City of Kalamunda

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 2020. The Annual Financial Statements along with the Audit Opinion were presented and noted at the City's Audit and Risk Committee on 1 December 2020, and will be presented at the Ordinary Council Meeting on 15 December 2020. 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 2020, the OAG identified a significant finding as reported under the Other Legal and Regulatory Requirements section in the Audit report.

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

Details:

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 ratios in June 2013.

Interestingly, the City achieved a Financial Health Indicator (FHI) of 75 for the 2019/2020 financial year. The FHI is a measurement of a local government's overall financial health. An FHI result of 70 and above indicates sound financial health. Albeit this is a good result, OAG identified an adverse trend in the Operating Surplus Ratio.

Extract from the Independent Auditors 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 significant adverse trends in the financial position of the City:

a. The Operating Surplus Ratio as reported in Note 34 of the annual financial report is below the DLGSCI's basic standard of 0.01 for the last two financial years.

Herewith an extract on the Operating Surplus Ratio as per the Local Government Operational Guidelines June 2013:

4.4 Financial Performance Ratio

A key indicator of a local government's financial performance is measured by the 'Operating Surplus Ratio'. If a local government consistently achieves a positive operating surplus ratio and has soundly based long term financial plans showing that it can continue to do so in future, having regard to asset management and the community's service level needs, then it is considered financially sustainable.

A positive ratio indicates the percentage of total own source revenue available to help fund proposed capital expenditure, transfer to cash reserves or to reduce debt.

A negative ratio indicates the percentage increase in total own source revenue (principally rates) that would have been required to achieve a break-even operating result.

Operating Surplus Ratio

$$\text{Operating Surplus Ratio} = \frac{\text{(Operating Revenue MINUS Operating Expense)}}{\text{Own Source Operating Revenue}}$$

Purpose:	This ratio is a measure of a local government's ability to cover its operational costs and have revenues available for capital funding or other purposes.
Standards:	**Basic** Standard between 1% and 15% (0.01 and 0.15) **Advanced** Standard > 15% (>0.15).

Definitions:

'Operating Revenue'	Means the revenue that is operating revenue for the purposes of the AAS, excluding grants and contributions for the development or acquisition of assets.
'Operating Expense'	Means the expense that is operating expense for the purposes of the AAS.
'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.

Extract from the City's Annual Financial Statements:

Description	2019/2020	2018/2019	2017/2018	Benchmark
Operating Surplus Ratio	(0.10)	(0.04)	0.01	>0.01

As this is the second year in a row the Operating Surplus Ratio (OSR) is below the benchmark, it has been raised as an adverse trend by the OAG.

Following are the key factors that affected the OSR ratio in 2019/2020:
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 $11.3 million in 2019/2020. To maintain a standard OSR the City would have had to increase an additional $5.3 million in revenue due to an increase in a non-cash item being depreciation.

Consideration 2: The City incurred a $2.6 million loss in assets disposals. The increase in loss was mainly due to the disposal of the Peter Anderton building. The City entered into a peppercorn lease agreement with the Department of Health to provide access to the building. The building was written off from the City's assets register in 2019/2020 as the remaining lease agreement period was less than 12 months.

Consideration 3: The COVID-19 pandemic was underway for the last few months of the financial year. In spite of that, the City continued to deliver on key strategies adopted by the Council and maintained high levels of services across all programs.

Consideration 4: Budget setting for 2021/2022 will likely be impacted by the current economic environment, in turn adding pressure to the OSR ratio in the short term.

Next steps and actions:

1. The administration to present to the Councillors at the strategic retreat early in 2021 on financial strategies for consideration and approval.
   Options to address the adverse trend of one of the six ratios being the operating surplus ratio:
   a. Undertake a review of all operating expenditure services and assets that could reduce expenditure levels;
   b. Identify opportunities and issues associated with increasing revenues through rates, fees and charges or exploring new revenue increasing opportunities;
   c. Undertake a review of depreciation rates;
   d. Identify the risk appetite of Council to either accept the adverse trend of this ratio or to address the trend by decreasing operational expenditure or increasing revenue streams.

2. Incorporate financial strategies selected by the Council into the preparation of the Annual Budget for 2021/2022
3. Incorporate financial strategies selected by the Council into the preparation of the Long Term Financial Plan