Western Australian
Auditor General's Report

Audit Results Report – Annual 2017-18 Financial Audits of Local Government Entities

Report 15: March 2019

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WESTERN AUSTRALIAN AUDITOR GENERAL'S REPORT

Audit Results Report – Annual 2017-18
Financial Audits of Local Government Entities

Report 15
March 2019

THE PRESIDENT
LEGISLATIVE COUNCIL

THE SPEAKER
LEGISLATIVE ASSEMBLY

AUDIT RESULTS REPORT – ANNUAL 2017-18 FINANCIAL AUDITS OF LOCAL GOVERNMENT ENTITIES

Under section 24 of the *Auditor General Act 2006,* this report covers the first year of a 4-year transition for my Office to conduct the annual financial audits of the local government sector, following proclamation of the *Local Government Amendment (Auditing) Act 2017*.

The 2017-18 financial audits of 42 local government entities completed to date include:

- Results of the audits of local government entities' annual financial reports, and their compliance with applicable legislation for the financial year ending 30 June 2018.
- Issues identified during these annual audits that are significant enough to bring to the attention of the Parliament.

I wish to acknowledge the assistance provided by the councils, their chief executive officers, finance officers, and others including my dedicated staff and contract audit firms throughout the annual financial audit program and in finalising this report.

CAROLINE SPENCER
AUDITOR GENERAL
7 March 2019

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Auditor General's overview

This report summarises the results of 42 local government entities' annual financial report audits completed by my Office to date for the year ending 30 June 2018, following proclamation of the *Local Government Amendment (Auditing) Act 2017*. This was the first of a 4-year transition of local government financial auditing to the Office of the Auditor General.

In addition to reporting the results of the audits to Parliament, this report is intended to provide further insight for Parliament and the local government sector to our approach for performing and reporting on financial audits.

I recognise that we, together with the sector, have only just begun our journey in this new era of local government financial auditing. The 42 audits completed in 2017-18 represent approximately one third of all WA local government entity audits.

During our audits, in addition to routine but important audit findings, we have made other observations about what we found is working well in the sector, where improvements may be considered and where opportunities exist. One such stark governance-related opportunity relates to audit committees.

Audit committees play a key role in assisting boards, councils and chief executive officers with financial management, control, and reporting. In this report, I have included a few preliminary observations about the role of audit committees in the annual reporting and audit process. I recognise the challenges regional local government entities may have in appointing independent members with financial or audit expertise, and intend to report more broadly on the role of audit committees and internal audit in the future.

In our first year auditing local government entities, we were concerned that some local government staff considered an audit finding not worthy of formal reporting if the control weakness did not result in a breach of legislation or misstatement. My Office reports weaknesses in internal controls and governance, so that they can be remedied before they potentially lead to non-compliance with legislation including misstatement due to fraud or error.

We also identified the need for more emphasis on auditor independence. We noted it was often common practice for auditors to perform other work for local government entities, in addition to the annual financial audit. As this can impair an auditor's independence, we have tightened controls around our contracted local government auditors performing this work, as we do for state government, while recognising practical challenges - such as limited availability of alternate skills in some regional areas.

I wish to thank my staff, our contract auditors, and staff in the local government entities we audited who contributed and assisted during our first year of transition into the sector and our first annual financial audits.

I am looking forward to working with the sector over the coming years to deliver high quality audits that contribute to enhancing the financial management and performance of local governments for the benefit of the WA community.

Executive summary

This Audit Results Report contains findings from the annual financial audits of local government entities (LGs) that we audited for the 2017-18 financial year.

Following proclamation of the *Local Government Amendment (Auditing) Act 2017* (Amendment Act), the Auditor General assumed responsibility for the audits of the 2017-18 annual financial reports of 46 LGs. The annual financial audits of remaining LGs are due to transition to the Auditor General by 2021.

Under the Amendment Act, the Office of the Auditor General (OAG) also assumed responsibility for performance audits of the local government sector. These audits are reported in separate reports to Parliament when they are completed.

Key findings

- We issued auditor's reports for 42 LGs by 1 March 2019 relating to their 2017-18 financial year. (Page 10)
- All but 2 auditor's reports included clear (unqualified) audit opinions on the financial reports. We issued qualified auditor's reports on the financial reports of the Shire of Brookton and the Town of Cambridge. (Page 10)
- We reported 36 material matters of non-compliance with the *Local Government Act 1995,* Local Government (Financial Management) Regulations 1996, or other written law in 24 of our auditor's reports. (Page 11)
- In addition to material matters of non-compliance reported in auditor's reports, we reported 290 financial management and control matters of varying significance to management in our management letters. (Page 15)
- In accordance with the Local Government (Audit) Regulations 1996, we reported adverse trends in the financial position of 24 LGs. (Page 13)
- In our first year of performing annual financial audits in the local government sector, we have made some general observations and included these in the report, with a view to improving audit outcomes in the future. These relate mainly to audit committees and reporting practices. (Page 17)
- The report includes details of our response, in the context of auditor independence, to existing practices where audit firms performed other work at local governments they were auditing. (Page 19)
- We detail our concerns that valuation methodologies used by various valuers to fair value property, plant, equipment and infrastructure, often differ significantly, potentially affecting comparability of asset values across local governments. (Page 20)
- We recommend that LGs make timely preparations for upcoming changes to Australian Accounting Standards and a local government regulation. (Page 22)

Recommendations

1. LGs should ensure they maintain the integrity of their financial control environment by:

    a. periodically reviewing and updating all financial, asset, human resources, governance, information systems and other management policies and procedures, and communicating these to staff.

    b. conducting ongoing reviews and improvement of internal control systems in response to regular risk assessments.

    c. regularly monitoring compliance with relevant legislation.

    d. promptly addressing control weaknesses brought to their attention by our audits. (Page 16)

2. In addition to compliance with legislation, management should promote a culture of applying better practice financial management and complying with internal policies. (Page 18)

3. An in-depth audit exit meeting should be held with audit committees, in advance of council meetings. As far as is practicable, the audit committee should include a few council members, rather than the entire council. (Page 18)

4. An audit entrance meeting should be held with the audit committee. (Page 18)

5. Audit exit meetings should provide the auditor the opportunity to highlight the key audit issues, in a structured manner, and the CEO adequate opportunity to comment. (Page 18)

6. LGs should not make interim audit findings public until they are received as part of our Audit Report on completion of the audit, unless specific urgent needs warrant earlier release. (Page 18)

7. The Department of Local Government, Sport and Cultural Industries (the Department) should re-assess the potential advantages if LGs are required to report equipment assets using the cost model. (Page 21)

8. LGs should robustly assess the assumptions and methodology of their valuers, in particular the approach for valuing land assets with restricted use. (Page 21)

9. LGs and the Department should monitor the progress of the Australian Accounting Standards Board and International Public Sector Accounting Standards Board public sector fair value projects. (Page 21)

10. LGs should continue to make timely preparations for implementation of the upcoming accounting standards changes, and the new regulation requiring assets with a value at acquisition below $5,000 to be expensed. (Page 23)

Introduction

Under the *Local Government Amendment (Auditing) Act 2017* (Amendment Act), proclaimed in October 2017, a staged transition has commenced for local government entities (LGs) annual financial audits to transition to the Auditor General as and when existing audit contracts between audit firms and LGs expire. The Office of the Auditor General (OAG) assumed responsibility for 46 audits from the 2017-18 financial year, with full take up of all financial audits by 2020-21.

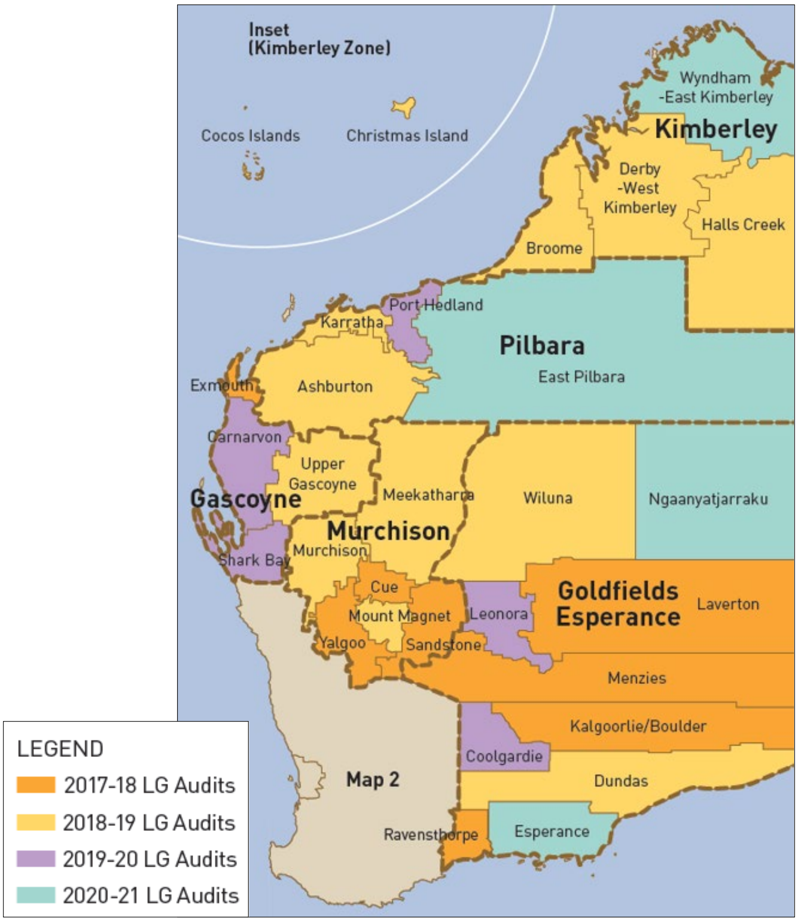
In 2017-18, OAG audit staff performed 3 of the 46 financial audits, with the others performed by contract audit firms on our behalf. Our oversight of these audits, coupled with in-house OAG audits, has provided our staff with valuable insight and understanding of the sector. From 2018-19, we will increase the number of audits performed using in-house audit teams.

For almost all of the contracted audits, we retained the existing audit firm for 2017-18 to maintain some continuity of the audit team. However, to provide open and fair competition and to ensure value for money, for 2018-19 we have now re-tendered most of these audits.

We are also committed to supporting local industry, and where possible and appropriate, we propose to use local financial auditing professionals in regional areas.

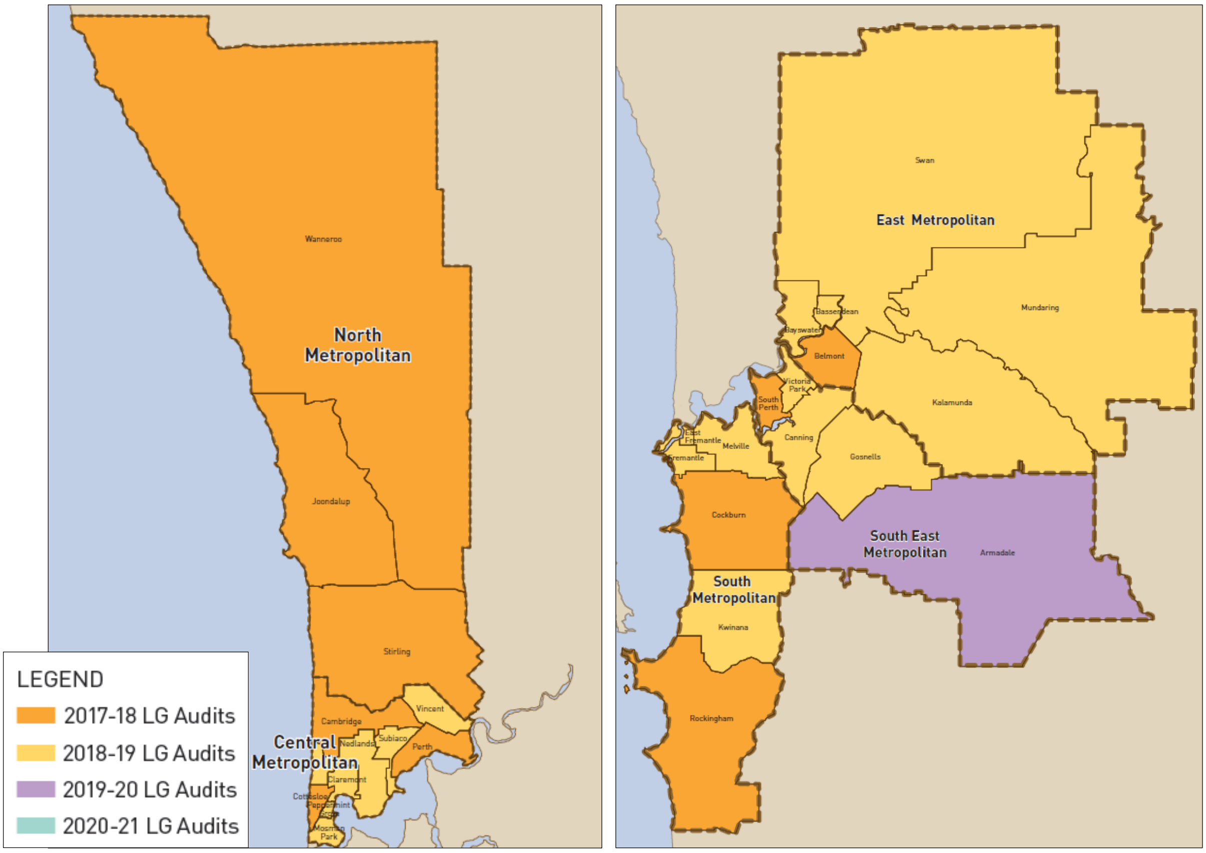
Local government entities audit program: 2017 onwards

The following maps show the local governments where we performed annual financial audits for 2017-18 (these are also listed at Appendix 1) and the transitioning schedule for other local governments over the next 3 years:



Map 1: Regional WA showing Auditor General's staged transition of audits

Map 2: South West region showing the Auditor General's staged transition of audits



Maps 3 and 4: Metropolitan WA showing Auditor General's staged transition of audits

Local government entity annual financial reporting framework and timeline

Each LG is required to prepare an annual financial report that includes:

- a Statement of Financial Position, Statement of Comprehensive Income by Nature or Type, Statement of Comprehensive Income by Program, Statement of Changes in Equity and Statement of Cash Flows
- a Rate Setting Statement
- seven financial ratios required under section 50(1) of the Local Government (Financial Management) Regulations 1996 (LG Financial Management Regulations), to be reported in the Notes to the financial report.

Under section 6.4(3) of the *Local Government Act 1995* (LG Act), a LG must submit its financial report for audit to the OAG by 30 September. Many of the 46 LGs we audited for 2017-18 submitted their financial reports for audit well in advance of this deadline. However, 10 submitted after 30 September 2018.

We completed 38 of the audits by 31 December 2018 as required by section 7.9 of the LG Act. A further 4 were completed after 31 December, and 4 are still being finalised, of which 3 were due to difficulties finalising asset balances.

Summary of auditor's reports issued

At 1 March 2019, we had issued auditor's reports for 42 LGs for the financial year ending 30 June 2018.

The auditor's report includes:

- the audit opinion on the annual financial report
- a description of significant non-compliance (if any) in relation to the financial report or other financial management practices
- an opinion whether there were any material matters that indicate significant adverse trends in the financial position of the LG.

Under the Amendment Act, the chief executive officer (CEO) is required to publish the annual report, including the audited financial report and the Auditor General's auditor's report, on the LG's website within 14 days of the annual report being accepted by the LG. A table of all auditor's reports issued by the Auditor General for 2017-18 is in Appendix 1.

Audit opinions on annual financial reports

An unqualified audit opinion in the auditor's report indicates the annual financial report was based on proper accounts and records, and fairly represented performance during the year and the financial position at year end. All but 2 LGs received unqualified (clear) audit opinions.

We issue a qualified opinion in our auditor's report on a LG's annual financial report if we consider it is necessary to alert readers to material inaccuracies or limitations in the financial report that could mislead readers. The following 2 LGs received a qualified opinion:

Shire of Brookton

We issued a qualified opinion as the Shire did not recognise the 2018-19 financial assistance grant of $504,598 received from the Commonwealth Government in June 2018 as revenue in accordance with Australian Accounting Standard AASB 1004 'Contributions'.

Instead, the Shire advised that it intended to recognise the revenue in 2018-19, and recorded the grant as Trade and other payables at 30 June 2018.

This resulted in the Shire's net result for the year being understated by $504,598 in its Statements of Comprehensive Income and its Trade and other payables in the Statement of Financial Position being overstated by the same amount.

In addition, this resulted in understatement of the current, debt service cover and operating surplus ratios disclosed in the Notes to their financial report.

Town of Cambridge

The opinion of the Town was qualified because in previous years the interest earned on invested trust funds was incorrectly recognised as income instead of being returned to the entitled recipients as required by the LG Act.

In 2017-18, to partially address this, the Town made a prior year adjustment to reduce income and cash balances, and also revised related Notes to the financial report.

The Town's best estimate of the cumulative effect of interest earned on trust funds at 30 June 2018 was approximately $450,000, of which a portion that had not yet been determined should have already been paid back to entitled recipients.

Prior year qualified opinion – 2017-18 audit still in progress

In 2016-17 the Shire of Laverton received a qualified opinion on its financial report because the auditor was unable to confirm that land, buildings, plant and equipment, furniture and equipment tools and infrastructure assets were reported at fair value.

The 2017-18 audit is still in progress because key aspects of a valuation, performed during the year, are still being reviewed.

Material matters of non-compliance with legislation

Regulation 10(3)(b) of the Local Government (Audit) Regulations 1996 (LG Audit Regulations) requires the auditor to report, in the auditor's report, any matters indicating non-compliance with Part 6 of the LG Act, the Local Government (Financial Management) Regulations 1996 (LG Financial Management Regulations) or applicable financial controls in any other written law. These matters may relate to the financial report or to other financial management matters.

In determining which matters to report, we apply the principles of materiality, as required by Australian Auditing Standard ASA 320 *Materiality in Planning and Performing an Audit.* Factors that we consider include the extent and frequency of the non-compliance, and the effect or potential effect.

Some of the matters we have reported relate to non-compliance with specific sections of the LG Act or regulations. We consider regulation 5(1) of the LG Financial Management Regulations to be particularly important, because failure to effectively apply those requirements can result in significant financial loss, inefficiency, financial misreporting or fraud. Regulation 5(1) requires efficient systems and procedures to be established, including:

- for the proper maintenance and security of the financial records of the LG
- to ensure proper accounting for municipal or trust revenue, expenses, assets and liabilities
- to ensure proper authorisation for the incurring of liabilities and the making of payments
- for the maintenance of payroll, stock control and costing records
- to assist in the preparation of …. accounts and reports required by the Act or the regulations.

We considered many of the findings that we reported to represent non-compliance with this important section of the LG Financial Management Regulations.

Our individual findings were included in our auditor's reports which are included in annual reports on each LG's website. For the convenience of Parliament and the public, we have summarised the matters we reported in the following table:

Issue	Finding
Controls over accounting journal entries	At 12 LGs, we found that accounting journal entries were posted with no evidence of independent review and approval by another person. Accounting journals can represent significant adjustments to previously approved accounting transactions, and could result in, for example, one type of expenditure being re-coded to another type of expenditure. Journals should therefore be subject to independent review.
Quotes not obtained for purchases below the tender threshold	At 4 LGs, 26% to 57% of purchases we sampled below the $150,000 tender threshold had inadequate or no evidence that a sufficient number of

	quotations was obtained, to test the market. There was no documentation to explain why other quotes were not sought. This practice increases the likelihood of not receiving value for money in procurement. This could also result in favouring of certain suppliers, although our audits did not identify any instances.
Review not performed of systems and procedures	At Bunbury-Harvey Regional Council, a review of the appropriateness and effectiveness of the Council's systems and procedures in relation to risk management, internal controls and legislative compliance was not completed at least once every two years as required by Regulation 17 of the LG Audit Regulations. The last review was in 2014.
Approval to make investments	At City of Cockburn, the officer sending communications to the City's investment advisor, instructing them to make investments, had not been delegated with authority to issue these instructions. Although management advised that another officer with delegation was consulted before making investment decisions, there was no evidence of consultation and no approval of the instructions to invest.
Inadequate recordkeeping for infrastructure assets	A stocktake of infrastructure was conducted at the City of South Perth for the first time in a number of years, and the City found $21 million of infrastructure assets that was not recorded on the asset register. The asset register has however now been appropriately updated.
System access controls	More employees than necessary at the Shire of Brookton had the ability to make modifications in the system to the rates used for fees and charges. The Shire did not have a system logging process to report and review changes made to fees and charges. In addition, a shared account could be used to modify creditor and debtor details in the system. This increased the risk of unauthorised changes to key information, although our audit sampling did not identify any.
Financial ratio not reported	The Shire of Bruce Rock did not report the Asset Renewal Funding Ratio in the annual financial report as required by regulation 50(1)(c) of the LG Financial Management Regulations, as planned capital renewals and required capital expenditure were not estimated in a long term financial plan and asset management plan respectively. The Shire has advised that the plans are currently being completed.
Financial ratios not reported	The Shire of Denmark did not report the Asset Renewal Funding Ratio in the annual financial report as required by regulation 50(1)(c) of the LG Financial Management Regulations, as planned capital renewals and required capital expenditure were not estimated in a long term financial plan and asset management plan respectively. The Shire also did not report the Asset Consumption Ratio for 2017 and 2016 in the annual financial report as required by regulation 50(1)(c) of the LG Financial Management Regulations, as current replacement cost of depreciable assets was not estimated in previous years.
Financial ratio not reported	The Shire of Kondinin did not report the Asset Renewal Funding Ratio in the annual financial report as required by section 50(1)(c) of the LG Financial Management Regulations, as management considered the available information on planned capital renewals and required capital expenditure was unreliable.
No signed employment contracts for 3 staff	For 3 employees at the Shire of Koorda, there were no signed employment contracts or letters of employment in the Shire's records.

Lack of policies, review not performed of systems and procedures, and financial ratio not reported	The Shire of Nungarin had not developed key policies and procedures, such as purchasing and risk management policies. A review of the appropriateness and effectiveness of the Council's systems and procedures in relation to risk management, internal controls and legislative compliance was not completed at least once every two calendar years as required by Regulation 17 of the LG Audit Regulations. The Shire has not reported the Asset Renewal Funding Ratio for 2016, as planned capital renewals and required capital expenditure were not estimated in a long term financial plan or asset management plan, as required by the LG Financial Management Regulations.
Bank reconciliation	Several monthly bank reconciliations at Shire of Perenjori were not completed in a timely manner, and some were not independently reviewed by management. In addition, one had alterations that were not explained, and one did not have schedules to support the reconciling items.
Review not performed of systems and procedures	A review of the appropriateness and effectiveness of the Council's systems and procedures in relation to risk management, internal controls, and legislative compliance was not completed by the Shire of Tammin at least once every two calendar years as required by Regulation 17 of the LG Audit Regulations.
Approval of payments, bank reconciliations and reporting to Council	For 19 of 26 payments we sampled at Shire of Yalgoo, there was no evidence of the signing officers examining supporting documentation to payments and documenting approval. Several monthly bank reconciliations were not completed in a timely manner, and some were not independently reviewed by management. In addition, the 30 June 2018 bank reconciliation included numerous uncleared payments and deposits in excess of 12 months old. Due to difficulties implementing new accounting software, four statements of financial activity were not presented at an ordinary meeting of Council within two months after the end of the month to which the statement relates, which is not in compliance with Regulation 34(4)(a) of the LG Financial Management Regulations.
Delegations, reporting of financial ratio, and reporting of a separate balance sheet for a trading undertaking	In April 2018 at the Town of Cambridge, Council approved a delegation to the CEO to make payments from the municipal fund. Management was however not able to provide evidence that these powers had been delegated prior to that date. Payments from the municipal fund were approved by the CEO or other staff prior to April 2018. The Town also did not report the Asset Renewal Funding Ratio for 2016 and 2017 as planned capital renewals and required capital expenditure were not estimated in the long term financial plan and asset management plan respectively, as required by the LG Financial Management Regulations. The Town did not report a balance sheet for its major trading undertaking, the Wembley Golf Course, in the Notes to the financial report, as required by regulation 45 of the LG Financial Management Regulations.

Table 1: Material non-compliance with legislation reported in auditor's reports

Adverse trends in the financial position of local government entities

Regulation 10(3)(a) of the LG Audit Regulations requires the auditor to report, in the auditor's report 'any material matters that in the opinion of the auditor indicate significant adverse trends in the financial position or the financial management practices of the local government'.

A performance audit of adverse financial trends would typically consider numerous aspects of a LG's finances, and inter-relationships between financial ratios. However, for purposes of the annual financial audit process, we have limited our audit to a high level assessment of whether the 7 financial ratios reported in the notes to the financial report achieved the standards set by the Department of Local Government, Sport and Cultural Industries (the Department). When determining whether a trend was significant, in some instances we allowed for a ratio to be slightly lower than the Department's standard, in recognition that failing to meet some standards is more significant than failing to meet others.

LGs report these ratios for the current year and the preceding 2 years. Our trend analysis was limited to these 3 years of information.

The 7 ratios, defined in regulation 50(1) of the LG Financial Management Regulations are:

- current ratio
- asset consumption ratio
- asset renewal funding ratio
- asset sustainability ratio
- debt service cover ratio
- operating surplus ratio
- own source revenue coverage ratio.

We reported that 38 ratios at 24 LGs indicated adverse trends. It is important to note that although most of the ratios are useful indicators, further assessment would be necessary before concluding on the overall financial position of an entity.

Emphasis of Matter included in auditor's reports

Regulation 16(a) of the LG Financial Management Regulations requires that the financial report of a LG is not to include the value of certain types of land, including land under roads, that are managed by or under the control of the LG. The Department informed us that it considered that the benefits of reporting land under roads did not justify the cost of its periodic valuation. The exclusion of any land under roads acquired on or after 1 July 2008 is inconsistent with Australian Accounting Standard AASB 1051 *Land Under Roads*. Regulation 4(2) of the LG Financial Management Regulations provides that if a provision of the Australian Accounting Standards is inconsistent with a provision of a regulation, then the regulation prevails to the extent of the inconsistency.

We noted that this significant divergence from the accounting standards was not being clearly disclosed in the annual financial reports of LGs. As land under roads is reported for the WA State Government sector and some other LG jurisdictions, we considered it important to alert readers to this different method of reporting. We requested that LGs prominently disclose this in their accounting policy notes to their financial reports. Although we considered that this inconsistency between the regulations and the accounting standards did not warrant a qualified audit opinion, we included an Emphasis of Matter paragraph in our auditor's reports to highlight this accounting treatment for readers:

> *Regulation 16 of the Local Government (Financial Management) Regulations 1996 does not allow a local government to recognise some categories of land, including land under roads, as assets in the annual financial report. My opinion is not modified in respect of this matter.*

Financial and management controls

In addition to the material non-compliance matters reported in our auditor's reports (see Table 1 on pages 11 to 13), we reported other matters to management, including less material non-compliance as well as financial management and information system control weaknesses identified in our audits. These management letters, together with the auditor's report, form part of our overall audit report that we provide under section 7.12AD of the LG Act to the mayor, president or chairperson, the CEO and the Minister for Local Government on completion of the audit.

In our management letters, we provide a rating for each matter reported. We rate matters according to their potential impact, and base our ratings on the audit team's assessment of risks and concerns about the probability and/or consequence of adverse outcomes if action is not taken. We consider the:

- quantitative impact – for example, financial loss
- qualitative impact – for example, inefficiency, non-compliance, poor service to the public or loss of public confidence.

Risk category	Audit impact
Significant	Those findings where there is potentially a significant risk to the entity should the finding not be addressed by the entity promptly.
Moderate	Those findings which are of sufficient concern to warrant action being taken by the entity as soon as practicable.
Minor	Those findings that are not of primary concern but still warrant action being taken.

Table 2: Risk categories for matters reported to management

We give LG management the opportunity to review our audit findings and provide us comments prior to completion of the audit. When management responds to our draft management letters, we request them to set a time frame for remedial action to be completed. Often management improves policies, procedures or practices soon after we raise them and before the audit is completed. Other matters may take longer to remedy and we will follow them up during our subsequent annual audits.

During 2017-18, we alerted 40 LGs to control weaknesses that needed their attention. We reported 290 control weaknesses, of which 56 rated as significant and 186 as moderate.

Figure 4 shows a breakdown of the categories of control weaknesses identified in our 2017-18 management letters.

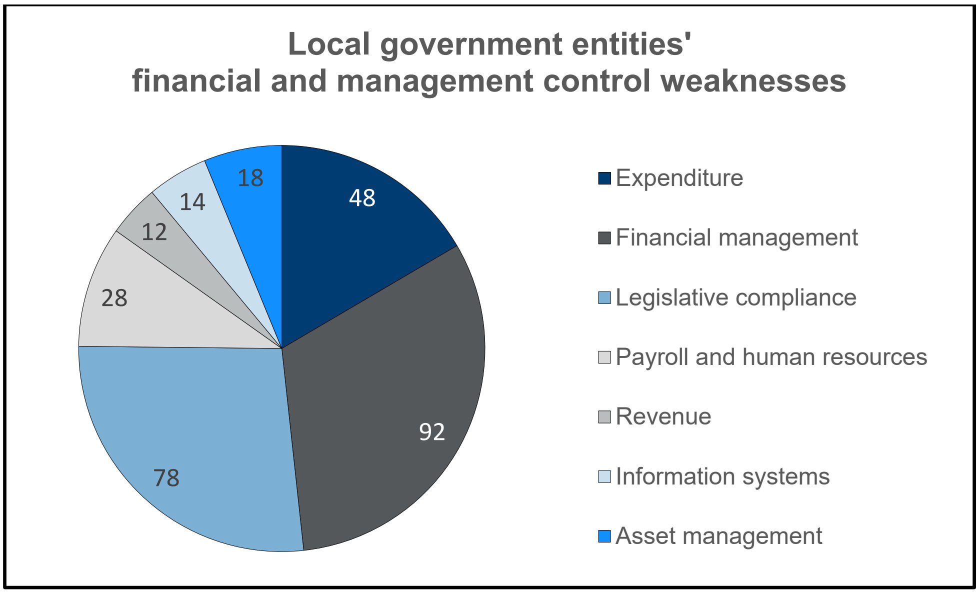


Figure 4: Financial and management control weaknesses reported to LGs

Recommendations

LGs should ensure they maintain the integrity of their financial control environment by:

a. periodically reviewing and updating all financial, asset, human resources, governance, information systems and other management policies and procedures and communicating these to staff

b. conducting ongoing reviews and improvement of internal control systems in response to regular risk assessments

c. regularly monitoring compliance with relevant legislation

d. promptly addressing control weaknesses brought to their attention by our audits.

Observations that may improve audit outcomes

The annual financial audit is focussed on providing assurance over a LG's annual financial report. During the audit we also make audit findings regarding compliance and financial and information system controls.

In this first year of auditing local government we have made some initial observations regarding opportunities for improving audit outcomes which would contribute to improved governance, financial management and performance for enhanced community satisfaction and confidence in LGs. It is important to note that each of the following issues was observed, with differing frequency across the LGs we audited.

Compliance vs better practice

At some LGs we noted an emphasis on minimum compliance (with the detailed regulations), rather than broader principles of good internal control and governance. In some instances, LG officers questioned why we were reporting their failure to comply with internal policies – it was apparent that some only regarded non-compliance with legislation to be an audit issue.

In our reporting we have made, and intend to continue making recommendations that not only address non-compliance, but which also assist to achieve better practice in financial management and control. This is aimed at remedying weaknesses before they contribute to potential breaches of legislation.

Internal audit

Only 11 of the 42 LGs we surveyed had an internal audit function. An effective internal audit function is important for ongoing maintenance and improvement of risk management, internal control and governance processes. The internal audit function acts as the independent eyes and ears for council on LG administration in key areas of risk. While recognising the difficulties for regional LGs to maintain an effective, independent internal audit function, we encourage LGs to collaborate with a view to effective internal audit assurance. We propose to cover this topic further in future performance audits.

Interaction with audit committees - audit entrance and exit meetings

Effective audit entrance and exit meetings are essential to good audit outcomes. These should facilitate informed, respectful and robust exchange between the auditors, management and the audit committee. This was the case for several of the 2017-18 audits.

On other audits however, the exit meeting was held with the entire council and this often hindered detailed discussion of the audit issues, due to the formality of proceedings and number of attendees. Section 7.12A of the LG Act requires the LG to meet with the auditor at least once each year, with the meeting typically occurring on completion of the audit. We strongly support this approach.

However, because of the number of attendees and time pressures at a full council meeting, it is preferable that, in advance of the council meeting, a more detailed exit meeting is held with the audit committee. The committee should preferably include a few council members only, with relevant skills/background in finance, risk management or auditing. We noted that 27 out of 42 LGs we surveyed had audit committees which included 5 or more council members. This is not considered better practice for facilitating effective entity-auditor communication, however we do recognise the potential challenges for regional entities in appointing members with specialist skills to their audit committees and the evident interest of councillors in audit-related matters.

We also made the following observations:

- In the past, it has generally not been common practice for audit entrance meetings to be held with the audit committee or council, and some exit meetings have also not been held with the audit committee or council. Australian Auditing Standard ASA 260 *Communication With Those Charged With Governance* requires the auditor to discuss certain key aspects of the audit planning and the audit results with those charged with governance. As a committee of council, the audit committee is the usual forum to enable effective audit communication.
- It is better practice for the auditors to highlight and explain the key elements of their entrance or closing report to the audit committee and management. Most of the meetings, especially exit meetings, did not follow a format that facilitated this but rather moved straight to councillors questioning the auditors. While this is important and as auditors we are happy to answer questions, as outlined above there are key matters that an auditor should directly communicate to those charged with governance.
- In some exit meetings, CEOs were, in our view, not given adequate opportunity to participate due to the formality of proceedings during audit meetings. CEOs and finance officers provide important information to those charged with governance, including updates on how audit findings have been prioritised and actioned.

At Appendix 3, we have briefly set out better practice guidelines for communications between auditors, management and councils.

Disclosure of audit communications

Sometimes during our planning or interim audit visit, we issue interim management letters to the CEO and council, to provide them early advice of our audit findings, to enable them to take timely remedial action.

However, these findings only form part of our report under section 7.12AD of the LG Act when we issue them as part of our report on completion of our audit. For this reason, our interim management letters advise that they may not be suitable for other purposes. They are not intended for public release until we issue them as part of our Audit Report, and indeed in our performance audit processes disclosure of draft findings is prohibited by the *Auditor General Act 2006* (AG Act).

Some LGs have made these interim management letters public. However, we regard them as 'working documents' until we issue them formally to the mayor, president or chairperson, the CEO and the Minister for Local Government as part of our final report.

Recommendations

1. In addition to compliance with legislation, management should promote a culture of applying better practice and complying with internal policies.
2. An in-depth audit exit meeting should be held with the audit committee, in advance of the council meeting. As far as is practicable, the audit committee should include a few council members, rather than the entire council.
3. An audit entrance meeting should be held with the audit committee.
4. Audit exit meetings should provide the auditor the opportunity to highlight the key audit issues, in a structured manner, and the CEO adequate opportunity to comment.
5. LGs should not make interim audit findings public until they are received as part of our Audit Report on completion of the audit, unless specific urgent needs warrant earlier release.

Auditor independence

OAG staff and contractors are required, by the AG Act, the ethical requirements of the Accounting Professional and Ethical Standards Board's APES 110 *Code of Ethics for Professional Accountants* and APES 320 *Quality Control for Firms,* and auditing standard *ASQC1*[1]*,* to be independent of the entities we audit.

Prior to assuming responsibility for LG financial audits, we were aware that it was often common practice for the existing auditors to perform other work for LGs, in addition to the annual financial audit. This can impair an auditor's independence. We have therefore given careful consideration to this, taking into account factors including:

- limited access to alternate accounting firms in regional areas to perform these other tasks
- the efficiencies that can sometimes be achieved if, for example, the auditor of the annual financial report also audits grant acquittals
- the key principle that auditors should not audit financial reports that they have prepared, to avoid the 'self-review threat to independence'
- whether some of the "other" tasks should be performed as part of the annual financial audit rather than as a separate task.

In 2017-18, we approved our contract auditors to perform various other audit tasks, in addition to the annual financial audit. We require our contractors to seek our approval, in advance. This is mainly to ensure that the nature of the proposed task does not impair their independence, and also to ensure that their fee is not too high in comparison to the fee for the annual financial audit, as that could also impair auditor independence.

For grant acquittals, including Royalties for Regions or Roads to Recovery, we generally permitted our contract auditors to, after obtaining our approval, engage directly with LGs and complete the required acquittals.

We also noted that some other work performed by audit firms was being regarded as separate from the annual financial audit, with separate fees, whereas part of the work should be routinely performed during the annual financial audit. For example, audit firms have often performed reviews of systems and procedures for the CEO as required by regulation 17 of the LG Audit Regulations or regulation 5(2)(c) of the LG Financial Management Regulations. Much of this work should already be covered during the annual financial audit and included in that audit fee. In our view, this had the effect of under-stating the audit fees for annual financial audits. We have taken steps to ensure adequate review of systems and controls as part of our annual financial audit process.

Some LGs also inquired whether our contract auditors could provide training to LGs where they were performing audits on our behalf. It is OAG practice that our contract auditors may provide general training in areas such as accounting principles or new accounting standards to entities, provided the fees are not so high as to impair their audit independence.

Independence can also be impaired through auditors instructing accounting staff on specific accounting entries that the auditors would subsequently audit. All additional work must be considered on a case by case basis for threats to impairment of auditor independence.

[1] ASQC1 Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, Other Assurance Engagements and Related Services Engagements

Financial reporting challenges relating to asset valuations

During our audits we noted a variety of valuation methodologies being used for property, plant, equipment and infrastructure in the WA LG sector. In this first year of our LG financial auditing, we noted several issues relating to these valuations. One issue was the timely completion of valuations – at least 3 audits were completed late because the LGs received their valuation reports too late.

Two other aspects were of particular concern:

- the cost of performing valuations
- inconsistent valuation methods.

The cost of performing valuations

Australian Accounting Standard 116 *Property, Plant and Equipment* requires entities to elect to measure property, plant and equipment, including infrastructure, using either a revaluation model (at fair value) or a cost model. In the public sector, it is common practice to measure assets such as land, buildings and infrastructure at fair value, requiring periodic valuations. However, it is more common for the public sector to measure assets such as equipment (including computing equipment), some plant, furnishings and motor vehicles at cost less accumulated depreciation, thereby avoiding the often significant expense and effort of periodically valuing the assets and auditing the valuations.

The WA State public sector measures these assets at cost, whereas local governments are required, by Regulation 17A of the LG Financial Management Regulations, to fair value the assets through periodic valuations. A recent revision to the LG Financial Management Regulations, effective 1 July 2018, will remove the requirement to value assets below $5,000. However, we suggest consideration also be given to requiring local governments to report all assets in these asset sub-classes using the cost model.

Inconsistent valuation methods

Valuation methodologies used for property, plant, equipment and infrastructure in the LG sector sometimes vary significantly across the different valuers. Some revaluations performed in 2017-18 yielded significant increments or decrements compared to the values of the previous revaluations, which were generally performed between 2013 and 2015. We concluded that most of the revalued assets were reported at amounts that materially represented fair value. However, in some instances, we asked LGs and their valuers to revisit the estimated values, resulting in some amendments.

Of particular concern is the inconsistent approach across different LGs, for valuing land assets that have restricted use. These include sports grounds, parks, gardens, sumps, foreshore, or land reserved as 'bush forever'. One of the reasons for inconsistency is differing interpretations of the principles in Australian Accounting Standard AASB 13 *Fair Value Measurement*. In particular, the standard requires valuers to take into account the highest and best use to which a market participant could put the asset. However, the standard also specifies the need to take into account the characteristics of the asset, including any restrictions on sale or use.

Different valuers are applying different interpretations of these principles, resulting in significant differences in values attributed to these types of restricted use assets. This impacts comparability of the assets of local governments. Both the Australian Accounting Standards Board (AASB) and the International Public Sector Accounting Standards Board

(IPSASB) currently have projects under way relating to fair value of public sector assets, and it is anticipated that they will provide guidance that could then be consistently applied in the LG sector.

Recommendations

1. The Department should re-assess the potential advantages if LGs are required to report equipment assets using the cost model.
2. LGs should robustly assess the assumptions and methodology of their valuers, in particular the approach for valuing land assets with restricted use.
3. LGs and the Department should monitor the progress of the AASB and IPSASB public sector fair value projects.

Upcoming changes to accounting standards and the local government regulations

A number of significant changes to Australian Accounting Standards will be applicable over the next few years, some commencing in 2018-19. These, and a change to the LG Financial Management Regulations are expected to require close attention by entities' finance officers and our audit teams.

Expensing assets with a value at acquisition under $5,000

Regulation 17A(5) of the LG Financial Management Regulations requires, with effect from 2018-19, assets with a value below $5,000 at the time of acquisition, to be excluded from the assets reported in the financial report. These assets will instead be reported as an expense in the statement of comprehensive income in the year of acquisition.

Australian Accounting Standard AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, requires this amendment to the asset values to be treated as a change in accounting policy. The standard requires balances to be adjusted retrospectively, unless it is impracticable to determine the period-specific or cumulative effects of the change.

Future impact of changes to accounting standards

The following new and revised standards issued by the AASB are expected to impact LGs to varying extent:

- AASB 9 – *Financial Instruments* – This standard changed the classification and measurement of financial assets from 1 January 2018 and therefore applies to LGs for the 2018-19 reporting year. Another change is earlier recognition of provisions for bad/doubtful debts based on expected credit losses.
- AASB 15 – *Revenue from Contracts with Customers* – This standard requires revenue to be recognised by entities on the fulfilment of the performance obligations of an enforceable contract at a point in time or over time, as applicable. An example for LGs is receiving grant moneys. LGs need to allocate the grant amount to each performance obligation in the contract and recognise the revenue only when the related performance obligations are satisfied. This will be consistent with current practice for the private sector.

  Also, authoritative implementation guidance has been issued for not-for-profit public sector licensors reporting transactions involving the issue of licences. This standard applied from 1 January 2018 reporting for for-profit entities, and from 1 January 2019 reporting for not-for-profit entities.
- AASB 1058 – *Income of Not-for-profit Entities* – This standard, in combination with AASB 15, establishes new principles for income recognition for not-for-profit entities from 1 January 2019 reporting and will therefore apply to LGs for the 2019-20 reporting year. AASB 1058 applies to transactions where assets are acquired at significantly less than fair value, including rates and grant moneys. It is anticipated that the implementation of these two standards will result in more delayed income recognition.
- AASB 16 – *Leases* – For lessees, this standard removes the distinction between operating leases and finance leases, and requires all leases (except short-term leases and leases of low-value assets) to be recognised as lease assets and lease liabilities on the balance sheet. This will result in the grossing-up of the balance sheet and higher expense in the early years of the lease term. Peppercorn lease assets can be elected to

be measured either at cost or at fair value. This standard applies from 1 January 2019 and will therefore apply to local governments for the 2019-20 reporting year.

- AASB 1059 – *Service Concession Arrangements: Grantors* – This standard is applicable to public sector entities (grantors) that enter into service concession arrangements with private sector operators. It requires grantors to recognise a service concession asset and, where applicable, a service concession liability on the balance sheet. The initial balance sheet accounting, as well as the ongoing income statement impacts, will have implications for grantors. AASB 1059 will apply for years beginning on or after 1 January 2020 and will apply to local governments for the 2020-21 reporting year.

We acknowledge that there are varying degrees of readiness and preparation for these new accounting standards. We are preparing and training financial audit staff in the new and revised requirements and updating relevant audit policies and procedures.

Recommendation

Local governments should continue to make timely preparations for implementation of the upcoming accounting standards changes, and the new regulation requiring assets with a value at acquisition below $5,000 to be expensed.

Appendix 1: Local government entities audited

We have to date completed 42 of the 46 audits for 2017-18. The auditor's reports issued are listed in the table below.

LGs are listed alphabetically.

Local government	Opinion issued
Bunbury-Harvey Regional Council	29/10/2018
City of Belmont	31/10/2018
City of Bunbury	17/10/2018
City of Cockburn	27/11/2018
City of Joondalup	14/11/2018
City of Kalgoorlie-Boulder	29/11/2018
City of Perth	13/12/2018
City of Rockingham	09/11/2018
City of South Perth	29/11/2018
City of Stirling	09/11/2018
City of Wanneroo	15/11/2018
Eastern Metropolitan Regional Council	05/10/2018
Pilbara Regional Council	14/12/2018
Rivers Regional Council	11/12/2018
Shire of Brookton	13/12/2018
Shire of Bruce Rock	13/12/2018
Shire of Capel	29/11/2018
Shire of Cranbrook	01/03/2019
Shire of Cue	11/12/2018
Shire of Cunderdin	Not finalised
Shire of Dandaragan	07/12/2018
Shire of Denmark	18/12/2018
Shire of Exmouth	27/11/2018
Shire of Jerramungup	11/02/2019
Shire of Kellerberrin	05/12/2018
Shire of Kondinin	12/12/2018
Shire of Koorda	18/10/2018
Shire of Laverton	Not finalised
Shire of Menzies	Not finalised
Shire of Moora	30/11/2018
Shire of Morawa	05/12/2018
Shire of Narrogin	20/12/2018
Shire of Northampton	03/12/2018

Shire of Nungarin	31/01/2019
Shire of Perenjori	10/12/2018
Shire of Ravensthorpe	Not finalised
Shire of Sandstone	30/10/2018
Shire of Tammin	31/01/2019
Shire of Three Springs	11/12/2018
Shire of West Arthur	13/12/2018
Shire of Woodanilling	18/12/2018
Shire of Wyalkatchem	18/01/2019
Shire of Yalgoo	18/12/2018
Shire of York	27/11/2018
Town of Cambridge	17/12/2018
Town of Cottesloe	05/12/2018

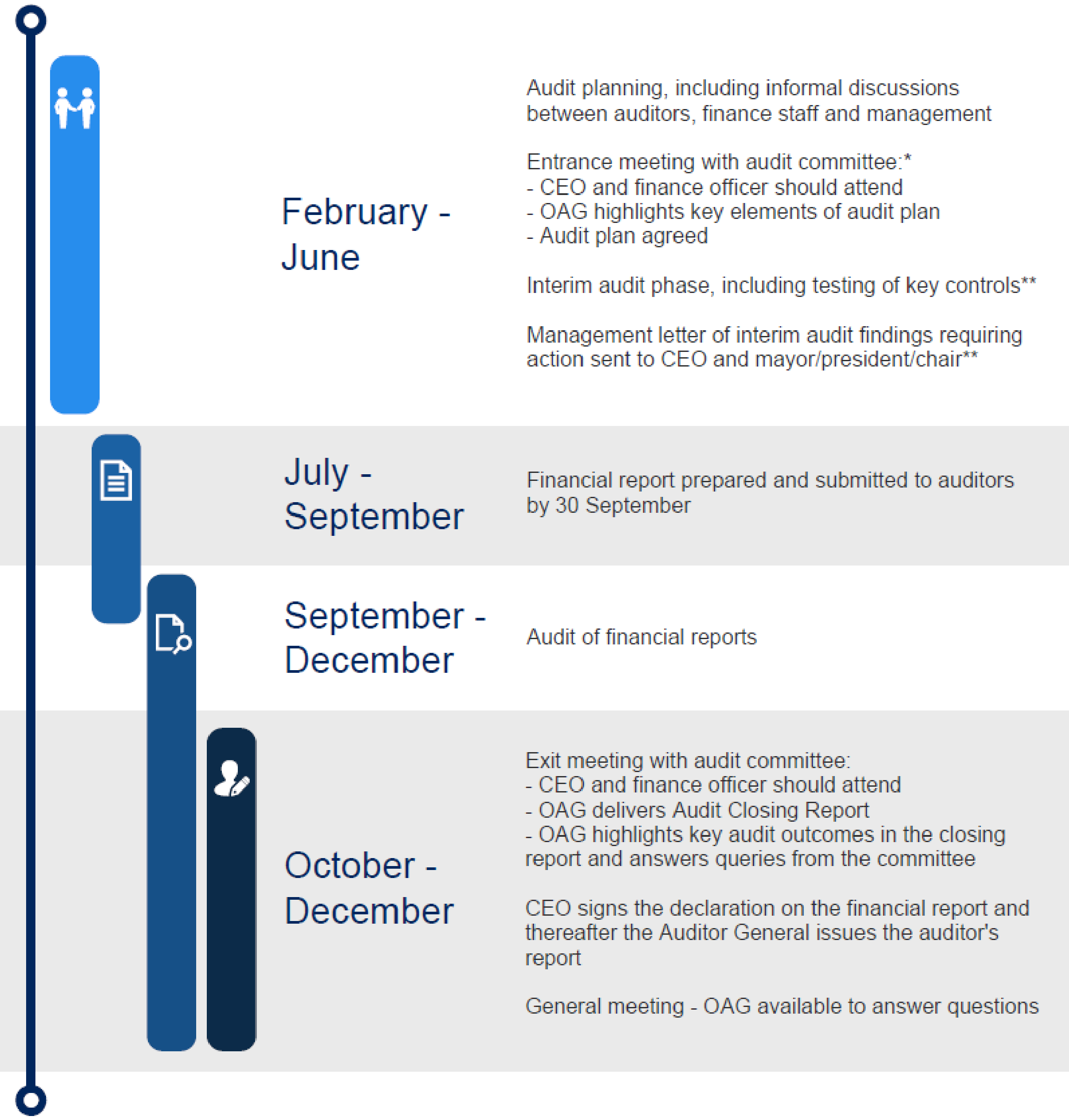
Appendix 2: Local government entity certifications issued

In addition to annual auditor’s reports, some LGs needed to acquit moneys received from other sources under grant agreements or other legislation. We issued the following 3 certifications on statements of income and expenditure of LGs, to help them discharge their financial reporting obligations, some being for Commonwealth grants.

LGs are listed alphabetically.

Local government	Opinions issued
City of South Perth – *National Land Transport Act 2014* – Roads to Recovery Funding	25/10/2018
Shire of Brookton – Pensioner Deferments	13/12/2018
Town of Cambridge – *National Land Transport Act 2014* – Roads to Recovery Funding	10/12/2018

Appendix 3: Timeline of communications between auditors, management and council members



Source: OAG

Notes

Meetings with some remote LGs will be conducted by teleconference due to cost and logistical reasons.

* If it is not practicable for the audit committee to meet for an audit entrance meeting, we suggest at least one councillor attends the entrance meeting.

** For small regional LGs, there may not be an interim audit visit. This work is usually completed at the same time as the audit of the financial report, and findings are reported at that time. The extent and proposed timing of interim work will be outlined in the audit plan.

Glossary and acronyms

AASB	Australian Accounting Standards Board
AG Act	*Auditor General Act 2006*
Amendment Act	*Local Government Amendment (Auditing) Act 2017*
Auditor's Report	The Auditor General's Auditor's Report that is published in the local government's annual report by the CEO, in accordance with section 5.55A of the LG Act.
Audit Report	The overall report under section 7.12AD of the LG Act, formally issued to the Mayor, President or Chairperson, the CEO and the Minister for Local Government on completion of the audit, including the Auditor's Report and the management letter(s).
CEO	Chief executive officer
Clear opinion (or unqualified opinion)	Auditor General's opinion expressed when an annual financial audit concludes that in all material respects the financial report is presented fairly in accordance with the *Local Government Act 1995* and, to the extent that they are not inconsistent with the Act, Australian Accounting Standards.
Contract audit	Audit of a local government undertaken by an appropriately qualified individual or firm, on behalf of the Auditor General, appointed under a contract.
Department	Department of Local Government, Sport and Cultural Industries
Emphasis of Matter	A paragraph included in an auditor's report that refers to a matter that is appropriately presented or disclosed in the financial report but which, in the auditor's judgment, is of such importance that it should be emphasised in the auditor's report.
Financial audit	Work performed to enable an opinion to be expressed regarding a financial report prepared by the party who is accountable for the financial transactions.
IS	Information systems, primarily computerised systems
LG Act	*Local Government Act 1995*
LG Audit Regulations	Local Government (Audit) Regulations 1996
LGs	Local government entities, being Western Australian local governments and regional councils
LG Financial Management Regulations	Local Government (Financial Management) Regulations 1996
Management letter	A letter to management of a local government that conveys significant audit findings and results of the audit. On completion of the audit, the management letter forms part of the audit report sent to the CEO, to the Mayor, President or Chairperson, and to the Minister for Local Government.
Materiality	The characteristic based on the size and/or nature of an omission or misstatement of accounting or compliance information that, in the light of context or circumstances, has the potential to adversely affect the economic decisions of users of the information or the discharge of accountability by senior management.
OAG	Office of the Auditor General
Qualified opinion	Auditor General's opinion expressed when an audit identifies aspects of the annual financial report that are likely to be misleading to users, there was material conflict with applicable financial reporting frameworks or a limitation of scope on audit work.
Significance	Relative importance in the circumstances, in relation to audit objectives, of an item, event or information, or problem the auditor identifies.

Auditor General's Reports

Report number	Reports	Date tabled
14	Opinions on Ministerial Notifications	13 February 2019
13	Opinion on Ministerial Notification	23 January 2019
12	Managing Disruptive Behaviour in Public Housing	20 December 2018
11	Opinions on Ministerial Notifications	20 December 2018
10	Opinions on Ministerial Notifications	18 December 2018
9	Treatment Services for People with Methamphetamine Dependence	18 December 2018
8	Opinions on Ministerial Notifications	10 December 2018
7	Audit Results Report – Annual 2017-18 Financial Audits of State Government Entities	8 November 2018
6	Opinion on Ministerial Notification	31 October 2018
5	Local Government Procurement	11 October 2018
4	Opinions on Ministerial Notifications	30 August 2018
3	Implementation of the GovNext-ICT Program	30 August 2018
2	Young People Leaving Care	22 August 2018
1	Information Systems Audit Report 2018	21 August 2018

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