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Your Ref:
Enquiries: Felicity Heading

11 February 2021

Hon D.A. Templeman, MLA
Minister for Local Government; Heritage; Culture and the Arts
7th Floor, Dumas House
2 Havelock Street
WEST PERTH WA 6005

Dear Minister

Matters Identified as Significant in the Shire of Wyndham East Kimberley's Audit Report

Pursuant to Section 7.12A(4) of the *Local Government Act 1995*, the Shire has prepared a report for the Minister relating to a matter reported in the Auditor's Report for the financial year ended 30 June 2020 dated 20 November 2020.

In accordance with the *Local Government (Audit Regulations) 1996* the Shire's Auditors reported that in their opinion, there is an adverse trend in the financial position of the Shire as the Operating Surplus Ratio has been below the DLGSCI standard for the past 3 years.

The Shire disagrees with this statement, as the Operating Surplus Ratio is determined without taking into account material facts, which would yield a different result had they been considered. In the attached report, the Shire demonstrates that there is not an adverse trend if these material facts are taken into account. The Shire considers its financial position to have been stable over the trend period despite the impact of the Covid-19 pandemic during the 2019-20 financial year. The Shire further requests that the calculation of this ratio be reviewed to address the matters highlighted in our report.

Yours faithfully,

Vernon Lawrence
Chief Executive Officer

Felicity Heading
Director Corporate Services



Report on Adverse Trend in Auditors Report – Operating Surplus Ratio

Background

The Shire prepares its annual financial report based on the Australian Accounting Standards and the requirements set out in the Local Government Act 1995, together with the supporting Regulations. One of the items to include in the report is the calculation of financial ratios to assess the sustainability of the local government entity. The Shire considers the ratio has to be appropriate and when viewing the trends in the ratios provide a good indicator of how the local government is progressing. For this to be true in practice, the ratios calculated must be determined following a rigorous process in order for them to be meaningful. The Shire believes that this is the case for all ratios except one – the Operating Surplus Ratio.

The guidelines published by the Department of Local Government, Sport and Cultural Industries (Department) for the calculation of the Operating Surplus Ratio state that it is a key indicator of financial performance and together with a sound long-term financial plan will underpin the financial sustainability of the local government. It further states that a positive ratio indicates the percentage of own source revenue that is available for capital expenditure, transfer to cash reserves or to reduce debt.

In determining these ratios the Shire has been advised that the Office of the Auditor-General directive is that auditors are not to include or report on adjusted ratios in the financial report. Based on our financial data we believe the reporting of unadjusted ratios to be fundamentally flawed as this results in misleading data being published. The Shire considers that it is necessary to require adjustments to be made to this ratio in order to accurately report on the financial sustainability of the local government. These adjustments can be detailed in amended guidelines and compliance with them can be verified by the auditors as part of their audit procedures.

The Shire considers the accounting treatment of the transactions discussed below to be correct in terms of the current accounting standards. As the standards have a very wide application to a range of entities across Australia, any change to the accounting treatment of the transactions is not expected to happen in the near future. However, the calculation of the Operating Surplus Ratio is determined by the Department and applies only to local governments. To change how the ratio is determined is in relative terms much easier to achieve.

Limitations of the current methodology

The current methodology is that the Operating Surplus Ratio is to be calculated with reference to the data in the financial statements without any adjustments being made. The Shire

considers this practice misleading to users of the financial statements. Adjustments should be made to ensure that the substance of what the ratio is meant to depict is reported rather than merely a mechanical calculation that has little relevance to the underlying data.

For example, the advance payments of the Commonwealth Financial Assistance Grants (FAGs) has resulted in the ratio being artificially inflated and deflated depending on whether an advance payment was received or not. The receipt or lack thereof of FAGs, generally received in the last couple of weeks of a financial year, can either deem the ratio to be positive or negative as the case may be without changing the underlying financial reality of the local government. The local government would be held to be financially sustainable in one year but not in the other. This hides the true performance of the local government.

The current methodology also requires the local government to include profits and losses on disposal of assets. We consider that these items are more closely linked to the investing activities of local governments rather than their operating activities. This is evidenced by the Australian Accounting Standards requiring statements of cash flows and the rate setting statements treating the disposal of assets as investing activities as opposed to operating activities.

The stated objective in calculating the Operating Surplus Ratio is that it indicates the percentage of own source revenue that is available for capital expenditure, transfer to cash reserves or to reduce debt. Including investing activities in calculating an operating ratio should not be permitted.

Finally, if the objective is to measure the amount of own source funds that are available for capital works, to be placed in reserves or to pay down debt, then depreciation should not be part of the calculation. Depreciation with reference to the local government is more closely linked to the capital renewal process and therefore investing activities. It is the amount that the local government should be spending on its capital renewals in order to maintain the service potential of its asset base. The evidence for this is the Asset Sustainability Ratio. For the Shire, it would make practical sense to determine the Operating Surplus Ratio based on cash flow information rather than the current basis.

Calculation of Operating Surplus Ratio for the Shire of Wyndham East Kimberley

The OSR data for the Shire over the last five financial years is as follows:

Financial Year	Unadjusted Ratio	Adjusted Ratio
2015-16	-0.27	-0.10
2016-17	0.02	-0.09
2017-18	-0.11	-0.11
2018-19	-0.14	-0.06
2019-20	-0.21	-0.20

2015-16

The financial data for the 2015-16 financial year has been adversely affected by not receiving an advance payment of FAGs for this financial period. This had an impact on the operating

income by reducing it by \$1.84 million. This has misrepresented the reality of the financial situation in that there was a full FAGs grant available for Shire operations.

An amount of \$1.10 million was included in operating expenditure for the rehabilitation of a major irrigation channel that was a “one-off” expense of a capital nature. It was included in operating expenses, as the Shire does not own the underlying asset. Funding this project was from capital works funds and consequently the capital works projects delivered for the financial year was significantly less than the prior two years.

The combination of the above two items skews the ratio negatively when the underlying reality is better represented by the adjusted ratio.

2016-17

An advance receipt of the FAGs grant has affected the financial data. This has once more inflated the performance of the Shire based on the calculation of the ratio and misrepresents the underlying reality.

2017-18

This financial year unadjusted ratio matches the adjusted ratio as the Shire received an advance receipt of FAGs for the 2018-19 year to off-set the advance receipt for the current financial year included in the 2016-17 financial year.

2018-19

In the 2018-19 financial year, the situation relating to FAGs was the same as for the 2017-18 year. The advance receipt for the 2019-20 year offset the advance receipt for the current financial year included in the 2017-18 financial year.

The unadjusted ratio included an amount for the loss on disposal of a bridge of \$1.33 million. The Shire believes that this item should be excluded from the calculation of the ratio for a number of reasons.

Firstly, the amount is capital in nature and relates to investing activities. It is not relevant when assessing the operating activities of the Shire.

Secondly, the bridge was not constructed from ratepayer funds and was initially recognised as an asset in the Shire’s asset register at fair value by creating a revaluation surplus for this asset in the revaluation reserve. The amount therefore that was written-off was based on its revalued amount and the “loss” does not represent a cash flow that has an impact on the Shire’s own source revenue. This “loss” does not have any practical impact on the Shire’s ability to fund capital works, transfer cash to reserves or pay down debt. In addition, the accounting standards do not permit adjusting the “loss” by any amount relating to the asset from the revaluation surplus carried in the Shire’s revaluation reserves.

Finally, the bridge asset was written off as it was replaced by a bridge that was entirely funded from funds other than ratepayer funds (Roads to Recovery funded). The receipt of these funds are correctly excluded from the calculation of the ratio. Similarly, the construction of the new bridge was excluded from operating expenses, as it was a capital project and related to

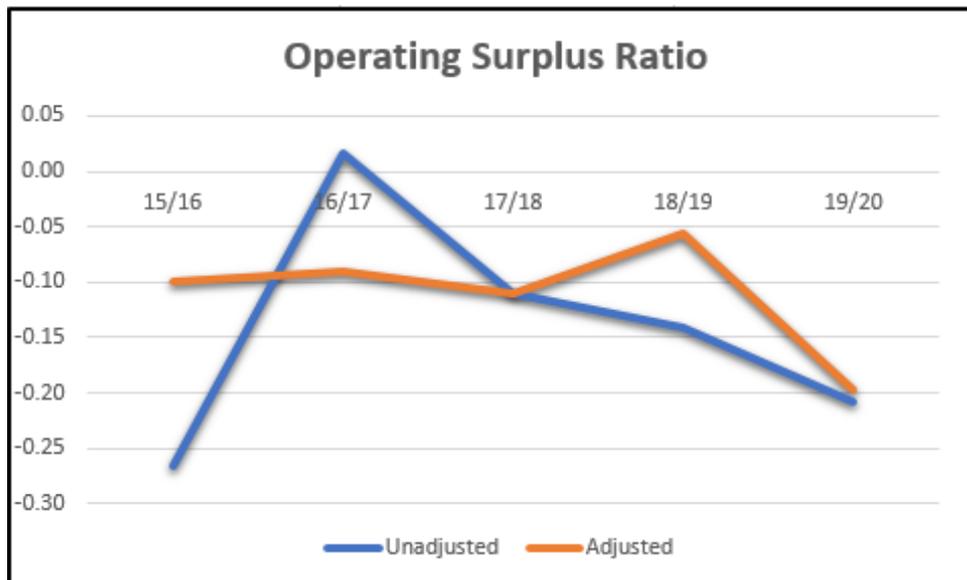
investing activities. The Shire considers the entire series of transactions relating to the replacement of the bridge to be capital in nature as it relates to investing activities, having no impact on ratepayer funds and therefore should be excluded from the calculation of the Operating Surplus Ratio.

2019-20

For 2019-20 the Shire recorded an unadjusted Operating Surplus Ratios of -0.21 and an adjusted ratio of -0.20. This was mainly due to a reduction in Airport and other revenue and increases in expenditure as a result of the Covid-19 pandemic and as such the Shire considers this to be a one off event and not reflective of a longer term trend.

Summary

The illustration below is the best way to demonstrate the difference between the unadjusted ratio's and the adjusted ratios.



When taking into consideration all the financial data available, the financial reality of the Shire is better represented by the adjusted data as opposed to the unadjusted data.

Conclusion

The Shire of Wyndham East Kimberley requests that the Department review the guidelines for calculating the Operating Surplus Ratio. The Shire considers it necessary for the Department to make it mandatory to make certain adjustments to the data to ensure the Operating Surplus Ratio reflects commercial and financial reality. In addition to this, the Shire requests that the Department consider that the Operating Surplus Ratio be determined based on cash flow data rather than the data in the statement of comprehensive income.