Luka Group
ACCOUNTANTS & ADVISORS

10 August 2014

General Manager
Warrumbungle Shire Council
PO Box 191
COONABARABRAN NSW 2357

Dear Steve,

RE: SECOND INTERNAL AUDIT VISIT – YEAR ENDING 30 JUNE 2014

We advise that we have completed our financial status review of Warrumbungle Shire Council for the year ended 30 June 2014 as part of Council's internal audit program.

Scope of Internal Audit

The aim of this review was to provide a report on the financial status of Warrumbungle Shire Council based on the review of eight (8) years of historical performance, current financial position and the future nine (9) years which form part of the Long Term Financial Plan. The review would also encompass the infrastructure backlog of Council, possible alternative sources of revenue and cost savings, and a comparison report against the other five Councils within the internal audit alliance.

Please find attached our report for your consideration in due course.

If you have any queries do not hesitate to contact me.

Yours faithfully
LUKA GROUP

Per:

JEFF SHANKS
PARTNER

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FINANCIAL REVIEW

WARRUMBUNGLE SHIRE COUNCIL
JULY 2014

Luka Group
ACCOUNTANTS & ADVISORS

FINANCIAL REVIEW

WARRUMBUNGLE SHIRE COUNCIL
JUNE 2014

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1. Scope

The aim of this review was to provide a report on the financial status of Warrumbungle Shire Council based on the review of eight (8) years of historical performance, current financial position and the future nine (9) years which form part of the Long Term Financial Plan. The review would also encompass the infrastructure backlog of Council, possible alternative sources of revenue and cost savings, and a comparison report against the other five Councils within the internal audit alliance.

Warrumbungle Shire Council commenced in 2006 (prior to this Coolah and Coonabarabran amalgamated to form Warrumbungle Shire Council) and its Long Term Financial Plan runs from 2012/13 to 2021/22 unlike other Councils with 2012/13 to 2022/23 plans. Therefore, we are limited to a review of eight (8) years of historical performance rather than ten (10) and nine (9) years of future Long Term Financial Plan.

We will examine these areas on the basis of a whole of Council operations perspective.

This report has examined:

1. A seventeen (17) year period being the past eight (8) years of audited financial statements and the next budgeted nine (9) years from the Long Term Financial Plan covering the years from 2006 to 2022.

2. Council's financial performance to budget over the past eight (8) years.

3. Financial ratio analysis using the ratios prescribed in the Update 22 of the Local Government Code of Accounting Practice and Financial Reporting.

4. Council's infrastructure backlog as reported in Special Schedule 7 of the financial statements.

5. Alternate sources of revenue and potential cost saving opportunities for Council.

6. Comparison of Council's financial ratios to the other five Councils which form part of the internal audit alliance.

In preparing this report, we have utilised:

- The past eight (8) years of Councils audited financial statements from 2006 to 2013;
- The Long Term Financial Plan 2012/13 to 2021/22 of Council;
- Asset Management Plan 2011/12 to 2021/22;
- The March 2013 TCorp Financial Assessment and Benchmarking Report of Council;
- Update 22 of the Local Government Code of Accounting Practice and Financial Reporting; and
- Discussions with key financial and engineering staff of Council.

2. Executive Summary – Luka Group Perspective

The review of Council's operations from a past and future perspective, analysing ratios, infrastructure backlogs, alternative sources of revenue and cost savings has been an interesting and worthwhile process. While each Council is unique, fundamentally they all face the same challenges.

2.1 General Observations

- Council was in a satisfactory financial position in 2013 with improving ratios and a strengthening cash position when compared to the past. The TCorp review reported that Council was in a weak financial position based on the Long Term Financial Plan. While Council has amended and improved its financial position in the Long Term Financial Plan, Council's future position will still be considered weak.

- Council's income has been increasing at an average of 5.7% per annum over the past 8 years from 2006 to 2013. Conversely, expenditure has been increasing at 7.3% per annum over the same period. Council has had 3 surpluses in the past 8 years. The average result over the past 8 years has been a small surplus of $5,000.

- Council's Long Term Financial Plan from 2014 to 2022 is very detailed, but conservative in terms of growth. Income is projected to increase at 2.5% per annum, while expenditure is forecast to increase at 2.6% per annum. Both growth rates are well below the trends of the past 8 years.

- There have been no special rate variations for the past 8 years. A rates variation would significantly improve the Council's ability to maintain its infrastructure assets and sustain the current level of services provided by the Council.

- From 2014 to 2022, Council has budgeted for 9 straight years of large deficits ranging from $2 million to $4 million. Council should be aim to have balanced budgets to allow Council to "live within its means". History suggests that Council will perform better than budget, but it may not be enough to reduce the deficits to a surplus position.

- The overall cash position of Council has decreased slightly from $18,411,000 in 2006 to $16,931,000 in 2013. By 2022, Council has budgeted to have $12,871,000 in cash assets. The unrestricted current ratio was 4.04:1 in 2013 but is budgeted to fall to 0.75:1 by 2022. While the overall cash position is not budgeted to weaken significantly, the position of general fund deteriorates while water and sewerage fund strengthen, resulting in the decrease in the unrestricted current ratio.

- In 2013, Council had borrowings of $5,298,000 and as part of its Long Term Financial Plan has indicated further borrowings of $3,100,000. Based on its budgets, in the short term Council will have limited capacity to borrow further. However, this is budgeted to improve in the medium to long term as the loans are repaid.

- Council's standings on key performance ratios are:

Ratio	Benchmark	2013 result	Ongoing Budget Result
Operating performance %	> (4)%	(4.4)%	Unachievable
Own source revenue %	> 60%	45.7%	Unachievable
Unrestricted current ratio	> 1.5	4.05	Achievable until 2019
Debt service cover ratio	> x 2	x 19.28	Achievable
Rates & annual charges O/S %	< 10%	13.30%	Unachievable
Cash expense cover ratio	> 3 months	6.2 months	Achievable

In the Long Term Financial Plan, Council's average operating performance ratio is negative 7.8%. If true, Council will be well outside the benchmark. Council may need to revise its forecasts further in consultation with the community to allow Council to achieve this benchmark in future years.

Like most rural Councils, Council can never achieve the 60% own source revenue benchmark due to having high levels of grants and contributions each year.

Council has a history of the rates and annual charges percentage being in excess of the 10% benchmark. This is not forecast to change in the future. Council may need to perform a cost benefit analysis to determine whether additional resources should be spent to reduce the ratio within benchmark levels.

- Council's standings on the infrastructure performance ratios are:

Ratio	Benchmark	2013 result	Ongoing Budget Result
Building and infrastructure renewal	> 100%	66%	Averages 91%
Infrastructure backlog ratio	< 2%	19.8%	Unachievable
Asset maintenance ratio	> 1	1	Achievable
Capital expenditure ratio	> 1.1	1.47	Unachievable

Infrastructure will continue to be an area of concern to Council. Council has made great strides in recent years via asset management plans, but the individual asset plans still need to be completed. They will be critical for Council to gain a greater understanding of the condition of assets and the rate they are depreciating. This will then determine Council's future expenditure needs.

In 2013, Council had an infrastructure backlog of $60,172,000 and believes it will not grow significantly in the future. However, this will be dependent on Council achieving the benchmark levels for the ratios.

Overall, Council has been stabilising and improving its financial position in general since forming as an amalgamated Council in 2006. However, based on the Long Term Financial Plan, Council's financial position is budgeted to weaken. Council may need to conduct further community consultation to reduce expectations and assist in Council living within its means. Maintaining infrastructure will be the focus of Council in years to come and improved asset management plans will enable Council to understand its assets better. Fully understanding infrastructure backlog and asset maintenance will assist in Council's creation of future Long Term Financial Plans.

2.2 Analysis from TCorp Report to Now

The TCorp report released in March 2013 was based on the 2011 financial reports and 2012 Long Term Financial Plan. Analysing the TCorp report to this report shows:

- The TCorp report was based on General Fund only. This report examines the whole of Council operations.

- Key performance areas comparing 2011 results to 2013 result show:

Key Performance Area	2011	2013	Improvement
Operating result	$(3,137,000)	$(929,000)	Yes
Budgeted results in LTFP	10 yrs of losses	10 yrs of losses	No
Special rate variation approved	No	No	N/A
Cash position	$14,715,000	$16,931,000	Yes
Operating performance ratio	(19.4)%	(4.4)%	Yes
Own source revenue %	41.8%	45.7%	Yes
Unrestricted current ratio	7.55	4.05	No, but still sound
Debt service cover ratio	9.71	19.28	Yes
Rates & annual charges O/S %	15.13%	13.30%	Yes
Cash expense ratio	4.5	6.2	Yes

The TCorp report indicated that Council faced financial sustainability issues in the future and is in a weak financial position, commenting that:

  - Operating deficit results are forecast to remain well below the benchmark target of negative 4%. This is a significant issue that could impact the long term financial stability of the Council.
  - Council will not be able to achieve the scheduled capital expenditure program with their current revenue base without impacting their financial stability.
  - Council will need to revise their assumptions and capital expenditure program in order to remain liquid over the Long Term Financial Plan.

Overall, Council has improved its financial position from 2 years ago, though the Long Term Financial Plan still indicates that Council is expecting its financial position to weaken considerably, but not to the extent of the previous plan utilised in the TCorp review.

- From an infrastructure performance perspective:

Ratio	2011	2013	Improvement
Building and infrastructure renewal	41%	66%	Yes
Infrastructure backlog ratio	5.54%	19.8%	No
Asset maintenance ratio	3.23	1.0	No
Capital expenditure ratio	0.7	1.47	Yes
Infrastructure backlog in $	$19,799,000	$60,172,000	No

While these ratios for the most part, have not improved, the level of detail that Council now has around its infrastructure assets has significantly improved. Council now has an overall asset management plan and is still working on the individual plans, which Council did not have when TCorp conducted their review. This has provided Council with more reliable knowledge in relation to condition of assets and infrastructure backlog, though the backlog appears to be too high, particularly in relation to buildings.

Overall Council's financial position has improved since the TCorp report, both in quantitative and qualitative matters, apart from the Long Term Financial Plan. There is still much to be done in relation to asset management, but Council is gaining a better understanding of its infrastructure assets.

3. Seventeen (17) Year Financial Assessment – Past and Future

In conducting the financial assessment of Council, we have utilised the past eight (8) years of audited financial statements and the next budgeted nine (9) years from the Long Term Financial Plan. We have used the "Base" Scenario, while noting that Council also has "Conservative" and "Optimistic" scenarios.

The key strategies underpinning the Long Term Financial Plan are:

- Maintaining a financial stability beyond a ten year timeframe;
- Reducing costs;
- Improving efficiencies; and
- Progressively increasing income.

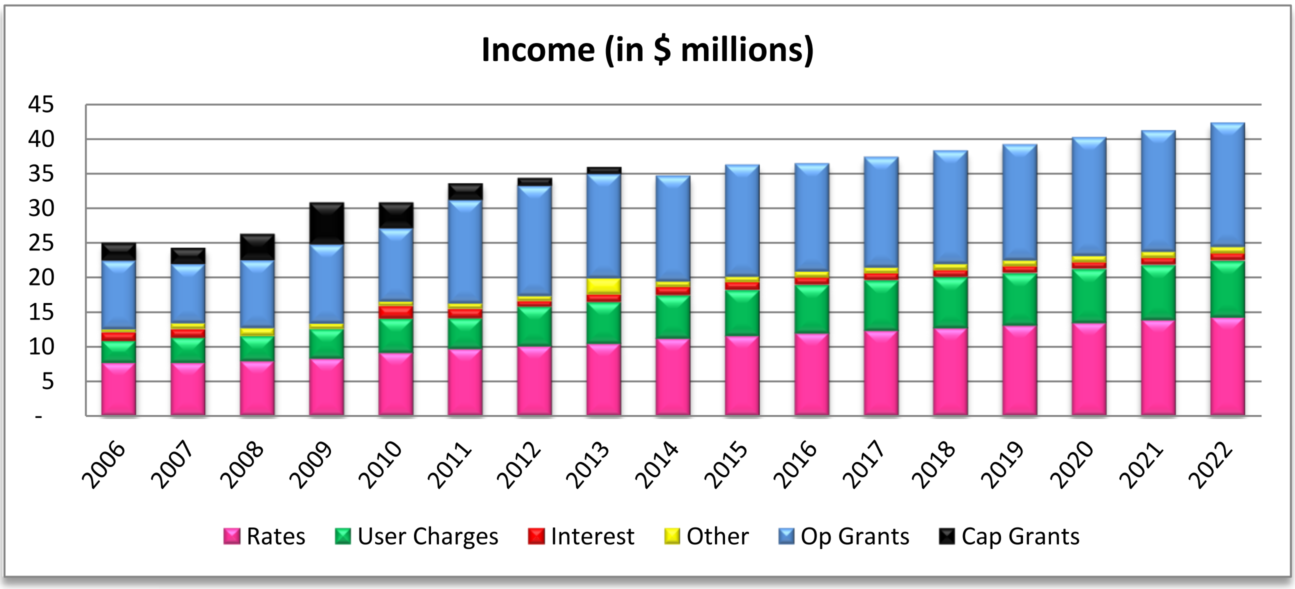
The major assumptions used in the Base Scenario of the Long Term Financial Plan are:

- CPI at 2.5% per annum;
- Employee costs at 3.25% per annum;
- Rate pegging on ordinary rates at 3.4% for the 2013/14 financial year and 3.25% thereafter;
- RMS charges, private works and other revenue at 2.5% per annum. Assumes that road maintenance contracts with RMS will continue as per prior years;
- Child care fees and swimming centres at 2.5% per annum;
- Aged care and cemeteries at CPI 2.5% per annum;
- Domestic waste management at 5% per annum over the first four years and 2.5% per annum thereafter;
- Interest rate at the relevant cash rate 4.25% per annum;
- Borrowing cost projections are based on current loans, finance lease and asset remediation schedules, plus an assumption that Council will take out new loans to the value of $3.1 million in 2013/14 as part of the Local Infrastructure Renewal Scheme to fund CAPEX;
- Water access charges increase by 2.5% per annum;
- Sewer charges increase by 5% per annum for the first four years of the LTFP followed by 2.5% thereafter;
- Domestic waste management charges 5% per annum in 2013/14 and 2.5% per annum thereafter;
- Grant income to increase in line with CPI at 2.5% per annum;
- Capital expenditure works of $78 million over the 9 years from 2014 to 2022;

The financial assessment is performed on the whole of Council operations comprising:

- General Fund
- Water Fund
- Sewerage Fund

3.1 Income



Council has a fairly consistent income growth over the 17 year period. Income dips slightly from 2013 to 2014 by $1.26 million before increasing again in future years. Council has budgeted for one instalment of the financial assistance grant to be received in advance. However, the Federal Government announced in May that there will be no advance payment. As a result, there will be a one off decrease in the 2014 year.

In the 8 year period from 2006 to 2013, income has increased from $24,360,000 to $35,905,000 at an average of 5.7% per annum. This is good growth considering the Global Financial Crisis hit in 2008/2009 in the middle of this period, though it is also impacted by the prepayment of the financial assistance grant.

Conversely from the budgeted 9 year period from 2014 to 2022, income is budgeted to increase from $34,643,000 to $42,241,000 at an increase of 2.5% per annum. This is below average growth, and indicates that Council may have prepared a conservative income budget.

Rates and Annual Charges

Rates and annual charges from 2006 to 2013 have increased on average at 4.5% per annum to $10,420,000. This is above the rate pegging limits and is due to increased annual charges in water supply, sewerage services and waste management services over the period. There have been no special rate variations since in the period from 2006 to 2013.

In the budgeted period from 2014 to 2022, rates and annual charges are budgeted to increase by 3.1% to $14,166,000. This estimate is largely in line with rate pegging limits. There is no special rate variation budgeted for in this period.

In the current environment, where costs are increasing significantly and Council has a massive infrastructure backlog, it is interesting that Council has not included a special rate variation as part of its Long Term Financial Plan. As an example, if Council sought a special rate variation of 7% above the pegging limit for 3 years from 2016 with the increase remaining permanently in the rate base, by 2018 Council would potentially have additional income of $1.71 million per year. This would grow to $1.93 million per year by 2022. While special variations tend to be unpalatable within the community, the need to continue to offer services and maintain road infrastructure assets in particular, makes it an option that needs to be seriously considered.

User Charges and Fees

The key sources of income from user charges and fees are user charges for water supply services, child care, quarry, RMS charges on State Roads and private works. In 2013, these sources represented 86% of user charges and fees.

User charges and fees from 2006 to 2013 have increased 9.2% per annum to $5,994,000. This was due to the introduction of user charges for water supply and sewerage services, increased child care fees with the acquisition in 2010 of the former ABC Learning Centre in Coonabarabran and increased RMS charges on State Roads for maintenance and construction work.

In the budget period from 2014 to 2022, user charges and fees are budgeted to increase by 3.3% per annum to $8,136,000. This is significantly lower than the past 8 year average and is slightly above the anticipated CPI.

Overall, Council appear to have taken a conservative approach with user charges and fees.

Operating Grants

The key sources of income for operating grants are financial assistance, bushfire and emergency services, child care and transport. In 2013, these sources represented 91.2% of operating grants.

Operating grants from 2006 to 2013 have increased on average by 6.2% per annum to $15,069,000. This growth has been influenced by additional grants in relation to flood damage works and Rural Fire Service grants of $1,515,000 in 2011, $2,021,000 in 2012 and $2,139,000 in 2013 due to the Coonabarabran bushfires. Growth has also been influenced by the prepayment of the financial assistance grant. In 2012 and 2013, the first two instalments of the financial assistance grant were received in advance.

In the budgeted period from 2014 to 2022, operating grants are budgeted to increase by 2% per annum to $17,868,000. While floods and a bushfire have significantly influenced grants in the past, a future budgeted growth of grants at less than inflation is conservative.

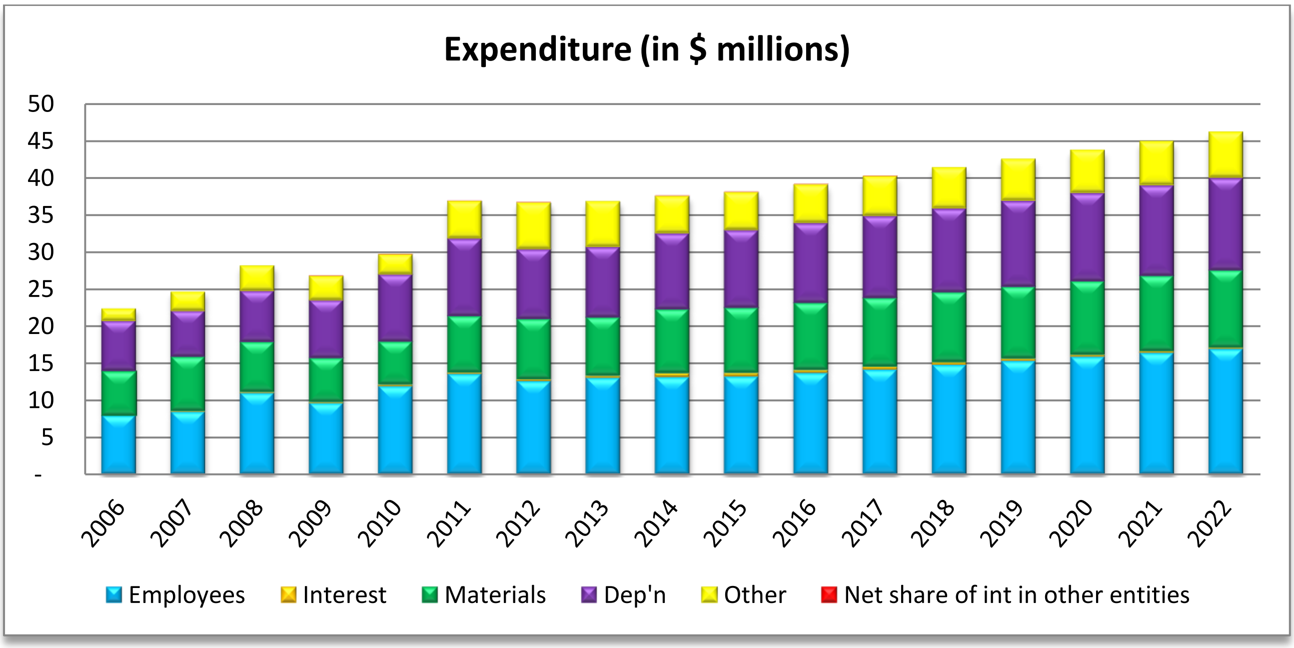
Overall, Council has taken a conservative approach with grant income.

Capital Grants

Capital grants can vary significantly from year to year depending on the project funded. From 2006 to 2013, capital grants have averaged $2,882,000 per year. In the budgeted period from 2014 to 2022, Council have not budgeted for any capital grants separately and have tied them in with the operating grants for budgeting purposes.

While capital grants are the most difficult source of income to forecast, it would appear that Council have been too conservative in its budgets.

3.2 Expenditure



In the 8 year period from 2006 to 2013, expenditure has increased from $22,488,000 to $36,834,000 at an average of 7.3% per annum. This average increase is higher than the average increase in income across the same period.

Conversely from the budgeted 9 year period from 2014 to 2022, expenditure is budgeted to increase from $37,549,000 to $46,104,000 at an increase of 2.6% per annum. As income is budgeted to increase by 2.5%; the gap between income and expenditure will continue to increase.

Employee Costs

Employee costs from 2006 to 2013 have increased on average at 7.2% per annum to $12,994,000. This has been above the general award increases over this period of 3% to 3.25%. Employment costs increased in 2008 by $2.5 million due to an increase in termination payments. In 2010, employee costs increased by $2.3 million and in 2011 by $1.6 million due to an increase in the number of employees and higher wage rates. This was partly due to the acquisition of the child care operations.

In the budgeted period from 2014 to 2022, employee costs are budgeted to increase by 3.2% per annum to $16,843,000. Council have forecast future competition from mines in the area and a declining rural population will decrease employment costs. Conversely Council have forecast an increase in employee costs due to a loss of skilled staff to the coast. Council may be required to pay higher than award levels of remuneration to attract and maintain skilled staff. Council is aiming to control employee costs further by workforce efficiencies. However, it will be challenging for Council to achieve this over a long period of time.

Materials and Contracts

Materials and contracts from 2006 to 2013 have increased on average at 4.5% per annum to $7,906,000. Timing and extent of works, in particular, flood events and/or heavy rainfall impact the amount of repairs and maintenance that is required on local and regional roads.

In the budgeted period from 2014 to 2022, materials and contracts are budgeted to increase by 2.4% per annum to $10,456,000. Given the difficulty in assessing materials and contracts, but based history, this appears to be conservative.

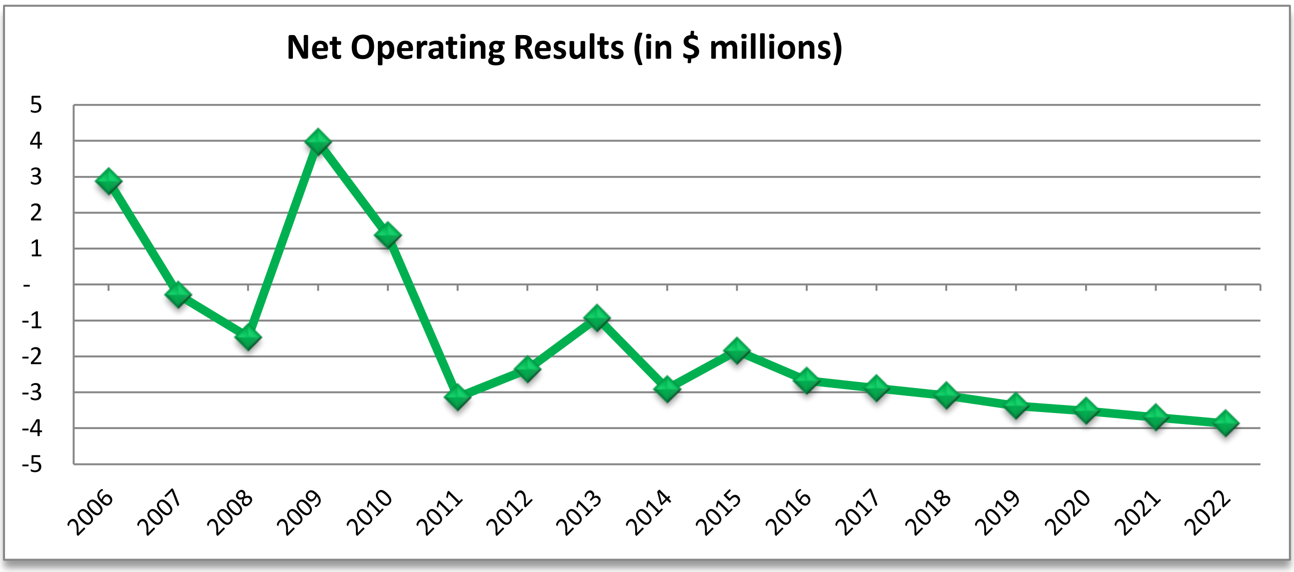
Depreciation and Amortisation

While a non-cash expense, depreciation has a significant impact on the Income Statement of Council.

Depreciation from 2006 to 2013 has increased on average by 4.9% per annum to $9,525,000. This was largely due to higher depreciation on re-valued assets. Over this time, IPP&E has increased in value from $243,095,000 to $428,890,000.

In the budgeted period from 2014 to 2022, depreciation and amortisation are budgeted to increase by 2.5% to $12,514,000. Council have prepared a detailed Asset Management Plan from which depreciation projections have been directly derived. This appears to be reasonable.

3.3 Net Operating Result



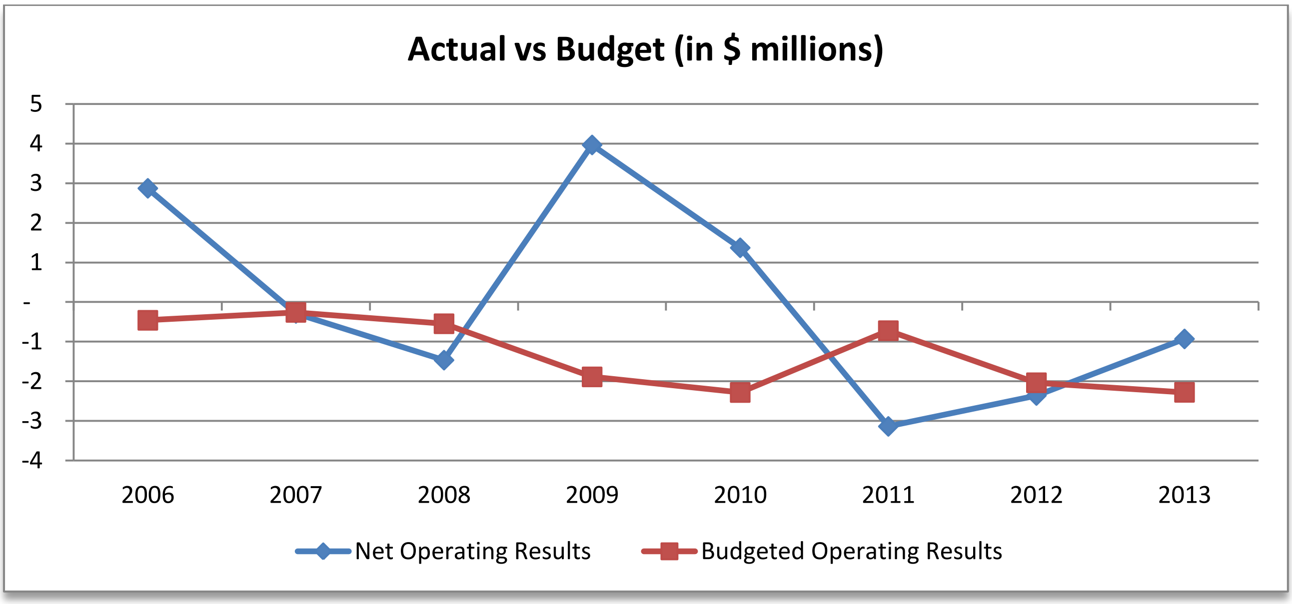
Over the period from 2006 to 2013 Council have reported a surplus for 3 out of 8 years. The largest surplus of $3,967,000 occurred in 2009, while the largest deficit of $3,137,000 occurred in 2011. Overall, the average result over the past 8 years has been a surplus of $5,000.

Based on this result, it is very surprising that Council has budgeted for significant and increasing deficits for the next 9 years from 2014 to 2022. Commencing in 2014, Council has budgeted for a deficit of $2,906,000 and this continues through to 2022 with a budget deficit of $3,863,000. Over this period, there is an average deficit of $3,095,000. If the budgets were to be fulfilled, the large deficits will affect the level of services that Council can provide in the future.

Clearly, in the current political environment, it is a high risk strategy to continually budget deficits that are growing larger each year.

Council may need to perform further consultation with the community to reduce expectations around services and maintenance of infrastructure. If expectations can be reduced, Council may be able to develop a Long Term Financial Plan that has Council "living within its means".

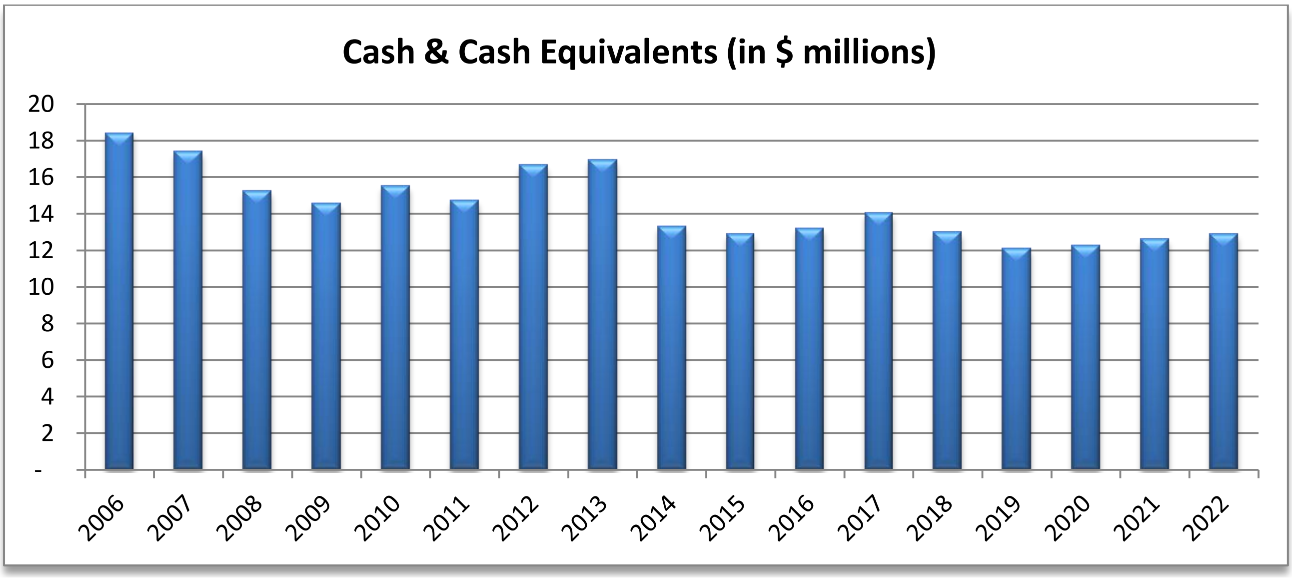
3.4 Budget vs Actual (2006 to 2013)



Based on Council's budgeted results in Section 3.3 for 2014 to 2022, we have analysed Council's actual result versus budgeted result over the previous 8 years. As can be seen in 4 out of 8 years, Council has performed better than budgeted.

From 2006 to 2013, the average budgeted result has been a deficit of $1,300,000, whereas Council has returned an average surplus result of $5,000. This is a turnaround of $1,305,000. However, even if this trend was continued in future years, it would still not stop the Council from operating at large deficits.

3.5 Cash Position



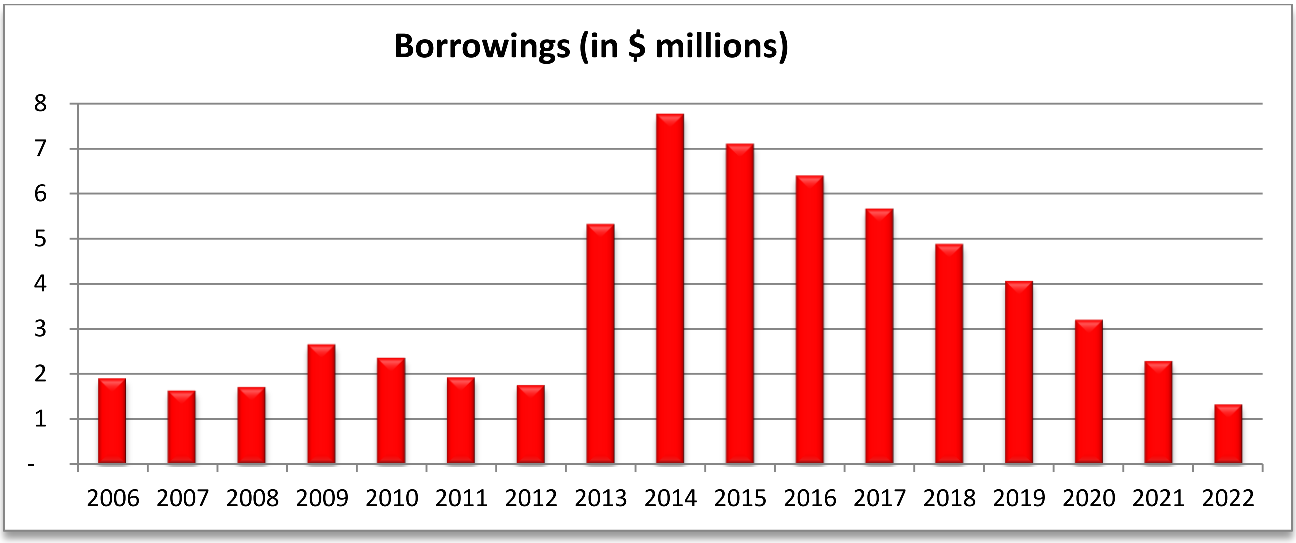
The cash position of Council has decreased from $18,411,000 in 2006 to $16,931,000 in 2013, with a declining trend from 2006 to 2009, before an upwards trend to 2013.

In 2011, Council had $14,715,000 in cash and cash equivalents with $6,636,000 tied to external restrictions, $911,000 set aside for internal restrictions and $7,168,000 unrestricted. This is compared to 2013, where Council had $16,931,000 with $6,050,000 tied to external restrictions, $5,222,000 set aside for internal restrictions and $5,659,000 unrestricted. Council has been able to improve its cash position over the two years, particularly in relation to internal restrictions, which in turn provides further cash if Council's management plans were to change.

The budgeted cash position decreases from $13,285,000 in 2014 to $12,871,000 in 2022. This is a decrease of $414,000. The cash position has remained stable over this period, despite the large losses. This is due to:

- Losses over the 9 year period of $27.85 million containing non-cash expenses of depreciation totalling $102.27 million.
- Capital acquisitions of $77.95 million
- Sale of assets of $7.8 million
- New borrowings of $3.1 million; and
- Repayments of loans of $7.06 million

3.6 Borrowings



From 2006 to 2012, the borrowings of Council have ranged from $1.6 million to $2.6 million. In 2013, Council drew down a $3.8 million loan under the Local Infrastructure Renewal Scheme to replace timber bridges in the shire. Loans at 30 June 2013 totalled $5.3 million.

From 2014 to 2022, Council have budgeted to draw down a further loan of $3.1 million in 2014. This will peak loans at $7.74 million. Repayments will then reduce the balance to $1.31 million by 2022.

In the short term, Council will have limited borrowing capacity, but this will change in the medium to long term as the loans are repaid.

4. Key Performance Indicators

This section of the report will review the key performance indicators of Council, utilising the Note 13 indicators from the update 22 of the Local Government Code of Accounting Practice and Financial Reporting. These ratios are:

- Operating performance
- Own source operating revenue
- Unrestricted current ratio
- Debt service cover ratio
- Rates and annual charges outstanding percentage
- Cash expense cover ratio

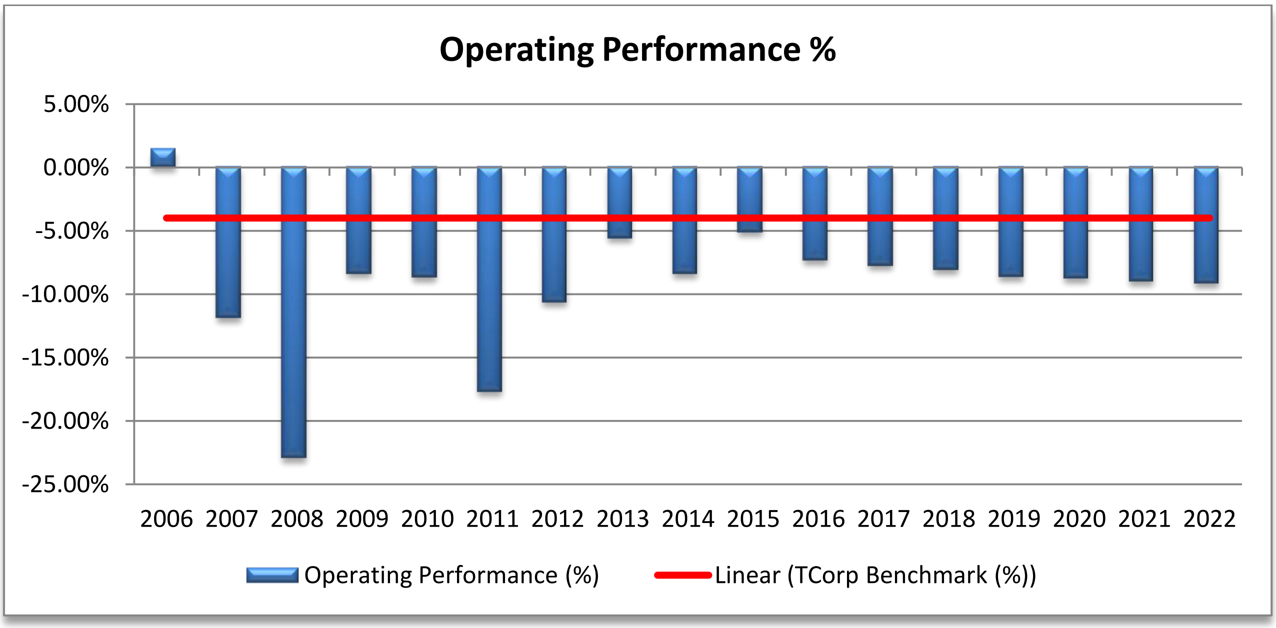
4.1. Operating Performance

The purpose of this ratio is to measure Council's achievement of containing operating expenditure within operating revenue. It is important to distinguish that this ratio is focussing on operating performance and hence capital grants and contributions, fair value adjustments and reversals of revaluation decrements are excluded.

The benchmark is greater than 0%.

Formula = $\frac{\text{Operating revenue excluding capital grants and contributions less operating expenses}}{\text{Operating revenue excluding capital grants and contributions}}$

The previous TCorp review had the benchmark of the operating performance percentage at negative 4%.



While the Office of Local Government has set the benchmark at 0%, it is an unrealistic expectation given the size of depreciation expense, coupled with the removal of capital grants and contributions as it creates a double whammy effect on the operating performance ratio.

In this case, the TCorp benchmark of negative 4% appears to be more realistic.

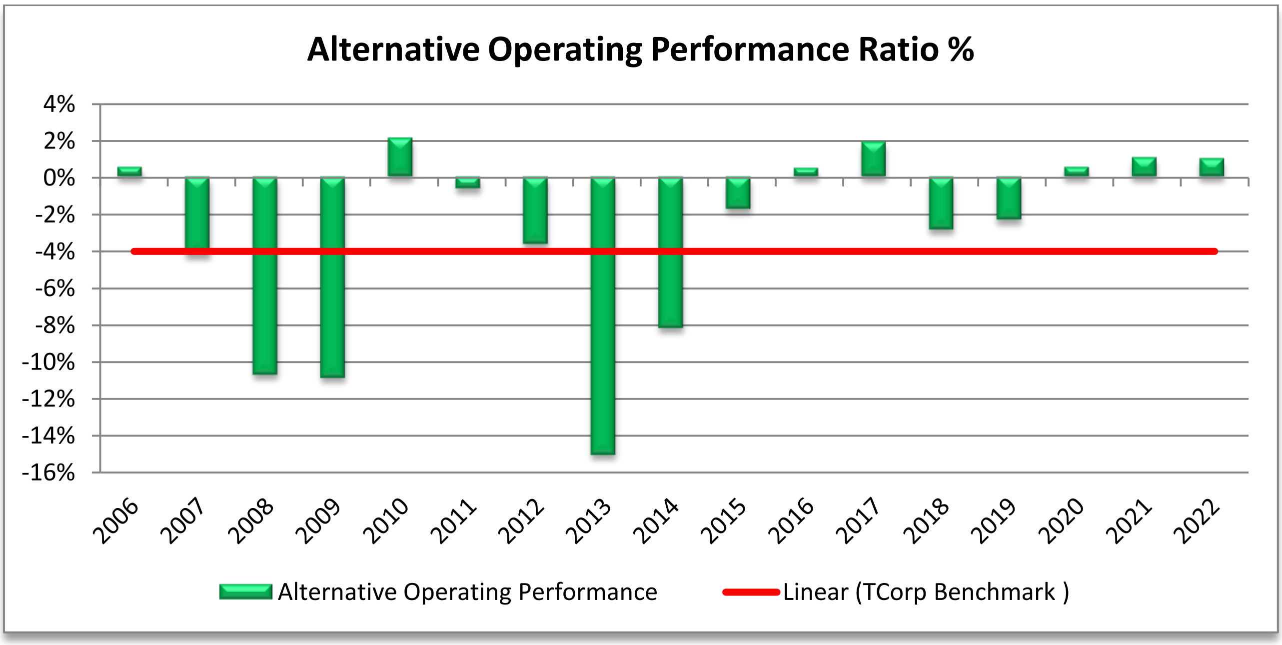
The operating performance ratio of Council has been a positive percentage once in 2006 since the formation of the Council. In relation to using the TCorp benchmark of negative 4%, only 1/17 occasions does Council satisfy the benchmark.

From 2006 to 2013, the average ratio has been negative 10.5%, with the best result being 1.4% in 2006 and the worst negative 22.9% in 2008. 2013 has been the second best year in the period at negative 5.5%. The revaluation of IPP&E and subsequent increase in depreciation expense has had an impact on the ratio. In 2008 depreciation expense was $6.9 million and it peaked at $9.67 million in 2011.

In the budgeted period from 2014 to 2022, the ratio is negative 8.4% in 2014, before improving to 5.1% in 2015, then deteriorating consistently to negative 9.2% by 2022. The average ratio across the period is negative 7.8%. Council is budgeted to fall well outside of the benchmark of negative 4%.

On a different perspective, to highlight how interpretation of the same information can provide differing results, we examined an alternative calculation for the operating performance ratio.

$$\text{Alternative formula} = \frac{\text{operating revenue less operating expenses plus depreciation less IPP\&E purchases}}{\text{operating revenue}}$$



This formula retains the capital grants and contributions as they are offset by the acquisition of IPP&E. Depreciation expense is removed as it is no longer relevant to the calculation as it is a non-cash expense.

The impact of the alternative operating performance is quite stark. In 7/17 years, the ratio is above 0%. Based on this ratio, Council's result appears to be improving with the worst year being 2013, and future budgets showing steady improvement. In the budgeted years only 4/9 years are below 0% and 8/9 years achieve the benchmark of above negative 4%.

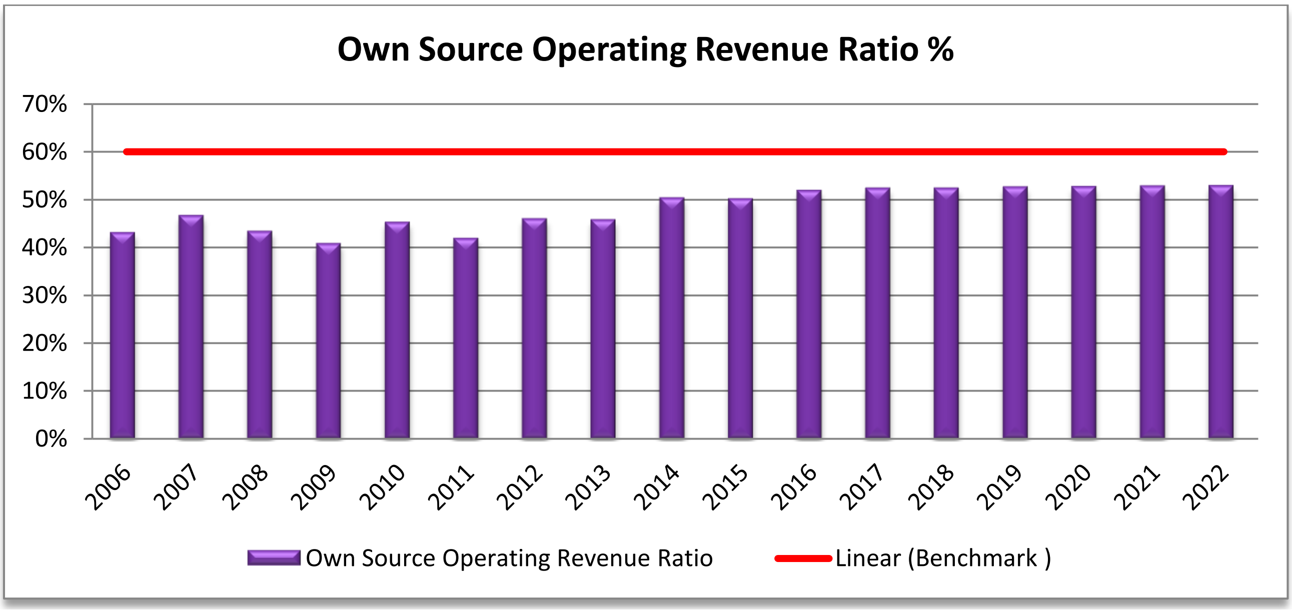
Overall, it is a clear example of why care needs to be taken when interpreting graphs, and that the big picture needs to be taken into account.

4.2. Own Source Operating Revenue

The purpose of this ratio is to measure fiscal flexibility. It is the degree of reliance on external funding sources such as operating grants and contributions. A Council's financial flexibility improves the higher the level of its own source revenue.

The Office of Local Government (and TCorp) benchmark is greater than 60%.

Formula = $\frac{\text{rates, fees and charges}}{\text{total operating revenue}}$



Over the 17 year period, Council's Own Source Operating Revenue Ratio is well below the benchmark. The ratio ranges from 40.8% in 2009 to 52.8% in 2022. This highlights that Council is reliant on income outside of its control, in particular grants and contributions. This is typical of a rural Council.

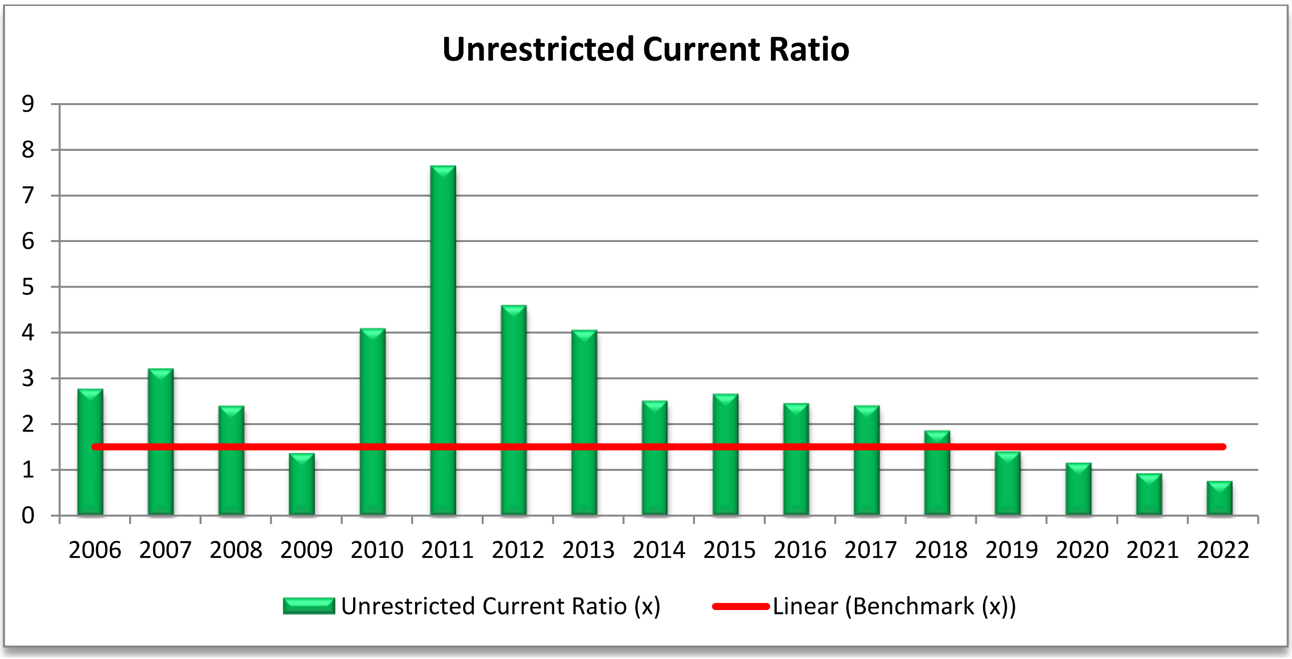
Based on 2013, for Council to achieve a ratio in excess of 60% and keeping the status quo with grant funding, own source revenue would need to increase by $15 million. Given the size of the rate base of Council and the ability to levy additional charges, achieving this ratio is unlikely to happen. Council should not feel driven to achieve this benchmark ratio when the Office of Local Government cannot substantiate why the benchmark should be 60%.

4.3 Unrestricted Current Ratio

The purpose of the unrestricted current ratio is to represent Council's ability to meet short term obligations as they fall due. The restrictions placed on various funding sources complicate the traditional current ratio used to assess liquidity of business as cash allocated to specific projects is restricted and cannot be used to meet a Council's other operating and borrowing costs.

The benchmark is greater than 1.5.

Formula = <u>Current assets less all external restrictions</u>
Current liabilities less specific purpose liabilities



Council performs strongly for the period from 2006 to 2013 with this ratio. The average is 3.75:1, with a peak of 7.62:1 in 2011 and a low of 1.36:1 in 2009. Overall it indicates a sound liquidity position with Council able to comfortably meet any unbudgeted expenses.

For the budgeted period from 2014 to 2022, the ratio averages 1.8:1 starting at 2.5:1 and decreasing to 0.75:1. While Council's cash assets are averaging $12.7 million over this period, the unrestricted current ratio is falling. This is due to restricted cash reserves in water and sewerage increasing, while the cash reserves of general fund are decreasing. From 2019 to 2022, the ratio falls below 1:1 and means Council will have insufficient unrestricted cash to cover its current liabilities. While rural Council's from time to time drop below 1:1, it is only for a short period of time and is usually corrected within a year. Unfortunately, the Long Term Financial Plan indicates this may be the norm as opposed to a one off.

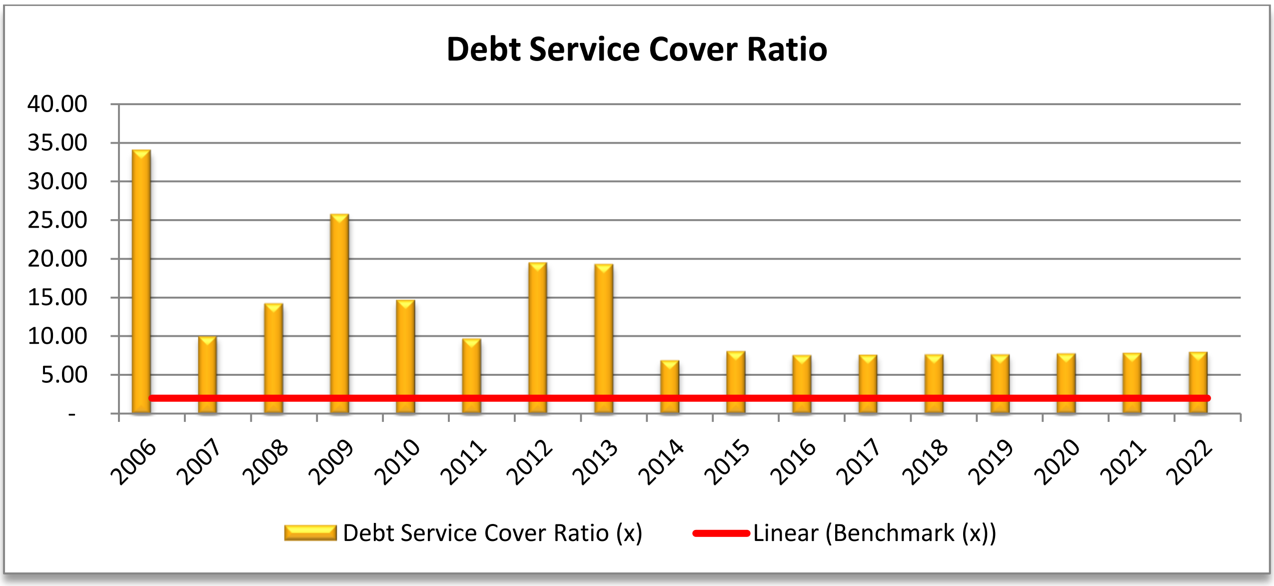
To correct the falling trend, Council may need to make some more hard decisions to stop general fund cash reserves becoming depleted and/or seek ways of cost shifting cash via management charges from water and sewer funds to general fund.

4.4 Debt Service Cover Ratio

The purpose of the debt service cover ratio is to measure the availability of operating cash to service debt including interest, principal and lease payments.

The benchmark is greater than 2.

Formula = Operating result before capital grants and contributions excluding interest and depreciation exp
Principal repayments plus interest borrowing costs



From the period 2006 to 2013, Council's debt service cover ratio has varied significantly from as low as 9.7 in 2011 to as high as 34 in 2006. The ratio can vary wildly as it is based on EBITDA and a strong surplus like the one achieved in 2009 can significantly shift the ratio. Over the 8 year period, the average ratio was 18.4.

In the budgeted period from 2014 to 2022, the ratio is predicted to average 7.71 and ranges from 7.60 to 8.11. The ratio is heavily impacted by the budgeted losses each year.

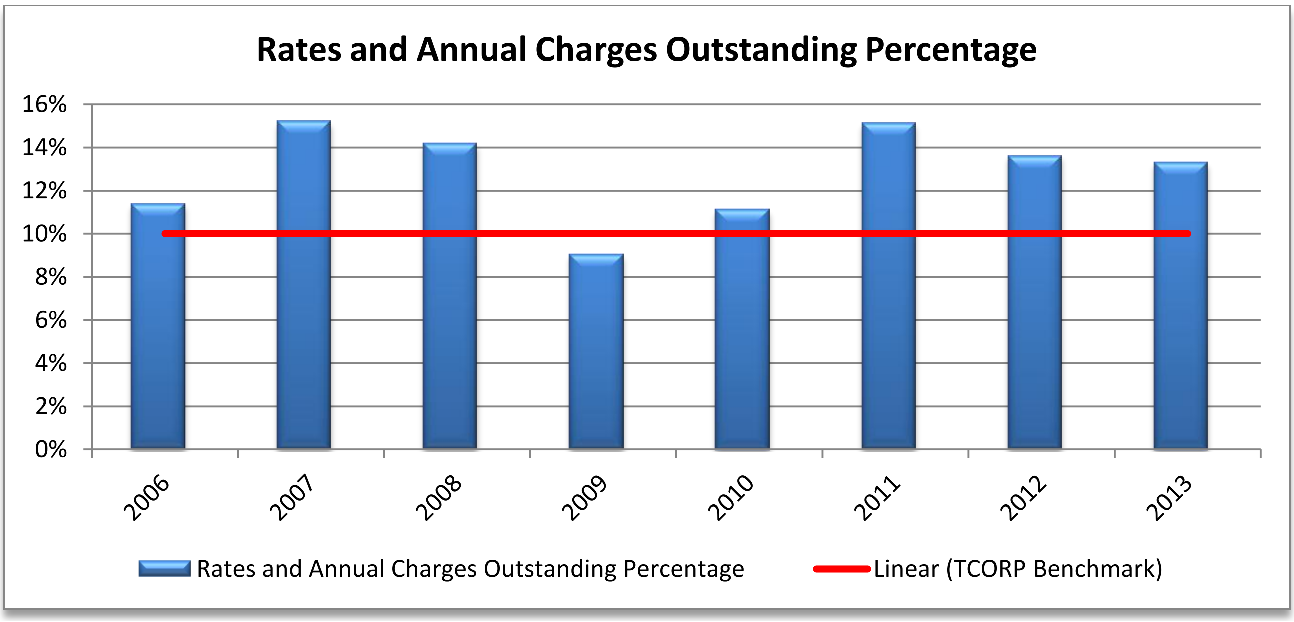
Council needs to be careful when assessing this ratio. For example, based on the 2013 year result, Council incurred a loss of $929,000 but had an EBITDA OF $8,445,000 and a debt service cover ratio of 19.28. To reduce the ratio to 2, Council could have made principal instalments and interest expense totalling $4,222,500. Council actually made payments of $443,000. In theory, Council could have taken out a loan for $23 million at 7% per annum for 25 years. Council currently has loans outstanding of $5,298,000. Based on the debt service ratio used in Council's 2013 financial statements, servicing a further $23 million loan would take the ratio from the reported 1.73% to 16.5%. This is completely unrealistic.

4.5 Rates and Annual Charges Outstanding Percentage

The purpose of the rates and annual charges outstanding percentage is to assess the impact of uncollected rates and annual charges on liquidity and the adequacy of recovery efforts.

The benchmark is less than 10%.

Formula = $\frac{\text{Rates and annual charges outstanding}}{\text{Rates and annual charges collectible}}$



Traditionally, Council has struggled to meet the benchmark for this ratio. The average ratio for the past 8 years has been 12.86%. Only once has Council been below the 10% benchmark. This occurred in 2009 where the ratio was 9.03%. In 2007 and 2011, the ratio was above 15%.

Care needs to be taken when interpreting this ratio with other Councils, as it can easily be manipulated by increasing the provision for doubtful debts to reduce the ratio to acceptable levels. For instance, in 2013 Council's ratio was 13.30% with rates and interest outstanding of $1,724,000 and a provision for doubtful debts of $91,000. The ratio could be reduced to 10% by increasing the provision for doubtful debts by $406,000. The impact on the income statement would be to increase the deficit from $929,000 to $1,335,000. Yet, this result would still have been stronger than the result of 2011 and 2012 and obtains a tick for achieving the Office of Local Government benchmark.

Budgeting of the rates and annual charges outstanding percentage into the future is difficult. Council do not make reference to their assumption going forward with this ratio in their Long Term Financial Plan.

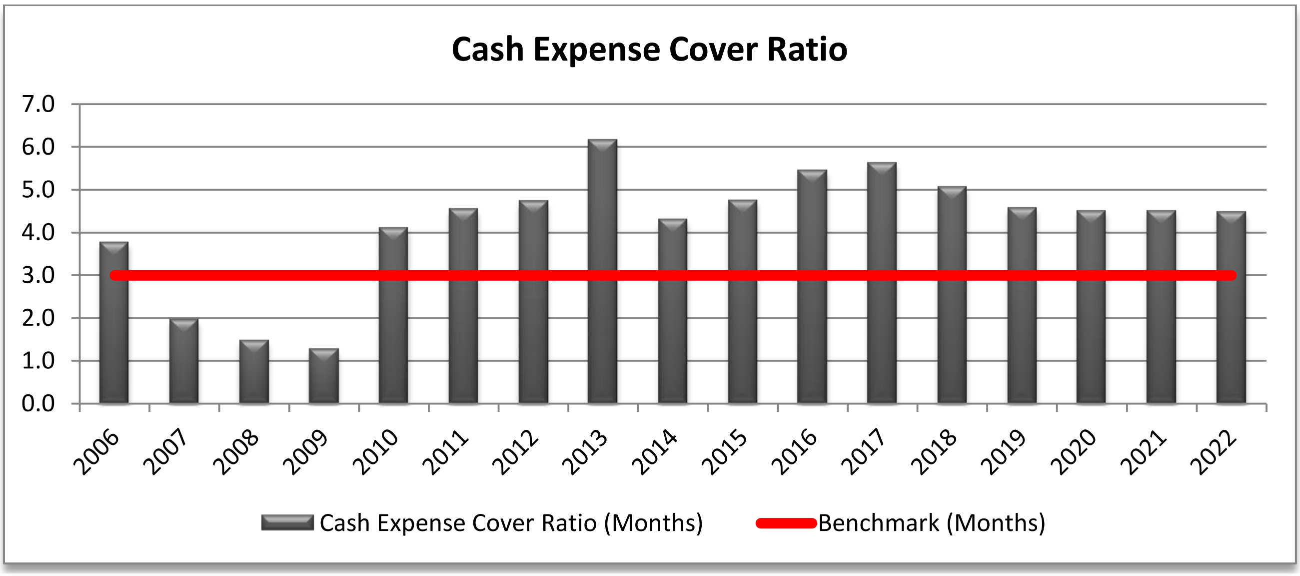
With the ratio well above benchmark levels, Council may need to dedicate more resources into collection to bring the ratio down, which in turn will improve the cash flow of the Council.

4.6 Cash Expense Cover Ratio

The purpose of this ratio is to indicate the number of months a Council can continue paying for its immediate expenses without additional cash inflow.

The benchmark is greater than 3 months.

Formula = Current year's cash, cash equivalents and term deposits multiplied by 12
Payments from cash flow of operating and financing activities



In general, the cash expense ratio will be greater for rural councils than city councils as the rural councils need greater protection against variations in financial performance and financial shocks. Rural councils tend to average around 6 months.

Council is above the 3 month benchmark on 14/17 years, and is above 4 months for 13/17 years.

Council's ratio is heavily impacted by its non term deposit investments not forming part of the formula. From 2006 and through to the budget of 2015, Council held floating rate notes. In 2006, Council had $13 million, peaking at $14.5 million in 2007 before steadily decreasing to $2.7 million in 2013. If these could be included in the formula, Council's ratio would appear a lot stronger.

The budgeted period from 2014 to 2022 shows a consistent improvement up until 2017 before a slight decrease in the ratio. Based on the current budget, by 2022 Council will have 4.5 months of cash remaining to pay out its immediate cash flow without additional cash flow.

5. Infrastructure Assets

Management of Council infrastructure assets is one of the biggest challenges that Council's currently face. The Office of Local Government has increased its scrutiny of infrastructure via Special Schedule 7 of the financial statements. At this years' Local Government Auditors Conference, the Office of Local Government indicated that their plans at this stage are to have Special Schedule 7 audited from 2015 onwards. This will be very difficult for auditors to perform, as there is a lack of understanding and consistency with many of the concepts within Special Schedule 7.

In an attempt to clarify, the Office of Local Government in Update 22 of the Local Government Code of Accounting Practice and Financial Reporting offers the following definitions:

Asset Condition

Asset condition assessment is the process of continuous or periodic inspection, assessment, measurement and interpretation of the data to indicate the condition of a specific asset so as to determine the need for preventative or remedial action.

Councils are strongly encouraged to use the asset condition rankings as set out in the Asset Condition Assessment table in the Integrated Planning and Reporting Manual for Local Government in NSW. Asset conditions are assessed using a scale of one to five. Assets in condition one are considered to be excellent and that there is no work required (other than normal maintenance) while assets in condition five are considered to be very poor with urgent renewal or upgrading required.

Most importantly, asset condition should be based on up to date asset condition assessments rather than an engineering estimate.

Estimated cost to bring to a satisfactory standard

Satisfactory is defined as "*satisfying expectations or needs, leaving no room for complaint, causing satisfaction, adequate*".

The estimated cost to bring assets to a satisfactory standard is the amount of money that is required to be spent on an asset to ensure that it is in a satisfactory standard. This should not include planned enhancements.

Unless Council has undertaken consultation with their community and has agreed to a level of service from council's assets, the bringing to a satisfactory standard should be measured against the second condition rating of Good as stated in the Integrated Planning and Reporting Manual.

Renewal

Renewal is defined as "*works to upgrade, refurbish or replace existing facilities with facilities of equivalent capacity or performance capability*".

Enhancement

Enhancement means "*to heighten, intensify or improve the facilities*".

Required annual maintenance

Required annual maintenance is "*what should be spent to maintain assets in a satisfactory standard*".

The Office of Local Government requires the following infrastructure asset performance indicators:

- Building and infrastructure renewal ratio
- Infrastructure backlog ratio
- Asset maintenance ratio
- Capital expenditure ratio

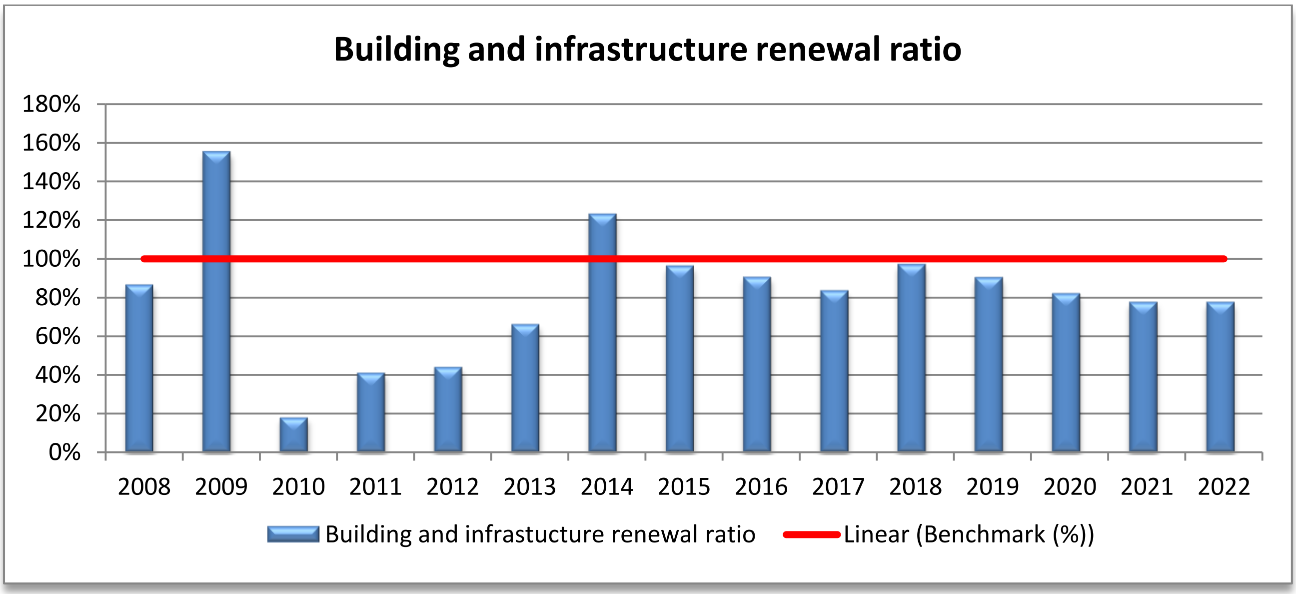
This section of the report will now examine these ratios.

5.1 Building and Infrastructure Renewal Ratio

The purpose of this ratio is to assess the rate at which these assets are being renewed against the rate at which they are depreciating.

The benchmark is 100%.

Formula = $\dfrac{\text{Asset renewals (building and infrastructure)}}{\text{Depreciation and impairment (building and infrastructure)}}$.



The building and infrastructure renewal ratio first appeared in Council's financial statements in 2008, and has been the cause of much debate, given the uncertainty around what constitutes an asset renewal.

For this ratio twice in the 15 year period has Council (actual or budgeted) achieved the benchmark of 100%. This was in 2009 and 2014. The lowest level was in 2010 at 18%.

Over the past 6 years the average ratio was 69%. From 2014 to 2022, the ratio is budgeted to be approximately 91%.

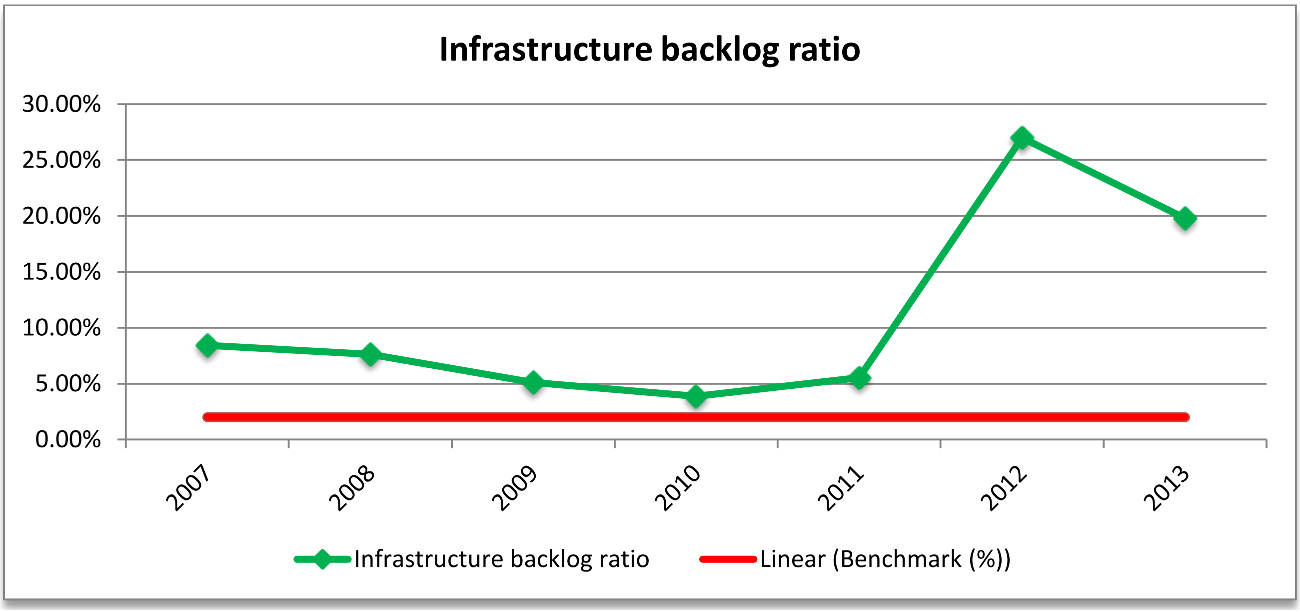
Based on these results, Council will continue to have infrastructure that will age and wear at a rate faster than it is being renewed. Over time, this will increase the asset maintenance backlog.

5.2 Infrastructure Backlog Ratio

The purpose of this ratio is to show what proportion the backlog is against the total value of a Council's infrastructure.

The aim is a zero backlog.

$$\text{Formula} = \frac{\text{Estimated cost to bring assets to a satisfactory condition}}{\text{Total WDV of infrastructure, buildings, other structures and depreciable land improvements}}$$



Infrastructure backlog is an area of concern within the Local Government sector. The Office of Local Government is under pressure to figure out how much it is, and Council's are struggling to truly identify what the backlog is.

Council reported in Special Schedule 7, that its dollar value of infrastructure backlog was:

2007	2008	2009	2010	2011	2012	2013
$19.82m	$18.42m	$12.67m	$12.67m	$19.80m	$85.5m	$60.17m

Council's ratios vary significantly. As more accurate asset condition assessments and asset valuations have come to hand over the past few years, the ratio has sky rocketed.

We note that there was no asset management plans or asset management systems in place prior to 2011. Therefore, the reported backlog according to Council from 2007 to 2011 was not representative of a true backlog and was largely a guesstimate.

Council do not have individual asset management plans for each asset class. At the time of our review, the asset management plans for individual assets were still to be finalised. However, once complete, Council expects to have a more realistic picture of its infrastructure backlog.

The current infrastructure backlog is reflective of the 2012/13 asset management plan. This has not been revised.

The infrastructure backlog as per Special Schedule 7 was:

	2013 $	2012 $
Buildings	22,897,000	8,272,000
Other structures	1,651,000	1,422,000
Public roads	21,461,000	27,599,000
Water	9,008,000	31,764,000
Sewerage	1,517,000	13,916,000
Drainage	3,638,000	2,550,000
	$60,172,000	$85,523,000

There have been large movements in the backlog of buildings which have increased by $14,625,000 due to the revaluation process in 2013, and reductions in the backlog of water for $22,756,000 and sewerage for $12,399,000. These are large movements in a single year, and highlight the difficulty of identifying a true backlog.

A backlog for roads, water and sewerage is understandable, but it is interesting that buildings are $22.9 million or 38% of the backlog. The other OROC internal audit alliance Councils have no backlog of note for their buildings. Upon further analysis of Special Schedule 7, the overall average condition rating for buildings is 2.35. This is between the range of good and average, which would suggest only a limited backlog. Council may need to review and revise its condition assumptions and/or the backlog for buildings.

Overall, we have noted that Council has a very large infrastructure backlog. If this is truly correct, then Council may find it very difficult to reduce the backlog without significant grant funding and/or via a special rate variation.

Council's thoughts on getting assets to a satisfactory position

Having put asset management practices in place, Council are of the opinion that their 2012, 2013 and forecast figures are more accurate. Council have developed a single *Infrastructure Asset Management Plan*. This plan is 12 months old and is currently being updated. Separate plans by asset class have not been developed.

It is anticipated that within the next 10 years, the backlog listed above will need to be spent to maintain infrastructure at a satisfactory standard. Council are optimistic that this will occur, and they will require a combination of loan funds and grant funds to finance the projects.

Council have planned to perform more asset assessment for example on roads, as transport/roads are due for valuation by 2015. Council's previous assessment of buildings for 2013 considerably reduced the infrastructure backlog. Council use expert valuers across all asset classes.

Any new loans within the Long Term Financial Plan are planned to be used on capital projects.

Asset condition assessments

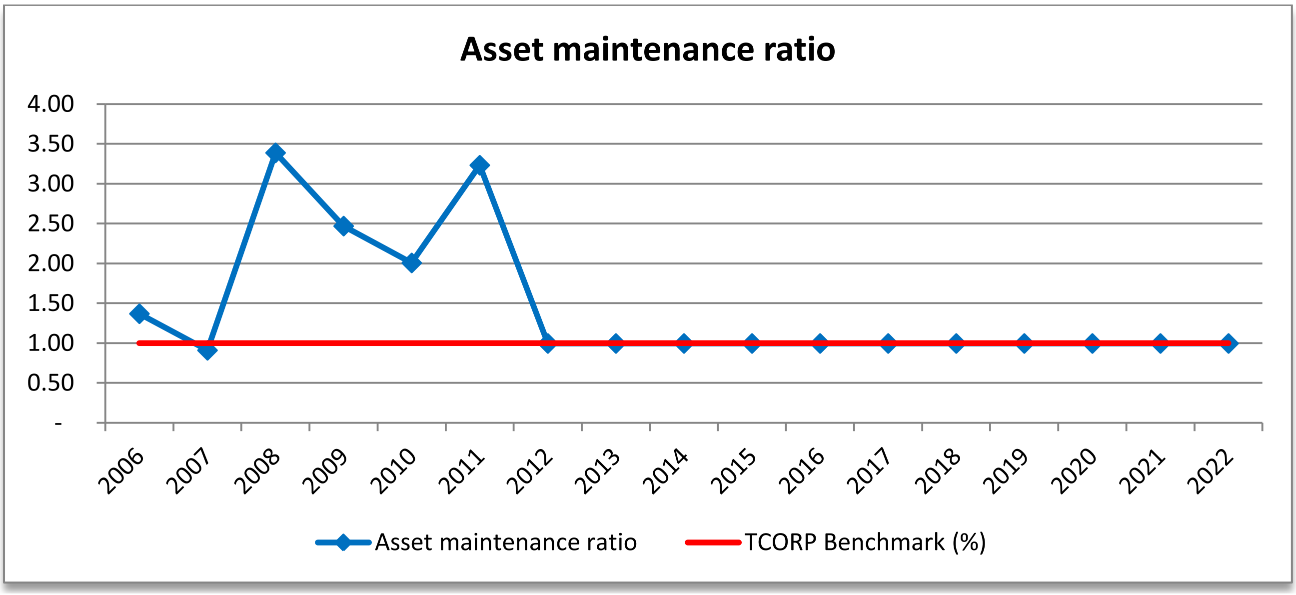
Council assesses asset conditions based on the recommended 1 to 5 scale. These assessments are performed "in house" relying on the expertise of staff. Qualified valuers perform the valuation of Council's assets using the asset condition assessment provided by Council.

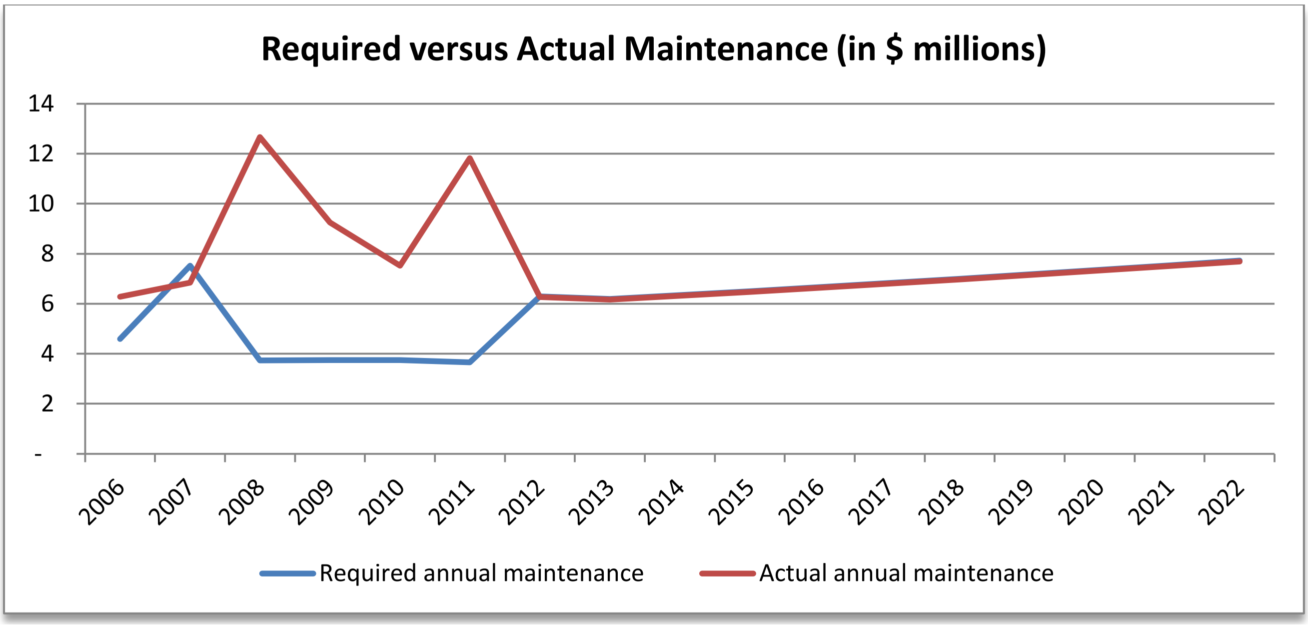
5.3 Asset Maintenance Ratio

The purpose of this ratio is to compare actual versus required annual asset maintenance. A ratio above 1.0 indicates that the Council is investing enough funds within the year to stop the Infrastructure Backlog from growing.

The benchmark is greater than 1.0

$$\text{Formula} = \frac{\text{Actual asset maintenance}}{\text{Required asset maintenance}}$$





For the period 2006 to 2013, Council's asset maintenance ratio has varied significantly from as low as 0.91 in 2007 to as high as 3.39 in 2008. There was only 1/8 years, in 2007, where Council had an asset maintenance ratio below the benchmark of 1. The average dollar maintenance over this period has been $8.35 million.

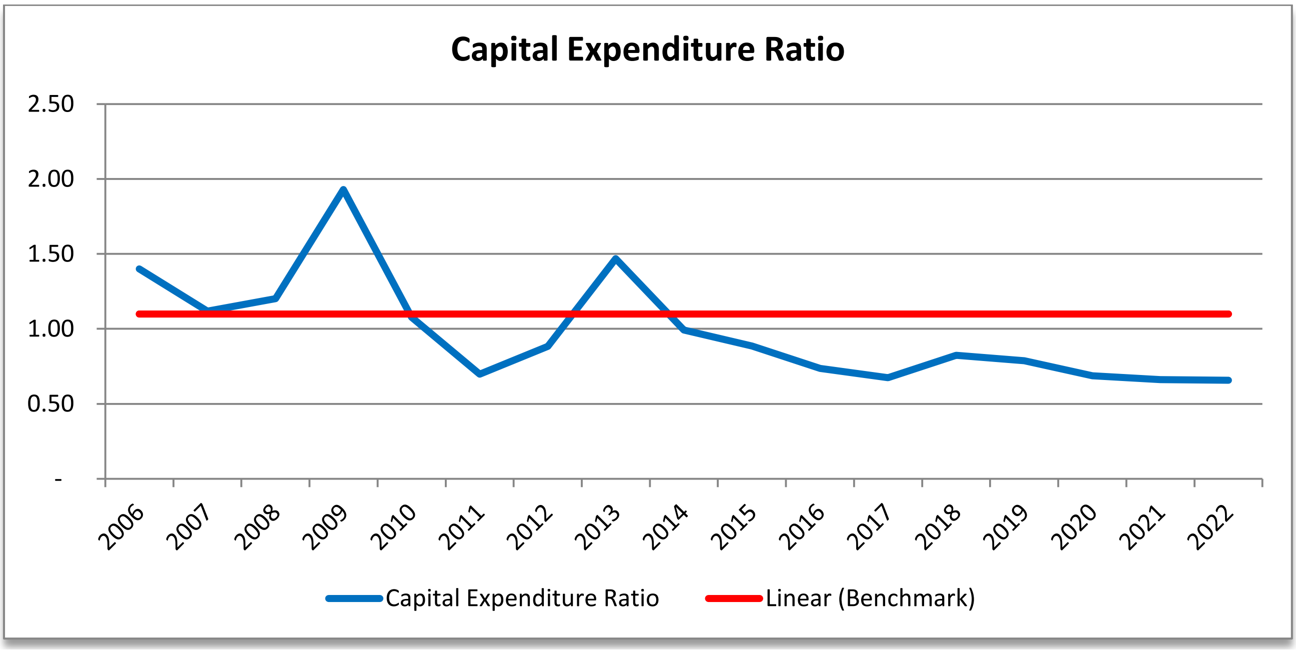
For the budgeted period 2014 to 2022, Council have provided guesstimates which indicate that required maintenance will be matched by actual maintenance. It is interesting that the budgeted actual maintenance is an average of $6.99 million, which is well below that of the past 8 years.

5.4 Capital Expenditure Ratio

The purpose of this ratio is to indicate the extent to which a Council is forecast to expand its asset base with capital expenditure spent on both new assets, and replacement and renewal of existing assets.

The benchmark is greater than 1.1

Formula = $\frac{\text{Annual capital expenditure.}}{\text{Annual depreciation}}$



The capital expenditure ratio from 2006 to 2013 varies from a low of 0.7 in 2011 to a high of 1.93 in 2009. Over the 8 years, the ratio has averaged 1.22. Based on a benchmark of greater than 1.1:1, there are 5/8 years where the benchmark was exceeded.

In the budgeted period from 2014 to 2022, the capital expenditure ranges between 0.99 and 0.66 with a falling trend. This indicates that Council anticipates its asset base to decrease over this period. These figures are based on guesstimates by the Council.

5.4 Summary of Infrastructure Assets

Council has made major improvements in understanding its infrastructure assets in recent years, and will continue to do so as the individual asset management plans are completed. The critical area for Council is a greater understanding of the condition of assets and the rate they are depreciating, as this will drive all future expenditure.

Based on the knowledge that Council currently has, the infrastructure backlog is not predicted to grow significantly. Hopefully it falls with better understanding of the condition of assets. Over the past 8 years, Council has spent greater than the benchmark on maintenance and capital, but is under the benchmark in relation to asset renewal. In theory, this should be sufficient to contain the infrastructure backlog at its current level. However, based on the future guesstimates provided by Council, these ratios are anticipated to fall below benchmark levels. If this occurs, then the infrastructure backlog may grow again in the future.

6. Alternative Sources of Revenue and Potential Savings

Councils are constantly under pressure to increase their revenue streams while reducing their costs. Over the past few years, Councils have been regularly reminded not to rely on grant revenue and that there is no new additional grant sources available from the Federal and State Governments. This is unlikely to be true, as the Federal and State governments collect our taxes and need to distribute the funds raised back into the needs and requirements of the population. With ageing infrastructure across all levels of government, a significant amount of funding will be required to maintain those assets.

6.1 Alternative Sources of Revenue

Currently Council has the standard revenue streams of most rural Councils and also has quarry, preschool and aged care.

Potential alternative sources of revenue are:

- Special rate variation. Council has not had, nor budgeted for, a special rate variation in the 17 year period examined in this review. There is a perception that special rate variations are too hard to get approved and put the community offside. However, in recent years, there have been many successful variations approved ranging between 7% to 10% on the basis of reducing the infrastructure backlog. When the community has been appropriately informed, the community has generally embraced the concept. The majority of Councils rate base is from farmland rates, but they need a road to get their goods to the silo or market. Council needs to seriously consider the merits of a special rate variation.

- Increased income from RMS contract works. Council can actively pursue more contract work outside of the Shire as the RMS moves away from the current Single Invitation Contract framework.

- Expansion of Aged Care facilities. With 30% of the current population in the shire over 60, aged care will become a major issue. To keep families together, Council should consider the opportunities to expand its current operation.

- Implementing a more rigorous grant identification and application approach to ensure grant opportunities are fully explored.

- Actively pursuing private works opportunities rather than waiting for the ratepayer to contact Council.

6.2 Potential Savings

Cost cutting is always a difficult area. However, as time goes on, Council will need to consider:

- Reducing the size of its workforce, by being more efficient and embracing technological changes. In 2013, employee costs represented 35% of Council's annual expenditure. The most significant savings Council can make will be in employee costs.

- Implementing share service arrangements with other Councils. For example, IT. Council may see the benefit of being on the same platform and resource sharing.

- Via its asset management plans and community consultation process, whether some infrastructure assets should be effectively "run down" with minimal amounts spent on maintenance. For example, a gravel road with minimal daily uses may not need to be graded as regularly as other higher use roads.

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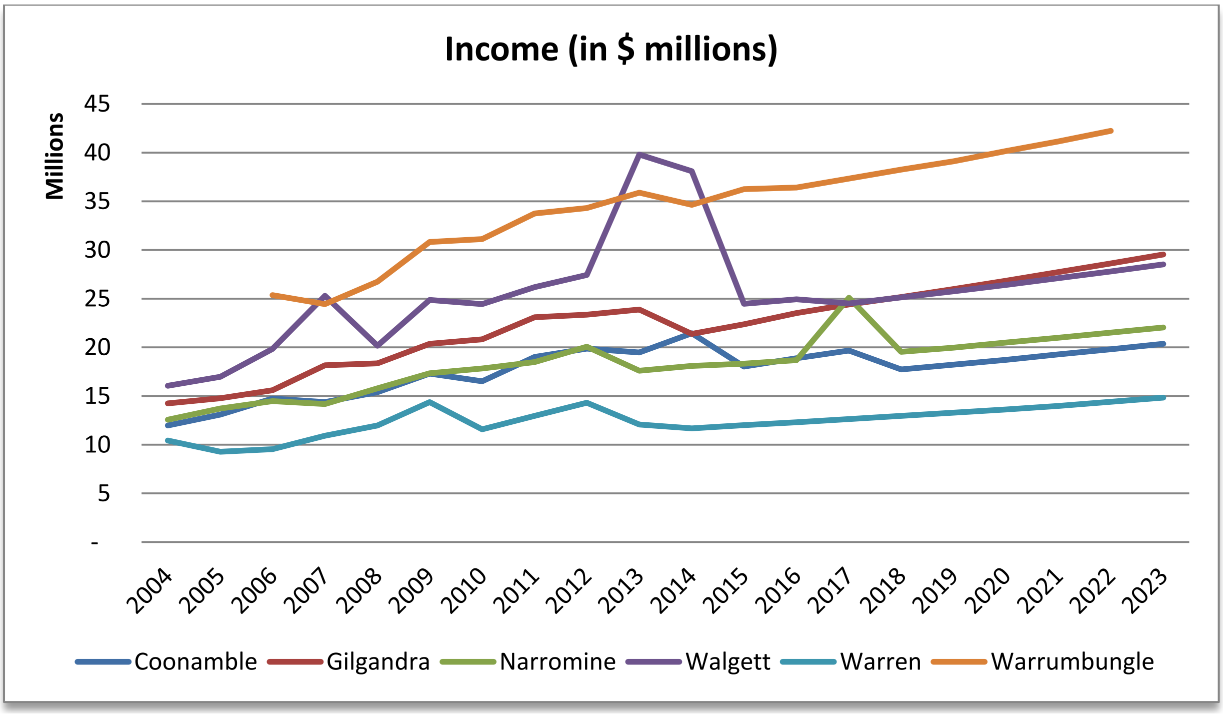
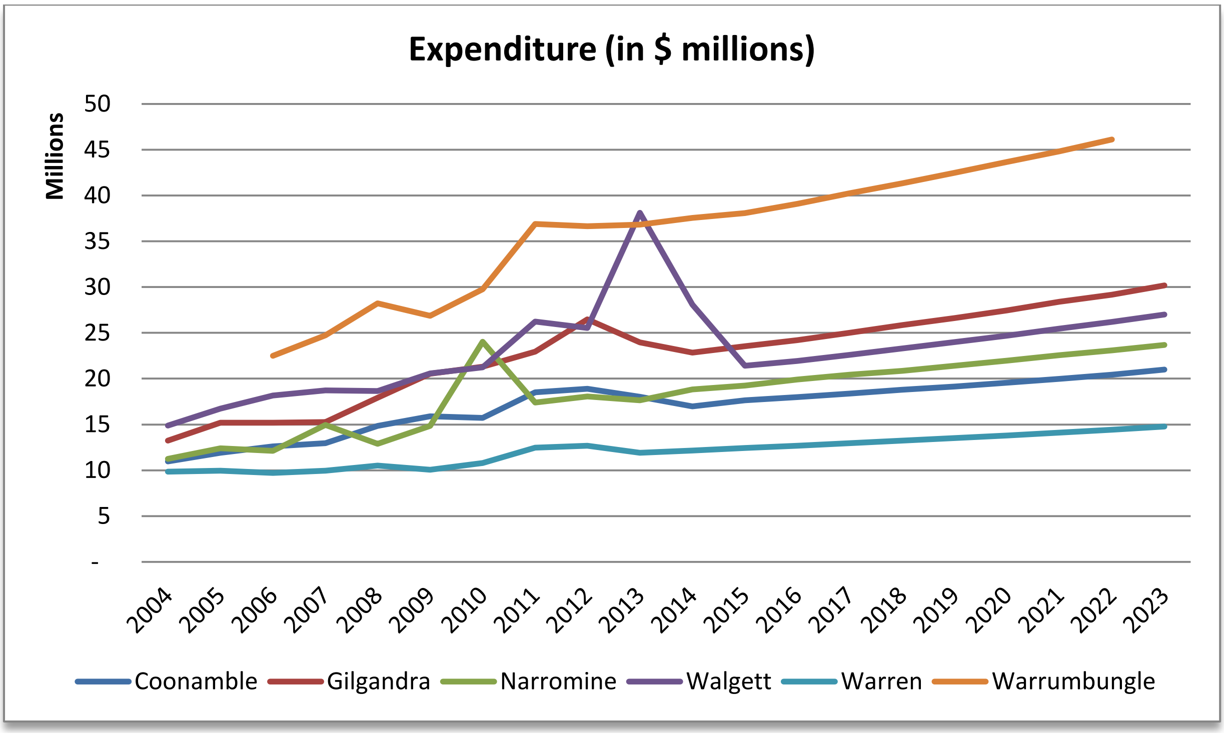
7. Comparisons with Other OROC Internal Audit Alliance Councils

Following are the combined graphs of the OROC internal audit alliance Councils. We have not provided commentary for each graph, as the trends and outliers are easily identified.

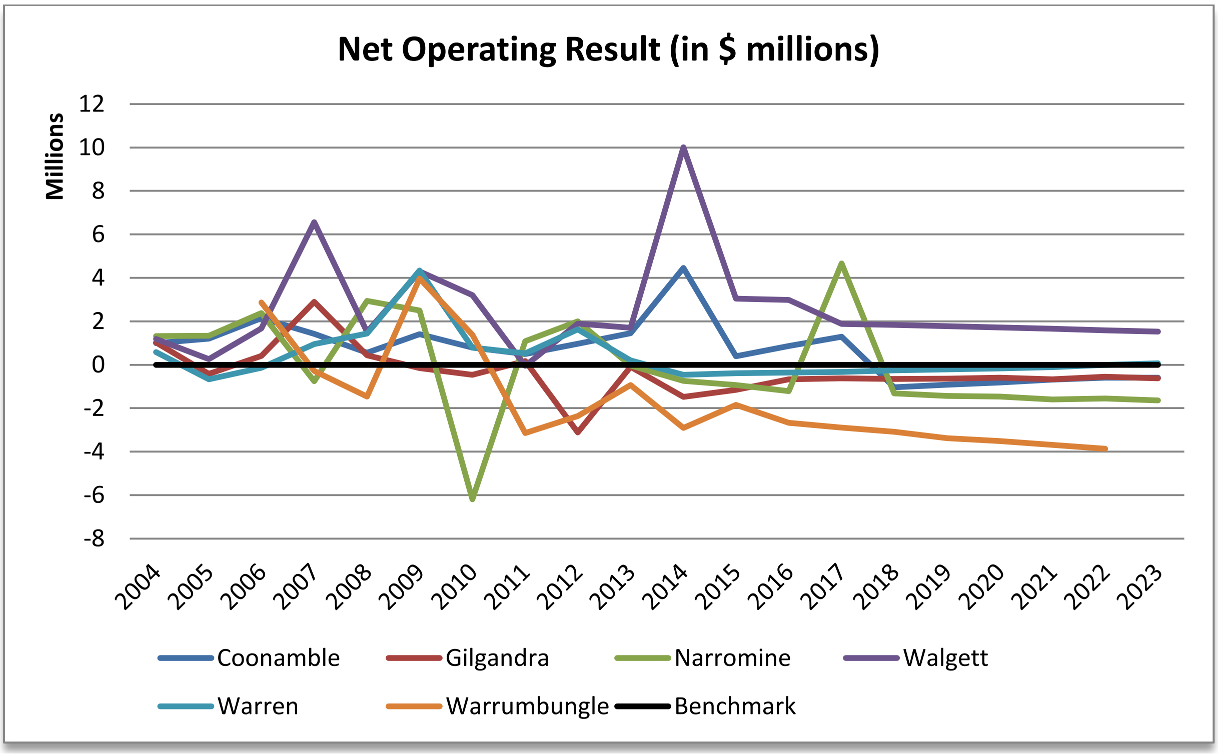
7.1 Income



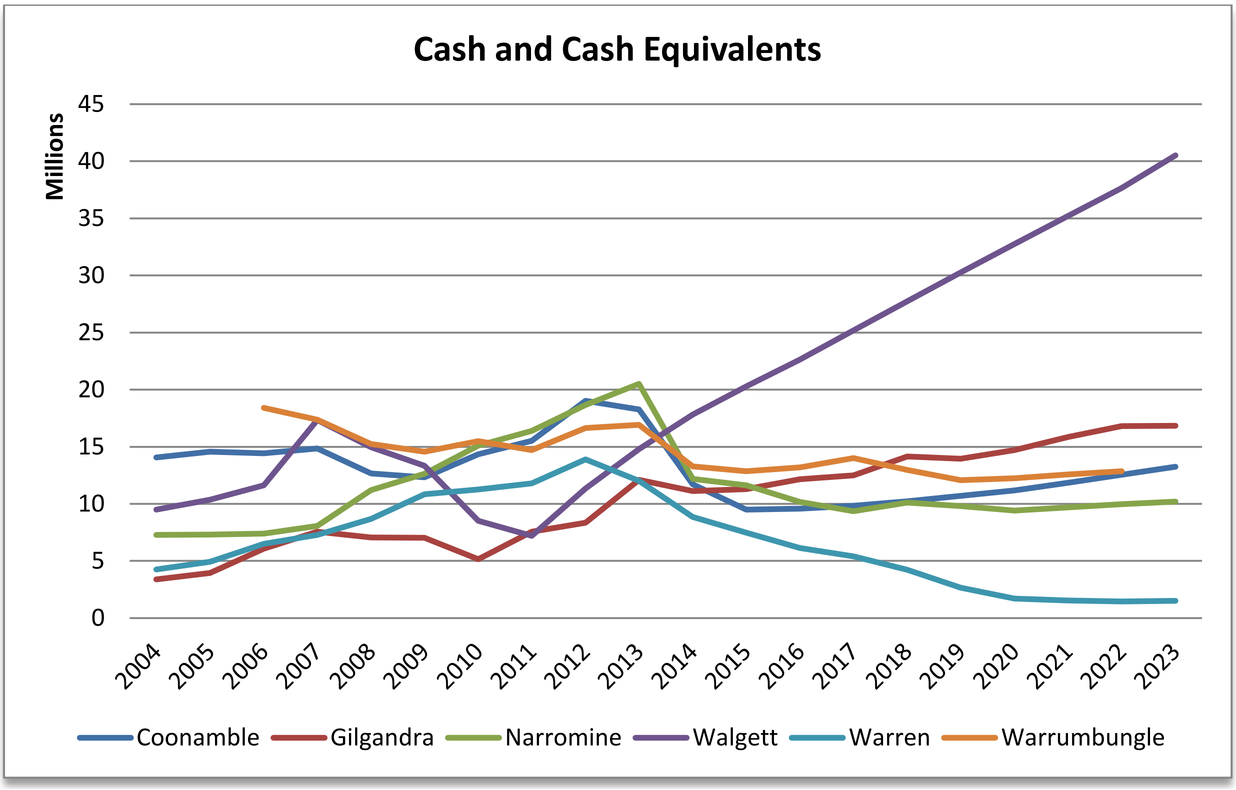
7.2 Expenditure



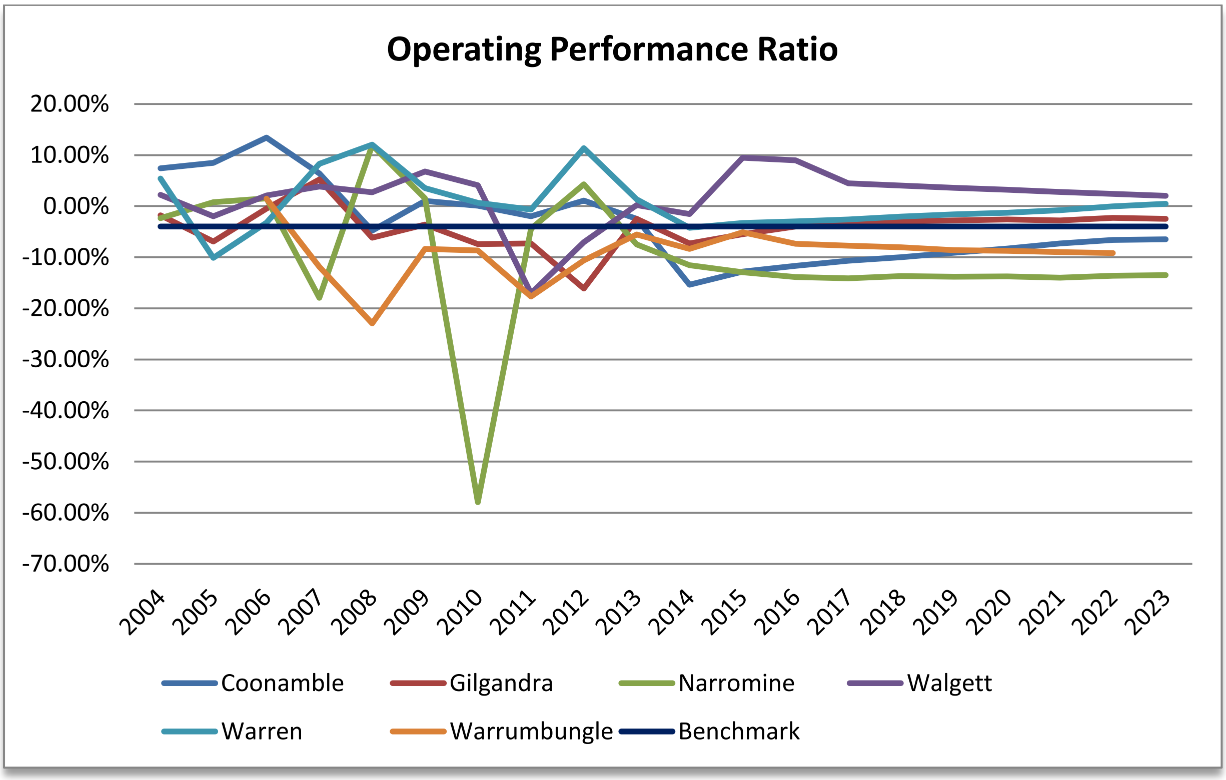
7.3 Net Operating Result



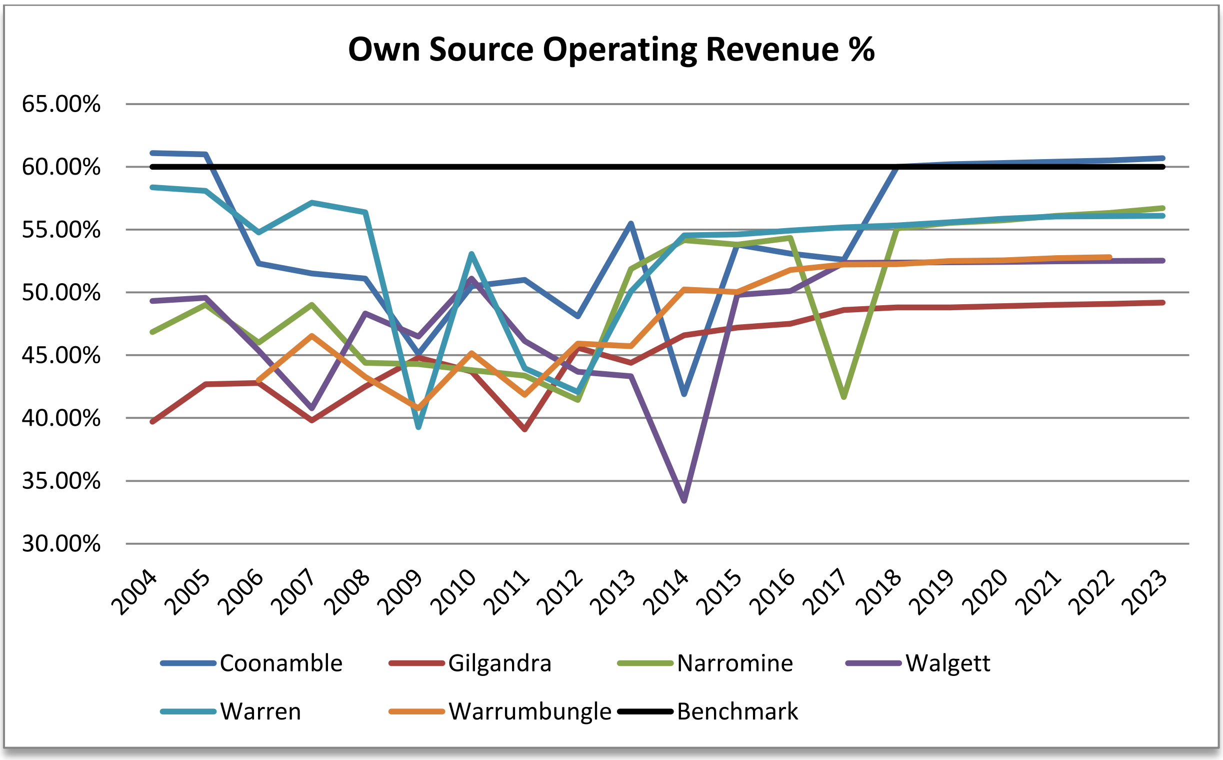
7.4 Cash Position



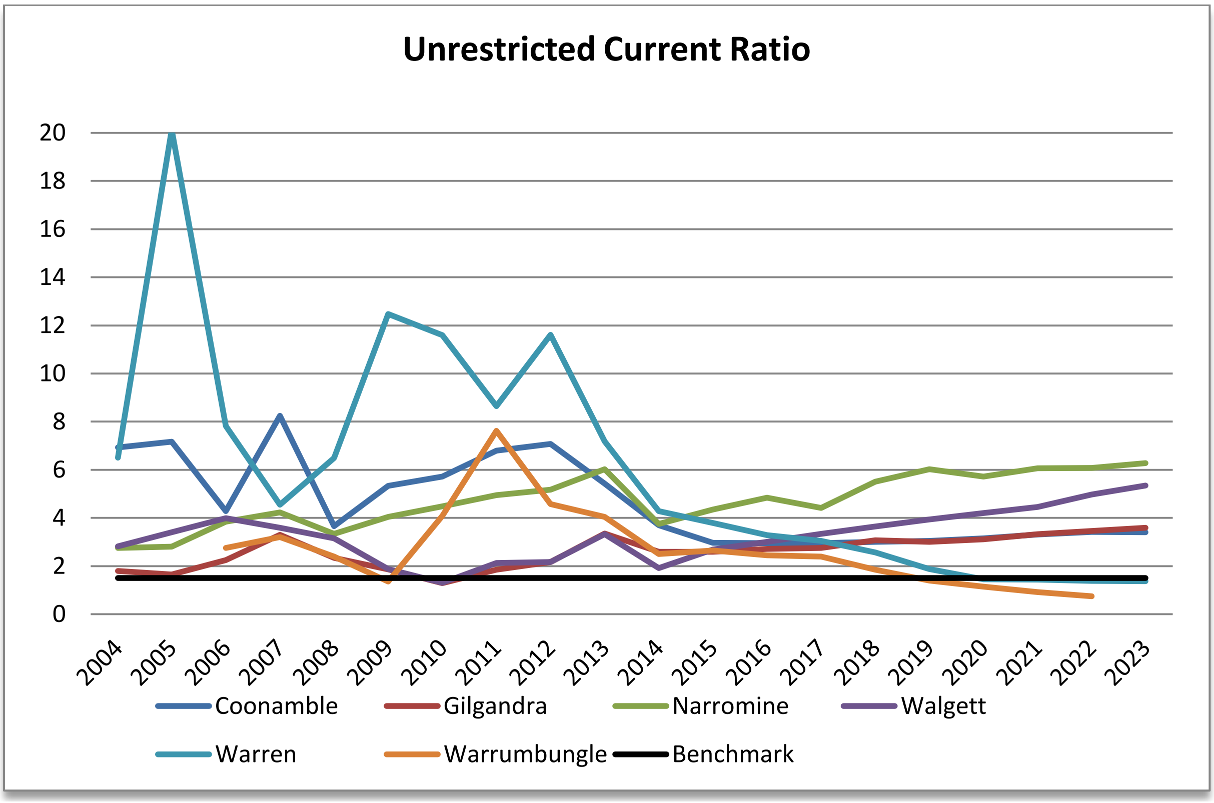
7.5 Operating Performance



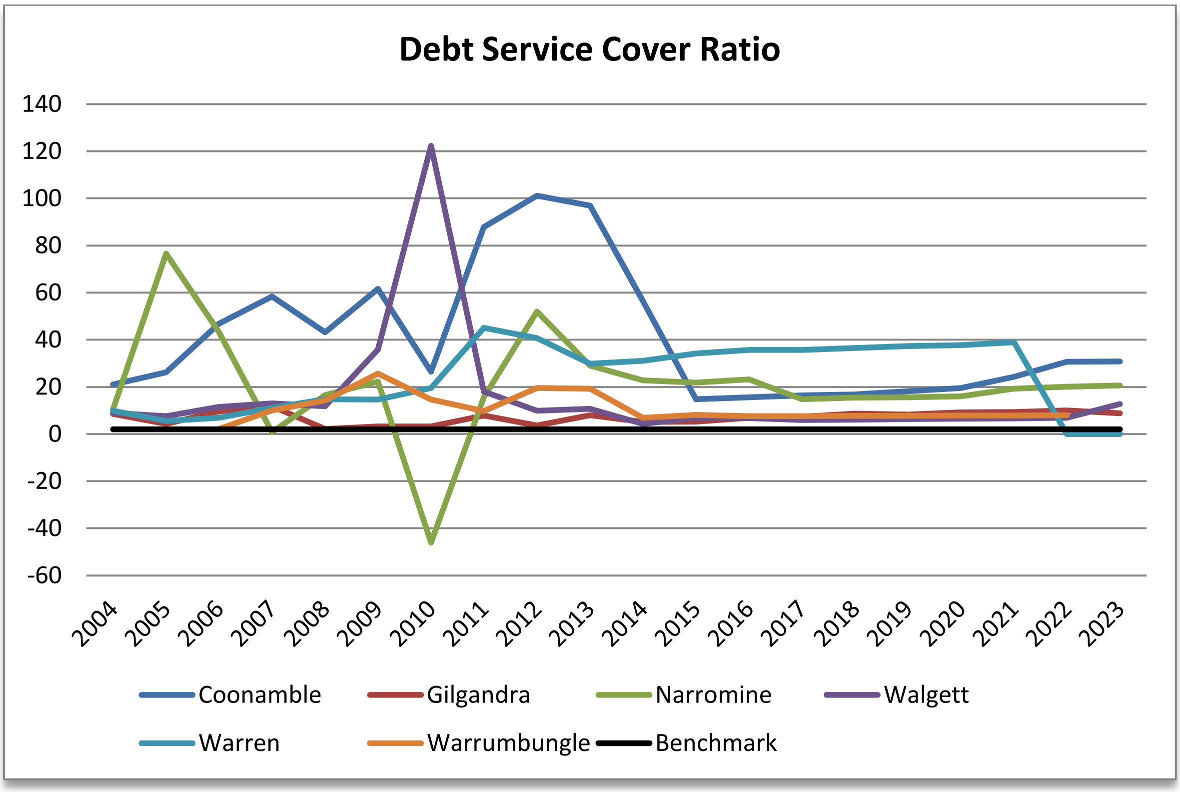
7.6 Own Source Operating Revenue



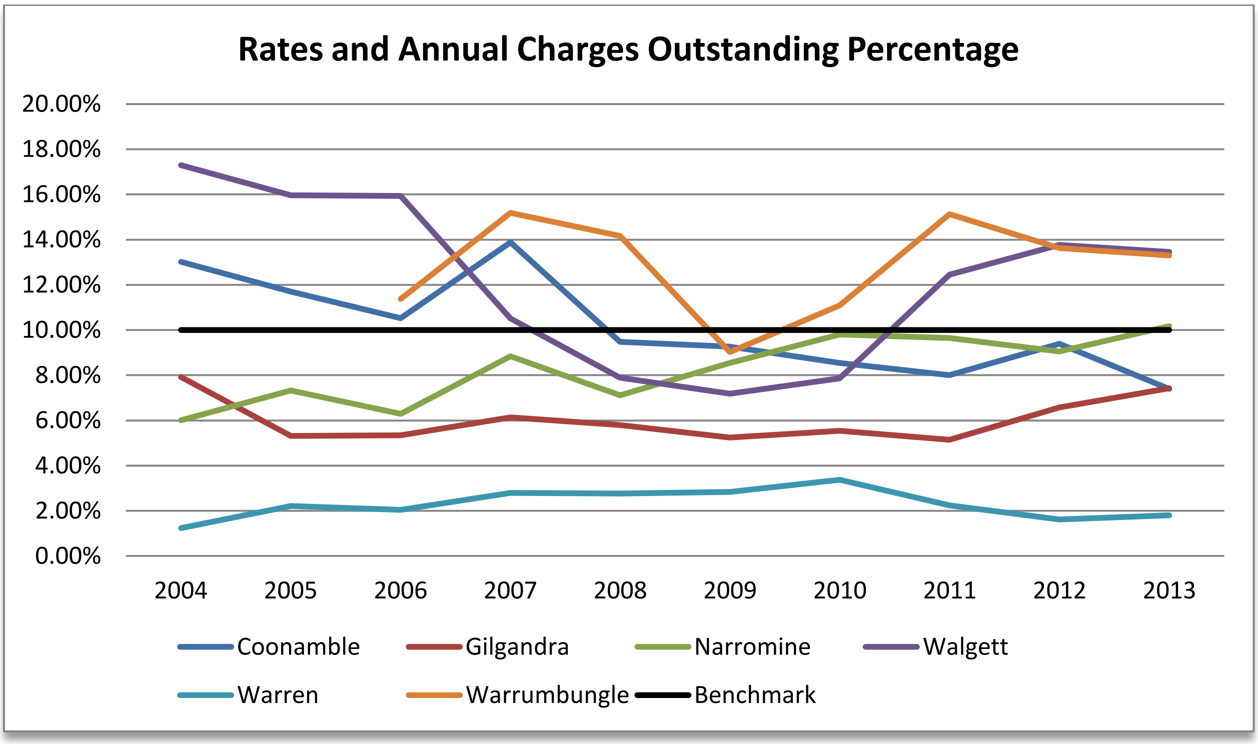
7.7 Unrestricted Current Ratio



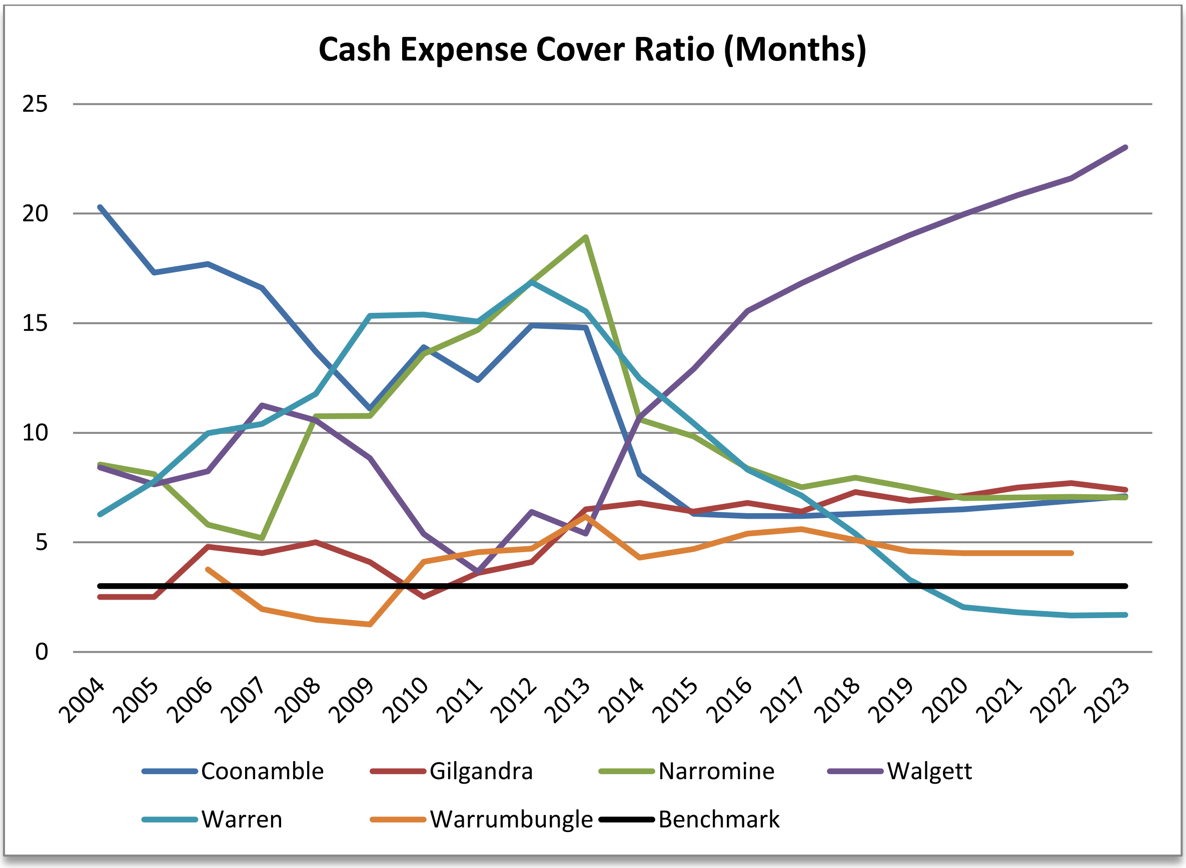
7.8 Debt Service Cover Ratio



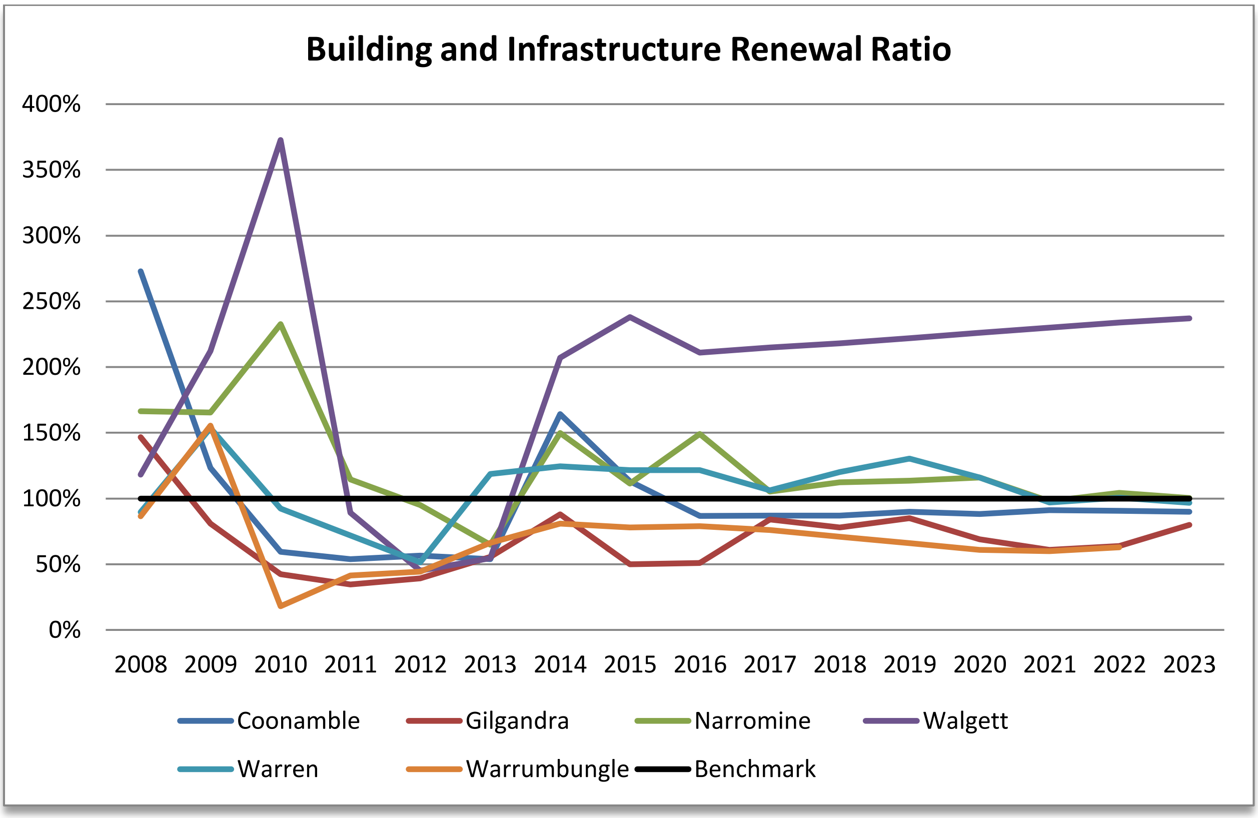
7.9 Rates and Annual Charges Outstanding Percentage



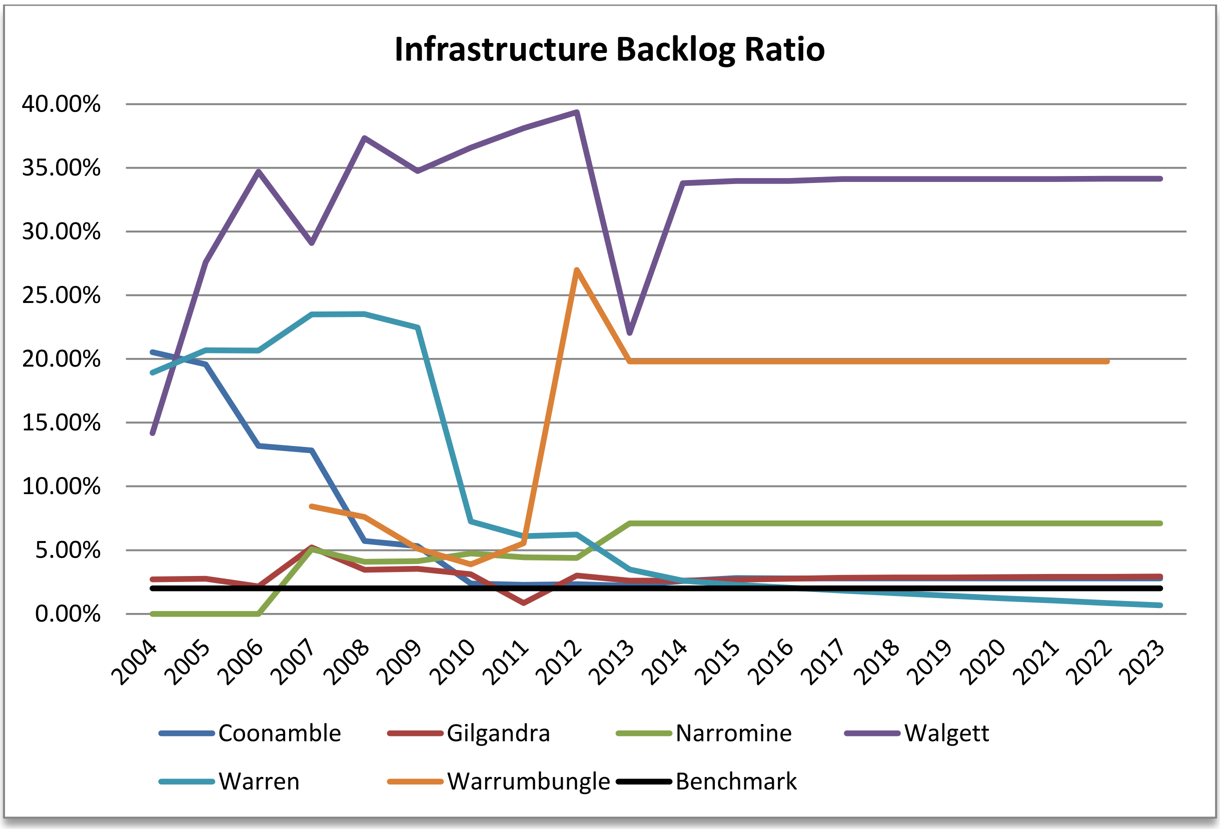
7.10 Cash Expense Cover Ratio



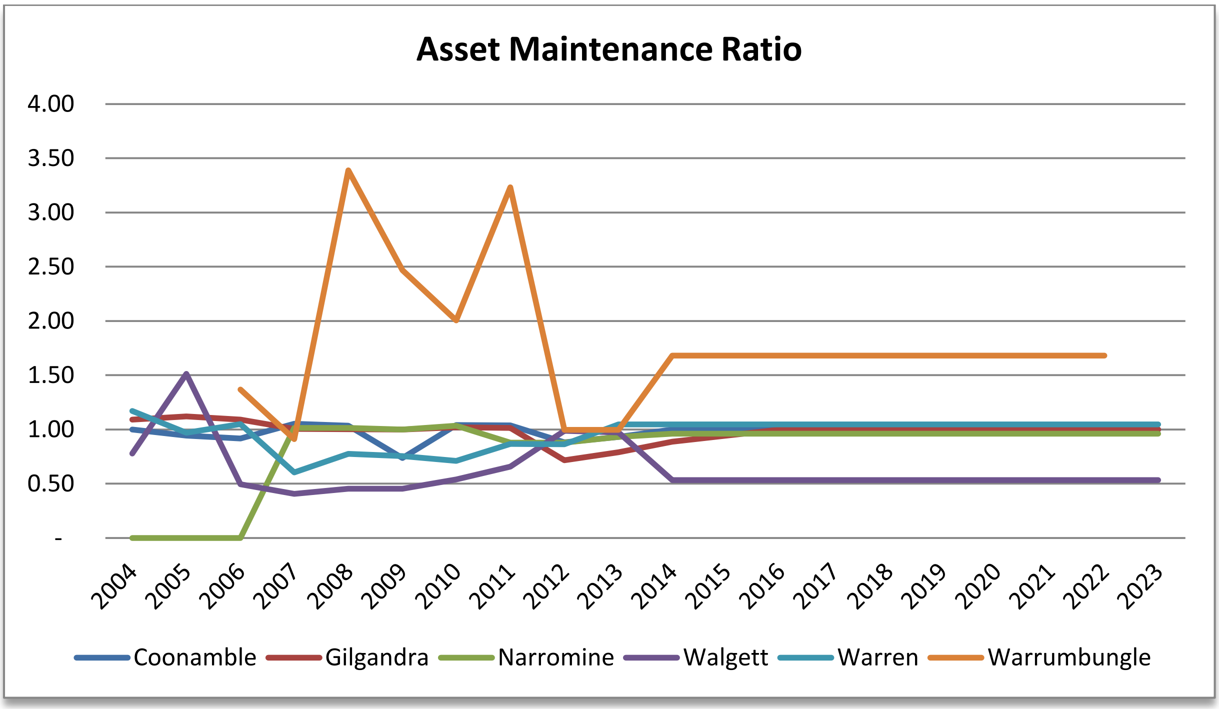
7.11 Building and Infrastructure Renewals Ratio



7.12 Infrastructure Backlog Ratio



7.13 Asset Maintenance Ratio



7.14 Capital Expenditure Ratio