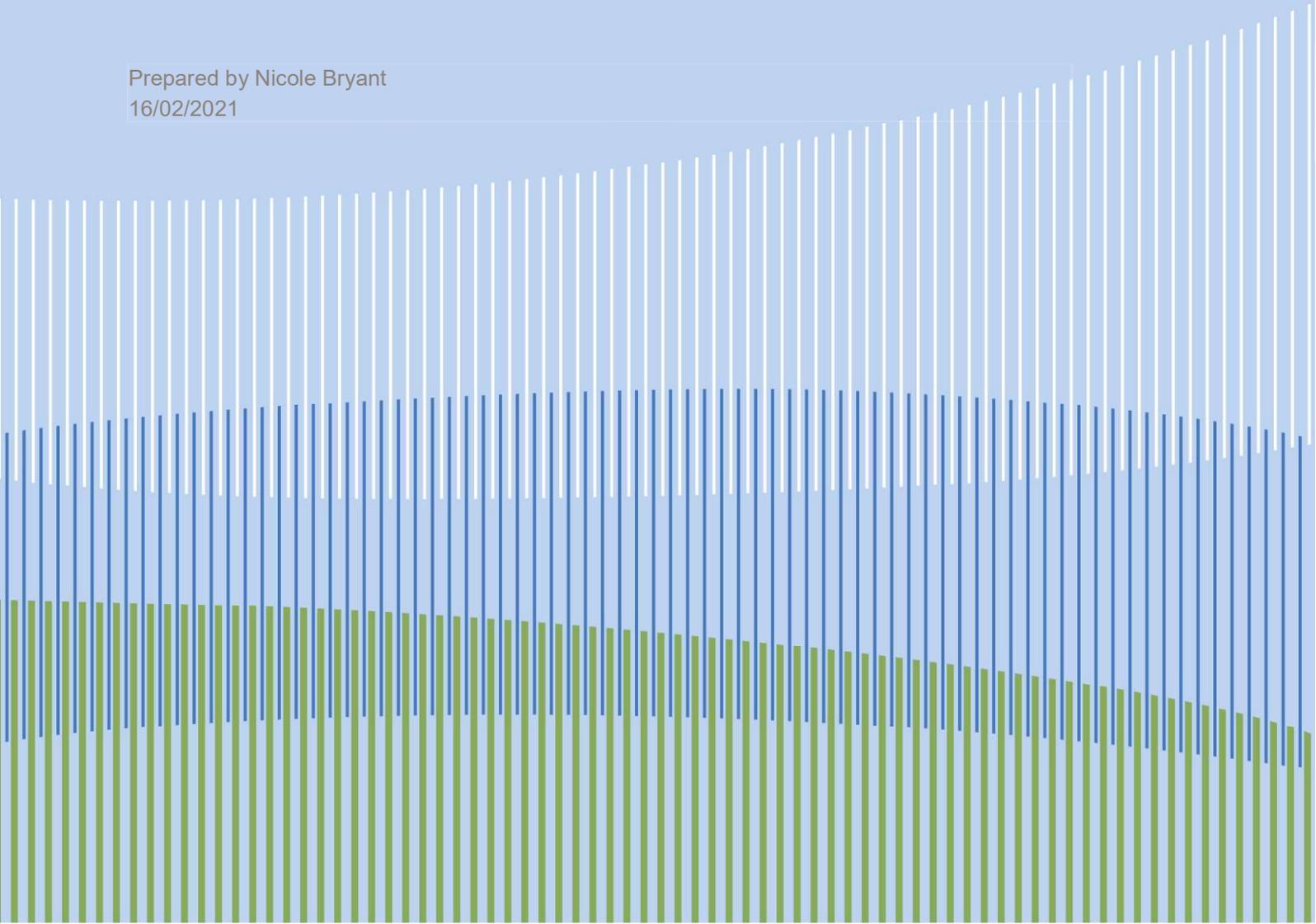


2019-20 Annual Financial Statement

Significant Adverse Trends

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Operating Surplus Ratio

In Brief

As part of the Statutory Audit process of the Annual Financial Statements, the requirement of section 7.12A to produce a report addressing the issues raised by the auditor were introduced by amendment in 2017. Due to this change the Audit Committee is required to consider the significant adverse trend in the ratio identified in the 2019/20 Audit report issued by the Auditor General of Western Australia for the 2019/20 Annual Financial Statement.

Background

Under the Local Government Act 1995 the Shire of Murray is required to prepare an audited Annual Financial Report each financial year.

Commencing the financial year ended 30 June 2020, the Auditor General of Western Australia (OAG) has assumed oversight of the Shire of Murray's audits. The OAG has appointed AMD Chartered Accountants as their contractor for audit services with the Council for 2019/20. AMD are experienced local government auditors and an accredited agent of the OAG.

A key audit requirement of audit standards under the OAG is the responsibility for the auditor to identify any financial trends which it considers adverse and of concern. For the 30 June 2020 year, the OAG has identified that the Shire of Murray meets six of the seven minimum standards for financial ratios, as set by the Department Local Government, Sport and Cultural Industries (DLGSCI), with the following financial measure of sustainability being cause for concern;

- Operating Surplus

Under section 7.12A of the act it states

1. a local government:
 - (a) must 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 these 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.
2. 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.

Report Detail

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. The ratio is calculated using the following equation:

$$\text{Operating Surplus Ratio} = \frac{\text{Operating Revenue} - \text{Operating Expenses}}{\text{Own Source Operating Revenue}}$$

The DLGSCI's minimum benchmarks are as follows:

- Not Meeting Standards <0.00 Minimum 0.00
- Standard 0.01 to 0.15
- Advanced > 0.15

The ratios should be read for what they are, a very simplistic measure. The operating surplus ratio excludes Financial Assistance Grants (FAG's). It has long been argued that FAG's are an integral component of revenue for local government and business models are predicted on receiving these funds. Removing this key source of operational revenue from the ratio calculation has a negative impact on the ratio and skews the result.

It is typical of a local government similar to Murray, to have an operating surplus ratio that does not meet the minimum requirements. This result reflects a reliance on sources of funding other than rates as mentioned above, to be sustainable. As seen in the graph below the operating surplus ratio has traditionally had a negative result:



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

- The level of rating increase.
- The timing of payment of grants, particularly large operating grants.
- The funding of operating projects from reserve funds. All operating expenditure must be included in the ratio calculations, however the income from reserve must be excluded, resulting in an apparent lower ability to fund operating expenditure.

In order to improve the Operating Surplus Ratio, the Council has limited options available to it. The measure could be improved by increasing rates substantially, however this must be balanced with the community's capacity to pay particularly considering the current economic circumstances. The measure could also be improved by Council reviewing its major operating costs centres, including employment costs and contractors and materials however this will certainly adversely impact on the level of service which Council is able to deliver to the community.

It is recommended that a detailed analysis of available options to improve the operating surplus ratio be undertaken as part of its long-term planning review during 2020/21. In addition to the above recommendations for the Council to consider, the following suggestions are provided and may warrant further discussion.

- The current assessment by the DLGSCI is a one size fits all approach. It is recommended that the DLGSCI consider reviewing what it considers an acceptable result in terms of the ratios from regional and remote councils. This could be determined by the band level of a local government as it is unreasonable to expect councils with vastly different resource levels to return similar ratio results. Consideration should also be given to individual council circumstances such as the limited amount of rateable land, population and growth rates and rateable property values as examples.
- The issue of adverse ratio's is a council wide issue and was discussed at the Local Government Professional's workshop held on the 23rd August 2019 at City of Kwinana.

At this meeting the DLGSCI 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. The outcome of these consultations are still pending.

The requirement to report remedial action as an outcome of the identified adverse trend is likely to at least in the short term be an annual process for the Shire of Murray. The management team will continue to monitor the ratio results and identify factors within its control that can be addressed with a view to improving the ratio outcome.

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