Auditor-General of Queensland

Report to Parliament No. 1 for 2007

Results of Local Government Audits for 2005-06

Queensland

Prepared under Part 6

Division 3 of the

Financial Administration and Audit Act 1977

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Auditor-General of Queensland

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The Honourable M F Reynolds MP
Speaker of the Legislative Assembly
Parliament House
BRISBANE QLD 4000

Dear Mr Speaker

This report is prepared under Part 6 Division 3 of the *Financial Administration and Audit Act 1977*, and is on the Results of Local Government Audits for 2005-06. It is the first in the series of Auditor-General's Reports to Parliament for 2007.

In accordance with s.105 of the Act, would you please arrange for the report to be tabled in the Legislative Assembly.

Yours sincerely

Glenn Poole
Auditor-General

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Overview

1.1 Auditor-General's overview

This report is the first audit report to Parliament for 2007 and deals specifically with the results of the audits of local governments, joint local governments, their respective controlled entities and joint public sector entities in the local government sector for the 2005-06 financial year which were completed and certified by audit at 31 March 2007. This report excludes Aboriginal Councils which are undergoing a period of staged transition towards contemporary reporting under the *Local Government Act 1993*. The results of the audits of Aboriginal Councils will be included in a later report.

This is my third report on the local government sector since my appointment as Auditor-General and it is disappointing to note that over this period there has been a general lack of improvement in the quality and timeliness of financial reporting, management of infrastructure assets and the robustness of underlying financial systems of many councils despite extensive reporting of these matters in my previous reports and by previous Auditors-General.

In my view, many of the audit issues raised with councils and observations made during the audit process indicate a poor level of governance across the sector. While I acknowledge there are some councils with sound internal controls and strong governance frameworks, there is scope for improvement in at least half of the councils in Queensland. Based on our audit findings, specific issues of concern that need to be addressed by those councils relate to the areas of financial management and strategic asset management.

These matters are detailed further in Section 1.2 of this report.

Long term financial viability remains a significant issue for the sector with an aggregate deficit of $290.09m for 68 councils being recorded for 2005-06. Reviews undertaken in other States indicate that financial viability issues are not unique to Queensland. Astute financial management and strategic asset management are integral to assisting councils in making informed decisions in relation to long term viability.

The Local Government Association of Queensland, the Minister for Local Government, Planning and Sport (the Minister) and the Department of Local Government, Planning, Sport and Recreation are working conjointly to address this issue through the "Size, Shape and Sustainability" initiative which outlines a number of models for voluntary structural reform across the sector. I acknowledge their work in this area and believe that this initiative is an important step to encourage councils to consider options for resource sharing that could help improve their efficiency and effectiveness and assist in overcoming the financial and asset management concerns raised in this report.

1.2 Summary of key findings and areas of improvement for councils

The matters which need more attention by councils under financial management and strategic asset management are as follows —

Financial management —

- more attention is required on quality systems designed to achieve accuracy, completeness and timeliness of reporting;
- audit committees (where operating) need to have a significant role in relation to internal and external reporting functions and their terms of reference or charters should reflect this;
- better use should be made of internal audit or a compliance function as part of the quality assurance process over internal and external reporting;
- the continued reliance on consultants for the provision of accounting services should be reassessed regularly;
- the work of those consultants needs to be monitored and closely reviewed by Council prior to the acceptance of any conclusions or recommendations;

- participation in the independent financial sustainability review conducted by the Queensland Treasury Corporation should be actively considered by all councils;
- ongoing financial viability needs to be regularly monitored through a framework of accurate and timely internal reporting, including the use of key ratios and trend analysis; and
- Councils should undertake a regular review of the level of operating revenue to ensure that it adequately covers depreciation expense. Where a decision has been made not to cover depreciation expenses for items of infrastructure, this decision should be supported by details of the specific assets involved.

Strategic asset management —

- a greater emphasis is required on sound asset valuation, recording and management practices, including analyses for future asset replacements;
- more focus is needed on establishing a robust framework to review valuations of property, major plant and equipment and infrastructure assets prepared by experts; and
- reviews should be undertaken by councils of the use of residual values and useful lives of the three road asset components taking into account the pattern of expected benefits to be consumed from the roads, as required by the accounting standards.

These issues are addressed in Sections 2 and 3 of this report.

Section 2
Governance

2.1 Introduction

Based on the nature of the audit issues raised and observations made during 2005-06 and their similarity to matters reported in my two previous reports on local government audits, I am not convinced that the standard of governance across the local government sector is at an acceptable level. There were 59 councils which had audit issues in the moderate or high risk categories as assessed by audit.

Effective governance is essential in providing an appropriate framework within which an organisation's objectives can be achieved efficiently and effectively, within an acceptable level of risk, while providing transparency and accountability for its use of resources in achieving those objectives.

A review of governance and risk management was conducted in the local government sector in 2002 and the results were reported in Auditor-General's Report No. 2 for 2002-03. Overall that review indicated that there appeared to be a genuine commitment to sound governance principles across the sector. A number of recommendations were made to further enhance governance and risk management practices including —

- maintaining effective committees and executive groups;
- establishing appropriate management standards;
- developing adequate internal controls;
- maintaining monitoring and reporting mechanisms; and
- improving risk management systems and policies.

In spite of these recommendations in 2002, the 2005-06 audits revealed continuing issues in relation to the quality and timeliness of financial statement preparation. This lack of apparent improvement indicates —

- underlying weaknesses in financial management standards or an understanding thereof;
- ongoing difficulties associated with valuation and depreciation of infrastructure assets;
- better use could be made of audit committees to manage the financial risks of local governments; and
- greater management oversight is needed where consultants and experts are contracted to provide services to councils.

A better understanding of what is required to achieve quality and timeliness and a commitment to implement these measures is needed.

2.2 Financial management

A broad summary of the financial management audit issues highlighted across councils during the 2005-06 audit program is contained in the following table —

Table 2.1 — Financial management issues

Issue
Viability — ● losses recorded for utility operations (water supply, sewerage and garbage); ● operating fund deficit budgeted for 2006-07; and ● significant levels of unfunded depreciation. Quality of financial statement preparation — ● lack of council oversight over the reporting function and internal control framework. Non-current assets — ● inadequate reconciliations of the subsidiary asset records with the general ledger; ● lack of componentisation of road infrastructure; ● various valuation issues including irregular reviews of the fair value of assets, inadequate assessments of impairment and inadequate use of indices in the periods between comprehensive revaluations; ● use of incorrect depreciation methodology; ● capitalisation of assets below the council approved recognition threshold; ● residual values not assigned to plant and equipment; and ● useful lives of roads not properly considered. Policies, standards and guidance — ● Financial Management Practice Manuals not up to date; ● no policies in place for entertainment/hospitality; and ● no policies in place for the use of corporate cards, borrowings and the management and accounting for properties held for resale. Procurement practices — ● no policy in place for purchasing; ● contract registers not up to date; and ● weaknesses in procedures carried out for tenders and quotations. Information systems issues including — ● absences of business continuity and data recovery plans; ● lack of an approved information technology strategic plan; and ● absences of properly managed data conversion processes when new systems are implemented. General internal control weaknesses in such areas as — ● Human Resource Information System applications; ● expenditure voucher preparation and approval; and ● management of trust accounts including aged and unclaimed trust moneys, interest on trust accounts not apportioned across individual trust accounts. Cash management — ● bank reconciliation errors. Debtor management — ● absence of control over arrears; and ● debtors with credit balances. Employee benefits — ● incorrect computation of the leave liability; ● incorrect calculations of oncosts; and ● inadequate management of annual leave resulting in abnormally high annual leave balances.

Financial management represents a key element of governance and an area requiring improvement by some councils. Effective financial management includes maintaining financial viability, timely preparation of the annual financial statements and the quality of those statements, effective use of key committees and internal controls which are designed to mitigate risks identified by councils under s.15(2)(b)(ii) of the *Local Government Finance Standard 2005.* Effective financial management stems from accurate accounting records and a regime geared towards compliance with the accounting standards.

The issues identified by audit, as set out in Table 2.1, support the need for some councils to place more focused attention on financial management as part of councils' fiscal responsibility contained in the *Local Government Act 1993* and the *Local Government Finance Standard 2005*. These matters did not apply to all councils but were common enough to suggest the need for attention from a broader local government perspective. These issues were identified through the audit testing of internal control systems and verification of the amounts reported in the financial statements.

The risk of misstatements occurring in council financial statements, for example, should be considered as part of the overall risk identification process. Audit findings revealed that this risk has not been effectively dealt with by 36 councils which required material adjustments to be made to the financial statements following audit. High risk audit issues relating to financial statement quality were reported for six of those councils.

Sound governance practices emanate from robust risk management techniques within an organisation. Regular assessments of risk should result in changes to governance frameworks to mitigate those risks. Risk management is a continuum of reviews of risk followed by the implementation and analysis of treatment measures. Financial management requires a strategic approach geared to effective risk management and compliance with accounting standards.

Some councils have opted for the use of audit committees to strengthen their governance framework, as provided for in the local government legislation. However, in a number of instances, the committees have been less effective in their responsibility for oversight of the council's internal and external reporting functions. This area is also dealt with separately in Section 2.4 of this report.

The weaknesses set out in Table 2.1 indicate poor financial management frameworks. This may impact on the ability of those councils to produce accurate records to satisfy their internal and external reporting requirements.

In attempting to address this situation, some councils have employed consultants to provide accounting services, particularly where there was a skills gap identified in relation to the preparation and maintenance of financial reports. As outlined in Section 2.5 in this report, shortcomings have been identified in the application of this strategy.

2.3 Strategic asset management

Local governments manage significant property, plant and equipment assets including infrastructure assets such as road networks, water supply and sewerage. These assets collectively represent the major proportion of the total assets on the balance sheets of these entities. The carrying value of these assets totalled $49,617m representing almost 90 per cent of the value of total assets reported by councils for 2005-06.

Accuracy, completeness, existence and valuation of local government non-current assets continue to be problematic for many councils. In excess of 100 audit issues have been reported in these areas across 45 councils. Based on the audit findings, I am not convinced that all councils can effectively achieve a whole-of-asset life and strategic management approach to significant property, plant and equipment items.

A review of the non-current asset findings from the 2005-06 audits highlighted several recurring issues, associated with poor asset management. These included —

- absence of proper valuation methodology, including the use of suitable indices to provide current values for assets between formal comprehensive asset revaluations;
- absence of componentisation of key assets such as road infrastructure (e.g. the identification of individual major components of roads such as formation, pavement and seals which have different useful lives, residual values and which attract different depreciation rates);
- lack of documentation to evidence that appropriate impairment testing had been performed and to support assumptions used in the valuation methodology;

- failure to reconcile the non-current asset registers with the general ledger on a regular basis; and
- application of incorrect depreciation methodology, including critical assumptions as to the remaining service potential of assets.

The inability of some councils to develop and retain experienced staff to carry out the roles of asset accounting and asset management is a critical contributor to the lack of effectiveness in these important areas.

Practices critical to strengthening governance in this area include —

- sound recruitment plans and comprehensive training for staff in all aspects of asset management, including the maintenance of robust asset records;
- use of a compliance regime through, for example, internal audit or self-assessment checklists;
- oversight by an executive group to critique the work performed by external consultants;
- oversight by a council focus group solely related to asset management; and
- robust internal reporting to management and to council on the outcomes of compliance, quality reviews, and asset condition.

Compliance with Accounting Standard AASB 116 *Property, Plant and Equipment* and Accounting Standard AASB 136 *Impairment of Assets* provided a significant challenge to councils. The changes to the accounting standards during 2005-06 meant that councils needed to keep abreast of those changes and to update their financial management records, computerised accounting systems and management practices to achieve compliance. Councils must continually monitor the ongoing developments in relation to the accounting standards to ensure that their accounting systems are correctly aligned with these standards.

Strategic asset management enables a council to maximise how assets that are critical to its business and financial performance are purchased, maintained and optimised throughout their useful life. It brings together elements such as strategy, practice, and benefit realisation to support a council's objectives of current and longer term service provision to the community. Strategic asset management includes a plan which aligns council's asset management and maintenance programs with council's objectives.

Good practice includes robust asset recording procedures to provide accurate and complete empirical data of asset history including consumption, maintenance, renewal and replacement. This information is key in providing a foundation for making informed decisions to procure or continue maintaining these significant assets. Capital asset replacement decisions for example are based, to a large extent, on historical information of similar existing items. Council's longer term funding forecasts need to take into account information derived from strategic asset management processes including asset life cycle budget analysis, maintenance strategy and a business asset needs analysis. Failure to maintain a robust framework therefore may result in adopting short term initiatives such as the deferral of key infrastructure replacement and may ultimately impact on a council's delivery of infrastructure and its ability to continue as a going concern if funds are not readily available at the time the replacement of the infrastructure asset becomes critical.

Specific issues of concern regarding the calculation and impact of depreciation expenses on council budgets and the treatment of road infrastructure data are considered in Sections 3.3 and 3.4 of this report.

2.4 The role of audit committees

I am aware, from my audit activity, that the audit committees of three large local governments did not independently review the 2005-06 financial statements of their particular local governments prior to the relevant Mayor and Chief Executive Officer completing the management certificate. One of the reasons this came to my attention was the poor quality of the financial statements presented to my auditors. The absence of governance over the quality of the annual statements led to significant changes being made to the initial statements following audit review. These adjustments resulted in additional work by council and by audit and consequently increased the overall cost of the audit. The average number of versions of statements produced to audit by these councils was five which, in my view, is excessive bearing in mind that a set of financial statements is required by law to be certified by council and provided to me for audit no later than 15 September of the next financial year.

In the audit report to the respective Mayors, these situations were reported as high risk because, in my view, they posed a significant business or financial risk to the council. The unsatisfactory state of the financial reports could potentially have resulted in a modified or qualified audit opinion being given if the issues had not been addressed as a matter of urgency by these councils.

I also have concerns that the inability of these and other councils to prepare financial statements to an acceptable standard at year end without considerable input from audit may reflect doubt on the reliability of the internal financial management reports produced for use by the council during the year. A council's decision making processes are likely to be significantly impeded through poor quality internal reports.

The use of an internal audit or a compliance function should be considered in testing the robustness of the accounting records and providing these committees with regular reports on the quality, accuracy and completeness of those records. This process should be seen as an internal value-adding exercise to the council's financial management responsibility under the *Local Government Act 1993*.

Under s.7 of the *Local Government Finance Standard 2005*, a local government is required to have a policy about the establishment or otherwise of an audit committee. If the individual local government's policy states that it is not required to establish an audit committee, the policy must provide for a review of that decision at regular intervals not longer than three years.

In general, s.13 of the Local Government Finance Standard requires that a "local government must consider the risks to which its operations are exposed" and consider internal control measures to manage these risks.

Section 15(2) of the Standard relates to the role of the audit committee for those local governments which elect to appoint an audit committee and includes a requirement under s.15(2)(b)(ii) for those committees to review at each meeting "the risks to which the local government's operations are exposed". The application of this section and s.13 by councils should involve consideration of the risk of misstatement of the financial statements. This aspect of a council's operations should come within the jurisdiction of a local government audit committee. If no audit committee is constituted, this responsibility could be allocated to an executive group with oversight by council.

Better practice audit committees have included in their functions a distinct role as an independent reviewer of an organisation's external reporting. In that role, these committees scrutinise the form and content of the financial statements prior to certification by the Mayor and Chief Executive Officer. Also, where any technical or operational issues arise in relation to the finalisation of such reports, the committee can act as a useful forum for resolving such issues, or reviewing and making recommendations on the various options and views. Although they do not apply directly to local governments, the "Queensland Treasury – Audit Committee Guidelines – Improving Accountability and Performance" issued in January 2000 provides better practice guidance on the operation of audit committees within the public sector. These guidelines are consistent with those published by other public and private sector bodies and I recommend their consideration to all councils.

2.5 Engagement of consultants in the provision of accounting services

At least 27 councils used consultants to assist with the preparation of their annual financial statements for 2005-06. I have noted that some councils are becoming increasingly dependent on the ongoing accounting support provided by consultants as an initiative to overcome the problems associated with staff shortages or a lack of suitably qualified staff. There have been varying degrees of effectiveness in the management of this initiative.

While this approach may prove cost effective in the short term, this trend is of concern as it suggests there is a lack of longer term capacity in some smaller councils to perform this work. In my view these consultants should be used as part of capacity building within the councils in terms of knowledge transfer and training of council staff. The continued use of consultants on the current basis may not be in longer term interests of the council's skills base. Processing of journal entries, providing internal management reports, preparing bank reconciliations and completing annual financial statements are just some of the duties performed by these consultants.

In the course of our year end audits, we observed some disturbing practices and outcomes in relation to the quality of this work. These included —

- preparation of annual financial statements which were clearly contrary to the council's accounting policies;
- preparation of financial statements which disagreed with the primary records of the council including the general ledger;
- incorrect application of accounting standards, particularly in relation to accounting for the revaluation of non-current assets;
- the absence of quality assurance in the production of financial statements resulting in more versions of financial statements being provided than would otherwise occur;
- delays in the correction and adjustment of financial statements and timely address of audit queries due to the consultant not being based locally;
- the use of inexperienced staff by some consultants in at least two instances. These staff did not possess adequate knowledge of accounting and did not have the ability to answer audit queries;
- inadequate workpapers to support the figures and notes contained in the statements; and
- numerous spelling, grammatical, and formatting errors which led to additional drafts of the annual financial statements being prepared.

Poorly set up council computer systems, e.g. incorrect mapping of the chart of accounts for the financial statements at the beginning of the financial year increased the need for these consultants as there was a lack of expertise of council staff as to how to correct the resulting problems at year end.

As a consequence, a considerable amount of audit time was incurred in advising council finance officers of the errors and the corrections required, liaising with the consultants and returning statements for correction. This additional audit activity resulted in increased consultant costs and audit fees. In addition, some of these local governments were required to seek extensions of time from the Minister for Local Government, Planning and Sport (the Minister) for the preparation of their annual reports (which include the audited financial statements).

The following table outlines one audit experience —

Table 2.2 — An example experienced by audit at the final audit of a council

- Liaison with the council prior to departure from Brisbane indicated that the council was ready for audit review. The financial statements had been prepared by a consultant and signed by management (without challenge) before the statutory deadline of 15 September.
- A perusal of the financial statements on arrival at the council revealed —
  - some accounting policy notes brought forward from previous years were no longer relevant to the current financial year;
  - some policy notes were inconsistent with the figures shown in the statements;
  - lack of note cross referencing to the financial statements; and
  - spelling and grammatical errors in the notes indicating that they had not been read or quality checked.
- The consultant had left the area and was only contactable by phone. Inadequate workpapers had been provided to support some financial statement figures, including prepayments and other accruals.
- There was an inadequate audit trail between the trial balance from the computer system and the financial statements.
- Council staff were unable to perform any amendments on the computer system due to lack of knowledge and inadequate set up of the system earlier in the financial year. The consultant had to be brought in to make these adjustments.
- After several phone calls by audit and the council to the consultant, five versions of the statements, and rework by the audit staff, the statements were eventually signed with an unqualified audit opinion, but obviously not in a timely manner consistent with legislative intent.
- Two extensions of time were sought and obtained from the Minister in relation to the annual report deadline.
- The council (small) was billed an increase of approximately 30 per cent on the original estimated audit fee due to the additional work required of audit.

A council's responsibility for the preparation of annual financial and other statements is enshrined in the *Local Government Act 1993*. Implicit in the management certificate to the annual financial statements are certain assertions, including that the statements are accurate and complete and comply with the accounting standards. The engagement of a consultant to produce financial statements does not absolve the council from its financial management responsibility under the Act. The position reported above reflects poor governance over the financial statement preparation process including oversight of the work of the consultant. In the above instance, the primary quality assurance process was provided by external audit and not management. This is an unacceptable situation.

Internal reporting (including the preparation and use of management reports) to the council may also be of an inadequate standard if the same framework is applied in their production. Poor quality reports are likely to affect the quality of council's decision making.

2.6 Engagement of experts for valuing non-current assets

Registered independent valuers are engaged by local governments to provide authoritative valuations for non-current physical assets such as land, buildings, infrastructure and major items of plant and equipment. The provision of reliable valuations is an important aspect of accounting where these assets need to be shown at fair value under Accounting Standard AASB 116 *Property, Plant and Equipment*. The audits identified issues in relation to —

- incorrect application of residual values;
- overlooking the ongoing maintenance programs of councils which extended the life and value of assets, such as roads; and
- lack of knowledge by management staff and valuers in relation to the need to test the underlying rationale and methodology used in the valuations.

These areas were subsequently addressed by the relevant councils' management and the valuers during the course of the audits, but only after being identified by audit.

The use of independent valuers is an important contributor to effective strategic asset management as independent valuers may be used to test assumptions and provide independent advice on areas such as unit costs, market rates, consumption and asset condition. Requirements for longer term funding of asset renewal and replacement may be derived from this expert information and opinions.

The auditor's responsibility in terms of relying on an expert, e.g. a valuer, is governed by Auditing Standard ASA 620 *Using the Work of an Expert*. These responsibilities include the requirement for an auditor to —

- review the scope of the expert's work, including the council's instructions to the valuer; and
- evaluate the work performed by the expert, including the source data used, assumptions and results obtained.

To comply with these requirements auditors must allocate significant audit time to this area, particularly where a comprehensive revaluation of council's non-current assets has occurred.

As a general guide, councils are expected to have the following better practice framework —

- competitive tenders sought for the valuation process;
- issue of formal and comprehensive instructions by the council to the valuer;
- formal evaluation by council's management or an executive group/committee of the valuation methodology, including assumptions made, expertise of the valuer and overall rationale leading to the values; and
- approval by council of the results of the valuation based on a formal report to council by management or executive group/committee of their scrutiny of the valuation.

Between comprehensive revaluations, indices appropriate for the relevant asset class should be applied to maintain the assets at fair value. Appropriate indices are available from the Queensland Office of Economic and Statistical Research, for example, the General Government Gross Fixed Capital Formation index includes a specific index for State and Local Government. Other suitable indices may be obtained from the Australian Bureau of Statistics. Indices should take into account technological change and local conditions as well as the effects of specific or general price levels. Again, councils should proactively critique the basis on which indices are selected and record details thereof in the council minutes.

A further area of concern in relation to valuation of non-current assets is the view of some councils that comprehensive revaluations of their non-current physical assets are required only every five years. Section 45 of the Local Government Finance Standard requires these assets to be shown at fair value in each year's financial statements. To effectively do this, comprehensive revaluations may be required more regularly depending on the nature of the asset, e.g. buildings, and trends within the relevant industry or market. Alert councils will maintain regular liaison with their independent valuers to ensure that their assets are shown at fair value in each year's financial statements. Accurate valuations are also required as a basis for calculating depreciation.

Although not prescribed for councils, Appendix G to the Non-current Asset Policies for the Queensland Public Sector issued by the Treasurer provides better practice guidelines for instructing valuers. The website address for this document is http://www.treasury.qld.gov.au/office/knowledge/docs/non-current-asset-policies/index.shtml. The document could be used in the absence of any specific guidelines in the local government sector.

The following table outlines one audit experience —

Table 2.3 — An example experienced by audit at a council

- A small/medium council comprehensively revalued its non-current physical assets at 30 June 2006 and used a qualified independent valuer from interstate. The previous comprehensive asset revaluation was performed in June 2001.
- Management advised the valuer that the valuation was for audit purposes and minimal further instruction was given to the firm undertaking the task.
- Completeness of council's asset register had been an issue in the audit reports of previous years. This aspect was not adequately addressed prior to the commencement of the valuation process.
- The asset register was held and maintained by the valuer on behalf of the council.
- On arrival, the auditor was handed the valuation folder supplied by the valuer.
- Council approved the valuation based on the recommendation of the chief executive officer.
- In carrying out his duty under Auditing Standard ASA 620 *Using the Work of an Expert*, the auditor inquired from the chief executive officer as to how the valuation methodology was assessed. The chief executive officer could not understand why the auditor was so interested in the valuation process.
- The auditor was provided with an interstate contact. The valuation folder contained little detail on the rationale used in the process and made no reference to the accounting standards.
- Enquiries by the auditor with the valuer produced additional workpapers and revealed that the residual values moved in line with the increment in the gross value of the relevant assets. Depreciation expense therefore remained unchanged. Benchmarking the unit rates against those contained in a valuation of a nearby local government revealed inconsistency in the unit rates applied. When queried by the auditor, the valuer agreed that the valuation was flawed and issued an amended valuation.
- The auditor established that management had not challenged the information supplied by the valuer.
- The process delayed the signing of the financial statements by the auditor and Ministerial approval was sought and obtained by the council to an extension of time for the annual report deadline.
- Significant additional costs arose from the extra work required on this area alone, including an audit fee increase of approximately 30 per cent.
- An unqualified audit opinion was issued on the financial statements but only after significant additional work was undertaken by audit and council officers.

Section 3
Financial performance

3.1 Introduction

Information reported in financial statements can be used in a number of ways to monitor performance, including financial viability and financing and investing. Borrowings, financial viability and coverage of depreciation expense by operating revenue or commonly termed “unfunded depreciation” are three indicators of the financial health of an entity.

3.2 Financial viability

The audit process includes an assessment of an agency’s ability to continue as a going concern. This process includes an assessment of the capacity of a local government entity to pay its debts within the next 12 months. A combination of a number of factors may indicate that the financial viability of a local government should be closely monitored. These include —

- cashflow difficulties between rate billings;
- inadequate attention to key ratios, such as the current ratio whereby current liabilities exceed current assets;
- high levels of unfunded depreciation;
- the existence of significant deferred capital works projects; and
- inadequate reserve funds.

It has been my practice to look for indicators of going concern in line with relevant audit and accounting standards. In the past, the councils which have met the following three criteria or indicators of ongoing viability problems have been listed in reports to Parliament —

- current ratio (current assets over current liabilities) of less than 1.5:1;
- material operating deficit (> 20 per cent of operating revenue); and
- significant borrowings (> 20 per cent of operating revenue).

In applying this criteria to the 2005-06 financial statement data, there were no councils where all three criteria applied. There are, however, nine councils where two of these criteria were present.

Sixty-eight councils disclosed an operating deficit in their respective Income Statements for the financial year ended 30 June 2006. The aggregate of these deficits was $290.09m. While these local governments had sufficient equity to cover these losses, a continuation of deficit results is not sustainable in the longer term.

Five councils each had a current ratio less than 1.5:1, the lowest being 0.74:1 held by three out of these five councils.

Stronger financial positions exist where there is a wide ratepayer base and diverse operations from which councils can attract revenue. The ability of smaller councils to improve their financial outcomes is constrained by a lack of growth in their community (and hence rate base) and the small scale of their operations from which other revenue can be obtained. A significant increase in rate levels by council may be to the detriment of voter appeal. Voter appeal may also influence councils to support unprofitable activities which, if left unchecked by a council with less effective governance, may in the longer term be to the detriment of council’s sustainability.

Operating efficiencies can be gained through cost sharing of resources. An opportunity to achieve this may be through the Size, Shape and Sustainability initiatives which are currently being undertaken by the Local Government Association of Queensland in conjunction with the Minister and the Department of Local Government, Planning, Sport and Recreation. Under this initiative, councils are encouraged to examine four main options for change through a regional collaborative process.

These options are —

- resource sharing through service agreements;
- resource sharing through joint enterprise;
- merger/amalgamation; and
- significant boundary changes.

In addition, the Queensland Treasury Corporation is providing independent financial sustainability reviews for councils. While this is not mandatory across the sector, nevertheless all councils should consider participating in these reviews at least from the aspects of astute financial management and as a "health check" on their financial sustainability.

I commend these initiatives to councils.

3.3 Depreciation expense

The financial management framework established under the *Local Government Act 1993* requires that current ratepayers pay for the services they are receiving and that future ratepayers should not have to pay for what has previously been consumed. In other words, current operating revenue for the year should cover total operating expenses, including depreciation expense which in 2005-06 amounted to $1,262m (22 per cent of total expenses). Depreciation expense for the year represents the value of the council's assets consumed by the current ratepayers during that year.

Accounting Standard AASB 116 *Property, Plant and Equipment* requires annual review of the assets' useful lives and their residual values. Failure of a local government to adequately comply with this Standard may result in over-depreciation or a depreciation methodology not appropriate to the behaviour of the relevant asset. Over-depreciation through not applying asset residual values may lead to operating losses in the Income Statement and potentially overcharging of current ratepayers. Significant non-compliance may impact on the form and content of the Independent Audit Report provided by the Auditor-General.

The existence of situations where depreciation expense is not covered by operating revenue is not always a concern as councils may elect not to fund depreciation on assets which are not to be replaced or which will be replaced through the use of external funding sources. The existence of consistently high levels of unfunded depreciation could indicate an insufficient revenue base to fund asset replacement in the longer term.

Before a council can determine the extent to which its annual depreciation expense needs to be funded, it must ensure that the depreciation expense is properly calculated by reference to realistic useful lives and residual values of infrastructure assets. Refer Section 3.4 Road Infrastructure Data.

An abnormally high depreciation expense could result from incorrect assessments of asset residual values and useful lives.

Previous reports to Parliament have highlighted that the issue of the recording, valuation and depreciation of non-current assets continues to provide problems for a number of local governments. In general, there has been no significant improvement in this area for 2005-06.

Based on a broad calculation from information derived from the financial statements for 2005-06, Table 3.1 sets out a comparative position in relation to depreciation expense covered by councils' operating revenue —

Table 3.1 — Proportion of depreciation expense covered by operating revenue

	No. of councils			
	2005-06	**2004-05**	**2003-04**	**2002-03**
All depreciation expense covered	43	36	45	40
Between 75% and 100% of depreciation charges	32	29	24	25
Between 50% and 75% of depreciation charges	24	37	37	43
Between 25% and 50% of depreciation charges	17	12	14	12
Between 0% and 25% of depreciation charges	9	11	5	5
Total number of councils	**125**	**125**	**125**	**125**

Thirty-four per cent (43) of the Council have fully funded all depreciation expenses during 2005-06 as compared to 29 per cent (36) during 2004-05 indicating a slight improvement. However, for the remaining 82 councils, it continues to be a challenge to raise operating revenue from current ratepayers that fully funds the costs of using the existing infrastructure (i.e. operator costs and depreciation). These councils are potentially building a liability for infrastructure expenditure that will have to be funded by future ratepayers.

3.4 Road infrastructure data

The roads infrastructure depreciation expense represented 29 per cent of total depreciation expenses for councils, a material element of the total depreciation expense for 2005-06.

On 25 September 2003, the Department of Local Government and Planning issued bulletin 19/03 on Roads Infrastructure Assets. Basically, the bulletin provided for transitional arrangements for councils to move, at the next full comprehensive revaluation, from the "Brownfield" approach which involved the expensing of formation costs to a methodology which complied with the accounting standards. Sufficient time has now been allowed for councils to achieve this transition.

Urgent Issues Group (UIG), Interpretation 1055, *Accounting for Road Earthworks* which was issued in September 2004 adopts the view that road earthworks, particularly formation, have a very long useful life and high residual value.

The residual value of a road is that value remaining at the end of its useful life. Roads are seldom disposed of, but rather, are renewed or upgraded. Therefore the residual value of the road is that amount which will still be held in the asset at the time of the next renewal or upgrade.

During 2003-04, QAO conducted an initial sector-wide survey relating to the practices applied by local government throughout the State to the valuation of their roads assets. In that year, the results of the review highlighted some large variances in residual values and useful lives of components in the asset registers of councils even where these councils were located in the same geographic region.

This information was updated for 2005-06 from the road data survey. The information requested related to the components of road assets, e.g. formation/earthworks; pavement or road base and seal; and the residual values and the useful lives of the components. Responses containing the required information were received from 112 councils. Some local governments were unable to extract the required data from their information systems.

The results were benchmarked against the 2003-04 survey results as set out in Table 3.2 and 3.3 below to compare information which was held by councils in their asset registers and used to prepare their annual financial statements.

Table 3.2 below indicates improvement in that more councils have set useful lives of roads infrastructure, in particular formation component greater than 50 years as compared to the 2004 results. While Table 3.3 indicates a slight improvement in the treatment of residual values compared to the last measurement, significant work needs to be done by approximately 70 per cent of the councils surveyed to review the residual values of these assets in line with the UIG, Interpretation 1055.

Based on the information presented in Table 3.4 more than 35 per cent (40) of the councils surveyed continue to have no residual values on all three road components and, as a result, higher depreciation expense is recorded.

The survey also revealed that only 55 per cent (62) and 47 per cent (53) of the councils annually review the useful life and the residual values, respectively of the road infrastructure in accordance with the requirements of Accounting Standard AASB 116 *Property, Plant and Equipment*.

Appendix A, in Section 6, outlines three scenarios for the treatment of residual values and depreciation expense for road infrastructure assets. These scenarios are —

- **Scenario 1:** The road has two components – Pavement and Seal. Formation costs are expensed when incurred. This is a practice which is non-compliant with the accounting standards and previously known as the Brownfield approach. No residual values have been determined.
- **Scenario 2:** The road has all three components capitalised. However, no residual values are applied for any of the components. This common practice may not be fully compliant with Accounting Standard AASB 116 *Property, Plant and Equipment* in that no residual values have been applied. Most sealed roads, for example, should at least have some residual value for the formation component.

- **Scenario 3:** The road has all three components with appropriate useful lives and residual values. This approach fully complies with AASB 116 *Property, Plant and Equipment* and is seen as better practice.

Scenarios 1 and 2 have been adopted by at least 40 councils. The depreciation expense for councils using scenario 2 will be up to three times higher than if they applied scenario 3 which fully complies with the accounting standards. For those councils using the valuation treatment in scenario 1, the depreciation expense will be at least twice the level that would apply using scenario 3.

The application by councils of scenario 3, Appendix A, is the recommended practice. Use of the other scenarios by councils may attract a modified audit opinion, in future years, as sufficient time has elapsed for completing the transition to compliance with the accounting standards. Where councils have well documented and supported residual values on the three components, depreciation expenses can be more reliably determined and will more closely reflect the pattern of usage of the assets.

Where councils do not accurately determine residual value and appropriate useful life for the formation component, then the potential exists for over-depreciation of road infrastructure. This could result in incorrectly high depreciation expense being reported in financial statements and current ratepayers may be contributing more than is appropriate for the usage of the infrastructure assets.

Accurate determinations of residual values are necessary to determine the depreciable amount (amount upon which depreciation is charged).

Better financial management of non-current assets will result from effective governance over asset accounting which includes —

- regular reviews of the residual values and resulting level of depreciation expenses that can be funded from operating revenue sources; and
- identifying alternative operating revenue sources and potentially reducing the impact on future ratepayers.

Table 3.2 — Road components useful lives

Range	Formation		Pavement		Seal	
	2006	2004	2006	2004	2006	2004
1-15 years	1	4	0	8	63	66
15-25 years	0	5	7	4	31	25
25-50 years	11	13	52	54	11	15
50-75 years	5	7	19	18	3	3
75-100 years	43	39	29	27	4	5
Over 100 years	14	10	4	3	0	0
Indefinite	27	26	0	0	0	0
Not valued	11	10	1	0	0	0
Number of council respondents	**112**	**114**	**112**	**114**	**112**	**114**

The comparative range of percentage of residual values of the three types of components of roads are disclosed in Table 3.3 below —

Table 3.3 — Comparative residual values

Component and % of residual values	Number of councils		Percentage	
	2006	2004	2006	2004
>90% residual for formation	31	22	27.7%	19.3%
>70% residual for pavement	9	12	8.0%	10.5%
>70% residual for seal	4	4	3.6%	3.5%

Further analysis of residual value components for 2006 is set out in Table 3.4 below. No comparative information is available at this level.

Table 3.4 — Stratification of residual values

% of residual value	Formation	Pavement	Seal
0	40	40	54
1<50%	13	50	47
50%>70%	1	13	7
70%-90%	27	4	0
> 90%	31	5	4
Number of council respondents	**112**	**112**	**112**

Section 4
Results for 2005-06

4.1 Overview of financial operations of councils

Local government councils are diverse in their demographics, the nature of the services they provide and their structure (e.g. operating divisions, regional centres, committees, etc.). They are both providers of service to the community and regulators. Services provided range from managing private health facilities and convention centres to maintaining roads, water and sewerage. A major source of revenue is achieved through the issue of rates to the land holders of a local government area.

Key broad financial information, including Brisbane City Council, has been reported in Tables 4.1 to 4.5 below to reflect the diversity and size of these councils —

Table 4.1 — Consolidated financial information

	2005-06 $m	2004-05 $m	2003-04 $m	2002-03 $m
Total revenues	6,682	6,107	5,449	5,012
Total expenses	5,644	5,112	4,733	4,583
Total assets	55,441	48,308	41,207	38,299
Total liabilities	3,798	3,559	3,485	3,429
Total number of councils	**125**	**125**	**125**	**125**

Table 4.2 — Total revenue

Ranges $	No. of councils 2005-06	Total revenue 2005-06 $m	No. of councils 2004-05	Total revenue 2004-05 $m
1m-10m	34	233	42	282
10m-20m	45	636	42	591
20m-50m	23	645	20	572
50m-100m	8	511	7	437
100m-500m	13	2,273	12	2,031
500m-1,000m	1	775	1	653
1,000m+	1	1,609	1	1,451
Total	**125**	**6,682**	**125**	**6,017**

Table 4.3 — Total assets

Ranges $	No. of councils 2005-06	Total assets 2005-06 $m	No. of councils 2004-05	Total assets 2004-05 $m
10m-100m	56	3,322	63	3,662
100m-500m	51	9,708	46	9,090
500m-1,000m	7	5,042	5	3,573
1,000m-5,000m	9	13,770	9	11,970
5,000m-10,000m	1	8,588	1	5,390
10,000m+	1	15,010	1	14,623
Total	**125**	**55,441**	**125**	**48,308**

Table 4.4 provides an analysis of the number of councils within discrete borrowing ranges for 2005-06 and compares this to previous years to highlight borrowing trends.

Table 4.4 — Borrowing trends

Range	2005-06	2004-05	2003-04	2002-03	2001-02	2000-01
No borrowings	30	29	29	29	30	27
$1<$10m	67	69	66	66	64	65
$10m<$30m	15	14	17	17	18	20
$30m<$50m	2	2	4	3	2	2
$50m<$100m	7	6	5	6	6	6
Over $100m	4	5	4	4	5	5
Total number of Councils	**125**	**125**	**125**	**125**	**125**	**125**

Table 4.5 — Total council borrowings

	2005-06 $m	2004-05 $m	2003-04 $m	2002-03 $m	2001-02 $m
Total borrowings	2,632	2,587	2,582	2,622	2,694

Table 4.4 and Table 4.5 disclose that total borrowings for the councils over the last four years have been relatively consistent with Table 4.1, a rise of 1.7 per cent being recorded between 2004-05 and 2005-06.

4.2 Timeliness

Apart from Brisbane City Council, local governments are required to observe the following deadlines —

Table 4.6 — Legislation compliance

Action	Deadline
Prepare and certify proposed financial statements	15 September each year
Present and adopt an annual report which contains the audited annual financial statements	30 November each year

In accordance with the *City of Brisbane Act 1924*, the Brisbane City Council must present financial statements to the Auditor-General by 31 August and these statements must be included in the annual report which must be completed by 31 October. The 2005-06 financial statements for Brisbane City Council were completed and certified within these timeframes.

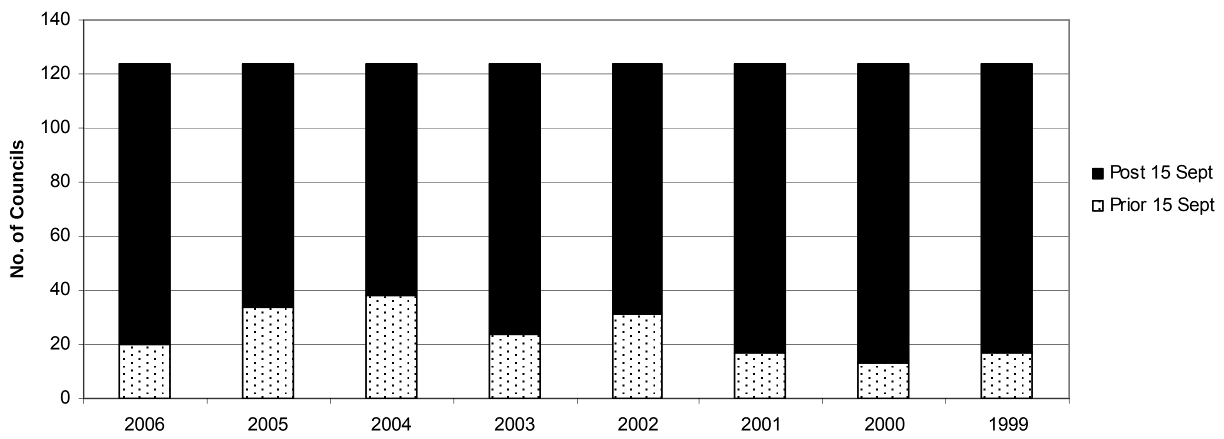
As these are separate requirements to other local governments, Brisbane City Council is excluded from the statistics shown overall in Section 4.2 of this report.

4.2.1 Proposed financial statements

The requirement for councils to prepare and certify proposed financial statements and supply them to the Auditor-General by 15 September is provided for in s.53 of the *Local Government Finance Standard 2005*. As soon as practicable after the proposed financial statements are provided to audit, the proposed financial statements must be presented to a meeting of the local government.

The following graphs represent the comparative situation with respect to the completion of the financial statements —

Table 4.7 — Comparative position for legislative compliance – proposed financial statements



	2006	2005	2004	2003	2002	2001	2000	1999
Post 15 Sept	104	90	86	100	93	107	111	107
Prior 15 Sept	20	34	38	24	31	17	13	17
Total	**124**	**124**	**124**	**124**	**124**	**124**	**124**	**124**

As a result of significant audit adjustments required to the original statements, management certificates originally dated prior to 15 September needed to be re-signed in the case of 36 councils. These adjustments were necessary to correct material errors or misstatements identified by audit. See commentary in Section 2.2 of this report.

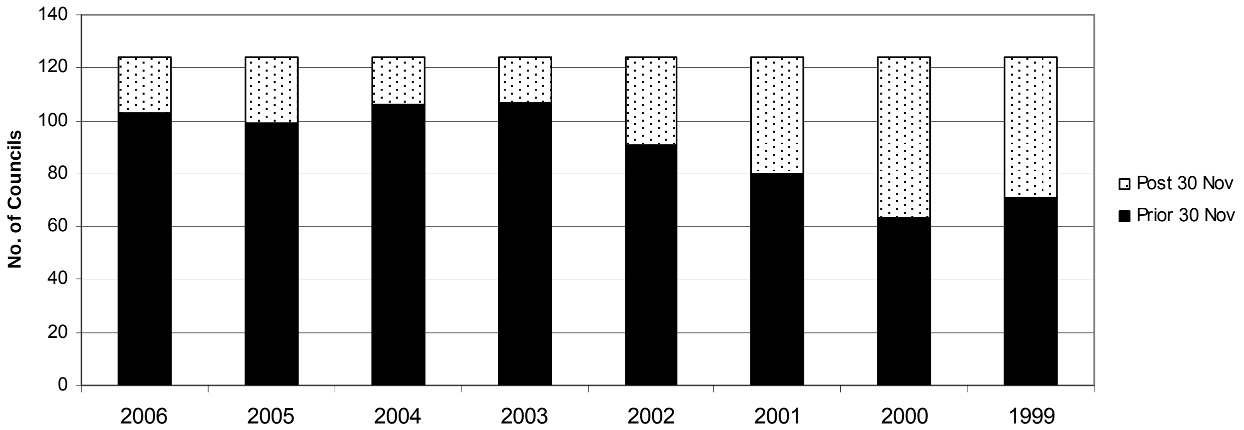
4.2.2 Financial statements completed by 30 November

Under s.532 of the *Local Government Act 1993* a local government must prepare an annual report for each financial year. This report must be presented to the local government and be adopted by 30 November in the year after the end of the financial year to which the report relates. If a local government is unable to meet the legislative timeframe for the preparation of the annual report, then the Minister may allow a longer period for compliance.

The annual report must contain the audited financial statements which includes the independent audit report of the Auditor-General. For the 2005-06 financial year, 21 councils and four joint local governments did not have their financial statements certified by 30 November.

Table 4.8 below provides a comparative position over the last eight financial years for local governments.

Table 4.8 — Comparative position of financial statements completed by 30 November



	2006	2005	2004	2003	2002	2001	2000	1999
Post 30 Nov	21	25	18	17	33	44	61	53
Prior 30 Nov	103	99	106	107	91	80	63	71
Total	**124**	**124**	**124**	**124**	**124**	**124**	**124**	**124**

The trend since 1998-99 has been one of improvement to 2003 and 2004 with a slight deterioration in 2005 and 2006. While there can often be some delay between finalisation of the audit field visit, resolution of residual audit issues and the issuing of the independent audit report, some common factors which have affected the timeliness of financial statement completion for 2005-06 include —

- asset valuation difficulties;
- implementation of new systems;
- staff leave;
- loss of key staff who have been unable to be replaced in a timely manner;
- lack of adequate accounting knowledge to prepare financial statements in accordance with the accounting standards;
- absence of quality control processes including the effective use of an audit committee or executive group to closely scrutinise the form and content of the statements; and
- lack of in-house expertise in using council's computerised accounting systems to produce well-presented financial statements.

Overall, there is scope for significant improvement in the timeliness of the financial statement preparation.

4.2.3 Extensions of time

The local government legislation allows local governments to apply to the Minister for extensions of time in which to finalise their financial statements and annual reports where they are unable to meet the respective legislated deadlines of 15 September and 30 November. Areas of non-compliance at 31 March 2007 were —

- the 2005-06 financial statements of Belyando Shire Council were certified by management and by audit on 14 December 2006 but the council had not requested an extension of time beyond 30 November 2006 from the Minister;
- the 2005-06 financial statements of Aurukun Shire Council were certified by audit on 28 February 2007 and, although the Minister had approved an extension of time for completion of their proposed financial statements to 28 February 2007, the council had not applied to the Minister for an extension of time in which to complete its annual report;
- the 2005-06 financial statements of Mornington Shire Council were certified by audit on 28 February 2007 and, although the council had applied for an extension of time to 28 February 2007 to complete their annual report, the Minister had not approved this extension prior to certification of the financial statements;
- the 2005-06 financial statements of Diamantina Shire Council were certified by audit on 16 February 2007 and, although the council had applied for an extension of time to 28 February 2007 to complete their annual report, the Minister had not approved this extension prior to certification of the financial statements;
- the 2005-06 financial statements of Emerald Shire Council were certified by audit on 30 March 2007 and, although the council had applied for an extension of time to 2 April 2007 to complete their annual report, the Minister had not approved this extension prior to certification of the financial statements; and
- the 2005-06 financial statements of Longreach Shire Council were certified by audit on 14 February 2007 and, although the council had applied for an extension of time to 28 February 2007 to complete their annual report, the Minister had not approved this extension prior to certification of the financial statements.

In all other cases, where local governments did not meet the 15 September or 30 November timeframes for their 2005-06 financial statements and annual reports, extensions of time were approved by the Minister.

In my opinion, the effectiveness of the 15 September deadline in achieving timely reporting should be examined by the Department of Local Government, Planning, Sport and Recreation in conjunction with the current review of the Local Government Act. A better practice would be to eliminate the two-step process currently prescribed and adopt the simple framework contained in the *Financial Administrative and Audit Act 1977* for government departments. Under this process, councils would negotiate a financial statement timetable with the auditor and be required to have their financial statements and annual reports completed by a specific date, currently 30 November.

4.3 Unfinalised financial statements

As at 31 March 2007, the financial statements of five controlled entities and two joint public sector entities were yet to be finalised. Details of the unfinalised financial statements are set out in Table 4.9 —

Table 4.9 — Unfinalised financial statements for 2005-06

Controlled entities
Boonah and District Art Gallery and Library Trust
Boonah and District Performing Arts Centre Trust Fund
Charleville COSMOS Centre Limited
Warwick Shire Tourism and Events Pty Ltd
Widelinx Pty Ltd
Joint public sector entities
Far North Queensland Regional Organisation of Councils
North Queensland Local Government Association*

* Financial year end is 31 December.

4.4 Qualified audit opinions

Entity	Details of qualification	Response
Gladstone City Council	The Council's annual financial report for the year ended 30 June 2005 was qualified because the Council was not able to provide sufficient documentation to substantiate that the reported carrying amounts of Land, Buildings, Vehicles, Roads and Other Infrastructure assets as at 30 June 2005 represented fair value. As a consequence of the 2005 qualification, for the year ended 30 June 2006, I was unable to express an opinion on the depreciation expense of $3,532,261 relating to Roads Infrastructure assets as this class of assets was not revalued until 30 June 2006. Based on the 30 June 2006 Valuer's report, it was estimated that the depreciation expense for 2005-06 was understated by a maximum of $1.4m. Had this additional depreciation expense been recognised, the net result attributable to the Council would have been approximately $16m.	The Mayor advised on 8 March 2007 — *"I am pleased to advise that the matter to which the qualification relates has been resolved for future years.* *Council is extremely confident for the future, now having the important position of Manager Financial Services filled and its new financial package planned to go live from 1 July 2007."*
Goondiwindi Town Council	The Property, Plant and Equipment note to the financial statements discloses that Roads, Water and Sewerage infrastructure assets were valued at current replacement cost and the accounts are amended each year to reflect the changes in valuation and useful lives. Note 15 of the financial statements discloses that Land and Buildings were last valued in March 2002. Council was unable to provide sufficient documentation to substantiate that an annual assessment of these asset values had occurred and consequently that these assets materially equated to fair value as at 30 June 2006. I was therefore unable to express an opinion on the reported written down value of those assets totalling $47,789,000, the associated depreciation expense of $1,234,000 and the Asset Revaluation Reserve balance of $6,675,000 as disclosed in Note 18 of the Council's 2005-06 financial statements.	On 12 January 2007, the Mayor advised — *"I refer to your correspondence of 1 December 2006 enclosing annual financial statements and drawing Council's attention to the audit opinion which was qualified for the reason described in the Independent Audit Report attached to those statements. Comments and remedial action implemented or proposed by Council is as follows —* *'In relation to the annual review of the fair value of non-current assets, the information will be appropriately evidenced and retained for audit purposes in future periods.' "*

Entity	Details of qualification	Response
Johnstone Shire Council	The reported value of Infrastructure Assets comprising Road and Bridge Network $45,775,879, Water $42,483,732 and Sewerage $19,304,017 as shown in Note 18(a) to the accounts include revaluation transactions based on condition assessments and other critical assumptions that could not be supported by appropriate evidence or supporting documentation. I was therefore unable to form an opinion on the value of these assets and the associated depreciation expense of $3,977,834. The written down value of buildings reported in the accounts as at reporting date was $25,458,060 however, as disclosed in Notes 1.01 and 2.13 in the accounts, the Council had not assessed the extent to which the value of buildings were impaired as at 30 June 2006 following large scale destruction as a result of a cyclone on 20 March 2006. This is a departure from Accounting Standard AASB 136 *Impairment of Assets*, which requires an entity to formally estimate at reporting date, the recoverable amount of assets where an indication of impairment exists, thus identifying and recording any impairment loss where the carrying value is greater than the recoverable value. The effect of any impairment loss was incapable of being measured reliably due to the lack of information to support the recoverable amounts of the affected assets.	On behalf of the Council, the Director Corporate Services advised on 26 January 2007 — *“With respect to infrastructure assets, Council’s efforts to date to comply with the Accounting Standards for the recognition and valuation of Infrastructure assets has and continues to be less than adequate. It is hoped that within the next two years with added resources to address the issues, Council will be able to reach an acceptable level of compliance.* *With respect to impairment of buildings the Council stated in its financial statements for 2005-06 that once all damage has been repaired, asset revaluations will be undertaken.”* (Note: Johnstone Shire Council was dissolved by the Minister on 8 February 2007 and an administrator appointed until the next local government election in March 2008.) The administrator was provided an opportunity to comment on the qualification issues and at the time of finalisation of this report no response had been received.

<table>
<tr><th>Entity</th><th>Details of qualification</th><th>Response</th></tr>
<tr><td>Mornington Shire Council</td><td>In my report for the 2004-05 financial year I did not express an opinion on the Financial Statements prepared by the Council as the Council failed to exercise sound managerial control, and maintain adequate systems of internal control and reporting, to fulfil its operational and legislative requirements, resulting in a limitation to the scope of the audit. I was therefore unable to express an opinion on the comparatives for 2004-05 or on the opening balances for 2005-06.
Further, as there was no independent valuation of Property, Plant, and Equipment assets performed to support the value of these assets reported at 1 July 2005 of $63,930,777 I was unable to express an opinion on the depreciation expense calculated for the 2005-06 financial year of $4,128,474 which is based on this opening balance.
Tavern Inventory stock control records were inadequately maintained by the Council for the period from 21 November 2005 to 24 April 2006. Consequently, I was not able to determine the completeness and accuracy of Tavern Inventory issued and any associated revenue from these issues. I was therefore unable to express an opinion on the figures reported in the Financial Statements for the following —
● Tavern Inventory of $158,293 reported at Note 16 to the Financial Statements as Current Inventory - Other Trading Stocks.
● Revenue from Tavern Sales of $2,235,828 reported within Note 4(e) to the Financial Statements as part of Sales - Contract and Recoverable Works revenue.</td><td>On 16 March 2007 the Mayor advised —
“In the absence of sound management control and maintenance of adequate internal systems during 2004-2005 we recognise that closing balances for 2005-2006 cannot be substantiated. However for the purposes of preparing our financial statements for 30 June 2007, we request that closing balances 2005-2006 be accepted.
Prior to the close of this financial year, Council will undertake an independent valuation of Property, Plant and Equipment Assets which will provide a comparative figure against depreciation expense for 2005-2006.
Stringent financial/stock controls have been instituted for the Tavern Operations and discrepancies as referred to in this point have been addressed, cash reconciliation is on a daily basis with a daily report to the CEO who is closely monitoring the situation.”</td></tr>
</table>

Entity	Details of qualification	Response
Mission Beach Marine Facilities Joint Board	The written down value of Property, Plant and Equipment reported in the accounts as at reporting date was $1,318,174 however, as disclosed in Notes 1, 1 (c) and 7 in the statements, the Board has not assessed the extent to which the value of its assets were impaired as at 30 June 2006 following large scale destruction as a result of a cyclone on 20 March 2006. This is a departure from Accounting Standard AASB 136 *Impairment of Assets*, which requires an entity to formally estimate at reporting date, the recoverable amount of assets where an indication of impairment exists, thus identifying and recording any impairment loss where the carrying value is greater than the recoverable value. Although the impairment loss was incapable of being reliably measured due to the lack of information to support the recoverable amounts of the affected assets, a material impairment loss should have been recognised. Had this impairment loss been appropriately recognised the Asset Revaluation Reserve of $65,768 would have been reduced to zero and the reported Net Profit for 2005-06 of $54,642 would have been a significant loss, notwithstanding the impact of any recoveries that might apply. The Property, Plant and Equipment, Total Asset and Net Asset figures would also have been materially reduced following the recognition of the impairment loss.	On 28 March 2007, the President advised — *“I have met with and received an explanation from the Chief Executive of the Board of why the impairment assessment of the Board’s Jetties was not carried out and concur with the Chief Executive that the Board did not have the financial capacity to undertake the assessment prior to 30 June 2006.* *Repairs to the Board’s assets as a result of Cyclone Larry are beyond the capacity of the Board unless a review of the Board’s Natural Disaster Relief Arrangements claim is successful.* *The future role of the Board is currently under consideration.”*

Section 5
Management of local government audits

5.1 Audit arrangements

Appendix B of Section 6 details the local government entities which are subject to audit by the Auditor-General for 2005-06. These include 125 councils each administering a local government area, 14 joint local governments established to administer specific activities, such as aerodrome boards, library boards, water boards and saleyard boards, 58 controlled entities of those local governments including a local government owned corporation (Wide Bay Water), and 29 joint public sector entities.

With the exception of the Brisbane City Council which is established under the *City of Brisbane Act 1924*, Queensland local governments are constituted under the *Local Government Act 1993*. Both Acts are administered by the Minister for Local Government, Planning and Sport. Under the Act, the Auditor-General is to prepare a report on any audit performed of a local government. Copies of that audit report are to be given to the Mayor who is required to table a copy of the Auditor-General's report at the next ordinary meeting of the local government. The Auditor-General is also required to give copies of this report to the Chief Executive Officer of the relevant local government and the Minister.

The *Local Government (Community Government Areas) Act 2004* brought Aboriginal Councils under the *Local Government Act 1993* and, as such, they are no longer differentiated from shire councils under the Local Government Act. Their transition to contemporary reporting in line with mainstream local governments is continuing and the results of the audits of these entities will be included in a later report.

Independent audit reports on each local government's financial statements are provided by the Auditor-General under the Local Government Act. The audited financial statements, together with the independent audit report, are required to be included in the annual report of the local government which is to be presented to that local government for adoption by 30 November.

5.2 Management of local government audits

Contract auditors are used by the Auditor-General to assist in completing the audits of local governments and their associated entities. To be eligible to be appointed as contract auditors, individuals must be partners of firms which have the capability to conduct financial and compliance audits and have an audit methodology and quality assurance process which fully comply with the Australian Auditing Standards. Each partner must be a member of either CPA Australia, Institute of Chartered Accountants in Australia or National Institute of Accountants at the Professional National Accountant (PNA) level.

Table 5.1 — Contracted audits during 2005-06

Number and type of entity	Number of audits undertaken by contractors
125 councils	106
14 joint local governments	10
58 controlled entities	35
29 joint public sector entities	21

The management of local government audits is subject to ongoing review to ensure high quality audits and best value are achieved for councils and the Auditor-General. Audits are generally performed by QAO on a rotational basis with the objective of QAO covering all councils on a cyclical basis.

Section 6
Appendices

Appendix A — Scenarios in the treatment of residual values and depreciation expense

The following three scenarios provide an indication of the impact of depreciation expense, depending on the methodology used and the criteria applied as set out in Tables 3.3 and 3.4 of this Report —

Scenario 1: The road has two components – Pavement and Seal. Formation costs are expensed when incurred, a practice which is not-compliant with the accounting standards and previously known as the Brownfield approach. No residual values have been determined.

Scenario 1	
Formation	$0
Pavement	$100,000
Seal	$50,000
Total	**$150,000**
Assumed useful lives	
Formation	0 years
Pavement	50 years
Seal	10 years
Residual	
Formation	0
Pavement	0
Seal	0
Depreciation expense per Income Statement	
Formation	$0
Pavement	$2,000
Seal	$5,000
Total	**$7,000**
Straight line method used for example, although this needs to be reassessed in line with the pattern of expected benefits to be consumed by the council.	
Adoption of this approach will result in a modified Independent Audit Report.	

Scenario 2: The road has all three components capitalised with estimated useful lives but residual values of nil. This common practice may not be fully compliant with Accounting Standard AASB 116 *Property, Plant and Equipment* in that no residual values have been applied. Most sealed roads, for example, should have some residual value for the formation —

Scenario 2	
Formation	$350,000
Pavement	$100,000
Seal	$50,000
Total	**$500,000**
Assumed useful lives	
Formation	100 years
Pavement	50 years
Seal	10 years
Residual	
Formation	0
Pavement	0
Seal	0
Depreciation expense per Income Statement	
Formation	$3,500
Pavement	$2,000
Seal	$5,000
Total	**$10,500**
Straight line method used for example, although this needs to be reassessed in line with the pattern of expected benefits to be consumed by the council.	
Adequate documentation is required to support the appropriateness and relevance of the methodology used.	
Failure to fully comply with AASB 116 will result in a modified Independent Audit Report in future.	

Scenario 3: Road has all three components with useful lives and residuals as below – better practice – this fully complies with Accounting Standard AASB 116 *Property Plant and Equipment* —

Scenario 3	
Formation	$350,000
Pavement	$100,000
Seal	$50,000
Total	**$500,000**
Assumed useful lives	
Formation	Indefinite
Pavement	50 years
Seal	10 years
Residual	
Formation	100%
Pavement	70%
Seal	50%
Depreciation expense per Income Statement	
Formation	$0
Pavement	$600
Seal	$2,500
Total	**$3,100**
Straight line method used for example, although this needs to be reassessed in line with the pattern of expected benefits to be consumed by the council.	
Adequate documentation is required to support the appropriateness and relevance of the methodology used.	

Appendix B — Local government entities

Councils
Aramac Shire Council
Atherton Shire Council
Aurukun Shire Council
Balonne Shire Council
Banana Shire Council
Barcaldine Shire Council
Barcoo Shire Council
Bauhinia Shire Council
Beaudesert Shire Council
Belyando Shire Council
Bendemere Shire Council
Biggenden Shire Council
Blackall Shire Council
Boonah Shire Council
Booringa Shire Council
Boulia Shire Council
Bowen Shire Council
Brisbane City Council
Broadsound Shire Council
Bulloo Shire Council
Bundaberg City Council
Bungil Shire Council
Burdekin Shire Council
Burke Shire Council
Burnett Shire Council
Caboolture Shire Council
Cairns City Council
Calliope Shire Council
Caloundra City Council
Cambooya Shire Council
Cardwell Shire Council
Carpentaria Shire Council
Charters Towers City Council
Chinchilla Shire Council
Clifton Shire Council
Cloncurry Shire Council
Cook Shire Council
Cooloola Shire Council
Crows Nest Shire Council
Croydon Shire Council
Dalby Town Council
Dalrymple Shire Council
Diamantina Shire Council
Douglas Shire Council
Duaringa Shire Council
Eacham Shire Council
Eidsvold Shire Council
Emerald Shire Council
Esk Shire Council
Etheridge Shire Council
Fitzroy Shire Council
Flinders Shire Council
Gatton Shire Council
Gayndah Shire Council
Gladstone City Council
Gold Coast City Council
Goondiwindi Town Council
Herberton Shire Council
Hervey Bay City Council
Hinchinbrook Shire Council
Ilfracombe Shire Council
Inglewood Shire Council
Ipswich City Council
Isis Shire Council
Isisford Shire Council
Jericho Shire Council
Johnstone Shire Council
Jondaryan Shire Council
Kilcoy Shire Council
Kilkivan Shire Council
Kingaroy Shire Council
Kolan Shire Council
Laidley Shire Council
Livingstone Shire Council
Logan City Council
Longreach Shire Council
Mackay City Council
Mareeba Shire Council
Maroochy Shire Council
Maryborough City Council
McKinlay Shire Council
Millmerran Shire Council
Mirani Shire Council
Miriam Vale Shire Council
Monto Shire Council
Mornington Shire Council
Mount Isa City Council
Mount Morgan Shire Council
Mundubbera Shire Council
Murgon Shire Council
Murilla Shire Council
Murweh Shire Council
Nanango Shire Council
Nebo Shire Council
Noosa Shire Council

Paroo Shire Council
Peak Downs Shire Council
Perry Shire Council
Pine Rivers Shire Council
Pittsworth Shire Council
Quilpie Shire Council
Redcliffe City Council
Redland Shire Council
Richmond Shire Council
Rockhampton City Council
Roma Town Council
Rosalie Shire Council
Sarina Shire Council
Stanthorpe Shire Council
Tambo Shire Council
Tara Shire Council
Taroom Shire Council
Thuringowa City Council
Tiaro Shire Council
Toowoomba City Council
Torres Shire Council
Townsville City Council
Waggamba Shire Council
Wambo Shire Council
Warroo Shire Council
Warwick Shire Council
Whitsunday Shire Council
Winton Shire Council
Wondai Shire Council
Woocoo Shire Council

Joint local governments

Dalby/Wambo Saleyards Board
Dalby/Wambo Aerodrome Board
Dalby-Wambo Library Board
Emerald Peak-Downs Saleyards Board
Esk, Gatton & Laidley Water Board
Gladstone/Calliope Aerodrome Board
Goondiwindi/Waggamba Aerodrome Board
Goondiwindi/Waggamba-Community Cultural Centre Board
Mission Beach Marine Facilities Joint Board
Nogoa River Flood Plain Board
Rockhampton District Saleyards Board
Roma - Bungil Showgrounds and Saleyards Board
The Caloundra/Maroochy Water Supply Board
Townsville/Thuringowa Water Supply Joint Board

Joint public sector entities

Advance Cairns Limited
Burnett Inland Economic Development Organisation
Central Queensland Local Government Association Inc
Central Western Queensland Remote Area Planning and Development Board
Council of Mayors (South East Queensland)
Far North Queensland Regional Organisation of Councils
Gulf Savannah Development Incorporated
Local Buy Pty Ltd
Local Government Association of Queensland
Local Government Workcare
Maranoa and District Regional Organisation of Councils Inc.
Moreton Bay Waterways and Catchment Partnership
North Queensland Local Government Association
Northern Sub-Regional Organisation of Councils
Port Curtis Alliance of Councils
Queensland Local Government Mutual Liability Pool
Resolute Information Technology Pty Ltd
South Burnett Local Government Association
Southern Regional Organisation of Councils
South West Queensland Local Government Association
The Darling Downs Regional Organisation of Councils Ltd
Townsville Breakwater Entertainment Centre Joint Venture
Townsville & Thuringowa Cemetery Trust
Urban Local Government Association of Queensland
Western Downs Regional Organisation of Councils
Western Queensland Local Government Association
Western Sub Regional Organisation of Councils
Whitsunday Hinterland and Mackay Bowen Regional Organisation of Councils Inc.
Wide Bay Burnett Regional Organisation of Councils Inc

Controlled entities

Barambah Community Services Ltd
Baypod Pty Ltd
Biggenden Medical Centre Pty Ltd
Biggenden Medical Trust
Boonah and District Art Gallery and Library Trust
Boonah and District Performing Arts Centre Trust Fund
Booringa Enterprises Pty Ltd
Brisbane Arts Trust
Brisbane Bitumen Pty Ltd
Brisbane City Enterprises Pty Ltd

Brisbane.Com Pty Ltd
Brisbane Environment Trust
Brisbane Marketing Pty Ltd
Brisbane Powerhouse Pty Ltd
Bulloo Enterprises Pty Ltd
Burdekin Cultural Complex Board Inc
Cairns Regional Gallery Limited
Caloundra City Enterprises Pty Ltd
Cassowary Coast Development Bureau Ltd
Castra Retirement Home Ltd
Charleville COSMOS Centre Limited
Citipac International Pty Ltd
City of Brisbane Arts & Environment Ltd
Empire Theatres Foundation
Empire Theatres Pty Ltd
Gladstone Entertainment Centre Association Inc
Gold Coast Arts Centre Pty Ltd
Hervey Bay (Community Fund) Limited
Hervey Bay (Cultural Fund) Limited
Hervey Bay Enterprises Pty Ltd
Ipswich Arts Foundation
Ipswich Arts Foundation Trust
Ipswich City Enterprises Pty Ltd
Kingaroy Private Hospital Limited
Kronosaurus Korner Board Inc
Linkpod Pty Ltd
Noosa Community Tourism Board Limited
Nuffield Pty Ltd
Organics Reclaimed Pty Ltd
OurBrisbane.Com Pty Ltd
Outback @ Isa Pty Ltd
Quad Park Corporation Pty Ltd
Redheart Pty Ltd
Riverfestival Brisbane Pty Ltd
Rockele Pty Ltd
Skilltrain Pty Ltd
Sunshine Coast Events Centre Pty Ltd
The Brolga Theatre Board Inc.
The Bulloo Enterprises Trust
The City of Brisbane Airport Corporation Pty Ltd
TradeCoast Land Pty Ltd
Turany Pty Ltd
Waltzing Matilda Centre Ltd
Warwick Shire Tourism and Events Pty Ltd
Waypod Pty Ltd
WBBROC Project Management Pty Ltd
Wide Bay Water
Widelinx Pty Ltd

Section 7
Acknowledgements

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Glenn Poole
Auditor-General

Section 8
Publications

8.1 Queensland Audit Office publications

Publication	Date released
Annual Report 2006	October 2006
INFORM	
Issue 1 for 2007	February 2007
Guidelines	
Checklist for Organisational Change — Managing MOG Changes	September 2006
Checklist — Preparation of Financial Statements	August 2006
Better Practice Guide — Output Performance Measurement and Reporting	February 2006
Other	
Performance Management Systems Audits — An Overview	January 2006

8.2 Auditor-General's Reports to Parliament 2007

Report No.	Subject	Date tabled in the Legislative Assembly
1	Auditor-General's Report No. 1 for 2007 Results of Local Government Audits for 2005-06	April 2007

Queensland Audit Office publications are available at www.qao.qld.gov.au or by phone on (07) 3405 1100