

SUBJECT: CCL 28/10/14 - ADOPTION OF ANNUAL FINANCIAL STATEMENTS

REPORT BY: CORPORATE SERVICES
CONTACT: DIRECTOR CORPORATE SERVICES / MANAGER FINANCE

PURPOSE

In accordance with the provisions of Sections 418 and 419 of the Local Government Act 1993 (as amended), Council's audited 2013/14 Annual Financial Statements are tabled for presentation to Council.

RECOMMENDATION

- 1 Council notes and receives Council's unqualified Annual Financial Statements and accompanying notes, in respect of the year ended 30 June 2014, together with the Auditor's Report which were presented to Council.

KEY ISSUES

- 2 Council's external Audit Report is unqualified.
- 3 Council's financial position as at 30 June 2014 shows sound liquidity and low Debt Service Ratio.
- 4 Council's Operating Result (before Grants and Contributions for Capital Purposes) for 2013/14 was a surplus of \$0.75m against a (\$13.40m) deficit in 2012/13.
- 5 Council also received \$18.0m in Grants and Contributions for Capital Purposes. The Operating Result including these Grants and Contributions resulted in Community Equity increasing by \$18.75m in 2013/14 as opposed to the decline of (\$3.68m) reported in 2012/13 which is primarily attributable to the revenue received from capital grants, contributions and dedications of \$18.0m.
- 6 Increases in the backlog for roads and stormwater drainage of \$11.8m and the inclusion of other infrastructure assets of \$10.2m are offset by reductions of \$29.2m in building and structures. The sale of assets that are not in satisfactory condition constitutes \$21.7m of this reduction. Council has made progress on each of the Infrastructure ratios but is still well below the NSW Treasury Corporation benchmarks. Council will need to reach a sustainable asset renewal level and also address the current asset backlog of \$90.4m by significantly increasing capital works on existing assets not in a satisfactory condition.

FINANCIAL IMPACT

- 7 **Operating Result**

The Operating Result is calculated on a full accruals basis which means that all costs/income of current year operations are included irrespective of whether a cash inflow/outflow has been made or not.

- 8 To facilitate evaluation, the Income Statement from the audited financial statements is reformatted and summarised below:

Line No		2013/14 (\$'000) Actual	2012/13 (\$'000) Actual
i)	Operating Income before Capital Amounts	223,826	217,506
ii)	Operating Expenditure before Depreciation	(179,199)	(184,326)
iii)	Operating Result before Depreciation/Capital Amounts	44,627	33,180
iv)	Depreciation	(43,873)	(46,585)
v)	Operating Surplus/(Deficit) before Capital Amounts	754	(13,405)
vi)	Capital Amounts (Grants and Contributions)	18,000	9,721
vii)	Net Operating Result for the Year (as reported in the Income Statement)	18,754	(3,684)

A summary of individual line movement details of the table above are:

9 **Line (i): Operating Income before Capital Grants**

Represents an increase of \$6.32m on the 2012/13 Revenue. Rates and Annual Charges income increased by \$6.82m arising from increases in the permissible rate of 3.4%. User Charges and Fees had a significant increase of \$8.70m due to additional income received at Summerhill Waste Management Facility. Grants and Contributions provided for Operating Purposes decreased by \$9.3m due to a change in the timing of the payment the NSW State Government Financial Assistance Grant which resulted in it being paid in arrears for 2013/14.

10 **Line (ii): Operating Expenditure before Depreciation**

The 2013/14 expenditure represents a decrease of (\$7.84m) on the 2012/13 result. Employee Benefits and Oncosts have decreased by \$7.46m primarily driven by the organisational restructure and associated redundancies across Council. Redundancy payments during 2013/14 were funded from the transition program in the 2013/14 budget whilst the accrued employee entitlements attributable to the redundancies were paid from provisions held within Council's Employee Entitlements Reserve. Borrowing Costs had a slight increase of \$0.31m Other Expenses increased by \$5.16m which was attributable to the NSW Government Waste Levy applicable to the increased waste volumes achieved at Summerhill Waste Management Facility. Additionally in 2013/14 Council disclosed a small net gain of \$0.23m from the disposal of assets compared to a net loss of \$5.99m in 2012/13.

11 **Line (iii): Operating Surplus/(Deficit) before Depreciation/Capital Amounts**

This line reflects the underlying operating result for the year prior to allowing for depreciation and shows an increase of approximately \$11.45m on the

equivalent 2012/13 result. This was due to an increase in revenue as outlined in Line (i) above and a decrease in expenditure as outlined in line (ii) above.

12 Line (iv): Depreciation

Infrastructure depreciation continues to be a major burden on Council however depreciation has decreased slightly by \$2.71m. Some buildings have been reclassified as Non-Specialised Buildings, with the relevant accounting treatment for this classification resulting in a lower depreciation charge. Under the Office of Local Government and Accounting Standard requirements Council is required to revalue its Infrastructure, Property, Plant and Equipment. The Office of Local Government mandates that all Infrastructure, Property, Plant and Equipment is revalued every five years. It is important to note that depreciation variations may occur in future reporting periods due to this revaluation regime and Council's significant infrastructure backlog continues to have a major impact on Council's finances.

13 Line (v): Operating Surplus/(Deficit) before Capital Amounts

Council's Operating Result before Capital Amounts show an operating surplus of \$0.75m, this is an increase of \$14.16m from 2012/13. The items giving rise to this variance are outlined in lines (i), (ii) and (iv) above.

14 Line (vi): Capital Grants

In the 2013/14 year this line includes roads and drainage dedications to the value of \$12.93m compared with \$2.40m in 2012/13. This represents the value of roads, land beneath roads and drains in new sub-divisions that are handed over to Council to maintain in perpetuity. Accounting standards require this value to be shown as income despite it being received as a non-cash asset and does not permit the future maintenance liability to be recognised in the Financial Statements.

15 Line (vii): Net Operating Result for the Year (as reported in the Income Statement)

This represents the net impact of all of the above line items. This amount is transferred to retained earnings and reflects an increase in Net Assets. The \$18.75m increase in Net Assets compares to a decrease in 2012/13 of \$3.68m. The increase in Equity demonstrates an improved financial position for Council.

16 Budget to Actual Comparison (page 3 of the Financial Statements)

The Budget disclosed at page 3 of Financial Statements is the original adopted budget for 2013/14 and does not include the carry forward program, the quarterly budget reviews subsequently reported to Council and the consolidated budget for Newcastle Airport. The actual result shows a net surplus of \$18.75m against an original budget deficit of \$22.39m.

17 The explanation of the key factors is as follows:

- Actual Revenue from Grants and Contributions for capital purposes exceeded budget by **\$11.3m** (\$6.7m compared to \$18.0m). This was due primarily to dedications of roads and land beneath roads,

constructed as part of new sub-divisions, that are handed over to Council to maintain in perpetuity.

- The consolidation of Newcastle Airport increases Operating Revenue by \$11.5m (reflected primarily in user fees and charges) and Operating Expenses by \$9.3m. The net impact from Newcastle Airport is an Operating Surplus of **\$2.2m** (this is 50% of the Newcastle Airport Net Profit in line with Council's ownership share).
- Summerhill Waste Management Facility has attracted more business resulting in an additional \$5.8m in revenue and \$3.8m in expenses (NSW state waste levy). A net benefit of **\$2m**.
- One time revenue impacts of **\$2.3m** involved retrospective rate recovery due to rerating of land and a writeback of investment funds to the recovery of principal associated with the Kakadu Collateralised Debt Obligation.
- Interest income was higher by **\$3.2m** due to higher reserve balances than budgeted and higher yields than forecast. (Note: the higher reserve balance is due to expenditure on capital works being less than budgeted and will reverse in 2014/15 due to the extensive capital works program planned).
- Depreciation decreased by **\$11.7m** against the adopted budget as the adopted budget estimates were impacted by a prior period adjustment. In addition building assets have been reclassified as non-specialist and will no longer be subject to depreciation but will instead be subject to market valuation.
- There has been a **\$5.9m** decrease in Operating Expenses excluding items already covered above (Newcastle Airport expenses (\$9.3m), State Waste Levy (\$3.8m), Depreciation (\$11.7m) and internal eliminations of \$7.9m. Savings have been achieved across Employee Costs, Materials and Contracts and Other Operating Expenses as part of Council's organisational restructure and ongoing cost management.
- The primary offset against these favourable variances is a reduction in operating grants revenue (net reduction due to lower Federal Assistance Grants income).

- 18 The actual versus budget variations detailed above are based on the original adopted budget, excluding the carry forward program and quarterly budget reviews.
- 19 A high level analysis of material budget variations (above 10%) is shown in Note 16 of the Annual Financial Statements.
- 20 Broadly, financial sustainability of Council operations requires that there is sufficient operational revenue to cover operational expenses in the long term. To build an accurate picture of Newcastle's future financial sustainability all revenue that cannot be applied to cover normal day to day operational costs should be excluded. Council revenue, as reported in the audited Financial Statements, includes some items which cannot be applied to cover normal operating costs. After adjusting for these items the underlying operating deficit is \$6.2m.

21 Newcastle City Council's share of profit from Newcastle Airport is \$2.2m. In addition Operating Revenue has included funding generated from the 2012 capital restricted special rate variation which amounts to approximately \$4.7m per annum. These funds cannot be applied to cover Council's Operating Expenses. These adjustments also contribute to the \$6.2m underlying operating deficit noted above.

22 Financial Performance Measures

Note 13 on page 46 of the Annual Financial Statements details Council's key financial performance measures. Key variances are discussed below.

23 Operating Performance Ratio -0.50%

This ratio measures a council's achievement of containing operating expenditure within operating revenue. It is important to distinguish that this ratio focusses on operating performance and capital grants and contributions, fair value adjustments and reversal of revaluation decrements are excluded. The benchmark is greater than 0%. Accordingly Council's performance falls below the benchmark ratio.

24 Own Source Operating Revenue Ratio 86.54%

This ratio measures fiscal flexibility and the degree of reliance on external funding sources such as operating grants and contributions. Council's financial flexibility improves the higher the level of its own source revenue. The benchmark is greater than 60%.

25 Unrestricted Current Ratio 3.22 : 1

This ratio is an indicator of the Council's liquidity and has remained relatively stable in recent years, and reflects the impact of the requirement of Accounting Standards to classify investments as current or non-current, depending on the maturity date.

26 The unrestricted current ratio has been calculated for the purposes of assessing the capability of Council to meet its obligations (current liabilities) using current assets. The ratio indicates an improvement on last year due to an increase in cash levels from positive cash flows from operating activities. The benchmark is greater than 1.5:1.

27 Debt Service Cover Ratio 4.13

This ratio measures the availability of operating cash to service debt including interest, principal and lease payments. The debt service cover ratio has decreased due to Newcastle Airport paying out all loans held by Council in November 2013 and Council's commitment in its Budget Principles to reduce debt and not borrow during 2013/14. The benchmark is greater than 2.

28 Rates and Annual Charges Outstanding Ratio 4.61%

This ratio assesses the impact of uncollected rates and annual charges on liquidity and the adequacy of recovery efforts. The Rates and Annual Charges Outstanding Ratio of 4.61% has fallen from 5.05% in 2012/13. This represents a decrease of 0.44%. This is an improvement on the result due to a more proactive approach with Council's mercantile agent. The benchmark is less than 5%.

29 Cash expense cover ratio 8.70x

This liquidity ratio indicates the number of months a Council can continue paying for its immediate expenses without additional cash inflow. The benchmark is greater than 3 months (ie 3x).

30 Special Schedule No. 7 covers another important area in the assessment of financial sustainability. The schedule addresses the condition of public works and the estimated cost to bring assets up to a satisfactory standard.

31 The cost to bring assets back to a satisfactory standard has reduced from \$97.7m to \$90.4m over the last financial year. The overall increase in the backlog has been offset by reductions resulting predominantly from the sale of assets that were not in satisfactory condition, resulting in a net reduction in the backlog of \$7.2m.

32 The reduction in Buildings and Other Structures by \$29.2m is largely due to the sale of assets so that no remediation work needs to be completed (\$21.6m) together with some capital work funded from an increase in borrowed funds (\$4.6m).

33 Other asset classes all reflect a worsening asset position. Specifically these are:

- Roads has increased by \$9.9m from \$7.2m to \$17.1m.
- Drainage Works has increased by \$1.9m from \$15.4m to \$17.3m.
- Creeks (\$7.9m) and Trees (\$2.3m) will require a total of \$10.2m of capital works to bring to a satisfactory condition. This asset class has been included to provide a more complete view of the asset maintenance and renewal backlog.

34 In summary, reductions have been largely achieved by selling assets in poor condition in the building asset class whilst the asset maintenance and renewal backlog has grown in Roads and Stormwater Drainage. This is not a sustainable approach and Council will need to increase the maintenance and capital works to address the backlog and ensure that sufficient funds are generated internally to fund the capital works. This situation is highlighted in the ratios noted below.

35 **Infrastructure Asset Performance Indicators** (Special Schedule No7 Page 7 of the Special Schedules details Council's Consolidated ratios. Key ratios are discussed below.

36 Building and Infrastructure Renewals Ratio 50%

This ratio compares the proportion spent on infrastructure asset renewals and the asset's deterioration measured by its accounting depreciation. Asset renewal represents the replacement or refurbishment of existing assets to an equivalent capacity or performance as opposed to the acquisition of new assets or the refurbishment of old assets that increase capacity or performance. NSW Treasury Corporation benchmark is **greater than 100%**.

37 Infrastructure Backlog Ratio 9%

This ratio shows what proportion the value of the backlog is compared to the total value of a Council's infrastructure. NSW Treasury Corporation benchmark is **less than 2%**.

38 Asset Maintenance Ratio 85%

This ratio compares actual versus required annual asset maintenance, as detailed in Special Schedule 7. A ratio of above 100% indicates that the Council is investing enough funds within the year to stop the infrastructure backlog from growing. NSW Treasury Corporation benchmark is **greater than 100%**.

39 Capital expenditure Ratio 97%

This indicates the extent to which a Council is forecasting to expand its asset base with capital expenditure spent on both new assets and replacement and renewal of existing assets. Treasury Corporation benchmark is **greater than 110%**.

40 Newcastle City Council has made progress on each of the Infrastructure ratios but is still well below the NSW Treasury Corporation benchmarks.

COMMUNITY STRATEGIC PLAN ALIGNMENT

41 This report aligns to the Community Strategic Plan under the strategic direction of 'Open and collaborative leadership' action 7.4b *'ensure the management of Council's budget allocations and funding alternatives are compliant with Council policy and relevant legislation to ensure the long term financial sustainability of the organisation.'*

IMPLEMENTATION PLAN/IMPLICATIONS

42 The Annual Financial Statements reflect the outcomes of actions, activities and projects contained in the 2013/14 Operational Plan and subsequent Quarterly Reviews which have been approved by Council.

RISK ASSESSMENT AND MITIGATION

43 Risk and mitigation of such risk is achieved through:

- a) The Local Government Act 1993 (as amended) requires the annual Financial Statements to be externally audited. This audit has been

completed by PricewaterhouseCoopers, who have issued an Unqualified Audit opinion for the 2013/14 financial year.

- b) A presentation on the Financial Statements to Council on 21 October 2014 and a proposed presentation to the Audit Committee on 30 October 2014 by the audit Partner of PricewaterhouseCoopers.

RELATED PREVIOUS DECISIONS

- 44 The actual revenue and expenditure classifications and movements in assets and liabilities detailed in the Annual Financial Statements are the outcomes of the strategic actions, activities and projects contained in the 2013/14 Operational Plan. These actions, activities and projects contributed to the delivery of Council's social, environmental and economic objectives.
- 45 Councillors resolved the following at the Council Meeting held on 23 September 2014:
- 1 *That Council notes the progress of the external audit and provisions of information on this progress to the Internal Audit Committee and Council.*
 - 2 *Council authorises the Deputy Lord Mayor, another Councillor, the General Manager and Responsible Accounting Officer to sign the s 413 (2) statements at the conclusion of the external audit.*

CONSULTATION

- 46 A presentation on the Financial Statements to Councillors at a Councillor Workshop session held on 21 October 2014 and a proposed presentation to the Audit Committee on 30 October 2014 by the audit Partner, of PricewaterhouseCoopers. In accordance with the provisions of Sections 418, of the Local Government Act 1993 (as amended), public notice of the meeting date at which the Council's audited Financial Statements will be presented was advertised in The Newcastle Herald on 21 October 2014.

OPTIONS

Option 1

- 47 The recommendation as at Paragraph 1.

Option 2

- 45 Council resolves not to receive the presentation of Council's Financial Statements and Accompanying Notes, in respect of the year ended 30 June 2014, together with the Auditor's Report. This would result in Council not complying with the requirements of the Local Government Act 1993 (as amended). This is not the recommended option.

BACKGROUND

- 48 Council's Financial Statements in respect of the year ended 30 June 2014 have been prepared in accordance with:
- The Local Government Act 1993 (as amended) and the Local Government (General) Regulations 2005;
 - Australian Accounting Standards and professional pronouncements;
 - The Local Government Code of Accounting Practice and Financial Reporting (Guidelines);and
 - The Local Government Asset Accounting Manual.
- 49 In accordance with the provisions of Sections 418, 419 and 420 of the Local Government Act 1993 (as amended), public notice of the meeting date at which the Council's audited Financial Statements will be presented was advertised in The Newcastle Herald on 21 October 2014. Copies of Council's audited Financial Statements, together with the Auditor's Report, were available for inspection by members of the public from 21 October to 5pm 28 October 2014 at the Customer Enquiry Centre of the City Administration Centre. Written submissions can be lodged by 5pm close of business on 28 October 2014.
- 50 Following presentation of the Financial Statements to Council, copies of the financial report will be available from the City Administration Centre or Council's website.

REFERENCES

ATTACHMENTS

Distributed under separate cover

Attachment A: 2013/14 Annual Financial Statements