depreciation data.

The 2017/2018 result was impacted by the reduced expenditure on road construction (renewal) due to the effort on storm damage rectification (maintenance), amounting to approximately $1.4 million.

The Shire's 2016/2017 result of 0.491 reflected a trend of increased capital expenditure on '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 Shire's auditor has advised that interpretation of this ratio should be considered together with the Asset Consumption Ratio (ACR) and the Asset Renewal Funding Ratio (ARFR). The ACR of 0.68 is now sitting at an intermediate level indicating the Council's assets are in an acceptable condition and the ARFR of 0.86 is consistently above its target of 0.750, indicating the planned renewal and replacement expenditure over the next 10 years is sufficient to meet the required renewal and replacement expenditure.

The main issue with the ASR is the level of depreciation as a result of adjustments to asset fair values. It has been recognised for some time that more work needs to be done to verify depreciation values, in particular road depreciation.

The **Operating Surplus Ratio** is calculated as follows:

$$\frac{\text{operating revenue minus operating expense}}{\text{own source operating revenue}}$$

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 2019/2020 result is (0.28); figures in parentheses being negative. This figure is worse than the 2018/2019 result of (0.18), but better than the 2017/2018 and 2016/2017 values of (0.47) and (0.29) respectively. However, it is well below the Basic standard of 0.01.

The 2019/2020 result has been negatively impacted by storm damage road maintenance expenditure of approximately $1,467,938, of which only $522,426 has been recouped from the Department of Fire and Emergency Services to date. If all of that expenditure had been recouped, the result would have been (0.18), the same as 2018/2019.

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. The consistent negative values are mainly due to levels of asset depreciation, which the Shire increased markedly several years ago with the advent of fair value accounting.

To some degree, the Shire contends that 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. However, ideally, future long term plans should achieve a reversal of this trend.

The depreciation values could be significantly overstated due to useful life assumptions.

At the Audit and Risk Management Committee and Council meetings held on 1 December 2020, these matters were presented with the Annual Financial Audit and Management Report being formally received.

3. Action Plan

The Shire has been aware for some time that an improvement of these and other ratios influenced by asset values was dependent on verification of condition and depreciation data. By far, road depreciation is the major contributor to the sub-standard ratios.

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.

The Shire has completed a condition assessment on its sealed road network. The fresh data has been uploaded into the RAMM II Database and this has realised a reduction in the accumulated depreciation on roads of about $38 million and substantially improved the Asset Consumption Ratio (from a basic to intermediate level).

A review of depreciation for Buildings, Infrastructure - Parks and Infrastructure - Other has also now been carried out and the 2019/2020 ratios have improved (from what they otherwise would have been) as a result. The result of the changes in depreciation on individual asset classes is shown below:

Depreciation	2020 Actual	2019 Actual	Change	Change
	$	$	$	%
Buildings - non-specialised	67,763	124,336	(56,573)	-46%
Buildings - specialised	596,251	910,333	(314,082)	-35%
Other infrastructure - parks and ovals	294,990	352,535	(57,545)	-16%
Other infrastructure - other	295,876	588,109	(292,233)	-50%

As mentioned in 2018/2019, the Shire has appointed a staff member to a new Asset Management Planning position. A large part of his role will be to continue this work, with a focus on verifying depreciation values and assessments of useful life. It is thought that, like condition, the depreciation values could be significantly overstated.

Over the last 12 months, that officer has been focusing on verifying the useful life assumptions on sealed and unsealed roads and reviewing construction unit rates. It is hoped that this analysis will reduce the road depreciation to levels which match the Shire's current renewal efforts.

The Shire's Audit and Risk Committee has previously supported the probability that the asset ratios reporting below standard are likely to be mainly attributable to data integrity than legitimate financial management weaknesses. It is anticipated that the work being done to verify data will continue to result in improvements in the asset based ratios.

It is also noted that the current ratio benchmarks is a 'one size fits all' approach. It is understood that the majority of rural local governments have not had an Operating Surplus Ratio that met the standards, and there has been an indication by the Auditor General that this benchmark may need review.