SHIRE OF BRIGETOWN-GREENBUSHES

REPORT ON SIGNIFICANT ADVERSE TREND

DECEMBER 2019

1. Background

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

The Shire's 2018/19 audit report was received from the Auditor General on 22 November 2019 and is attached at appendix 1 of this document.

A key audit requirement requires the auditor to identify any financial trends which it considers adverse and of concern. For the 30 June 2019 year, the Auditor General has identified a significant adverse trend in relation to the financial position of the Shire. The Shire of Bridgetown-Greenbushes has not met the minimum standard as set by the Department of Local Government, Sport and Cultural Industries (the Department) for the Operating Surplus Ratio for the last three financial years.

Section 7.12A(4) of the Local Government Act 1995 requires that a local government must:

"(a) 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 those 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."

Section 7.12A(5) further requires that:

"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."

2. 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 the future, having regard to asset management and the community's service level needs, then it is considered financially sustainable.

The ratio is calculated using the following equation:

$$\frac{\text{Operating revenue minus operating expense}}{\text{Own source operating revenue}}$$

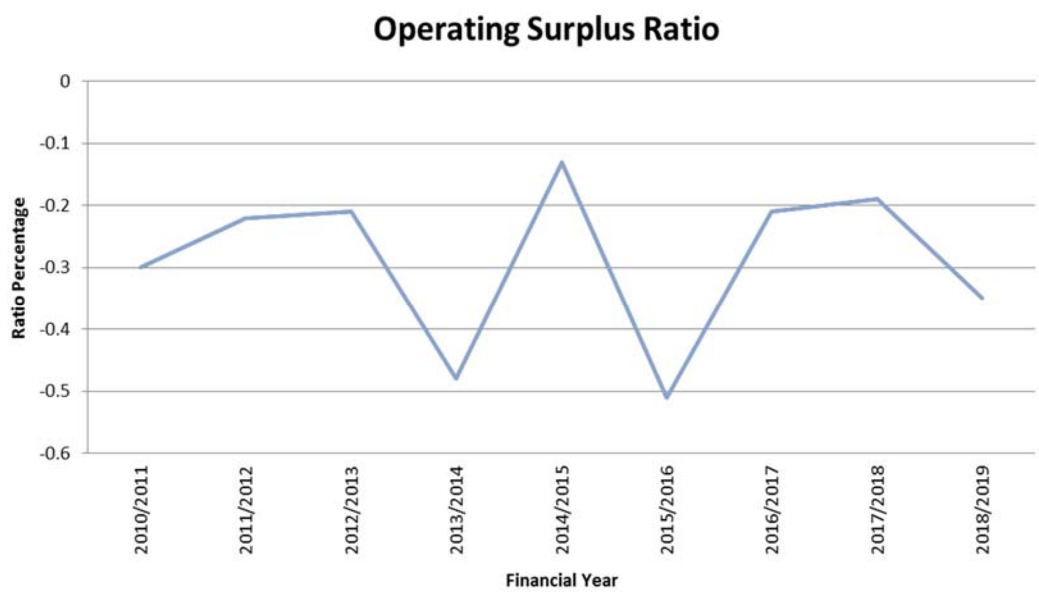
A positive ratio indicates the percentage of total own source revenue available to help fund proposed capital expenditure, transfer to cash reserves or to reduce debt. When the ratio starts to drift into negative territory it indicates a deficit and higher risk.

The Department's minimum benchmarks for this ratio are as follows:

Advanced Standard – 15% or greater
A ratio of greater than 15% indicates the Shire is providing a strong operating surplus which will give flexibility in the future in relation to operational service levels and asset base.
Basic Standard – between 1% and 15%
Basic Standard is met if the operating surplus ratio is between 0% and 15%.
Below Standard – 0% or less

The operating surplus ratio calculation excludes grants received to assist with capital works but includes depreciation expense. It has long been argued by the local government sector that these grants are an integral component of revenue for local government and long term financial plans are predicted on receiving these funds. Removing this key source of 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 the Shire of Bridgetown-Greenbushes to have an operating surplus ratio that does not meet the minimum requirements. This result reflects a reliance on sources of funding other than Council's own source funds such as rates, 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, such as:

- The timing of operating grant funds being received in one financial year and expenditure being incurred in another e.g. pre-payment of the Federal Government Financial Assistance Grants.

- One off operating projects when the expenditure allocation has been carried over to the next financial year in part or in full.
- 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 cost centres, including employment costs, materials and contracts however this will almost certainly adversely impact the level of service which Council is able to deliver to the community.

The current ratio benchmarks adopted by the Department is a “one size fits all” approach. It is understood that the majority of rural local governments have not had an Operating Surplus Ratio that met the standards set by the Department, and there has been an indication by the Auditor General that this benchmark may need review.

The issue of adverse ratios was discussed at the Local Government Financial Professional’s workshop held on the 23rd August 2019 at the City of Kwinana. At this workshop the Department representative in attendance acknowledged the issue required reviewing and advised that a consultation process had commenced with the West Australian Local Government Association (WALGA) and Local Government Professionals Australia WA. The outcomes of these consultations are still pending.

3. Conclusion

The Operating Surplus Ratio requires Council to ensure that its own revenue sources grow at the same or a greater rate than its operating expenses, including depreciation. It is well known that most country local governments struggle to fully fund asset depreciation via its own revenue sources and there is a reliance on grant funding such as Regional Road Group and Roads to Recovery to assist with asset renewal expenditure.

Council is very aware of its ratio performance in relation to benchmarks set by the Department. In December 2017 Council adopted 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.*

Items contained in the above plan are still being progressed and it has previously been acknowledged by Council and its Auditor that improving the Operating Surplus Ratio to meet the Department's benchmark is unlikely to occur in the short to medium term but Council should still demonstrate improvement towards achieving the benchmark through its integrated planning processes.

Council will shortly be undertaking the annual review of its Long Term Financial Plan and will again discuss strategies to improve this ratio. It is quite possible however, that the Operating Surplus Ratio will remain at levels below the "standard", due to cost pressures and limited revenue sources.

The requirement to produce this report as an outcome of an identified adverse trend is likely, at least in the short term, to be an annual process for the Shire of Bridgetown-Greenbushes.