REPORT IN RESPONSE TO A MATTER IDENTIFIED AS SIGNIFICANT BY THE AUDITOR

REFERENCE: D2019/04650

PURPOSE OF REPORT

The purpose of this report is for the Eastern Metropolitan Regional Council's to provide a response to a matter identified as significant by the auditor.

BACKGROUND

As required by the *Local Government Act 1995 - Section 7.12A (4) and (5)* the following report is provided in response to a matter identified as significant by the auditor in the Independent Auditors Report (IAR) for the 2017/2018 Annual Financial Report relating to the Eastern Metropolitan Regional Council (EMRC).
In 2017/2018, the EMRC joined the first tranche of local governments to be audited by the Office of the Auditor General (OAG) and was in fact the first in which its audit report had been finalised by the OAG.

LOCAL GOVERNMENT REPORTING REQUIREMENTS

Regulation 50 of the *Local Government (Financial Management) Regulations 1996* states;

> *Financial ratios to be included in annual financial report*
>
> *(1) The annual financial report is to include, for the financial year covered by the annual financial report and the 2 preceding financial years –*
> - *(a) the current ratio; and*
> - *(b) the asset consumption ratio; and*
> - *(c) the asset renewal funding ration; and*
> - *(d) the asset sustainability ratio; and*
> - *(e) the debt service cover ratio; and*
> - *(f) the operating surplus ratio; and*
> - *(g) the own source revenue coverage ratio.*

ASSET SUSTAINABILITY RATIO (ASR)

The ASR calculation is based on:

$$\frac{\text{Capital Renewal and Replacement Expenditure}}{\text{Depreciation Expense}}$$

This ratio indicates whether Council is replacing or renewing existing non-financial assets at the same rate that its overall asset stock is wearing out.

IMPACT OF THE ASR ON THE EMRC

The OAG's IAR for the 2017/2018 Annual Financial Report has taken a strict interpretation of the standard benchmark for the Asset Sustainability Ratio (ASR) set by the then Department of Local Government and consequently reported under the heading "*Report on Other Legal and Regulatory Requirements*" that:

> *"In accordance with the Local Government (Audit) Regulations 1996 I report that:*
>
> (i) *In my opinion, the following material matter indicates significant adverse trends in the financial position or the financial management practices of the Council:*
>
> *a. The Asset Sustainability Ratio has been below the Department of Local Government, Sport and Cultural Industries standard for the last three years…."*

IMPACT OF THE ASR ON THE EMRC *(Continued)*

This was based on the interpretation provided by the Department where the ASR is below the 0.90 threshold:

> *"….indicates the local government is having difficulty undertaking a substantial capital investment program sufficient to renew/replace assets while also negating the effects of inflation on purchasing power over time."*

The EMRC has been compliant with the reporting requirements with regards to the ASR since its introduction, of which only one year was it above the benchmark set at between 0.90 to 1.10. In all other years, the ratio has been below the threshold of 0.90 including a 0.06. While the presentation of the ASR in successive annual financial reports has been audited previously, the previous external auditor had recognised the limitations of this ratio and its impracticality to apply that threshold set to the EMRC due to the nature of its operations. Consequently the EMRC has not received any adverse finding in any of its IAR prior to the 2017/2018 financial year.

Consistent with the application of AASB 101 para 19, the EMRC believed that the compliance with the requirement to report on the ASR would be so misleading that it would conflict with the objective of the financial statements.

It was recommended by the OAG that the EMRC seek an exemption from the Department from being subject to the ASR in its annual financial report.

Accordingly, the EMRC sought an exemption from Regulation 50 of the *Local Government (Financial Management) Regulations 1996* in respect of the requirement to report on the ASR in the Annual Financial Report on the basis that reporting it will provide a misleading interpretation by the user of the annual financial report.

A response was received by the EMRC on 20 December 2018 from Michael Connolly, Acting Director General, Department of Local Government, Sport and Cultural Industries, advising the Department was unable to grant the EMRC's request for exemption from being required to report on the ASR in the Annual Financial Report as the *Local Government Act 1995* and associated regulations do not provide any statutory power to exempt a local government from complying with Regulation 50.

FLAWS OF THE ASR

The EMRC is of the opinion that the ASR is flawed in that:

1. The numerator only includes the capital expenditure for replacements and not for new projects or new assets. It also does not include the capital expenditure for the construction of new waste disposal cells which is the major capital expenditure for the EMRC to replace its assets. The numerator does not include any operating expenditure such as maintenance costs for those assets which may enhance the useful life of assets.
2. Depreciation costs are now also influenced by valuation principles required under the accounting standards. Revaluations have generally resulted in an increase in the valuation of a number of significant plant assets resulting in higher depreciation expenditures associated with those assets in subsequent years following the revaluation. This is especially so as the EMRC, through its maintenance program is able to lengthen the useful life over the prescribed normal operating life.
3. Depreciation included in the ASR includes all capital assets and not just capital assets subject to replacements. This higher value in the denominator compounds the lower value of the resultant ASR.

The ASR indicates whether Council is replacing or renewing existing non-financial assets at the same rate that its overall asset stock is wearing out. This assumes that the capital asset spend for the year equates near the same level of depreciation of its capital assets.

LIMITATION OF THE ASR ON THE EMRC

(i) *Impracticality of the application of the ASR*

The EMRC is a regional local government and is unlike the traditional ratepayer-based local governments with which the ASR can be more appropriately applied to. The EMRC does not have traditional building assets like town halls, libraries or recreational facilities in its assets, nor does it have a range of infrastructure assets such as roads, footpaths and drainage works to the extent that a traditional local council would have. The EMRC has depreciable assets such as office buildings, plant and equipment and waste disposal cells for waste management purposes.

The bulk of the EMRC's capital expenditure is budgeted to be spent on new resource recovery projects, new plant and equipment as it continues to deliver on positive outcomes and new initiatives for its member Councils and the region. Additionally, as outlined above, the ASR does not take into account the revaluation of the assets as prescribed by the Accounting Standards (eg AASB116) nor having regard to the maintenance (operating costs) of those assets.

The EMRC employs in-house mechanics to undertake on-going maintenance and repairs to its plant assets which in turn results in an extended useful life of the plant. If assets are well maintained, they will increase in value through the revaluation of those assets which result in an increase in depreciation expenses (ASR denominator) which in turn will decrease the ASR figure.

(ii) *The EMRC experience with the ASR*

As a result of significant "new" capital expenditure undertaken by the EMRC and the relatively low requirement for annual replacement of assets and the consequential high level of depreciation, the EMRC finds itself in a position of being below the asset sustainability ratio of 0.90 most years.

Each year most "renewal/replacement" assets include the replacement of vehicles, minor plant and equipment and on occasion when due for changeover a piece of significant plant. However, the value of this expenditure (average of $875k per annum) is unlikely to attain 0.90 or 90% of the value of the annual depreciation (average of $3m per annual). The only time that the ratio of 0.90 will be attained will be in the years where the EMRC's major items of plant (ie: 2 x waste compactors valued at approximately $1.5m each) are changed over.

The other major item of capital expenditure undertaken by the EMRC which is not included in any of the values outlined above is the construction of new waste disposal cells (at an estimated value of $5.0m each) and the subsequent amortisation of the cell over a 1½ - 2 year period. Although the cell can be construed as a "replacement" cell to the previous cell that was being utilised it is not defined as a "replacement" asset for the purposes of the ASR but more so a "new" asset.

As a result, in the current format and definition, the ASR as it applies to the EMRC will be lower.

(iii) *Dysfunctional Interpretation Using the ASR*

One of the pitfalls of strictly interpreting the ASR under the current definitions is the potential of missed opportunities to generate savings and may result in making uneconomical decisions.

For example, a review of whether to replace the existing waste compactors or overhauling and extending its useful life would arrive at different conclusions using a Net Present Value (NPV) analysis or an ASR basis.

By overhauling, the asset can be redeployed at a significant cost savings, extending its useful life. However, this would reduce the recorded replacement cost and as a result would create a lower ASR figure (due to a lower spend as defined in the numerator of the ASR) when compared to replacing waste compactor at a full new replacement cost.

Another example is its application for fleet vehicles. The ASR assumes the current asset base with which the depreciation expenditure is appropriate and not subject to downsizing. Over the past few years, the EMRC has done away with the legacy and traditional use of local government issued vehicles, especially vehicle entitlements under individual employment contracts. While it makes good management decision to reduce the capital cost of the fleet vehicles, a rigid application of the ASR would suggest otherwise and result in "poor decision making".

LIMITATION OF THE ASR ON THE EMRC (Continued)

(iv) *Implications for Audit*

The EMRC takes its responsibility as custodians of its assets and the financial management practices for these assets very seriously. The adverse finding in the 2017/2018 annual financial report is flawed and unfortunate, and reflects poorly on good governance principles in general and on the EMRC specifically. The ASR in the case of the EMRC does not reflect an adverse trend; rather it demonstrates a vigilant effort by the EMRC in effective assets and best practice financial management.

Worryingly, if the EMRC is subject to continuing to report on the ASR, the EMRC is extremely unlikely to achieve the ASR standard under its current definition and application set for what is more appropriate for regular local governments. As the OAG takes a strict interpretation of the standard set by the Department and with the EMRC continuing to be subject to a flawed ASR standard, it will only result in continual adverse audit findings which is neither warranted nor appropriate.

Hence, the “one size fits all” approach of the ASR has its limitations in its practicality in general and specifically to apply to regional local governments with its different asset portfolio mix. The ASR is not robust to also consider the appropriateness and quality of the maintenance program applicable to different organisations.

NEXT STEP AS APPLICABLE TO THE EMRC

For the reasons as outlined above, the EMRC will be unable to meet the existing requirements of the reporting regime. The EMRC acknowledges the importance of the ASR; however, its practicality to be applied to the EMRC’s operations is severely limited and misleading.

The EMRC will continue to invest in asset replacement and/or refurbishment where it is economically viable, not only in the short term, but also the long term.

WENDY HARRIS
Acting Chief Executive Officer

29 March 2019