



Our Ref: 305.00
Enquiries: Dianne Raymond

18th February 2020

Hon David A Templeman
Minister for Local Government Heritage and the Arts
Department of Local Government, Sport and Cultural Industries
7th Floor, Dumas House
2 Havelock Street
WEST PERTH WA 6005

Dear Mr Templeman,

SIGNIFICANT ADVERSE TREND-OPERATING SURPLUS RATIO

Please find attached the Shire of Chapman Valley report in relation to the independent audit report item raised as a significant matter.

Yours faithfully,

Maurice Battilana
CHIEF EXECUTIVE OFFICER

Emailed: Minister.Templeman@dpc.wa.gov.au



Shire of Chapman Valley

Independent Audit Report Items Raised as Significant Matters – Significant Adverse Trend Operating Surplus Ratio

REPORT

Section 7.12A(4)(a) of the *Local Government Act 1995*

Purpose of Report

The purpose of this report is to address the matter from the Independent Auditors Report for a significant adverse trend in the financial position for the Operating Surplus Ratio which was raised as a matter of significance.

The following is required under legislation for all matters identified as significant in accordance with Section 7.12A(4):

7.12A. *Duties of local government with respect to audits*

(4) *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.*

Significant Matter Identified by Independent Auditors Moore Stephens

The Operating Surplus Ratio has been below the Department of Local Government, Sport and Cultural Industries standard for all three years reported in the annual financial report (as per extract below):

MOORE STEPHENS

INDEPENDENT AUDITOR'S REPORT
TO THE COUNCILLORS OF
THE SHIRE OF CHAPMAN VALLEY (CONTINUED)

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

In accordance with the Local Government (Audit) Regulations 1996, we also report that:

- a) In our opinion, the following matters indicate a significant adverse trend in the financial position of the Shire:
 - i. The Operating Surplus Ratio has been below the DLGSCI standard for all 3 years reported in the annual financial report.
- b) All required information and explanations were obtained by us.
- c) All audit procedures were satisfactorily completed in conducting our audit.
- d) In our opinion, the asset consumption ratio and the asset renewal funding ratio included in the annual financial report were supported by verifiable information and reasonable assumptions.

Implication

There is a reputational implication in the public and wider community of the local government being unsustainable and performing poorly. LGA Audits are a public document and with the current flawed ratio formulas the results we are sending out an untrue and poor reflection of how the LGA is financially tracking, which only adds to the angst within the community. The other issue is the ratios are used to calculate a LGAs Financial Health Index, which is placed on the My Council Website and adds to the community and media impacts on LGAs operations.

Management Comment

While it is acknowledged this ratio is a negative value, it must also be acknowledged the Shire, as with many other of similar size and nature, is heavily reliant on the grant funding to sustain its expenditure year to year (roadworks in particular)_and would be difficult to achieve huge improvement to this ratio without increased rate revenue adversely impacting ratepayers. Rate increases have been kept consistent with the Long-Term Financial Plan with adopted increases over the past five years. These have averaged 4.98% from 2015/2016 to 2019/2020.

Clearly fundamental change to the reporting guidelines around local government sustainability using this ratio is required. Without such change all small local governments will remain affected due to reliance on grant funding for which yearly road programs are a large component.

Action Taken or Intended to be Taken

In order to address this adverse trend, the Shire will continue to monitor its operating revenue and expenditure and attempt to reduce the ratio over time. It is not however feasible to increase rate revenue substantially to improve this figure; nor is the revenue raised from fees and charges significant enough to impact this ratio.

Action to be taken comes from the December 2019 ordinary meeting of council resolution below:

MOVED: CR FORTH

SECONDED: CR ROYCE

- 1. The Management Report for year ending 30 June 2019 be received and it be noted there are no further actions required from the report.*
- 2. The Financial Audit Report for the year ending 30 June 2019 be received, which identifies the Operating Surplus Ratio being reported as a significant adverse trend being dealt with in accordance with legislation.*

The content of the report to the Minister include the following Council position:

- a) The Operating Surplus Ratio will continue to be monitored in conjunction with all other Ratios;*

- b) *The formula to calculate the Operating Surplus Ratio is considered flawed as it currently does not incorporate Financial Assistant Grants, which Council believe must be considered as Own Source Revenue to provide services.*
3. *Council endorse:*
- a. *The inclusion of an independent, external member with the relative knowledge in financial reporting and audits; and*
- b. *The Chief Executive Officer to determine an appropriate person to fill the role and advise Council accordingly, with an invitation to be formally extended to Mr. Grant Middleton, Deputy Chief Executive Officer, Shire of Northampton in the first instance.*
4. *Council approach the Western Australian Local Government Association requesting an industry review on how all financial ratios are reported, specifically the Operating Surplus Ratio.*

**Voting 7/0
CARRIED
Minute Reference: 12/19-5**

The Chief Executive Officer has dispatched an email to WALGA 20th December 2019 a copy of which is presented below along with WALGA response.

-----Original Message-----

From: Nick Sloan <NSloan@walga.asn.au>
Sent: Friday, 20 December 2019 6:46 PM
To: Maurice Battilana <ceo@chapmanvalley.wa.gov.au>
Cc: James McGovern <JMcGovern@walga.asn.au>
Subject: Re: Financial Ratios

Hi Maurice

I understand your concerns, we've done quite a bit of work on this. We took the decision to defer the item to the most recent State Council meeting concerning the ratios. The intent is to undertake more consultation and workshop a more appropriate set of ratios for consideration by state Govt. The Auditor General is well aware of our concerns and is willing to work with us on this.

James will touch base next week to ensure your specific concerns and views are captured.

Nick

On 20 Dec 2019, at 3:34 pm, Maurice Battilana <ceo@chapmanvalley.wa.gov.au> wrote:

From: Maurice Battilana
Sent: Friday, 20 December 2019 3:34 PM
To: Nick Sloan (nsloan@walga.asn.au) <nsloan@walga.asn.au>
Subject: Financial Ratios

Hi Nick

Like many other local governments, specifically those in the rural and remote areas of the State, the issue of not meeting the Department of Local Government's desired levels for the various Financial Ratios has been highlighted in this Shire's Annual Audit.

The ratio of specific concern to us is the Operating Revenue Ratio. However, we also have concerns with the Debt Service Cover Ratio, which is significantly affected by the periodical Infrastructure Asset Revaluation and the depreciation rates linked to these revaluations.

The feeling is all the relevant ratios should incorporate grant revenue when required. The removal of the FAG (and Direct Road Grants) is not appropriate. FAGS must be considered an as-of-right revenue source for the local government to provide services to its constituents. The concept of an LGA being grant reliant is refuted

strongly by those of us who are required to provide services from our own resource revenue only. This is not reflected with the funding the State & Commonwealth provide Departments under their control for them to provide services (e.g. Health, Education, Main Roads, Agriculture, Police, Environments, etc. etc.). If the government funding was taken away from the State & Commonwealth Departments and they were asked to provide services from their own resources then they simply could not provide these services. Why should local government authorities be treated any differently?

If you follow the Grants Commission methodology on what grants are required to provide a minimum service to constituents in local governments then you will notice we are provided funding far less than the minimum funds required for such services. This even after the rating capacity of an LGA is taken into account.

The ratios are distorted if grant funds (FAGS in particular which should be re-badged as “As-Of-Right Service Delivery Revenue” and not “Grants”) are not considered own resource revenue.

My dialogue with the DLGC simply adds to the confusion as they do not appear to have a clear understanding of how current ratio formulas are distorted and do not portray the real operating position of a local government authority. This is evident with the Auditors disagreeing with the DLGC interpretation of how grants are to be dealt with when calculating ratios. With the fact of life being the Auditors have the final say until the DLGC clarifies the situation with them and LGAs.

Below is an extract from the DLG LG Operational Guidelines No 18 – Financial Ratio (from DLG Website) where it clearly stated the LG Operating Revenue does not include Grants (i.e. FAGS) which contrary to a response I received from the DLGC when I sought clarification on the formula.

Debt Service Cover Ratio	
Debt Service Cover Ratio =	$\frac{\text{Annual Operating Surplus BEFORE Interest and Depreciation}}{\text{Principal and Interest}}$
Purpose:	This ratio is the measurement of a local government’s ability to repay its debt including lease payments. The higher the ratio is, the easier it is for a local government to obtain a loan.
Standards	A Basic standard is achieved if the ratio is greater than or equal to two. An Advanced standard is achieved if the ratio is greater than five.
Definitions:	
‘Annual Operating Surplus Before Interest and Depreciation’	Means operating revenue minus net operating expense.
‘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.
‘Net Operating Expense’	Means operating expense excluding interest and depreciation.
‘Interest’	Means interest expense for moneys borrowed, credit obtained or financial accommodation arranged under section 6.20 of the Act.
‘Depreciation’	Has the meaning given in the AAS.
‘Principal and Interest’	Means all principal and interest for moneys borrowed, credit obtained or financial accommodation arranged under section 6.20 of the Act.

Own Source Revenue Coverage Ratio

Own Source Revenue Coverage Ratio =

$$\frac{\text{Own Source Operating Revenue}}{\text{Operating Expense}}$$

Purpose: This ratio is the measurement of a local government's ability to cover its costs through its own revenue efforts. Different standards have been established to recognise the varying revenue raising capacities across the sector, where some rural and remote local governments have limited rate bases and revenue raising capacity, whereas others such as major metropolitan and regional local governments have significant rate bases and other own source revenues.

Standards A **Basic** standard is achieved if the ratio is between 40% and 60% (or 0.4 and 0.6).
An **Intermediate** standard is achieved if the ratio is between 60% and 90% (or 0.6 and 0.9).
An **Advanced** standard is achieved if the ratio is greater than 90% (or > 0.9).

Definitions:

'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.

'Operating Expense'

Means the expense that is operating expense for the purposes of the AAS.

***Note:** Typically local governments disclose, in their annual financial statements, a nature or type classification described as 'Reimbursements and Recoveries, Contributions and Donations' (or similar). In order to calculate the value of own source revenue, it is essential that reimbursements and recoveries are disclosed separately from contributions and donations. This can be by way of note.

Operating Surplus Ratio	
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.

***Note:** Typically local governments disclose in their annual financial statements, a nature or type classification described as 'Reimbursements and Recoveries, Contributions and Donations' (or similar). In order to calculate the value of own source revenue, it is essential that reimbursements and recoveries are disclosed separately from contributions and donations. This can be by way of note.

The concern is the LGA Audits are a public documents (which is rightly so) and with the current flawed ratio formulas the results we are sending out an untrue and very poor reflection of how the LGA is financially tracking, which only adds to the angst within the community. The other issue is the ratios are used to calculate a LGAs Financial Health Index, which is placed on the My Council Website and adds to the community and media frenzy on LGAs operations.

Council is requesting WALGA address this anomaly with the DLGC and the Minister as a matter of urgency.

I look forward to your response.

Maurice Battilana | CHIEF EXECUTIVE OFFICER



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Completion or Proposed Completion Date

As per the council resolution monitoring will continue until such time this ratio formula is no longer required.

Recommendation

We will continue to address our financial performance to ensure we are financially sustainable while addressing asset management and the community service level requirements. However, the current calculation model implemented by the Department doesn't provide a true reflection of the financial performance of local government entities which receive a large component of their revenue in the form of Financial Assistance Grants.

As the Minister for Local Government, Sport and Cultural Industries we recommend you initiate

Departmental staff to review the ratio and consider reinstating Financial Assistance Grant revenue and other integral grant revenue components as own source revenue as soon as possible.