REPORT ON SIGNIFICANT ADVERSE TREND

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

21 DECEMBER 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 2020/2021 audit report was received from the Office of the Auditor General on 16 December 2021 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 2021 year, the Auditor has raised the following significant matters.

'In my opinion, the following material matters indicate a significant adverse trend in the financial position of the Shire:

a) The Operating Surplus Ratio as reported in Note 33 of the annual financial report is below the Department of Local Government, Sport and Cultural Industries' standard for the last 3 financial years.

b) The Asset Sustainability Ratio as reported in Note 33 of the annual financial report is below the Department of Local Government, Sport and Cultural Industries' standard for the last 3 financial years.'

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	2015	2016	2017	2018	2019	2020	2021
Asset Sustainability Ratio	0.49	0.49	0.68	0.48	0.60	0.76	0.71
Operating Surplus Ratio	-0.32	-0.59	-0.29	-0.47	-0.18	~~-0.28~~ -0.20	-0.19

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 2020/2021 Asset Sustainability Ratio of 0.71 is the second highest in the last six years, just lower than the 2019/2020 value of 0.76. The 2018/2019 was higher than the 2017/2018 figure of 0.48, 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 and 2020/2021 was that the total depreciation amount was reduced from $6.06 million in 2018/2019 to $5.29 million in 2019/2020 ($5.28 million in 2020/2021), as part of the efforts to verify condition and depreciation data.

In 2020/2021, 80% of capital works was spent on renewals (4.2 million), with 13% on upgrade works and 7% on new works. By far the Council’s own source funding has been allocated to renewals. A significant effort has been put into the planning and subsequent expenditure on Commonwealth Drought Relief Fund and Local Roads and Community Infrastructure Program (LRCIP) projects.

The Shire’s previous 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 0.66 is now sitting at an intermediate level indicating the Council’s assets are in an acceptable condition and the ARFR of 0.89 is consistently above its target of 0.75, 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 2020/2021 result is (0.19), figures in parentheses being negative. The Shire’s 2019/2020 result was last year reported as (0.28), but that value has now been corrected to be (0.20), due to recognition of accrued storm damage grant income. These figures have stabilized with the 2018/2019 result of (0.18). They are much 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.

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. For recurring capital expenditure, there is a likelihood that traditional grant funding sources will continue and therefore perhaps should be included.

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

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 2020/2021 and 2019/2020 ratios have improved (from what they otherwise would have been) as a result.

The Shire is continuing to verify the condition and remaining useful life of unsealed road infrastructure to ensure depreciation rates are reliable. There are many factors which could influence this and work will be ongoing for some time before decisions on significant changes to depreciation can be justified.

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.