

Local Government Act 1993

Section 438A

Performance Improvement Order

I, the Honourable Shelley Hancock MP, Minister for Local Government, do, by this order pursuant to section 438A of the *Local Government Act 1993*, require Armidale Regional Council, for the reasons specified in schedule 1 below, to undertake the actions described in schedule 2 below within the period specified in schedule 2.

I hereby appoint the persons specified in Schedule 3 as financial controller and temporary adviser to Council to exercise the functions for the terms specified in Schedule 3.

This Order takes effect upon service on the council.

Dated this 9th.....day of December.....2020



The Hon. Shelley Hancock, MP.
Minister for Local Government

SCHEDULE 1

Reasons for Order – section 438A(3)(a)

1. During Administration there has been a robust process for the recruitment and appointment of a new General Manager. Because of previous difficulty in managing the relationship between councillors and senior staff, actions are required to prevent inappropriate termination of the newly appointed General Manager's contract. The newly appointed General Manager needs to be given an adequate opportunity to undertake the role.
2. During Administration deficiencies were identified in Council's governance practices which need to be remedied. These matters come under the General Manager's responsibilities and the organisation needs to be given time and adequate resources to implement improvements. Deficiencies include:
 - a. a number of public registers are not available on Council's website as required by the Government Information (Public Access) Act 2009 (GIPA Act);
 - b. a number of statutory appointments not being made eg Privacy Officer;
 - c. a very low rate of declaration of conflicts of interests by councillors with no central register of declarations;
 - d. no centralised location for delegations and lack of clarity around staff delegations resulting in decisions escalating to senior staff;
 - e. Council's information management practices are poor;
 - f. while Council has an existing Enterprise Wide Risk Management Policy and Framework, they are based on an outdated standard. Council's risk register omits some important risks such as cyber security and strategy for digital services; and
 - g. lack of oversight of the procurement processes at Council.
3. A lack of evidence that Council has taken the Capital Expenditure Guidelines into

consideration before exercising its functions. There are a number of projects undertaken by Council that meet the threshold in the Guidelines. OLG has no record of Council having applied for a capital expenditure review as required by the Guidelines.

4. There is evidence that Council has not met its legislated responsibilities in relation to the management of land under its care and control. A review indicates that:
 - a. Council does not have a land register that meets the statutory requirements of the Local Government Act 1993 and outdated plans of management;
 - b. generic plans of management for land do not meet the requirements of the *Local Government Act 1993* and the *Crown Lands Management Act 2016*; and
 - c. the public exhibition requirements of the *Local Government Act 1993* in relation to the leasing of community land are not being met.
5. Evidence from an interim financial review of Council's position indicates that:
 - a. there are a number of unbudgeted financial commitments that are beyond the financial capacity of Council to support without reducing service levels;
 - b. a number of asset ratios are below the recommended benchmark levels; and
 - c. the cash position remains tenuous as internal reserves are established for specific purposes and unrestricted cash level is low.
6. There is evidence that Council may have made some decisions at councillor briefings and/or workshops. For example, the calling for expressions of interest for the airport.
7. There is an apparent failure to comply with statutory obligations that attach to procedures relating to section 356 of the *Local Government Act 1993*.
8. In my opinion, the financial controller with the requisite financial expertise is needed to implement financial controls at the Council and oversee the implementation of the financial elements of the performance improvement order.
9. In my opinion, the temporary adviser with expertise in the governance of councils is needed to oversee the implementation of improvements to Council's governance framework and to monitor the conduct and performance of the governing body at meetings of the council and committees of the council and at councillor briefings and workshops.

SCHEDULE 2

Action required to improve performance – section 438A(3)(b)

In accordance with section 438A of the *Local Government Act 1993*, this order requires that:

1. Council can only terminate its general manager's contract of employment with the concurrence of the Deputy Secretary, Local Government, Planning and Policy.
2. Council can only change its delegations with the concurrence of the Deputy Secretary, Local Government, Planning and Policy.
3. Council can only restructure the organisation with the concurrence of the Deputy Secretary, Local Government, Planning and Policy.
4. Council must implement the recommendations made in the report on the review of Council's governance practices under the oversight of the Audit, Risk and Improvement Committee.
5. Council must implement the recommendations made in the report on the review of Council's land management practices.
6. Council must implement the recommendations made in the report of the review of Council finances.
7. Council can only amend its councillor/staff interaction policy with the concurrence of the Deputy Secretary, Local Government, Planning and policy.
8. Within three months of the commencement of this order, Council must review its code of meeting practice to ensure it complies with the *Model Code of Meeting Practice for Local*

Councils in NSW (the Model Meeting Code).

9. Council must amend its code of meeting practice to adopt clauses 3.32 and 3.34 – 3.35 of the Model Meeting Code and to provide that councillor briefings are to be open to the public unless the general manager is satisfied that grounds exist to exclude members of the public from a briefing to consider information that should not be made public.
10. Council must conduct its meetings in accordance with its code of meeting practice and must not make decisions at councillor briefings and workshops.
11. Council must within one month of the commencement of this order ensure that the General Manager develops a councillor request system to manage email requests from councillors that incorporates rules about the use of the councillor request system with a focus on ensuring that communications are respectful, the number of requests are reasonable and include provisions permitting the General Manager to impose limitations where disrespectful or excessive use of the system occurs..
12. Council is to ensure that resources are provided to the General Manager so that adequate funds are provided for:
 - a. governance standards to be maintained;
 - b. the delivery of the operational plan;
 - c. infrastructure maintenance; and
 - d. the improvement of financial ratios.
13. Council must take immediate steps to implement improvements to Council's financial monitoring and reporting. In doing so Council is to:
 - a. utilise the services of the financial controller to assist Council in assessing the adequacy or otherwise of the existing system of financial accounting, monitoring and reporting;
 - b. have due regard to the advice of the financial controller to ensure Council has an effective system of financial accounting and internal control; and
 - c. prepare an improvement plan with advice and direction from the financial controller giving timeframes for each action and requiring all improvements to be implemented by 04 September 2021.

Period for compliance with Order

Compliance report one: A report on the implementation of action item 10 is due six weeks from the commencement of this order.

Compliance report two: A report on the amendments to the code of meeting practice (action items 7 and 8) is due four months from the commencement of this order.

Compliance report three: A report on the implementation of the governance review, finance review and land management review recommendations (action items 4, 5 and 6) is due six months from the commencement of this order.

Final compliance report: A report on Council's compliance with actions in this order is due on 04 September 2021.

Evidence to be provided with the compliance report

Compliance report one: A copy of the councillor request system rules to be provided.

Compliance report two: A copy of the amended code of meeting practice is to be included with the compliance report.

Compliance report three: A copy of the recommendations and actions taken is to form the compliance report.

SCHEDULE 3

Appointment of financial controller

1. Pursuant to section 438HB of the *Local Government Act 1993*, Mr John Rayner PSM is hereby appointed as a financial controller to Armidale Regional Council to:
 - a. undertake the role of financial controller as provided in section 438HC of the Act;
 - b. implement financial controls;
 - c. provide advice on the adequacy of Council's assessment of its current financial position and make any recommendations to improve Council's immediate financial position;
 - d. provide advice on the adequacy of Council's financial accounting, monitoring and reporting systems and internal controls and make recommendations to improve Council's processes;
 - e. monitor the council's compliance with the performance improvement order; and
 - f. provide advice on the adequacy of Council's financial position and control environment at the end of the order implementation.

This appointment will cease upon Mr Rayner providing a report to me on Council's final compliance report and financial position, due on 04 September 2021.

Pursuant to section 438HB(8) of the *Local Government Act 1993*, the financial controller shall be paid from the Council's funds for the period of the appointment as agreed to under the terms of the contract.

Appointment of temporary adviser

1. Pursuant to section 438G of the *Local Government Act 1993*, Mr John Rayner PSM is hereby appointed as a temporary adviser to Armidale Regional Council to:
 - a. observe Council meetings for the purpose of ensuring Council is complying with the code of meeting practice in respect of meeting procedures and dealing with acts of disorder;
 - b. observe Council workshops and councillor briefings for the purpose of ensuring that no decisions are made at those sessions;
 - c. provide advice in relation to the implementation of the recommendations from the governance review;
 - d. provide advice and assistance to the council for the purpose of ensuring that it complies with the performance improvement order; and
 - e. monitor the council's compliance with the performance improvement order.

This appointment will cease upon Mr Rayner providing a report to me on Council's final compliance report.

Pursuant to section 438G(7) of the *Local Government Act 1993*, the temporary adviser shall be paid from the Council's funds for the period of the appointment as agreed to under the terms of the contract.

24 Nov 2020

The Administrator
Armidale Regional Council
Rusden St
ARMIDALE NSW 2350

Dear Sir,

Review of Council Finances

In accordance with an engagement agreement dated 4 Nov 2020 we have been commissioned to undertake a review of Councils finances, specifically:

- a. Undertake a forensic review of Council finances, in particular the deterioration of internally restricted and unrestricted cash since the merger of the Armidale Dumaresq and Guyra Shire Councils. The analysis is to focus on General Fund over expenditures, unplanned expenditures and budget revenue shortfalls.
- b. Report on the status and utilisation of Reserves, both pre and post merger.

Our review has been conducted with the assistance of the Council's Finance Team. Due to the state of the records, there have been scope limitations in sourcing relevant records and compiling financial information. The capacity to interview Management Team members was restricted as key personnel employed in the early years are no longer with Council. The current Finance Team have provided valuable assistance in extracting data and recompiling information to assist the review.

From a governance perspective we have relied on Council resolutions and reports presented to Council. We have not considered reports, discussions or decisions that may have been part of Councillor workshops.

A summary of our findings is available on page 2 and recommendations arising from our review are included on page 13.

We would be happy to respond to any questions in relation to this review.

Yours faithfully



Robert Finch
Finch Consulting

1. Executive Summary:

A summary of our findings is as follows:

- Net Current Assets (working capital and reserves) declined by \$11m in the first three years of the new Council.
- The decline in Net Current Assets and Reserves is attributable to:
 - Council adopting deficit budgets (excluding capital grants) exceeding \$8.2m in total for FY2017 to FY2019.
 - Operating Expenditure in FY2017 and FY2018 substantially exceeding budget by \$11.6m thus exacerbating the original budget deficits.
 - Merger Implementation project expenditure (included in operating expenditure above) and funded by the \$5m NSW government grant, exceeding budget by \$0.6m. Redundancy payments of \$1.2m were included in merger project expenditure and an additional \$0.9m in redundancy costs associated with organisational restructures was funded by Council, bringing total redundancy costs since merger to \$2.1m.
 - Specific major capital projects (including the Library) exceeding the original budget estimates by \$4.2m.
 - Council proceeding with capital purchases without a budget or identified funding source, such as land adjacent to the Airport for \$0.67m.
 - Cash generated by operating cash surpluses together with external funding sources being insufficient to fund the capital works programs in FY2017 and FY2018, which, as a result, impacted on cash reserves.
- Expenditure on the new Library exceeded the original projection of \$3.5m by \$0.9m. Project approval was outside the original budget for FY2017 and as the original proposal to fund the project via a loan did not proceed, total costs contributed to the erosion in Net Current Assets. NSW Government Capital Expenditure Review guidelines do not appear to have been followed.
- Reserves (Internal Restrictions) established in FY2017 and FY2018 were either unfunded or relied on limited working capital cash for funding. This includes the Plant and Vehicle Reserve of \$2.24m, documented as a source of funding for acquisitions totalling \$3.2m in FY2017 and FY2018.
- Projects were initiated on the assumption that Reserves existed but in fact they had been extinguished.
- In the initial years, there was a significant lapse in management control, oversight and reporting to the Council in relation to expenditure on operating and capital projects and budget forecasting.
- Project management and oversight, from a financial perspective, was inadequate in the early years of the new Council.

2. Background

The Armidale Regional Council (ARC) was formed on 13 May 2016 as a result of the amalgamation of the former Armidale Dumaresq Council (ADC) and Guyra Shire Council (GSC). The Council governance structure operated under an Administrator until Sept 2017 and an elected Council until June 2020, when the current Administrator was appointed.

The audited General Purpose Financial Reports of the former entities for the period ended 12 May 2016 indicate that both Councils were in a stable financial position, but with limited reserves to fund future commitments and asset renewals and doubts over future financial sustainability.

The audited Financial Reports as at 12 May 2016 disclosed cash and investment balances (excluding external restrictions) of \$12.7m. The unrestricted current ratio for ADC was 1.5 and GSC 2.8. The industry accepted minimum benchmark is 1.5. Loan liability stood at \$32.4m as at 12 May 2016 (\$26.6m for General Fund.)

The audited Financial Reports are consolidated accounts for the General, Water and Sewer Funds. The Water and Sewer Funds are restricted funds to the extent that their financial resources cannot be utilised to fund General Fund operations or capital projects without Ministerial approval. The financial position of the Water and Sewer funds appears to be reasonably sound. Accordingly, the focus of this review has been on the General Fund.

As a merger incentive, the NSW Government provided ARC with \$15m in grants for Community Projects (\$1m), Merger Implementation (\$5m) and Major Projects (\$9m).

The majority of the \$1m from the Community Grants Program was distributed to not-for-profit community groups during 2016/17. Merger Implementation grants of \$5m were expended over four years ending June 2020 on over eighty projects including:

- Organisation and Restructure Reviews
- Redundancies
- Workforce Planning and development
- Strategic and Asset Management Planning
- ITC Development
- Project Management

We have not considered whether Council has received value for money for merger implementation expenditures.

Prior to amalgamation ADC and GSC Councils approved several major projects, including the Armidale Airport Terminal and Kolora Aged Care facility. These projects became the responsibility of the new Council.

3. Current Financial Position

Since amalgamation, the General Fund's financial standing has eroded. The last audited Financial Reports of ADC and GSC for the period ended 12 May 2016 disclose combined Net Current Assets for General Fund amounting to \$29.8m compared with a balance of \$18.2m for ARC as at 30 June 2019.

Net Current Assets is an important measure of the Council's available working capital necessary to fund day to day operations and its ability to fund reserves and capital projects.

This report explores the reasons for this substantial decline in Net Current Assets.

4. Financial Performance

The audited financial reports of the Armidale Regional Council disclose the following General Fund operating results since merger.

| Income Statement General Fund | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
|--|----------|----------|---------|---------|
| | \$'000 | \$'000 | \$'000 | \$'000 |
| Operating Surplus (Deficit) Excluding Capital Grants | 6,359 | (16,424) | (1,797) | (2,203) |
| Asset Revaluation Decrements/Write Offs | 669 | 5,650 | 1,242 | 3,446 |
| Less: Merger Grant Implentation/Capital Projects | (15,000) | - | | |
| Add Back: Merger Grants Expenditure | 2,758 | 2,401 | 880 | 65 |
| Adjusted Operating Surplus (Deficit) | (5,214) | (8,373) | 325 | 1,308 |

The operating surplus reported in 2016/17 includes the merger grants totalling \$15m, so for comparative purposes, the operating result has been adjusted to reflect the operating position had Council not received these grants, nor incurred the associated expenditure.

The actual results also compare unfavourably compared with the original adopted budget.

| OPERATING BUDGETS | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
|---|---------|---------|---------|---------|
| Operating Surplus (Deficit) before Capital Grants | -607 | -4301 | -3459 | 22 |

Of significance, is the substantial operating deficit in both 2016/17 and 2017/18. In both cases the deficit exceeded the original budget deficit by \$4.6m and \$4m respectively. Councils inability to achieve budget expectations in these two years has significantly impacted on available funding for capital works and reserves.

Further analysis of these results follows:

Financial Year 2016/17

Management is required to provide council with quarterly budget review reports detailing actual versus budget income and expenditure. The Regulations also require that a budget review statement must include or be accompanied by a report as to whether or not the Responsible Accounting Officer believes the report indicates that Council's financial position is satisfactory, having regard to the original estimate of income and expenditure.

The first quarter budget review, which was tabled at the Council meeting of 16 Nov 2016, lacked appropriate financial information for the consideration of actual versus budget performance and did not include the declaration required by the Regulations.

The second quarter review for the period 31 Dec 2016 was not received by Council until 12 April 2017, some nine months into the financial year and only included some minor budget adjustments and an indication that a fully detailed report would be include in the 3rd quarter review.

Council considered the third quarter budget review report at its meeting on 24 May 2017. This report anticipated a General Fund operating surplus (excluding capital grants) of approximately \$16.5m by 30 June 2017. This projection included the \$15m in merger grants that had to be disclosed as operating revenue in the year of receipt in accordance with the Accounting Standards.

The actual operating result disclosed in the audited financial statements for the year ended 30 June 2017 was a net surplus of only \$7m, a reduction of \$9.5m compared with the 3rd quarter projections. It is noted that audited financial statements did not include the normal original budget comparison as Council was exempt from this disclosure in its first year of operations.

| General Fund 2016/17 | 3rd Qtr Review | Projected | Actual | Variance |
|---|-----------------------|------------------|---------------|-----------------|
| | \$'000 | \$'000 | \$'000 | \$'000 |
| GF Surplus (excl Cap Grants/Revaluations) | 15,934 | 16,520 | 7,028 | 9,492 |
| Exclude Merger Grants | (15,000) | (15,000) | (15,000) | - |
| Add back Merger Grant Expenditure FY2017 | 2,758 | 2,758 | 2,758 | - |
| Adjusted Net Surplus (Deficit) | 3,692 | 4,278 | (5,214) | 9,492 |

In adopting the third quarter review, Council also agreed to defer \$10m in capital expenditure until the 2017/18 financial year due to project delays. This would have had the impact of offsetting any cash deficiency at financial year end caused by the unexpected operating result.

At the same meeting Council adopted (subject to community consultation) the 2017/18 Operational Budget which, to some degree, may have been incorrectly compiled based the anticipated results disclosed in the third quarter review.

On 26 Oct 2016 the Council resolved to acquire and refurbish an existing commercial property for a new Library. The estimated cost was \$3.5m and was to be funded by way of a 10 year loan. This capital expenditure was outside the original adopted budget. The acquisition and refurbishment of the Library was completed for a total cost of \$4.4m a budget overrun of \$0.9m. We have been unable to determine why the proposed loan funding did not proceed. As no loans were utilised, funding of the Library was met from Council's revenue and reserves.

Under Office of Local Government (OLG) Capital Expenditure Guidelines for projects over \$1m or 10% of ordinary rate revenue, whichever is higher, Council is required to complete a Capital Expenditure Review (Business Case) and notify the OLG prior to commencement of the project, unless the project falls within an exempt category, such as roads and bridges.

If project costs increase by 10% or more of the initial estimate Council must advise the OLG of the revised project cost. We have been unable to site any evidence that these Guidelines were followed.

In its first year of operations, the new Council appeared to be struggling in consolidating accounting systems and processes and managing projects. Opening balances from ADC and GSC were not incorporated into the general and project ledger until Feb 2017 and budgetary controls over projects appeared inadequate or non existent. Complex ledger configuration and lack of understanding of the cost integration aspects of the system contributed, but there was a total lack of consistency in how costs were allocated in the system. Therefore, it would have been very difficult to obtain any meaningful management reporting in a timely manner.

This situation is evidenced in reporting by the Chief Finance and Information Officer (CFO) to the Executive Leadership Team (ELT) from that time and instances where projects exceeded budget or had no budget.

During 2016/17 there was a significant disconnect in commentary on budgetary issues being reported to ELT and that reported to Council. For example, a report by CFO to the ELT on 6 Dec 2016 exposes the weaknesses in General Fund finances. Comments such as *“Cash in General Fund remains stressed”* and a *“constant history of operating deficits is partially covered up in the reporting period ended 12th May 2016”* and *“the amount of Cash available for working funds once external restrictions are applied, is at the minimum limit and must be addressed”*.

The CFO commented further that *“over 23% of all project costs (for the 2016/17 period) did not have a budget”*.

The CFO also stated in a report dated 18 April 2017 to ELT that *“an assessment of the budget position for 2016/17 seems to be ok at a macro level but at a micro level it is poor. A number of activities have incurred costs without a budget allocation. The dilemma is that these costs plus the programmed budgeted works are sending the budget a long way in to deficit. The Capital budget is causing the most financial concern. Project are not tracking very well and all financial buffers have been used for the shortfall. Project management remains an issue. We are observing a number of variations with no updated information from the project manager.”*

These adverse comments do not appear to be reflected in formal management reporting to Council.

The draft Financial Statements for 2016/17 were referred to Council on 25 Oct 2017 for approval to be referred to the Auditor for audit. The commentary accompanying the report to Council stated *“The financials presented are in line with the past performance of ADC and GSC combined and is consistent with assumptions made in the future forecasted results as part of the long term financial plan”*.

There was no reporting on the poor operating result recorded by the General Fund, after excluding Merger Grants, other than a comment that *“in the Financial Strategy, LTFFP and recent Report with Morrison and Low there needs to be some effort to improve the unrestricted cash levels in 2018”*.

Financial Year 2017/18

The Income Statement table above demonstrates that after one-off adjustments (disclosed in the table), Council recorded an operating deficit (excluding capital grants) of \$8.3m. This poor result compares unfavourably with the original budget deficit of \$4.3m. Part of the variance is due to the carry-over of approximately \$2.4m in Merger Project expenditure from the previous year, whereas the grant income was booked to the 2016/17 financial year.

Council also revalued assets which resulted in a \$5.6m expense charged to the Income Statement. This adjustment had no impact on cash so has been excluded from the comparison.

The first quarter budget review which was tabled at the Council meeting of 22 Nov 2017 provided for minor changes to budget and suggested that the projected financial position will be “*satisfactory*” at year end. The resolution adopting the report included a statement by Council that “*staff be instructed to achieve a break even budget result by June 2018*”.

The second quarter budget review, tabled on 28 Feb 2018, adopted a net increase in the budget deficit, together with first quarter variations of \$937,909 (Operating and Capital). The report indicated that “*management are currently reviewing operations and looking to present options around what can be adjusted to achieve a balanced result to the original budget as per resolution by 30 Jun 2018*”.

The third quarter review was presented to Council 24th May 2018. With only a little over a month to go before year end, it would be expected that any substantial blowout in the budget would be apparent.

The third quarter report stated that for General Fund “*Tight cash flow controls over the year ensure that the operating result lands as projected. As at the end of the third quarter there has been no additional information received to change expectations that the 4th quarter will not land as planned*”.

Financial Years 2018/19 and 2019/20

For the last two financial years Council has been able to achieve a modest adjusted operating surplus in General Fund.

For the FY2020 cash generated by the operating result was sufficient to fund the capital works program, thus avoiding a further deterioration in unrestricted Net Current Assets.

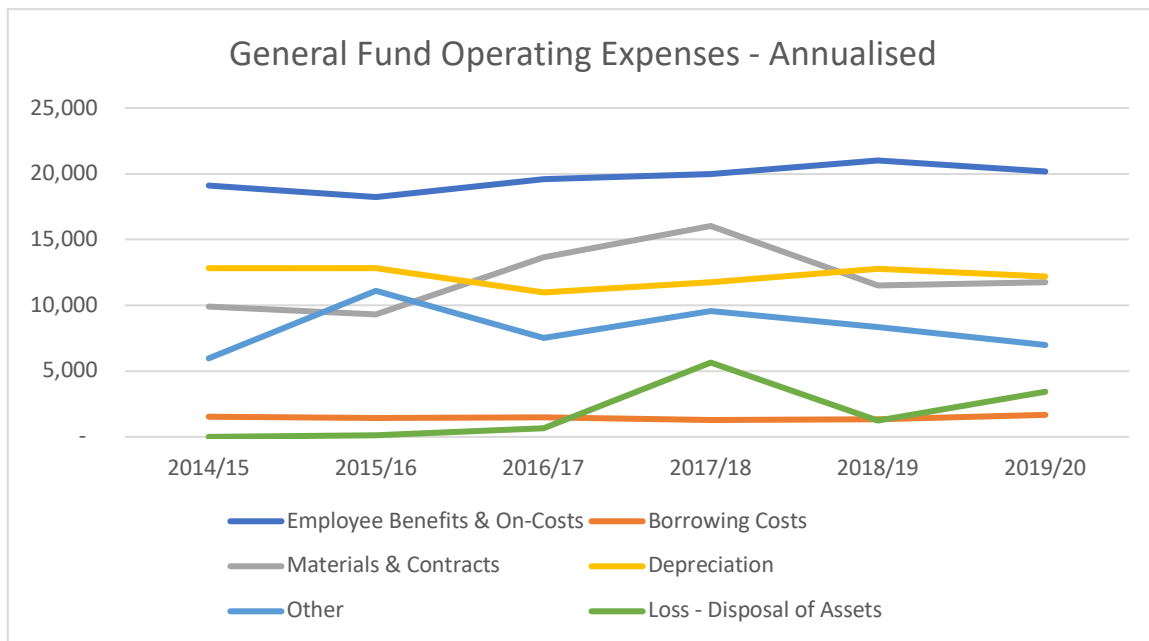
Operating Revenue – General Fund FY2017 - FY2020

Revenue from Rates and Annual charges exceeded budget expectations by a total of \$6.9m for the four years under review. There was an offsetting shortfall in revenue from User Charges and Fees due to changes in operations and conditions associated with the drought. The explanations for revenue budget variances as disclosed in the audited financial statements appear reasonable.

Total revenues (excluding grant revenues) were within budget expectations and we do not believe contributed to the operating results exceeding budget.

Operating Expenses – General Fund

The audited Financial Reports of the respective Councils for 2015/16 cover a 10.5 month period and the 2016/17 reports cover a 13.5 month period. In attempting to compare the operating expenses of the Council both pre and post merger, pro-rata adjustments have been made to the following graph for these respective years to approximate a twelve month reporting period. (It is accepted that the apportionment methodology may result in some inaccuracies between the two years, however the purpose is to highlight trends.)



This graph shows that Materials and Contracts category rose significantly in the 2016/17 and 2017/18 Years. The Materials and Contract category incorporates raw materials, consumables, contractor and consultancy costs. An increase was to be expected, given the subsequent expenditure of the Merger Grants in this category. However, after adjusting for merger grant expenditure, there are still apparent substantial over expenditures of up to when compared with the pre-merger average and against the original budgets.

Part of the variation in 2017/18 is due to increased costs associated with the Airport Roundabout which is classed as an Operating Expense rather than capital as it is a State Highway. Expenditure on the roundabout in 2017/18 amounted to \$1.2m. Total project expenditure was \$4.16m, a budget overrun of \$.96m.

Merger Implementation Grant \$5m

The Merger Implementation Grant of \$5m was utilised to fund over eighty separate projects. After further analysis, it has been identified that not all project costs were charged to the relevant projects. The following table demonstrates that total merger project expenditure was \$1.78m over budget and thus funded by Council operating revenue and reserves.

A significant cost related to redundancies as the result of the merger and subsequent restructure. The total cost of redundancies since merger has totalled \$2.3m.

| MERGER GRANT \$5M | 2016/17 | 2017/18 | 2018/19 | 2019/20 | TOTAL |
|--|---------|---------|---------|---------|--------|
| | \$'000 | \$'000 | \$'000 | \$'000 | \$'000 |
| Merger Expenditure as per the Project Ledger | 1,939 | 2,300 | 942 | 153 | 5,334 |
| Identified Additional Expenditure on Merger Projects | 458 | 226 | - | 87 | 622 |
| Additional Restructure Redundancy Costs | - | - | 81 | 630 | 711 |
| | 2,397 | 2,526 | 936 | 808 | 6,667 |
| Over Expenditure (Budget \$4.88M General Fund) | | | | | 1,787 |

As discussed above, the existence of appropriate project management protocols, budgetary controls and reporting accountability appeared lacking in the FY2017 and FY2018 years.

5. Capital Expenditure

Council has voted significant funds for capital expenditure in General Fund since the merger, however, expenditure in FY2017 to FY2018 fell short of the total allocation due to delay in commencing and completing projects.

Major projects have been the focus of attention in this review. The following table demonstrates significant over expenditures on many projects compared with the original budget.

| PROJECT | FY 2017 to FY2020 | | |
|--|-------------------|-------------------|--------------------|
| | Original Budget | Actual | Over Budget |
| Regional Airport Terminal Extension | 10,500,000 | 10,414,999 | |
| Airport Apron Expansion and upgrade | # 3,279,000 | 3,603,369 | (324,369) |
| Airport Roundabout construction and design | * 3,200,000 | 4,165,028 | (965,028) |
| Airport Business Park | # 9,750,000 | 5,558,130 | - |
| New Library Construction | 3,500,000 | 4,352,000 | (852,000) |
| Kolora Aged Care Facility | 6,300,000 | 7,085,012 | (785,012) |
| New Landfill - Construction Waterfall Way | # 14,000,000 | 10,270,263 | |
| Kempsey Road | # 5,551,083 | 2,074,526 | |
| Bridge Renewal | 2,903,903 | 3,177,921 | (274,018) |
| Stormwater | 1,905,000 | 2,924,832 | (1,019,832) |
| Guyra Main Street upgrade | # 2,495,845 | 1,454,582 | |
| Total Capex | 63,384,831 | 55,080,661 | (4,220,258) |
| <i># These Project are still in progress * This Project has been treated as an Operating Expense</i> | | | |

These significant project budget overruns have contributed to the decline in Council's Net Current Assets and Reserves.

It has been difficult to extrapolate approved life to date budget allocations for these major projects due to mismatch between project ledgers, originally adopted budget, revised budget reporting and alternative sources such as community newsletters.

During 2016/17 Council expended \$6.5m on new roads or renewals which were capitalised as assets. Expenditure in 2017/18 totalled \$5m. For those projects that had an identified budget, over expenditures of \$.045m were recorded. Fifteen Projects totalling \$4.7m for the two years did not have a budget allocation recorded in the Project Ledger.

In April 2017. The Executive Leadership Team was advised of \$2.8m in over expenditure on specific projects for that year. These over expenditures do not appear to have been reported to Council. Expenditure overruns were to some extent hidden by delays in commencing or completing projects in the capital expenditure program.

6. Cash Flows for Project Funding – General Fund

The audited Financial Statements do not include a Statement of Cash Flows for the General Fund and Councils internal reporting systems are not geared to provide such a report.

It has therefore been necessary to extrapolate cash flow movements by adjusting the operating income and expenditure categories to exclude non-cash items. This approach will only provide an approximate cash movement and there may be timing differences between years.

The following table demonstrates that deficit results in FY 2017 and FY2018 impacted on Council ability to fund capital works in those years. The shortfall in capital funding would have contributed to the decline in Net Current Assets.

| Capital Expenditure - General Fund | 2016/17 | 2017/18 |
|---|----------|---------|
| | \$'000 | \$'000 |
| Capital Expenses | 27,154 | 27,200 |
| External Funding Source: | | |
| Loans utilised | 2,175 | 5,253 |
| Merger Grant (\$9m) Utilised | 62 | 1,901 |
| Capital Grants/Contribs Utilised | 5,329 | 7,306 |
| Net Operating Cash (see below) | 15,691 | 3,889 |
| Total Funding Sources | 23,257 | 18,349 |
| Shortfall in Funding (Reserves Utilised) | (3,897) | (8,851) |
| Operating Cash Flows available for Capex | | |
| Net Cash from Operating Activities | 32,846 | 9,513 |
| Less: Capital Grants Received | (4,913) | (8,025) |
| Less: Merger Grants Received | (15,000) | |
| Plus: Merger Grant Operating Expenditures | 2,758 | 2,401 |
| Net Cash from Normal Operations | 15,691 | 3,889 |

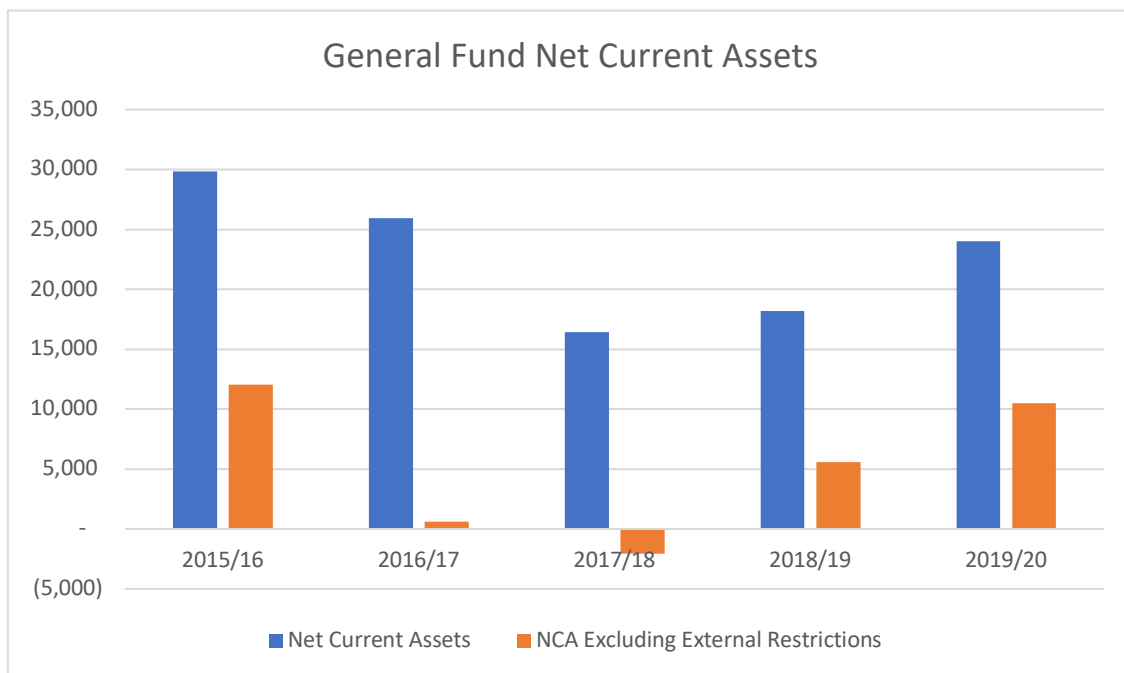
7. Net Currents Assets

The Net Current Asset balance is an important financial performance indicator because it is a measure of Council’s capacity to fund its day to day working capital needs, meet liabilities arising in the next twelve months and it’s ability to fund reserves.

Included in current assets is cash that is externally restricted. External restrictions include unexpended grants, contributions and loans for specific purposes and are therefore not available to fund day to day working capital needs.

The following graph demonstrates the decline in Net Current Assets since merger and the recovery in the last two years. It also shows the impact of external restrictions if they are excluded from the measurement.

The decline in Net Current Assets by \$11.6m in the first three years since merger is due in part to Council adopting operating budget deficits and actual operating expenditure substantially exceeding budget, thus exacerbating the deficits, and major project expenditure overruns.



Note: For comparative purposes NCA in FY 2020 excludes contract liabilities under new Accounting Standards

This graph demonstrates that after excluding external restrictions, the Net Current Asset balance in FY2017 was borderline and turned negative in FY2018.

We are therefore of the view that Council did not have the financial capacity to fund internal restriction (reserves) in those years and that disclosed internal restrictions were being funded by cash needed for working capital.

8. Reserves

Local Government “Reserves” are known as Internal Restrictions. As discussed above Council should only set aside reserves if there are sufficient unrestricted funds in excess of working capital needs.

Upon the formation of the new Council, the internal restrictions of the former ADC and GSC were extinguished, other than \$2.9m for the Employee Entitlements Reserve. This fact is disclosed in the final audited Financial Statements of ADC and GSC as at May 2016. The following table discloses internal restrictions as at 12 May 2016 and since merger.

| Internal Restrictions | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
|-----------------------------|--------------|--------------|--------------|--------------|---------------|
| | \$'000 | \$'000 | \$'000 | \$'000 | \$'000 |
| Plant and Vehicles | | 2,240 | - | | 885 |
| Employee Leave entitlements | 2,900 | 5,000 | 2,521 | 3,194 | 4,053 |
| Infrastructure Replacement | | | | | 3,317 |
| Carry Over Works | | | | 2,368 | 1,136 |
| Other | | | | 2,092 | 629 |
| Total | 2,900 | 7,240 | 2,521 | 7,654 | 10,020 |

Prior to merger internal restrictions for ADC totalled \$3.4m and GSC \$7.1m. As there was only \$9.2m in unrestricted Net Current Assets as at the date of merger, there is considerable doubt, as discussed above, as to whether these extinguished reserves could have been fully funded, had they been retained.

Even though most reserves were extinguished upon merger, ARC still continued to make project funding decisions based these extinguished reserves. For example, in Dec 2017 expansion of the Guyra Pre School was considered at a Councillor’s Workshop and it was reported that “Council has approximately \$500,000 in reserves for the redevelopment of the Pre School Centre”.

On 27 July 2016, Council considered a report that stated that part of the funding for new Kolora Aged Care facility would come from “Kolora Reserves \$1.37m”. The adopted resolution stated “That the proposed means of funding the new Kolora Aged Care Facility as identified in this report be endorsed which includes the use of the Real Estate Reserve of \$1.5m”.

On 28 Jun 2017 Council adopted a “Reserve Accounting Framework”. This framework identified the process for establishing reserves and how they would be funded. For example, surpluses from Saleyards operations should fund the Saleyards reserve and as the “Plant and Fleet program operates as a self-contained business” any surplus generated from plant operations should be re-directed into a dedicated Fleet Replacement Reserve. It appears that this adopted framework was never followed, probably due to Councils incapacity to fund these reserves. The Employee Entitlements reserve was to be funded based on the aged profile of the work force but major movements suggest otherwise.

Plant and Vehicle acquisitions in FY 2017 and FY 2018 totalled \$3.2m and thus depleted the booked Reserve of \$2.2m. As Net Current Assets, excluding external restrictions, was neutral or negative in FY2017 and FY2018, we are of the view that the Plant and Vehicle Reserve was unfunded or relied on working capital for funding.

9. Budget Monitoring, Reporting and Governance

For the first two years of the new Council, reports to Council supporting budget adoption provided very little detail in relation to specific capital projects and their source of funding.

The quarterly budget review reports were not timely, contained substantial inaccuracies and failed to predict the deficit outcomes.

Project ledgers lacked appropriate budget allocations, making monitoring difficult. Substantial Project overruns known to the ELT were not reported to Council.

Major Project management reporting was poor and lacked scrutiny, both internally and from a Council governance perspective.

10. Recommendations

As a result of issues identified during the review, we recommend that Council adopt the following recommendations:

- a) Council should adopt surplus budgets that ensure financial sustainability over the longer term.
- b) Council should adopt a Reserves policy that ensures a minimum of \$4-5m is available as unrestricted cash to fund working capital requirements before setting aside funds as Internal Restrictions.
- c) Establishment and funding of Reserves should be supported by Council resolutions.
- d) Council should request a fourth quarter budget review report to ensure that Councils financial position and performance is sound and that the budget for the ensuing year is based on current information.
- e) Council and the Audit and Risk Committee should ensure appropriate governance oversight and risk monitoring of major projects and budget reporting.
- f) Council should ensure that the budget approval and monitoring process incorporates detailed information in relation to major capital projects and funding sources.
- g) Management should establish an appropriate Project Management framework that is best practice, together with a reporting architecture that ensures accountability for budget variances.
- h) Management should ensure that quarterly budget reviews are complete, timely and accurate and reflect any adverse trends known to management.
- i) Projects should not be initiated in the Projects Ledger unless there is a fully funded budget allocation. The Project Ledger should be regularly reconciled with the General Ledger and adopted budget.
- j) Office of Local Government guidelines pertaining to Capital Expenditure Reviews should be applied to relevant projects.
- k) Council should ensure that sufficient resources are provided within the organisation to address the above recommendations.

11. Acknowledgment

We would like to commend the Manager Financial Services and her team, particularly the Financial Accountant, for their valuable assistance during the course of the review

Because of the inadequate state of existing reports, it was necessary to recreate financial records, drill down into large and complex databases and compile spreadsheets to assist in achieving the scope of the review. The Finance team provided timely information and worked long hours to achieve the results.