

Delegated Authority – Not Applicable

Voting Requirements – Simple Majority

Council Decision Moved Cr Scallan, Seconded Cr Moore
C.06/1217 That Council receives the List of Accounts Paid in November 2017
as presented in Attachment 4. Carried 8/0

ITEM NO.	C.07/1217	FILE REF.	108.5
SUBJECT	Ratio Action Plan - Fair Value Accounting & Depreciation Expense		
OFFICER	Executive Manager Corporate Services		
DATE OF REPORT	13 December 2017		

OFFICER RECOMMENDATION that Council endorse the following Ratio Improvement Action Plan:

- A full review of Council's asset depreciation expenditure is undertaken. Specifically, a review of each individual Council asset (at component level) of its condition, useful life, remaining useful life and residual value.*
- An assessment as to whether the Shire is revenue short or expenditure long by undertaking a comparison of neighbouring and similar sized Shires in relation to the level of own source revenue (i.e. rates, fees and charges) compared to expenditure.*
- Develop a policy to guide future Council decisions in relation to the allocation of funds to renewal works versus upgrade works.*
- That various scenarios are modelled during the next review of Council's Long Term Financial Plan in relation to achieving minimum ratio benchmarks. The results of these scenarios to be workshopped with Council.*

Summary/Purpose

This report provides comments regarding fair value accounting and the effect on Council's depreciation expense and ratio performance. A suggested action plan has been developed to improve Council's ratio performance in meeting the Department of Local Government, Sport and Cultural Industries' (the Department) financial ratio benchmarks.

Background

Following presentation of the 2014/15 Annual Financial Statements and consideration of the independent audit and management reports the following recommendation by Council's Audit Committee was considered and resolved by Council at its ordinary meeting held 17 December 2015 (via Resolution C.02/1215):

"That a report be presented to Council on the effect of fair value and depreciation on the operating surplus ratio and asset sustainability ratio and meeting the current benchmark."

At the time of presenting the 2014/15 Annual Financial Statements it was highlighted by Council’s auditor that a number of ratios were outside the Department’s ‘basic’ standards, specifically the Asset Sustainability Ratio and Operating Surplus Ratio. During discussion with Council’s Auditor it was highlighted that both of these ratios include depreciation expenditure as part of the ratio formula. With the implementation of fair value accounting it was perceived that resultant depreciation expenditure may be having a negative effect on these ratios.

Following completion of the 2015/16 annual financials assistance was sought from Mr Ron Back a local government financial specialist to undertake a review Council’s financial statements and ratios since the introduction of fair value accounting (2012/13 to 2015/16) and provide administration with comments and recommendations.

Officer Comment

Mr Back reviewed Council’s financial statements since 2010/11 and undertook research of ratio results for all Western Australian Local Governments for the four year period ended 2015/16. Following his review of this Council’s Annual Financial Statements and ratio performance, the following observations were reported by Mr Back.

“Since 2012/13 the Shire has implemented a program of revaluing assets in accordance with the legislative requirements. Major valuation changes occurred in land and building in 2013/14 and road and other infrastructure in 2014/15.

These revaluations have had a material impact on the depreciation expense for each of these asset classes with increased expenses flowing through to the Income Statement in the following financial years.

Depreciation expense	2011/12	2012/13	2013/14	2014/15	2015/16
Buildings	170,651	196,253 ✘	282,721 ✘	618,383 ✘	640,073
Furniture/Equipment	44,293	44,320	48,555	49,453	35,155 ✘
Plant & Equipment	535,883	616,315 ✘	324,239 ✘	347,392	368,588
Road Infrastructure	1,684,482	1,718,509	1,740,886	1,768,000	2,112,596 ✘
Drainage Infrastructure	65,102	65,877	66,048	66,543	88,447 ✘
Footpath Infrastructure	38,770	43,101 ✘	44,460	49,894 ✘	74,289 ✘
Airport Infrastructure	0	0	0	0	0
Recreation/Parks Infrastruc	138,754	151,038	164,065	190,023 ✘	161,431 ✘
Other Infrastructure	100,741	101,649	101,695	103,208	143,240 ✘
Total Depreciation	2,778,676	2,937,062	2,772,669	3,192,896 ✘	3,623,819 ✘
x movements greater than 10%	-	-	-	-	-

Clearly, the revaluations have had a negative impact on the operating result of the Shire. However, when considering the level of depreciation expense relative to operating expenses, it shows the Shire is in the highest quartile in the industry. That is, the percentage of deprecation compared to the normal operating expenses of the Shire is in the largest 25% of local governments. This has been high for a period of time.

This could be a lead indicator that the depreciation rate is consuming assets faster than they are actually diminishing. If not it would suggest that the asset renewal backlog could be increasing, which would require substantial revenue increases to correct in future years.”

In summary Mr Back provides the following comments:

“The use of fair values, in the three yearly revaluation cycle of assets, has resulted in a higher depreciation expense in the Income Statement. Higher depreciation arising from revaluations has a negative impact on both the Operating Surplus Ratio and the Asset Sustainability Ratio.

Declining Own Source Revenue also negatively impacts on the Operating Surplus Ratio. Whilst this is a factor determining declining outcomes in the financial ratios it is not the major reason why the Shire is not meeting the industry benchmarks.

The Shire has a higher than normal percentage of depreciation to operating expenses reflected in the Income Statement (mid-thirties compared to a median of 23%). A possibility is that the depreciation rates used by the Shire are too high. If not, then the current consumption of fixed assets will cause long term financial problems in maintaining and replacing the Shire’s asset base.”

The issue of depreciation has an integral link with Council’s asset management improvement plan that identifies the need to review and record the condition, remaining useful life and residual value of all Council’s assets at major component level. Depreciation expenditure included in Council’s operating expenditure is calculated as follows:

Fair Value less Residual Value divided by Remaining Useful Life (years)

Condition assessments are critical in determining the remaining useful life of an asset. If the remaining useful life of an asset is understated this will increase the annual depreciation expense. Similarly if residual values are understated this too will increase the annual depreciation expense.

Administration have reviewed Mr Back’s comments and developed an action plan to address the issues and recommendations raised by Mr Back. This action plan is presented for the Committee’s review and endorsement.

This report was presented to the Audit Committee meeting on 12 December 2017 where the following recommendation was carried:

Committee Recommendation *Moved Cr Pratico, Seconded Cr Moore*
AC.04/1217 That the Audit Committee endorse the following Ratio Improvement Action Plan:

- *A full review of Council’s asset depreciation expenditure is undertaken. Specifically, a review of each individual Council asset (at component level) of its condition, useful life, remaining useful life and residual value.*
- *An assessment as to whether the Shire is revenue short or expenditure long by undertaking a comparison of neighbouring and similar sized Shires in relation to the level of own source revenue (i.e. rates, fees and charges) compared to expenditure.*

- *Develop a policy to guide future Council decisions in relation to the allocation of funds to renewal works versus upgrade works.*
- *That various scenarios are modelled during the next review of Council's Long Term Financial Plan in relation to achieving minimum ratio benchmarks. The results of these scenarios to be workshopped with Council.*

Carried 4/0

Statutory Environment

Section 6.4 of the Local Government Act 1995 requires a local government to prepare financial reports including an annual financial report. Regulation 50 of the Local Government (*Financial Management*) Regulations 1996 specifically requires the inclusion of seven financial ratios as developed by the Department to be included in the annual financial report. These statutory ratios are also included in Council's long term financial plan and are key sustainability measures. The Department's Integrated Planning and Reporting Advisory Standard includes benchmarks in relation to the ratios that sets minimum regulatory requirements that ensure an acceptable minimum standard of practice.

Integrated Planning

- Strategic Community Plan
 - Key Goal 5: Our leadership will be visionary, collaborative and accountable
 - Objective 5.2: We maintain high standards of governance, accountability and transparency
 - Strategy 5.2.6: Ensure the future financial sustainability of the organisation
 - Objective 5.3: We operate within the Integrated Planning Framework
 - Strategy 5.3.2: Apply best practice asset management principles
- Corporate Business Plan
 - Action 5.2.6.6: Develop a long term strategy to achieve compliance to financial ratios
- Long Term Financial Plan – The long term financial plan provides a platform to model various scenarios to ensure ongoing improvement in Council's financial performance and ensuring the Shire is sustainable into the future.
- Asset Management Plans – Asset management plans provide the key data in relation to asset condition and remaining useful life estimates that is used when calculating depreciation expenditure.
- Workforce Plan – Nil
- Other Integrated Planning - Nil

Budget Implications – Nil

Policy Implications – As part of the proposed action plan, development of a new policy is being recommended to guide future Council decisions in relation to the allocation of funds to renewal works versus upgrade works in Council's Long Term Financial Plan.

Fiscal Equity – Not Applicable

Whole of Life Accounting – Not Applicable

Social Equity – Not Applicable

Ecological Equity – Not Applicable

Cultural Equity – Not Applicable

Risk Management

Failure to meet the Department's financial ratio benchmarks will put the Council at risk of being classified as unsustainable. There is a risk to Council's reputation in the event of increased public scrutiny of its financial ratios particularly if it cannot demonstrate improvement in ratio performance over the medium to long term.

Continuous Improvement

Implementation of the actions contained within the Ratio Improvement Action Plan will aid Council in ensuring it meets the Department's financial ratio benchmarks.

Voting Requirements – Simple Majority

Council Decision Moved Cr Scallan, Seconded Cr Bookless

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Carried 8/0