Memorandum: Independent Auditors Report

Background:

The Office of the Auditor General (OAG) performed the statutory audit of the Annual Financial Statements for the year ended 30 June 2019. The Annual Financial Statements along with the Audit Opinion was presented to the City's Audit and Risk Committee on the 10 December 2019 and Council on the 17 December 2019. The overall result of the audit was positive for the City with an unqualified audit opinion.

As part of the Statutory Audit process of the Annual Financial Statements, the OAG is required to report on any matters relating to Legal and Regulatory Requirements that come to their attention. For the City's Annual Financial Statements for the year ended 30 June 2019, the OAG identified the two significant findings as reported under the Other Legal and Regulatory Requirements section in the Audit report.

This memorandum addressing the actions the City intends to take in respect of those matters. Additionally, will be published on our website as required by the Local Government Act section 7.12A (5).

Details:
<u>Item 1:</u>

Extract from the Independent Auditors Report:

In accordance with the Local Government (Audit) Regulations 1996 I report that:

(i) In my opinion, the following material matters indicate significant adverse trends in the financial position of the City:

a. Asset Sustainability Ratio as reported in Note 37 of the annual financial report is below the Department of Local Government, Sport and Cultural Industries' standard for the last three financial years.

There are seven ratios required to be included in the annual financial report under section 6.4(2) of the *Local Government Act 1995* and Regulation 50 of the *Local Government (Financial Management) Regulations 1996*. The Department of Local Government, Sport and Cultural Industries issued a guideline regarding financial rations in June 2013. Herewith an extract on the Asset Sustainability Ratio:

4.6 Asset Sustainability Ratio

This ratio is an approximation of the extent to which assets managed by a local government are being replaced as these reach the end of their useful lives. It is calculated by measuring capital expenditure on **renewal** or **replacement** of assets, relative to depreciation expense. Expenditure on new or additional assets is excluded.

Depreciation expense represents an estimate of the extent to which the assets have been consumed during that period. Measuring assets at fair value is critical to the calculation of a valid depreciation expense value.

Asset Sustainability Ratio	
Asset Sustainability Ratio =	$\frac{\text{Capital Renewal and Replacement Expenditure}}{\text{Depreciation}}$
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.
Standards:	Standard is met if the ratio can be measured and is 90% (or 0.90) Standard is improving if this ratio is between 90% and 110% (or 0.90 and 1.10).

Extract from the City's Annual Financial Statements:

Description	2018/2019	2017/2018	2016/2017	Benchmark
Asset Sustainability Ratio	0.67	0.51	0.54	>0.90

As this is the third year in a row the Asset Sustainability Ratio (ASR) is below the benchmark, it has been raised as an adverse trend by the OAG.

There are a few factors to consider:

Consideration 1: There was an amendment to the Local Government (Financial Management) Regulations and the measurement of non-current assets at fair value became mandatory. This resulted in a significant increase in the City's depreciation from $6 million in 2015/16 to $11 million in 2018/19. To maintain a standard ASR the City would have had to fund an additional $4.5 million since 2015/16 on renewal works due to an increase in a non-cash item being depreciation.

Consideration 2: As part of Consideration 1, to be able to have maintained the standard ASR significant rate increases would have been required. By way of example the City would have needed to adopt a rate increase of 11.3% in 2016/17 to achieve the standard benchmark of this ratio.

Consideration 3: Council have been over the view to accept Grant funded new capital work items whenever a Grant has been available. It would be nonsensical to decline a Grant on the basis that it would cause the ASR to appear unhealthy in any given financial year.

Consideration 4: The financial sustainability and the maintenance of the asset base over it's extensive lifetime should be explored over an extended period of time, rather than one financial year at a time.

Based on all of the above the City considers the ASR as part of the City's Annual Budget and Long Term Financial Plan (LTFP) processes. The ASR has specifically been mentioned in previous versions of LTFP and remains a focus for the revision taking place early in 2020.

We further note that the issue of adverse Ratios is a Council wide issue and were discussed at the Local Government Professional's workshop held on the 23rd of August 2019. At this meeting the Department representative acknowledged the issue required reviewing and have commenced the consultation process with the West Australian Local Government Association (WALGA) and the Local Government Professionals Australia WA.

Item 2:

Extract from the Independent Auditors Report:

(ii) The following material matters indicating non-compliance with Part 6 of the *Local Government Act 1995*, the Local Government (Financial Management) Regulations 1996 or applicable financial controls of any other written law were identified during the course of my audit:

a. Rates Adjustment journal entries prior to March 2019 were posted by one employee, without being reviewed by a senior staff member independent of preparation. Rates adjustment journals can represent significant adjustments to previously approved rates transactions, and should therefore be appropriately reviewed and approved. After we reported this finding, management reviewed and approved the journal entries that had not been reviewed and did not identify any errors.

As noted in the report this item has already been addressed by way of changes to the process for approval of journal entries.