



— Shire of —
Donnybrook Balingup

**REPORT ON SIGNIFICANT
FINDINGS IN THE 2020-21 AUDIT
REPORT**

February 2021

BACKGROUND

Under the Local Government Act 1995, the Shire of Donnybrook Balingup is required to prepare an Annual Financial Report each financial year and that report is to be the subject of an independent audit.

The Shire's 2019-20 audit was conducted by the Office of the Auditor General and their report, received on 21 February 2021 is attached.

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

“(a) prepare a report addressing any matters identified as significant by the auditor in the audit report, 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:

“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.”

For the year ending 30 June 2021, the Auditor General identified a significant adverse trend in relation to the financial position of the Shire in relation to one statutory ratio present in the Financial Report that did not meet the minimum standard as set by the Department of Local Government, Sport and Cultural Industries (the Department).

Excerpt Audit Opinion:

“(i) In my opinion, the following material matters indicates a significant adverse trend in the financial position of the Shire:

- a) *The Operating Surplus Ratio as reported in Note 35 of the annual financial report is below the Department of Local Government, Sport and Cultural Industries standard for the past 3 financial years.”*

The Operating Surplus Statutory Ratio has been under the Department's recommended levels for at least three years.

Operating surplus ratio

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

own source operating revenue means revenue from rates and service charges, fees and user charges, reimbursements and recoveries, interest income and profit on disposal of assets.

The Operating Surplus Ratio measures the extent to which revenues raised cover operational expenses (including depreciation). The Department considers the ratio standard is met if the ratio is above 0.00. To achieve a positive level in the ratio

requires operating revenue (excluding capital grants and contribution) to be greater than operating expenditure (including depreciation).

It is typical of a local government similar to the Shire of Donnybrook Balingup to have an operating surplus ratio that does not meet the minimum requirements. This result reflects a reliance on sources of funding other than Council's own source funds such as rates.

A number of additional major items also directly influence the results of the Operating Surplus Ratio, such as:

1. The timing of operating grant funds being received in one financial year and expenditure being incurred in another e.g. pre-payment of the Federal Government Financial Assistance Grants.
2. The exclusion from the ratio of recurrent capital grants (such as specific purpose road grants) as a revenue.
3. The funding of operating projects from reserve funds. All operating expenditure must be included in the ratio calculations, however the funds from cash reserve are excluded, resulting in an apparent lower ability to fund operating expenditure.

In order to improve its Operating Surplus Ratio, the Council has limited options available to it. One measure could be to increasing rates substantially, however, this must be balanced with the community's capacity and willingness to pay.

An alternative is to review the Shire's major operating costs, including employment costs, materials and contracts, however, to achieve the required cost savings would have a dramatic adverse impact the level of service which the Shire is able to deliver to the community.

The Audit report also raised two compliance matters as follows:

Excerpt Audit Opinion:

“(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) *Accounting journal adjustments were processed with no evidence of independent review and approval. Accounting journals can represent significant adjustments to previously approved accounting transactions, and therefore should be appropriately reviewed and approved.*
- b) *The Shire has not reported the Asset Renewal Funding Ratio for 2021, 2020 and 2019 in the annual financial report as required by Section 50(1) of the Local Government (Financial Management) Regulations 1996, as the long-term financial plan adopted by the Shire does not include the required information to calculate the ratio.”*

Accounting Journal Adjustments

Management acknowledges this finding and notes that the above recommendation is in operational practice.

Asset sustainability ratio

$$\frac{\text{capital renewal and replacement expenditure}}{\text{Depreciation}}$$

capital renewal and replacement expenditure means expenditure to renew or replace existing assets;

The asset sustainability ratio measures the extent to which assets managed by the Shire are being renewed and replaced over time. The Department considers the ratio standard is met if the ratio is above 0.90, meaning that spending on renewal in any one year is 90% of the level of depreciation in that year.

ACTION TO BE TAKEN

Action to be taken on the Operating Surplus Ratio in the future

The Shire's Operating Surplus Ratio is being adversely impacted by non-cash depreciation charges. A preliminary review of Depreciation Rates has been undertaken and points to a potential over calculation of depreciation as does the fact that Road Infrastructure Assets are not disaggregated therefore residual values cannot be put in place where appropriate.

Officers note that the Department of Local Government, Sport and Cultural Industries (DLGSC), under direction from the Minister, has recently released its draft Model Financial Statements as part of the broader Local Government Reform currently being undertaken.

The following is contained in the current draft which if progressed would remove the current Ratio calculations:

- *“Prescribed financial ratios have been removed. Consequently, it should be assumed that financial data required to report useful financial ratios will be prescribed in the model accounts.”*

The methodologies of calculating the operating surplus ratio are generally recognized, within the Local Government sector, as being inappropriate to be used to determine a significant adverse trend.

Pending the final outcome of the Local Government Reform Officers will undertake a full review of Depreciation calculation and methodology.

Action to be taken Accounting Journal Adjustments.

Management acknowledges this finding and notes that the above recommendation is in operational practice.

The Director of Corporate and Community has personally reviewed the 1148 general journals processed in the 2020/21 Financial Year and has found a total of 6 that had no evidence of review by a senior staff member. This equates to a failure rate in the process of 0.52% with compliance standing at 99.48%. The 6 journals were also checked for legitimacy and supporting

documentation with no adverse findings.

Staff appreciate the importance and significance of the process and will continue to strive for 100% compliance.

Action to be taken on the Asset Renewal Funding Ratio in the future.

The Shire adopted its Long Term Financial Plan (LTFP) 2020-2040 on 22 December 2020 however this plan was not considered by the OAG as it does not categorise Capital expenditure into type; that being New, Upgrade or Renewal, for this ratio to be calculated the Renewal component needs to be itemised in the LTFP.

All the necessary asset management planning is complete to a sufficient level to inform the development of the calculation of the asset renewal funding ratio, this however needs to be imbedded into the LTFP.

Officers note that the Department of Local Government, Sport and Cultural Industries (DLGSC), under direction from the Minister, has recently released its draft Model Financial Statements as part of the broader Local Government Reform currently being undertaken.

The following is contained in the current draft which if progressed would remove the current Ratio calculations:

- *“Prescribed financial ratios have been removed. Consequently, it should be assumed that financial data required to report useful financial ratios will be prescribed in the model accounts.*
- *Asset ratios requiring audit attestation have been removed from audit scope. This will require amendment to regulation 10 (3) (e) and 4A of the Local Government (Audit) Regulations 1996.”*

Pending the final outcome of the Local Government Reform Officers will work to ensure that the appropriate data is compiled in the LTFP which is currently under review to allow for this ratio to be calculated if required.