

**SHIRE OF MUKINBUDIN
2018-2019 ANNUAL FINANCIAL STATEMENTS
SIGNIFICANT ADVERSE TREND**

Summary

The 2018-2019 Independent Auditor's Report has identified a significant adverse trend in the financial position of the shire.

This significant adverse trend is that the Operating Surplus ratio as it has been below the Department of Local Government, Sport and Cultural Industries (DLGSCI) standard for that ratio for past 3 years as reported in the financial report.

The DLGSCI standard for the Operating Surplus Ratio is 0.01 or greater. The Shire Of Mukinbudin's Operating Surplus Ratio for the last 4 years has been:

- 2016 – (0.09)
- 2017 – (0.05)
- 2018 – (0.77)
- 2019 – (0.30)

Figures in () are negative.

Despite this significant adverse trend the Shire of Mukinbudin Audit Concluding Memorandum dated 2 December 2019 states:

“Based on the audit evidence obtained up to the date of our auditor's report, we are not aware of material uncertainty exists related to events or conditions that may cast significant doubt on the Shire's ability to continue as a going concern.”

Council and management have reviewed the Operating Surplus Ratio and the factors determining this.

It has been concluded that although some improvement occurred in 2018-2019 with the limited ratepayer base it will not be possible to achieve the minimum standard without significant additional untied external funding.

Operating Surplus Ratio

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

For this ratio to become positive, rather than negative, as it is now, it is necessary for Operating Revenue to exceed Operating Expense.

Operating Revenue

“Operating Revenue” excludes grants and contributions for the development or acquisition of assets.

Operating revenue includes rates, fees & charges and operating grants. The only income the council can control is rates, fees and charges. Based on the audited 2018-2019 figures to correct the situation:

- a) All rates, fees and charges would have to increase by over 34%
- or
- b) Rates would have to increase over 48%.

Increases of this magnitude are clearly unacceptable and unaffordable to the ratepayers and council’s customers.

The only practical way that this ratio could be become positive through an increase in income in the foreseeable future would be if the untied operational grants were increased by at least 30%.

Operating Expense

A major component of Council’s Operating Expense is depreciation, this makes up almost 38% of councils operating expenditure and this is largely beyond council’s control and subject to significant changes from year to year.

Another 7.5% is spent on essential road maintenance.

If a reduction in operating expenses alone is made in order to meet the essential target for the Operating Surplus Ratio the reduction in operating expenditure would need to be approximately \$550,000. This could not be achieved without impacting on Council’s ability to meet its essential responsibilities and legal compliance obligations.

Own Source Operating Revenue

Own Source Operating Revenue is revenue from rates and service charges, fees and user charges, reimbursements and recoveries, interest income and profit on disposal of assets. This is the only component of the ratio that is subject to significant Council control.

Changes in this figure will change the magnitude of the ratio however to it is essential that Operating Revenue exceed Operating Expense for the Operating Surplus Ratio meet the DLGSCI minimum standard of 0.01.

Final Approach

The following alternatives have been considered:

- a) A publicly unacceptable fees and charges and/or rates increase.
- and/or
- b) An unworkable decrease in service and compliance levels to reduce operating expenditure.
- or
- c) Accepting that the in the foreseeable future Operating Surplus Ratio will be reported as having a significant adverse trend.

After considering these options it is considered that the best way council can serve its community and visitors is to accept that in the foreseeable future Operating Surplus Ratio will be reported as having a significant adverse trend.

Additional Information and Future Considerations

Historical and Background Information

On 28 October 2017 the Local Government Act 1995 Section 7.12A paragraphs 3 to 5 inclusive were amended to include the following requirements:

- i. A local government must prepare a report addressing any matters identified as significant by the auditor.
- ii. Give a copy of that report to the Minister within 3 months after the audit report is received by the local government.
- iii. Within 14 days after a local government gives a report copy to the Minister

These changes were first implemented for the 2017-2018 financial year and ratios were measured against the Department of Local Government, Sport and Cultural Industries (DLGSCI) standard.

In the 2017-2018 financial year a significant adverse trend was reported as the Asset Sustainability and Operating Surplus ratios had been below the DLGSCI standard for those ratios for past 3 years as reported in the financial report.

Ratios can be measured relative to the minimum DLGSCI standard or the minimum OAG standard. The standards are sometimes different as shown below.

Ratio	DLGSCI Standard	OAG Standard
Current Ratio	1.00	1.00
Asset Consumption Ratio	0.50	0.45
Asset Renewal Funding Ratio	0.75	0.60
Asset Sustainability Ratio	0.90	0.80
Debt Service Cover Ratio *	2.00	1.90
Operating Surplus Ratio	0.01	0.00
Own Source Revenue Coverage Ratio	0.40	0.35

Source; Moore Stephens - *Short Guide to Financial Ratios May 2019*

* The Treasury Cooperation’s minimum guideline for the Debt Service Cover Ratio is 3.00.

At 30 June 2019 the minimum OAG Standard was used to determine if a “significant adverse trend” exists. Ratios below the DLGSCI standard but meeting the OAG standard will be considered adverse but not “significant”.

However whenever and ratio meets the requirements to be reported as having a “significant adverse trend” it will be reported in reference to the DLGSCI standard.

Asset Sustainability Ratio

$$\text{Asset Sustainability Ratio} = \frac{\text{Capital Renewal and Replacement Expenditure}}{\text{Depreciation}}$$

The Shire Of Mukinbudin's Asset Sustainability Ratio for the last 4 years has been:

- 2016 – 0.81
- 2017 – 0.58
- 2018 – 0.78
- 2019 – 1.01

As expected the Asset Sustainability Ratio improved and for 2018-2019 was 1.01. This improvement was largely the result of infrastructure revaluations at the end of 2017-2018 that reduced depreciation in the 2018-2019 financial year by \$155K. As a result in 2018-2019 the Asset Sustainability Ratio is not considered to be an indicator of a significant adverse trend in 2018-2019.

However the the Asset Sustainability Ratio is expected to decrease in 2019-2020 and again the following year due to new building construction and new plant and an associated increase in depreciation. As a result it may not be possible to maintain the OAG minimum standard of 0.80 with the limited rate base and a reliance on external funding beyond councils control.

Operating Surplus Ratio

The 2018-2019 Independent Audit Report again identified a significant adverse trend in the financial position of the shire with respect to the Operating Surplus Ratio despite an improvement from (0.77) to (0.30).

Like the Asset Sustainability Ratio Operating Surplus Ratio the is expected to decrease in 2019-2020 and again the following year due to new building construction and new plant and an associated increase in depreciation which will increase the overall operating expense and decrease the ratio.

The Ratio Operating Surplus Ratio unlikely to meet the OAG standard in the foreseeable future.

The Future

Although the Shire of Mukinbudin has control over rates and fees charged and most cash expenses incurred there are practical limits imposed in making Mukinbudin an affordable and friendly place to live whilst maintaining service levels to the community.

Other factors beyond the Shire of Mukinbudin's control can play a much more significant part in determining ratios. The most significant items are:

- Depreciation – This will change due to revaluations and changes in accounting standards.
- External grants – These may change in value or timing. Over the recent years a significant proportion of our operating grants have been prepaid. Should this not occur it would have a very significant adverse impact on the on the ratios in that year.

Although there limitations in what the Shire of Mukinbudin can do an optimum outcome can be achieved for the Mukinbudin community by:

- Implementing rate rises as per the LTFP including the correction between GRV and UV and have no rate increases less than the LTFP.
- Monitoring service levels to ensure they are not higher than required.
- Monitoring and reviewing the implemented depreciation rates so that they accurately effect the decrease in value of each asset.

Conclusion

Although the Operating Surplus Ratio is, and will almost certainly continue to be, below the OAG standard it is not currently a significant concern.

In foreseeable future Operating Surplus Ratio will be reported as having a significant adverse trend.