



To : Audit Committee

RE: Significant Matter Raised in Audit Report

Background

As part of the 2020/21 Audit Report the Shire of Manjimup's Auditors, being the Office of Auditor General deemed a matter to be significant in nature. The following comment was included in the Shire's Audit Report:

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 has been below the Department of Local Government, Sport and Cultural Industries' standard for the past 3 years. And the Asset Sustainability Ratio has been below the Department of Local Government, Sport and Cultural Industries' standard for the past 2 years. The financial ratios are reported in Note 32 of the annual financial report.

Due to the Auditor highlighting matters that they deem to be significant in the 2020/21 Audit Report, the Shire is statutorily required to follow the process set out in the section below:

Section 7.12A(4) of the Local Government Act 1995 states 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) of the Local Government Act 1995 also states:

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.

The Operating Surplus Ratio in Detail (extracted from DLGSCI guidelines)

Calculation:
$$\frac{\text{(Operating Revenue MINUS Operating Expense)}}{\text{Own Source Operating Revenue}}$$

Purpose: This ratio is a measure of a Local Government's ability to cover its operational costs and have revenues available for capital funding and other purposes.

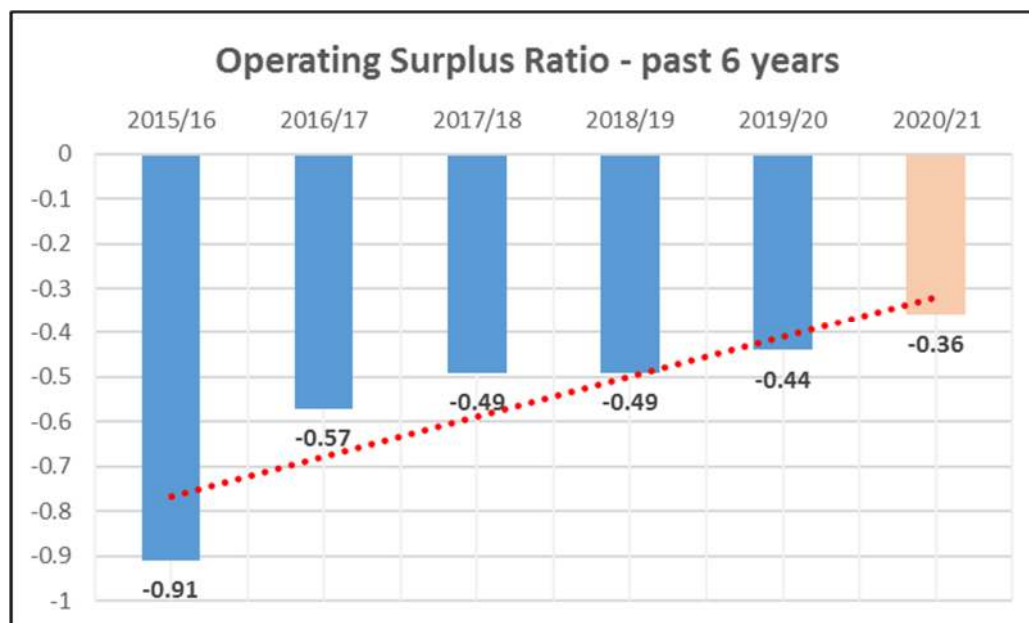
Standard: **Basic** standard (0.01 and 0.15) **Advanced** standard (>0.15)

The Operating Surplus ratio for the Shire of Manjimup in the last 6 years is:

- 2015/16: -0.91
- 2016/17: -0.57
- 2017/18: -0.49
- 2018/19: -0.49
- 2019/20: -0.44
- 2020/21: -0.36

Comment

The Shire of Manjimup's Operating Surplus Ratio has been under the DLGCI's standards since the ratio was introduced in the 2013/14 financial year. The Operating Surplus Ratio for any Local Government that heavily relies on grant funding would always be below the DLGCI's standard for this ratio, as it assesses own source revenue against operating expenditure (inclusive of depreciation and grant funded expenditure). It is acknowledged that the Auditor General believed the ratio indicated a "significant adverse trend" due only to the fact that it was not within the DLGCI's benchmarks, as the trend for the previous 6 years shows an improving trend rather than an adverse trend.



Like several of the ratios specifically applied to Local Government in Western Australia by DLGCI, there are considerable anomalies that arise during the calculation of the Operating Surplus Ratio that significantly weaken the interpretive usefulness of the outcome when judging the sustainability of a Local Government. Specific issues that affect the Shire of Manjimup when calculating this ratio are:

- The Shire is very grant reliant and receives substantial financial assistance grants each year. Unless significant population growth, economic growth, significant increases (70%+) in existing rates or the ability to rate additional land occurs, the Shire will continue to be heavily reliant on grant funding into the future;

- The Shire has a 1,358km road asset base arising from being the largest Local Government district land mass in the South West. This means that a substantial non-cash depreciation expense forms a significant part of the base calculation. The depreciation expense of road infrastructure is highly subjective that is open to manipulation and as it exists as a non-cash item should be reconsidered for its worth in contributing the Operating Surplus Ratio;
- The Shire auspices many operating grant programs like the Commonwealth Home Care Programs, NDIS services etc. As these programs are grant related the grant is removed from the Operating Surplus calculation, however the expenditure must remain in the operating expense portion. In most cases if this grant money was not received the programs would not go ahead which equates to approximately \$4.5M per year in Shire expenses and therefore should not be included in the Operating Surplus Ratio calculation; and
- When Council has any form of a carry forward, the carried forward expense from a previous year affects the ratio, however the funding for that expense is not recognised.

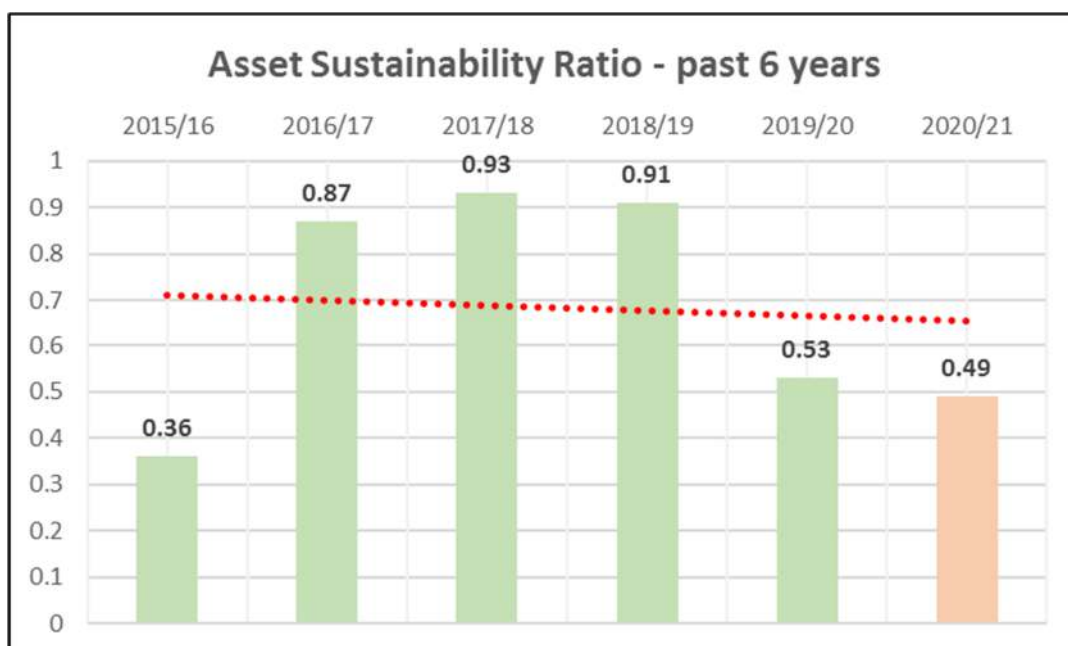
The Asset Sustainability Ratio in Detail (extracted from DLGSCI guidelines)

Calculation:
$$\frac{\text{Capital Renewal and Replacement Expenditure}}{\text{Depreciation}}$$

Purpose: This ratio indicates whether a local government is replacing or renewing existing non-financial assets at the same rate that its overall asset stock is wearing out.

Standard: Standard is met at 0.90, Standard is improving between 0.90 - 1.10

The graph below tracks the performance of the Shire's Asset Sustainability Ratio since 2015/16. The ratio varies from year to year depending on what projects have been completed and the nature of those projects, being renewal, upgrade or new.



The Asset Sustainability Ratio is heavily influenced by the level of assets a Local Government has under their control (\$564,295,808). The Shire of Manjimup has one of the longest road networks, highest number of bridges and due to the number of towns, replicates key public service buildings across other Shire towns.

To offset such a large asset base and subsequent depreciation, the Shire would typically rate money to fund the asset renewal. The Shire of Manjimup is in the difficult position where only 15% of the Shire's land mass is rateable with the other 85% unable to generate income.

There are two primary components of the ratio that the Shire can influence to affect the overall outcome. Firstly review depreciation rates to ensure that they reflect the reducing condition of assets, and secondly, prioritise renewal expenditure over expenditure for creating new assets.

Whilst a review of depreciation rates can be carried out with the support of an appropriate consultant, the spending of available funding solely on renewing assets is problematic given community pressure to upgrade current assets or replace existing assets with fit for purpose facilities.

The Shire of Manjimup look forward to the outcomes from the Local Government Financial Ratios Sector Working Group's findings and recommendations which should see a significant improvement in the calculation of the financial ratios taking into account the differences experienced from one Local Government to another.

Proposed Action

1. The Operating Surplus Ratio trend at the Shire is continuing to improve. This should be continued to be monitored and consideration given to further action if required if declines occur in future years;
2. Through the review of the Long Term Financial Plan consider the recommencement of the increase to municipal infrastructure funding by \$100,000 per year to increase asset renewal spending;
3. Undertake a review of depreciation rates and residual asset values in 2021/22; and
4. The Shire will continue to review operating costs as part of regular reviews and budget processes to control costs, but maintain levels of service expected by ratepayers.



Greg Lockwood
Director of Business
Shire of Manjimup