NOTICE OF MEETING

AUDIT AND RISK COMMITTEE

Members of the Audit and Risk Committee are advised that a meeting of the Committee will be held in the Council Chamber, 83 Mandurah Terrace Mandurah on:

Tuesday 19 May 2020
at 5.30 pm

MARK R NEWMAN
Chief Executive Officer
13 May 2020

Committee Members:
Councillor P Jackson (Chairperson)
Mayor Williams
Councillor J Green
Councillor P Rogers
Councillor A Zilani
Mr W Ticehurst

Deputies:
Councillor D Lee (Deputy Member)
Councillor D Pember (Deputy Member)

AGENDA

1 OPENING OF MEETING

2 APOLOGIES

Leave of Absence
Councillor Schumacher (Non-Committee member)
Councillor Lee (Committee deputy member)

3 IMPORTANT NOTE

Members of the public are advised that the decisions of this Committee are referred to Council Meetings for consideration and cannot be implemented until approval by Council. Therefore, members of the public should not rely on any decisions of this Committee until Council has formally considered the resolutions agreed at this meeting.

4 RESPONSE TO PREVIOUS QUESTIONS TAKEN ON NOTICE

5 PUBLIC QUESTION TIME

Public Question Time provides an opportunity for members of the public to ask a question of Council. For more information regarding Public Question Time please visit the City's website www.mandurah.wa.gov.au or telephone 9550 3787.

6 PRESENTATIONS AND ANNOUNCEMENTS

Risk Management Framework – Governance Services

7 DEPUTATIONS

Any person or group wishing to make a Deputation to the Committee meeting regarding a matter listed on this agenda for consideration must complete an application form. For more information regarding making a deputation please visit the City's website www.mandurah.wa.gov.au or telephone 9550 3787.

NB: Persons making a deputation to this Committee meeting will not be permitted to make a further deputation on the same matter at the successive Council meeting, unless it is demonstrated there is new, relevant material which may impact upon the Council's understanding of the facts of the matter.

8 CONFIRMATION OF MINUTES

17 March 2020 (attached)

9 DECLARATIONS OF INTERESTS

10 QUESTIONS FROM COMMITTEE MEMBERS

10.1 Questions of Which Due Notice Has Been Given

10.2 Questions of Which Notice Has Not Been Given

11 BUSINESS LEFT OVER FROM PREVIOUS MEETING

12 REPORTS FROM OFFICERS:

13 REPORTS FROM AUDITORS

Nil

14 LATE AND URGENT BUSINESS ITEMS

15 CLOSE OF MEETING

MINUTES OF AUDIT AND RISK COMMITTEE MEETING

HELD ON

TUESDAY 17 MARCH 2020
5.30 pm

IN COUNCIL CHAMBERS
83 MANDURAH TERRACE MANDURAH

PRESENT:

COUNCILLOR	P JACKSON [CHAIRMAN]	NORTH WARD
MAYOR	R WILLIAMS	
COUNCILLOR	J GREEN	COASTAL WARD
COUNCILLOR	A ZILANI	NORTH WARD
COUNCILLOR	P ROGERS [5.38PM]	TOWN WARD
COUNCILLOR	D PEMBER [DEPUTISING]	EAST WARD

ELECTED MEMBERS OBSERVING:

COUNCILLOR	C KNIGHT	NORTH WARD

OFFICERS

MR	M NEWMAN	CHIEF EXECUTIVE OFFICER
MRS	C MIHOVILOVICH	DIRECTOR CORPORATE SERVICES
MR	A CLAYDON	DIRECTOR WORKS AND SERVICES
MRS	L SLAYFORD	MINUTE OFFICER

OPENING OF MEETING [AGENDA ITEM 1]

The Chairman declared the meeting open at 5.31pm.

APOLOGIES [AGENDA ITEM 2]

Leave of Absence
Councillor D Schumacher (Non-Committee)

Apologies
Mr W Ticehurst (Committee Member)
Councillor D Lee (Deputy Member)

Councillor D Pember deputising for Mr Ticehurst.

IMPORTANT NOTE [AGENDA ITEM 3]

The purpose of this Committee Meeting is to discuss and make recommendations to Council about items appearing on the agenda and other matters for which the Committee is responsible. The Committee has no power to make any decisions which are binding on the Council or the City of Mandurah unless specific delegation of authority has been granted by Council.

No person should rely on or act on the basis of any advice or information provided by a Member or Officer, or on the content of any discussion occurring, during the course of the meeting. The City of Mandurah expressly disclaims liability for any loss or damage suffered by any person as a result of relying on or acting on the basis of any advice or information provided by a Member or Officer, or the content of any discussion occurring, during the course of the Committee meeting.

RESPONSE TO PREVIOUS QUESTIONS TAKEN ON NOTICE [AGENDA ITEM 4]

Nil.

PUBLIC QUESTION TIME [AGENDA ITEM 5]

Nil.

PRESENTATIONS [AGENDA ITEM 6]

AR.1/3/20 R KING / P LADLOW: 2019-2020 OSH YEAR TO DATE OVERVIEW

The presentation provided a summary of 2019-2020 year to date OSH data.

DEPUTATIONS [AGENDA ITEM 7]

Nil.

CONFIRMATION OF MINUTES [AGENDA ITEM 8]

AR.2/3/20 CONFIRMATION OF MINUTES MONDAY 9 DECEMBER 2019

MOTION
Moved: Councillor J Green
Seconded: Mayor R Williams

That the Minutes of the Audit and Risk Committee meeting of Monday 9 December 2019 be confirmed with the following amendment:

Minute AR.4/12/19, Page 4 the name "Greene" be corrected to "Green".

CARRIED: 6/0

DECLARATIONS OF INTERESTS [AGENDA ITEM 9]

Nil.

QUESTIONS FROM COMMITTEE MEMBERS [AGENDA ITEM 10]

Questions of Which Due Notice Has Been Given

Nil.

Questions of Which Notice Has Not Been Given

Nil.

BUSINESS LEFT OVER FROM PREVIOUS MEETING [AGENDA ITEM 11]

Nil.

REPORTS [AGENDA ITEM 12]

AR.3/3/20 COMPLIANCE AUDIT RETURN (TJ) (REPORT 1)

<u>Summary</u>

The Department of Local Government, Sport and Cultural Industries (DLGSC) has circulated to all Western Australian Local Governments the annual 2019 Compliance Audit Return for completion. The return covers the period 1 January 2019 to 31 December 2019. The return is a requirement of the *Local Government Act 1995* and its Regulations and is prepared for the Minister Local Government in an approved form.

There is a statutory requirement to have the compliance audit reviewed by the Audit and Risk Committee and then adopted by Council. Once adopted, it will be certified by the Mayor and Chief Executive Officer and forwarded to the DLGSC prior to the 31 March 2020 deadline.

The compliance audit has been conducted for 2019 which resulted in the City achieving 100% (104/104) compliance.

Officer Recommendation

That the Audit and Risk Committee recommend that Council:

1 Adopts the *2019 Local Government Compliance Audit Return* for the period 1 January 2019 to 31 December 2019 as per Attachment 1 of the report.

2 Submit, in accordance with Regulation 15 of the *Local Government (Audit) Regulations 1996*, the completed 2019 Compliance Audit Return to the Department of Local Government, Sport and Cultural Industries.

Alternate Officer Recommendation

That the Audit and Risk Committee recommend that Council:

1 Adopts an amendment to response to Section 6, Question 2, Integrated Planning and Reporting and Section 2, Question 1, Delegation of Power/Duty of the *2019 Local Government Compliance Audit Return* as per Attachment 1 of the report with the following changes:

Section 6, Question 2, Integrated Planning and Reporting:

No	Reference	Question	Response	Comment	Respondent
2	s5.56 Admin Reg 19DA (4)	Has the local government reviewed the Corporate Business Plan in the 2018-2019 Financial Year? If Yes, please provide date of Council meeting the review was adopted at?	No	A review of the Corporate Business Plan was undertaken in the 2018-2019 Financial Year. The review was completed as part of the adoption of the annual budget, however a separate resolution point for Council to adopt the review of Corporate Business Plan was not included in the resolution.	Casey Mihovilovich

Section 2, Question 1, Delegation of Power/Duty:

No	Reference	Question	Response	Comment	Respondent
1	s5.16, 5.17, 5.18	Were all delegations to committees resolved by absolute majority?	N/A		Casey Mihovilovich

2 Adopts the *2019 Local Government Compliance Audit Return* for the period 1 January 2019 to 31 December 2019 as per Attachment 2 of the additional information.

3 Submit, in accordance with Regulation 15 of the *Local Government (Audit) Regulations 1996*, the completed 2019 Compliance Audit Return to the Department of Local Government, Sport and Cultural Industries as per Attachment 2 of the additional information.

Comment: The City of Mandurah has obtained clarification from the Department of Local Government, Sport and Cultural Industries regarding question two, section 6 Integrated Planning and Reporting of the 2019 Compliance Audit Return.

In accordance with Regulation 19DA(4) of the Local Government (Administration) Regulations 1996 (the Regulations) the Local Government is required to review the current Corporate Business Plan for its district every year.

Whilst Council reviewed the Corporate Business Plan and subsequent operational plans as part of the annual budget adoption process, there was no separate resolution point by Council to adopt the annual review of the Corporate Businesses Plan in the 2018-2019 Financial Year.

The second amendment relating to Question 1, Section 2 Delegation of Power/Duty was an administrative error and the return should state N/A as there are no delegations to committees.

City Officers will undertake a review of the Integrated Planning and Reporting Framework process to ensure all compliance requirement under the Regulations are met in the future.

<u>Committee Recommendation</u>

That the Audit and Risk Committee recommend that Council:

1 Adopts an amendment to response to Section 6, Question 2, Integrated Planning and Reporting and Section 2, Question 1, Delegation of Power/Duty of the *2019 Local Government Compliance Audit Return* as per Attachment 1 of the report with the following changes:

Section 6, Question 2, Integrated Planning and Reporting:

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2	s5.56 Admin Reg 19DA (4)	Has the local government reviewed the Corporate Business Plan in the 2018-2019 Financial Year? If Yes, please provide date of Council meeting the review was adopted at?	No	A review of the Corporate Business Plan was undertaken in the 2018-2019 Financial Year. The review was completed as part of the adoption of the annual budget, however a separate resolution point for Council to adopt the review of Corporate Business Plan was not included in the resolution.	Casey Mihovilovich

Section 2, Question 1, Delegation of Power/Duty:

No	Reference	Question	Response	Comment	Respondent
1	s5.16, 5.17, 5.18	Were all delegations to committees resolved by absolute majority?	N/A		Casey Mihovilovich

2 **Adopts the *2019 Local Government Compliance Audit Return* for the period 1 January 2019 to 31 December 2019 as per Attachment 2 of the additional information.**

3 **Submit, in accordance with Regulation 15 of the *Local Government (Audit) Regulations 1996*, the completed 2019 Compliance Audit Return to the Department of Local Government, Sport and Cultural Industries as per Attachment 2 of the additional information.**

MOTION
Moved: Councillor D Pember
Seconded: Councillor J Green

CARRIED: 5/1
FOR: Councillors Jackson, Green, Zilani, Pember, Mayor Williams
AGAINST Councillor Peter Rogers

Comment: The City of Mandurah has obtained clarification from the Department of Local Government, Sport and Cultural Industries regarding question two, section 6 Integrated Planning and Reporting of the 2019 Compliance Audit Return.

In accordance with Regulation 19DA(4) of the Local Government (Administration) Regulations 1996 (the Regulations) the Local Government is required to review the current Corporate Business Plan for its district every year.

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The second amendment relating to Question 1, Section 2 Delegation of Power/Duty was an administrative error and the return should state N/A as there are no delegations to committees.

City Officers will undertake a review of the Integrated Planning and Reporting Framework process to ensure all compliance requirement under the Regulations are met in the future.

AR.4/3/20 OSH SIX MONTHLY REVIEW (RK/PL) (REPORT 2)

<u>Summary</u>

The City is now operating under our second Three Year Strategic OSH Plan which has been developed alongside the 2018 LGIS Worksafe Plan Audit outcomes and known legislative requirements. The first six months of 2019-2020 show strong indicators that both the reported injuries and workers' compensation costs and severity are decreasing. All directorates within the City continue to improve their OSH engagement which is reflective in the OSH Performance Overview (attachment 1). Council is requested to note the progress being made in continuing the Three Year OSH Plan and the imperatives made to address the management of workplace injury. Council is also requested to note the City's current OSH performance

Officer Recommendation

That Council:

1. Notes the progress of the implementation of the Three Year Strategic OSH Plan.

2. Notes the City's current OSH performance for the YTD 2019/20 financial year.

Committee Recommendation

MOTION
Moved: Mayor Williams
Seconded: Councillor J Green

That Council:

1. **Notes the progress of the implementation of the Three Year Strategic OSH Plan.**

2. **Notes the City's current OSH performance for the YTD 2019/20 financial year.**

CARRIED: 6/0

AUDITOR REPORTS [AGENDA ITEM 13]

Nil.

LATE AND URGENT BUSINESS ITEMS [AGENDA ITEM 14]

Nil.

CONFIDENTIAL ITEMS [AGENDA ITEM 15]

MOTION
Moved: Councillor D Pember
Seconded: Councillor Peter Rogers

That the meeting proceeds with closed doors at 6.14pm in accordance with Section 5.23(2)(a) of the *Local Government Act 1995*, to allow for the confidential discussion of an item.

CARRIED: 6/0

Members of the media, employees and persons in the gallery left the meeting at this point. The Minute Officer and Manager Governance Services remained in the Chamber with senior employees.

THE MEETING PROCEEDED WITH CLOSED DOORS AT 6.14PM

AR.5/3/20 CONFIDENTIAL ITEM: OPERATIONAL REVIEW (GD) (CONFIDENTIAL REPORT 1)

Confidential discussion ensued regarding this issue.

MOTION
Moved: Mayor Williams
Seconded: Councillor Peter Rogers

That Council:

1. **Endorses the review of In-house Construction Review Findings and Recommendations for Implementation;**

2. **Agrees to a further review to be undertaken in two years' time to measure progress.**

CARRIED: 6/0

AR.6/3/20

MOTION
Moved: Councillor D Pember
Seconded: Councillor J Green

That the meeting proceeds with open doors.

CARRIED: 6/0

THE MEETING PROCEEDED WITH OPEN DOORS AT 6.29PM

AR.7/3/20

MOTION
Moved: Councillor Peter Rogers
Seconded: Councillor A Zilani

That Council endorses the resolutions taken with closed doors.

CARRIED: 6/0

CLOSE OF MEETING [AGENDA ITEM 16]

There being no further business, the Chairman declared the meeting closed at 6.30pm.

CONFIRMED: ……………………………………………………………….[CHAIRMAN]

1	**SUBJECT:**	Office of the Auditor General Purchasing Cards
	CONTACT OFFICER/S:	Jarred King/ Casey Mihovilovich
	AUTHOR:	Jarred King

Summary

The Office of the Auditor General (OAG) has released a report on Controls Over Purchasing Cards that was tabled on 27 March 2020 (Attachment 1.1). The OAG selected a sample of nine state government entities to conduct the audit. These entities had a number of purchasing cards ranging from 8 to 1,022. The City currently holds 116 active cards.

Disclosure of Interest

N/A

Previous Relevant Documentation

N/A

Background

The OAG routinely conduct audits of matters considered to be risk areas called performance audits. Although this particular audit focused on State Government entities, the concept and controls can be transferred to local government.

Comment

Purchasing cards offer significant benefits to local governments including reduced costs and streamlined authorisation processes. With the use of purchasing cards comes the risk of improper, wasteful or unauthorised expenditure. The City needs to ensure that there is appropriate controls in place to ensure appropriate use of purchasing cards.

The City currently holds 116 purchasing cards with an average monthly spend of around $80,000.

The OAG found that the State Government entities audited generally had the appropriate policies and systems in place to manage the use of purchasing cards. Compared with the last audit the OAG conducted on the same matter in 2017, there was a general improvement in controls however, there were still some poor practices.

The focus of the audit was on the following criteria:

- Do entities have appropriate policies and administrative systems in place for government purchasing cards?
- Are suitable controls in place to monitor and manage the use of cards and the timely approval of transactions?
- Do entities periodically review their use of purchasing cards and act on any identified shortcomings?

The City officers have commented on the City's current practice to the following audit findings:

- *All entities had up to date and approved policies and procedures for the use of purchasing cards, however some aspects were not included*
    - *In five entities, there was no policy or clarification regarding the return of cards while on extended leave*
      City officer comments - This does not exist at the City. The cardholder is responsible for notifying Finance of their extended leave. The Finance team will also be implementing a procedure when an officer is on extended leave.

  - *Four entities did not have a policy regarding the use of Paypal.*
    City officer comments - The City does not currently refer to payment gateways in its current CEO Purchasing Card Policy. A section will be added to the CEO policy for purchasing cards outlining the requirements of using payment gateways such as Paypal.
  - *Four entities needed clearer policy around hospitality and entertainment expenses*
    City officer comments - The City adopted a CEO policy on the use of purchasing cards and petty cash for entertainment expenses that is very clear on acceptable use and limits for these types of expenditure.

- *Most entities need to apply better controls over the use of cards:*
  - *Two entities had instances of rewards cards being used. Public sector guidelines on gifts, benefits and hospitality require that purchasing cards should not be used to gain private advantage through the transaction.*

    City officer comments - The City does not allow the use of personal rewards/use of personal loyalty cards when the expenditure relates to public purposes. Finance conduct a monthly audit on receipts through purchasing cards and there has been no evidence in the last 12 months that City officers have used their own personal rewards to gain private advantage.

  - *Sharing a card. The risk of sharing a card is that an entity cannot hold a cardholder accountable for all of the transactions paid for using that card.*

    City officer comments - The City does not allow City officers to share a card and this is included in the terms and conditions the City officer signs when receiving the purchasing card.

  - *Splitting of payments. The risk of splitting a payment is that the cardholder is making a purchase at a value that they are not delegated to make.*

    City officer comments - The City does not allow City officers to split payments unless approved by the Manager Finance (exceptional circumstances). All transactions are reviewed by finance staff.

  - *Personal use on purchasing cards*

    City officer comments - All City purchasing card transactions are reviewed by finance and the relevant Manager.

- *Purchases not acquitted and approved in a timely manner:*
  - *155 out of 600 transactions tested were not acquitted and approved in a timely manner.*

    City officer comments - The City's terms and conditions on the use of credit cards state a transaction must be coded and approved five days after the end of the monthly billing statement cycle.

  - *Transaction limits not applied to purchasing cards in 7 of the 9 entities sampled.*

    City officer comments - The City has transaction limits on all purchasing cards.

- *None of the entities sampled had a formal review process to identify any shortcomings:*
  - *Most of the entity's samples stated they performed a formal review but had no formal evidence.*

    City officer comments - The City reviews cards and card limits on a quarterly basis and presents to the CEO for approval. The finance team should undertake a review of the under use and inactivity and present to the CEO for cancellation.

There are two actions the City needs to take as a result of this report.

1. Update the CEO Purchasing Card policy to include the process and timeframes during leave periods as well as including the City's requirements for payment gateways such as Paypal transactions.

2. Introduce a formal three monthly review of monthly spend on cards and identify areas of under use and inactivity for recommendation to the CEO for cancellation.

Consultation

N/A

Statutory Environment

Section 2.7(2)(a) and (b) of the *Local Government Act 1995* states:

(2) Without limiting subsection (1), the council is to —
(a) oversee the allocation of the local government's finances and resources; and
(b) determine the local government's policies.

Regulation 11(1)(a) of the *Local Government (Financial Management) Regulations 1996* states:

11. Payments, procedures for making etc.
(1) A local government is to develop procedures for the authorisation of, and the payment of, accounts to ensure that there is effective security for, and properly authorised use of —
(a) cheques, credit cards, computer encryption devices and passwords, purchasing cards and any other devices or methods by which goods, services, money or other benefits may be obtained;

Policy Implications

Procurement Council Policy
Purchasing Card CEO Policy

Economic Implications

N/A

Risk Analysis

If the use of purchasing cards is not managed correctly and the proper internal controls are not in place, there is potential for improper, wasteful or unauthorised expenditure.

Strategic Implications

The following strategy from the *City of Mandurah Strategic Community Plan 2020 – 2040* is relevant to this report:

<u>Organisational Excellence</u>:

- Ensure the City has the capacity and capability to deliver quality services and facilities through accountable and However, if not managed correctly, there is potential for improper, wasteful or unauthorised expenditure. practices, governance, risk and financial management.

Conclusion

The City has reviewed the OAG's report on Controls Over Purchasing Cards and while the City does have adequate controls in place over the use of the cards and the acquittal of the transactions, there is a need for a formal review process and an update to the Purchasing Cards CEO Policy.

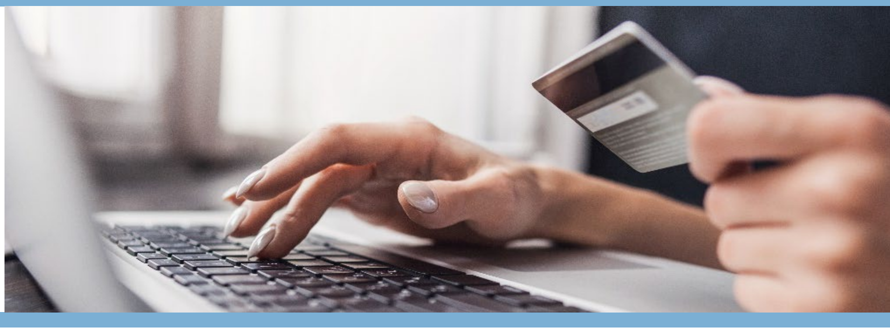
NOTE:

- Refer ***Attachment 1.1 OAG report on Controls Over Purchasing Cards***

RECOMMENDATION

That the Audit and Risk Committee note the City officers' responses in the Comment section of this report in relation to the Office of the Auditor General's report on Controls Over Purchasing Cards.

Western Australian
Auditor General's Report



Controls Over Purchasing Cards

Office of the Auditor General
Western Australia

Audit team:
Carly Meagher
Joanne Clarke
Carol Brownfield
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Paula Du Plessis
Jojo Liew

National Relay Service TTY: 13 36 77
(to assist people with hearing and voice impairment)

We can deliver this report in an alternative format for those with visual impairment.

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ISSN: 2200-1921 (online)

The Office of the Auditor General acknowledges the traditional custodians throughout Western Australia and their continuing connection to the land, waters and community. We pay our respects to all members of the Aboriginal communities and their cultures, and to Elders both past and present.

WESTERN AUSTRALIAN AUDITOR GENERAL'S REPORT

Controls Over Purchasing Cards

Report 17: 2019-20
March 2020

THE PRESIDENT
LEGISLATIVE COUNCIL

THE SPEAKER
LEGISLATIVE ASSEMBLY

CONTROLS OVER PURCHASING CARDS

This report has been prepared for submission to Parliament under the provisions of section 25 of the *Auditor General Act 200*6.

This focus area audit assessed if sampled entities have effective controls over expenditure using corporate purchasing cards.

I wish to acknowledge the entities' staff for their cooperation with this report.

CAROLINE SPENCER
AUDITOR GENERAL
27 March 2020

Contents

Executive summary

Background

Western Australian government purchasing cards are an important part of the public sector purchasing system. Purchasing cards offer significant benefits to State government entities (entities), suppliers and the environment. They can reduce costs and streamline business processes associated with authorising, tracking, purchasing, payment and reconciling entity purchases and can also significantly reduce the use of paper.

However, if not managed correctly, there is potential for improper, wasteful or unauthorised expenditure. Entities need to ensure that appropriate controls are in place and be continually vigilant against misuse, and that the controls are assessed on a regular basis.

The use of WA government purchasing cards is governed by the *Financial Management Act 2006* and Treasurer's Instructions (TI) particularly TI 321 *Credit Cards – Authorised Use*.

We last reported an across government audit of State government purchasing cards in 2017. In that audit we identified a range of findings but concluded that there had been some improvement since our previous report in 2014.

Conclusion

Entities generally have appropriate policies and administrative systems in place to manage the use of purchasing cards. Although our findings indicate a general improvement in controls compared to our last report on this topic in 2017, we still identified examples of poor practice. Entities still need to improve their policies, the monitoring of purchasing card use, and better manage transaction limits.

What we did

The focus of our audit was to assess whether sampled entities have effective controls over expenditure using corporate purchasing cards, using the following criteria:

- Do entities have appropriate policies and administrative systems in place for government purchasing cards?
- Are suitable controls in place to monitor and manage the use of cards and the timely approval of transactions?
- Do entities periodically review their use of purchasing cards and act on any identified shortcomings?

As part of this audit, we used data analytics to review large volumes of transactions and data for unusual items, patterns and events that could indicate fraud. We then further investigated the transactions or events.

Detailed findings have been reported to audited entities. Entity audit committees should follow up to ensure the audit findings and recommendations are appropriately addressed by management in a timely manner.

We conducted this audit under section 18 of the *Auditor General Act 2006* and in accordance with Australian Auditing and Assurance Standards. The approximate cost of undertaking the audit and reporting is $220,000.

Entities included in our audit

Focus area audits assess entities against common business practices to identify good practices, and control weaknesses and exposures so that all entities, including those not audited, can evaluate their own performance.

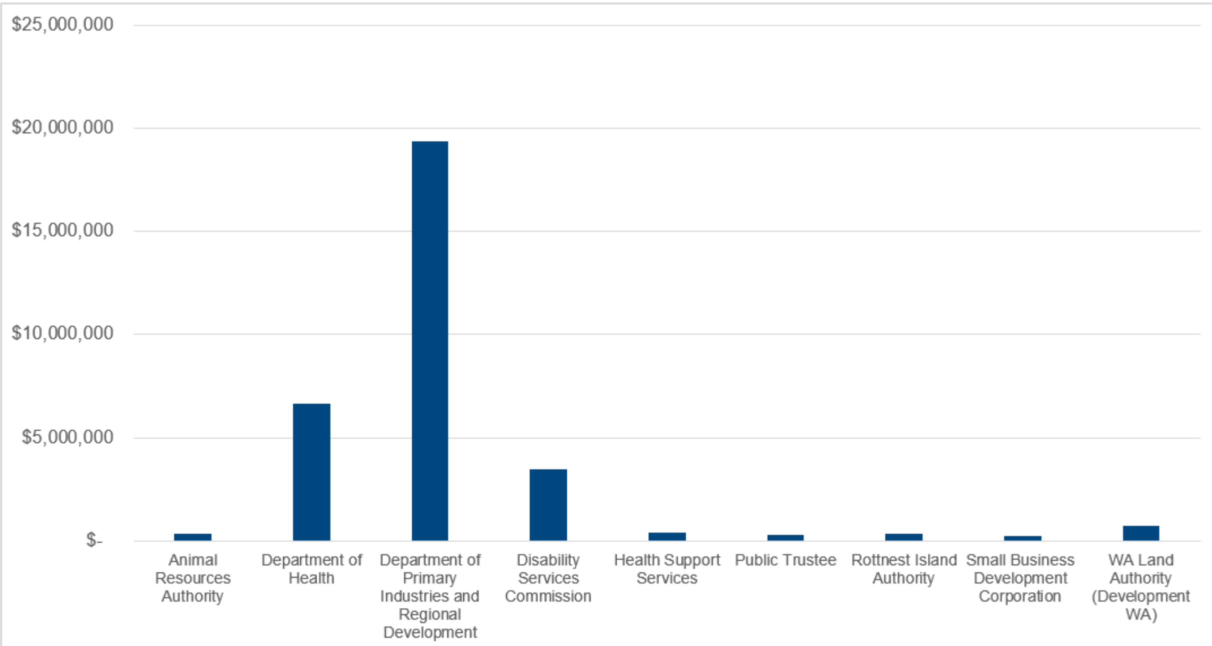
We selected a sample of 9 entities for this focus audit. When selecting the entities to be included, we considered the size of the entities and the different levels of purchasing card use to ensure that we were covering a wide variety in our sample.

Entity	Number of purchasing cards	Total purchasing card expenditure 1 July 2018 - 30 June 2019
Animal Resources Authority	8	$317,772
Department of Health	111	$6,662,154
Department of Primary Industries and Regional Development	1,022	$19,361,424
Disability Services Commission	772	$3,460,601
Health Support Services	47	$395,034
Public Trustee	25	$652,458
Rottnest Island Authority	62	$362,440
Small Business Development Corporation	14	$219,896
WA Land Authority (Development WA)	103	$739,269

Source: OAG

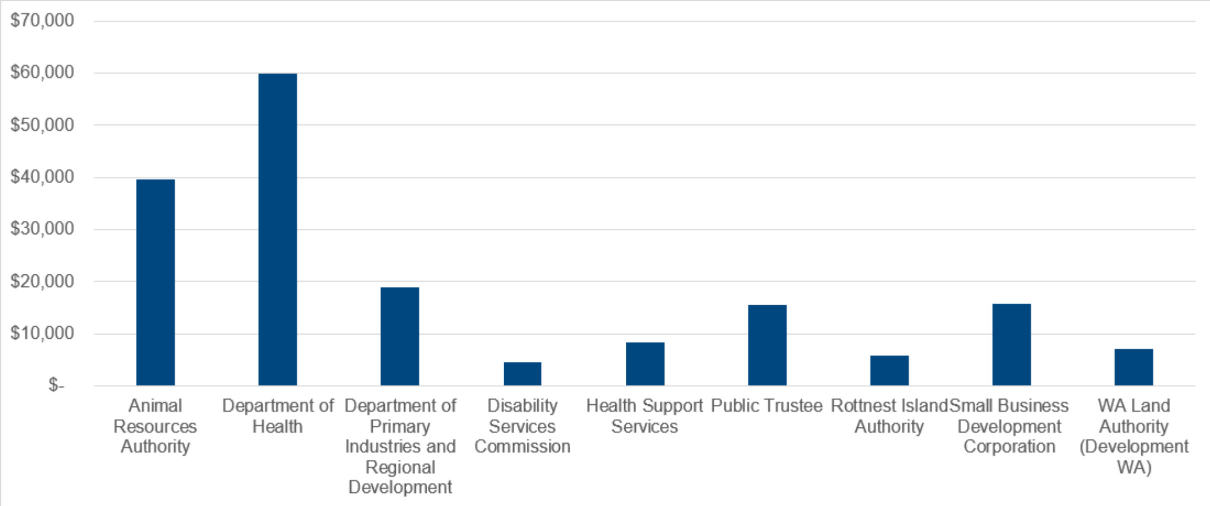
Table 1: Entities included in our sample

Figure 1 shows entities' total purchasing card expenditure during 2018-19 and Figure 2 shows the average spend on the purchasing cards we sampled.



Source: OAG

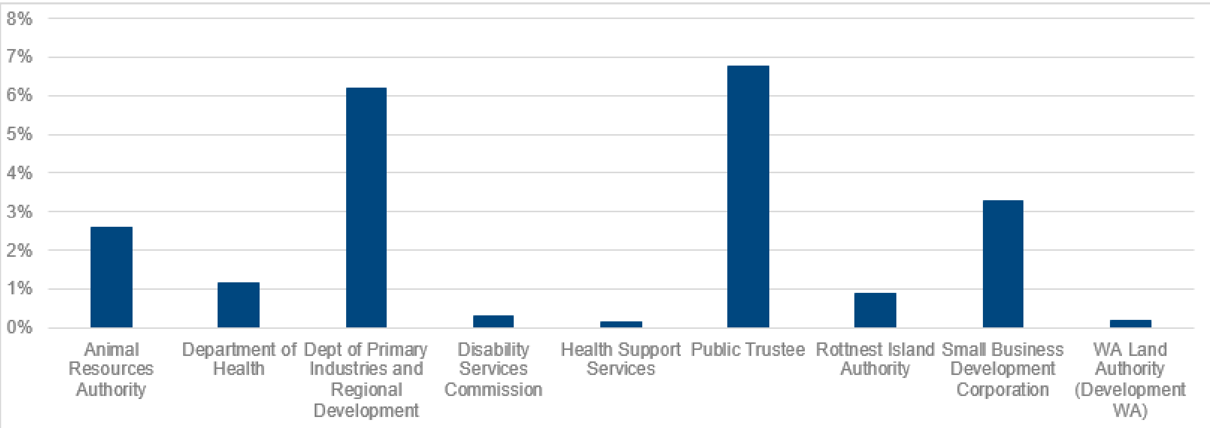
Figure 1: Total purchasing card spend per entity during 2018-19



Source: OAG

Figure 2: Average spending on purchasing cards during 2018-19

Figure 3 shows the total purchasing card expenditure at the entities for the period 1 July 2018 to 30 June 2019 as a percentage of total expenditure.



Source: OAG

Figure 3: Purchasing card expenditure as a percentage of total expenditure

What we found

All entities had up to date and approved policies and procedures for the use of purchasing cards, however some aspects were not included

Good policies and procedures provide essential guidance for staff to manage purchasing cards in accordance with management's expectations. They should cover matters such as controls over issuing and cancelling cards as well as approving and acquitting purchases.

In 5 of the entities sampled, there was no policy or clarification regarding the return of cards while on extended leave. The policy should state what length of time represents extended leave and the need for the cardholder to return the card to the finance area while they are on leave.

Four of the entities also did not have a policy regarding the use of Paypal. Paypal can be an effective method of payment for certain purchases. However, its use creates an increased risk as the purchasing card is required to be linked to a Paypal account, which could result in the officer's personal expenses being recorded with the entity's transactions. If an entity uses Paypal, then it should have a more detailed policy on what can be purchased, and the type of evidence required for these purchases.

In 4 of the entities tested, the policy around hospitality and entertainment expenses needed to be clearer. Our data analytics testing noted a number of purchases in relation to food, gifts and alcohol. The policy at these entities is not clear on what is acceptable expenditure for hospitality, and delegated limits for these types of expenditure have not been set.

Most entities need to apply better controls over the use of cards

We tested a sample of 100 purchasing card transactions per entity and noted that a large number of them were supported by appropriate documentation, acquitted and approved in a timely manner, and were for business purposes. However, we still found a number of poor practices that had not been identified by the entities.

At 2 of the entities sampled, we noted instances where grocery store rewards program cards had been used when purchasing groceries. Public sector guidelines on gifts, benefits and hospitality require that purchasing cards should not be used to gain private advantage through the transaction. When rewards programs are used in conjunction with government purchasing cards, there is an increased risk of individuals making purchases through a particular supplier to gain a private advantage.

As part of our data analytics, we reviewed the purchasing card transactions to identify if expenditure on the card had occurred while the cardholder was on leave. Our testing identified that purchasing cards were being shared between staff at 5 of the entities sampled while the cardholder was on leave. One low value transaction was made when the cardholder was on leave, which was an allegedly fraudulent transaction that had not been reported. The risk of sharing a card is that an entity cannot hold a cardholder accountable for all of the transactions paid for using that card.

Our data analytics further identified instances of splitting payments at 3 entities. This occurs where the cardholder splits the payment of a transaction into 2 or more instances to circumvent the transaction limit set on the purchasing card. The risk of splitting a payment is that the cardholder is making a purchase at a value that they are not delegated to make.

We also found instances of personal use on purchasing cards in 3 of the entities where the cardholder did not notify the appropriate authority in a timely manner. We also noted a number of instances at these 3 entities where the money had not been repaid within 5 days of notification, as required by Treasurer's Instruction 321 *Credits Cards – Authorised Use*. If personal use of a government purchasing card is not tightly controlled, it is possible that amounts may not be reimbursed.

Five entities had purchases that were not acquitted and approved in a timely manner

Of 600 transactions tested at 6 entities, 155 were not acquitted and approved in a timely manner (within 30 days). When transactions are not acquitted and approved in a timely manner, there is an increased risk that unauthorised transactions are not identified and resolved promptly.

We also noted that transaction limits were not applied to purchasing cards in 7 of the 9 entities sampled. The purchasing card system is set up to implement a transaction limit on cards, but these entities are not implementing or enforcing these limits. Not implementing a transaction limit increases the risk of a large monetary loss, as large inappropriate transactions can be processed in 1 transaction. For example, if a purchasing card has a $100,000 limit with no transaction limit, the card holder could use the entire purchasing card limit in the 1 transaction.

None of the entities sampled had a formal review process to identify any shortcomings

Most of the entities sampled stated that they performed a periodic review of their purchasing cards, but none had formal records to evidence this.

From our review of the activity on purchasing cards across the 9 entities, we noted 475 cardholders who had used their purchasing card less than 12 times in the last 12 months, suggesting that they may not have a need for a purchasing card.

We also noted instances where business items were bought on the purchasing card that were outside the entity’s purchasing card policy, for example, the purchase of IT equipment and fuel.

Regular formal reviews would identify similar issues in a timely manner, and enable an entity to take appropriate corrective action, including training for card users.

Recommendations

All entities should:

1. have appropriate polices and administrative systems in place for the use of government purchasing cards
2. ensure that they have suitable controls in place to monitor and manage the issue and use of cards and the timely approval of card transactions
3. periodically review the use of purchasing cards within the entity to identify and act on any shortcomings, such as whether there are too many cards within the entity, or that they are not being utilised to their full advantage.

Response from State government entities

Entities in our sample generally accepted the recommendations and confirmed that, where relevant, they have amended policies and administrative systems, or will improve practices for managing purchasing cards.

Appendix 1: Better practice principles

The following table shows control principles on which our audit focused. They are not intended to be an exhaustive list.

<table>
<tr><th>Controls over purchasing cards</th><th>Focus area</th><th>What we expected to see</th></tr>
<tr><td rowspan="2">Policy</td><td>Policies and procedures</td><td>Entities should have a purchasing card policy that is up to date and accessible to all staff. The policy should include items such as:
processes and controls for the issue, management and cancellation of a credit card, including credit card limits, validation and acquittal of expenditure
purposes for which a card may, or may not, be used
cardholder’s obligations (including during leave periods)
processes for discharging any debt for personal expenditure on a credit card
process for online purchases, including Paypal.</td></tr>
<tr><td>Delegations</td><td>There are appropriate delegations in place for monetary limits on cards, monitoring the use of purchasing cards and approval of expenditure.
Where appropriate, delegations should also be set for certain types of expenditure.</td></tr>
<tr><td>Use of purchasing cards</td><td>Managing and monitoring the use of cards</td><td>All purchasing card transactions should be valid, properly incurred, certified and accounted for in accordance with the entity’s purchasing card policies.
New cards should be properly authorised before use.
Cancelled cards should be cancelled on a timely basis to ensure unauthorised transactions do not occur.
When employees go on leave, purchasing cards should be returned to the Card Administrator or another approved officer, and not shared with other employees.
All transactions should be within the delegated transaction limits and transactions should not be split to circumvent these limits.</td></tr>
<tr><td>Monitoring of purchasing cards</td><td>Appointment of a reviewer</td><td>The entity should have an appointed reviewer as required by TI 321.
A review of purchasing cards should be carried out on a regular basis and evidence of the review should be retained.
Management should periodically review credit card activity to identify inactive or under-used cards that may warrant cancellation.</td></tr>
</table>

Source: OAG

Auditor General's reports

Report number	2019-20 reports	Date tabled
16	Audit Results Report – Annual 2018-19 Financial Audit of Local Government Entities	11 March 2020
15	Opinion on Ministerial Notification	28 February 2020
14	Opinion on Ministerial Notification	31 January 2020
13	Fee-setting by the Department of Primary Industries and Regional Development and Western Australia Police Force	4 December 2019
12	Audit Results Report – Annual 2018-19 Financial Audits of State Government Entities	14 November 2019
11	Opinion on Ministerial Notification	30 October 2019
10	Working with Children Checks – Follow-up	23 October 2019
9	An Analysis of the Department of Health's Data Relating to State-Managed Adult Mental Health Services from 2013 to 2017	9 October 2019
8	Opinions on Ministerial Notifications	8 October 2019
7	Opinion on Ministerial Notification	26 September 2019
6	Opinions on Ministerial Notifications	18 September 2019
5	Fraud Prevention in Local Government	15 August 2019
4	Access to State-Managed Adult Mental Health Services	14 August 2019
3	Delivering Western Australia's Ambulance Services – Follow-up Audit	31 July 2019
2	Opinion on Ministerial Notification	26 July 2019
1	Opinions on Ministerial Notifications	19 July 2019

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Office of the Auditor General for
Western Australia

2	**SUBJECT:**	Office of the Auditor General Financial Control Matters
	CONTACT OFFICER/S:	Jarred King/Casey Mihovilovich
	AUTHOR:	Jarred King

Summary

The Office of the Auditor General (OAG) has released a COVID-19 Financial Control Matters circular to local governments with the view of conducting a self-assessment on the internal controls in place throughout the COVID-19 pandemic. In these uncertain times, there is an increased risk of an entity taking advantage and good controls over finances and key decisions during this period will help to mitigate that risk.

Disclosure of Interest

N/A

Previous Relevant Documentation

N/A

Background

The OAG are responsible for performing year end and performance audits for most local governments. As part of the financial statements audit, there is a strong focus on internal controls and processes to ensure the risk of error or fraud is minimised.

Comment

The OAG's report focuses on three key areas of controls being assets, cash and expenditure. Under each area there are several key controls that are recommended as well as City officer comments in relation to whether they exist at the City:

<u>*Assets – Risk of misappropriation, unauthorised purchases or disposals*</u>
Entities should ensure:

- *all purchases are in line with their procurement policy and any temporary divergence from the policy is approved by the DG or CEO and recorded in a central registry*
  - City Officer comments - Communication has been provided to staff that even with COVID-19, the procurement process must be followed. Any requests that are not in accordance with the Procurement Council Policy, must go to Council for approval. There have been no such instances to date.
- *asset acquisitions are approved in line with the delegation of authority*
  - City Officer comments – Asset acquisitions remain in line with the delegation of authority and this is part of the purchase order controls settings that are in place.
- *asset reconciliations between the register and the general ledger are prepared and reviewed on a timely basis*
  - City Officer comments – Currently asset reconciliations are prepared on a yearly basis due to the complexities of the corporate business system. This has also been noted in the year end audit report. The reconciliations are due to go monthly with the implementation of the new corporate business system (often referred to as the ERP).
- *asset disposals/write-offs are appropriately authorised*
  - City Officer comments – Asset disposals are in line with the delegated authority that is in place.
- *loans of assets to other entities are properly recorded and authorised*
  - City Officer comments – The City has a register however this has not occurred yet and if the City approves an organisation to use an asset, it would enter into an agreement to do so to ensure the City is protected from any liability claims while the third party is using the asset.

- *where necessary, key responsibilities continue to be segregated in relation to asset acquisition, recording, custody, disposal and reconciliation*
    - City Officer comments – There are no changes to the segregation of duties. All Officers are undertaking their normal duties and therefore the City has sufficient segregation of duties controls in place.
- *appropriate records of portable and attractive assets are maintained, particularly those that staff may take home to use when working from home.*
    - City Officer comments – The City has recorded the portable assets that have been taken home by City officers during this time.

Cash – Risk of misappropriation
Entities should ensure:

- *regular bank reconciliations are prepared and reviewed, reconciling items are investigated and resolved*
    - City Officer comments – Daily bank reconciliations remain as a daily task as well as the monthly bank reconciliation. Any issues are investigated and resolved.
- all bank accounts have at least 2 signatories
    - City Officer comments – The current controls of two signatories to make payments from the bank are still required and there will be no changes to this significant control that is in place.
- online purchasing policies are reviewed to reflect the current period
    - City Officer comments – City officers have not seen any increase in online purchasing. This is reviewed and any irregular purchases would be investigated.
- increases in purchasing card limits are appropriately approved
    - City Officer comments – There has been no increases in purchasing card limits. It has been timely that some City officers have recognised their limited use and as a result their purchasing cards have been cancelled.
- there are appropriate and timely reviews of credit card usage.
    - City Officer comments – Managers review City officer statements monthly. The financial team also review transactions and present a list of City officers to the CEO for approval on a quarterly basis to ensure there is a regular review of the City Officers who require a purchasing card.

Expenditure – *Risk of unauthorised or invalid payments, incorrect or invalid suppliers, and increased risk of fraudulent payments*
Entities should ensure:

- *all purchases are in line with their procurement policy and any temporary divergence from the policy is approved by the DG or CEO and recorded in a central registry*
    - City Officer comments – As stated above in the assets section, communication has been provided to staff that even with COVID-19, the procurement process must be followed. Any requests that are not in accordance with the Procurement Council Policy, must go to Council for approval. There have been no such instances to date.
- *changes to vendor master files are documented and approved (for better practice guidance see our March 2019 report Management of Supplier Master Files)*
    - City Officer comments – The finance team do not document that the changes have been checked by a supervisor. There is an informal check of the changes. The new ERP has been configured so that it will document the approvals.
- *there is separation between the vendor creation and payment approval functions*
    - City Officer comments – This is in place
- *a 3-way match is performed of invoices, receipt of goods and purchase orders*
    - City Officer comments – This is in place
- *payment authorisation is made in line with the delegation of authority and requires 2 to sign. Signatories should pay particular attention to the delivery addresses of goods received*
    - City Officer comments – This is in place

- *purchase orders are prepared and appropriately authorised*
    - City Officer comments – This is in place. Where a purchase order has not been raised requisitioners are required to raise one before the invoice is paid.
- *appropriate security and checks are in place over EFT payment data*
    - City Officer comments – This is in place

Statutory Environment

Section 2.7(2)(a) and (b) of the *Local Government Act 1995* states:

(2) Without limiting subsection (1), the council is to —
(a) oversee the allocation of the local government's finances and resources; and
(b) determine the local government's policies.

Policy Implications
N/A

Economic Implications

N/A

Risk Analysis

The OAG state:

It is vitally important that entities are aware that times of disruption present a heightened risk environment. Those who are dishonestly inclined will be keen to take advantage of any sense of crisis. Good control over finances and key decisions during this period means that entities and senior decision-makers will be better prepared to resume normal operations when the crisis is over. It also means they won't be left dealing with the ramifications of fraud, error or decisions taken in haste that may be regretted when conditions are calmer. Importantly, public trust will be upheld.

Management should ensure staff maintain good controls, particularly over cash, expenditure and assets. Good controls are also important for any regulatory or non-financial decisions that bind the entity, or the State, into the future, such as for approvals, concessions, operating permits, or conditions.

Strategic Implications

The following strategy from the *City of Mandurah Strategic Community Plan 2020 – 2040* is relevant to this report:

<u>Organisational Excellence</u>:
- Ensure the City has the capacity and capability to deliver quality services and facilities through accountable and transparent business practices, governance, risk and financial management.

Conclusion

The City has reviewed the suggested internal controls guidelines and determined that the City has the majority of these controls in place. The City's current ERP system and asset system does not provide for extensive controls but, with the City's implementation of the Tech One system, controls will be strengthened.

NOTE:

- Refer ***Attachment 2.1 Office of the Auditor General COVID-19 Financial Control Matters***

RECOMMENDATION

That the Audit and Risk Committee note the City officer responses in the Comment section of this report to the Office of the Auditor General's COVID-19 Financial Control Matters.

COVID-19
Financial control matters

Office of the Auditor General
Serving the Public Interest

We recognise that State and local government entities are spending significant time and effort dealing with the operational ramifications of the COVID-19 public health response. We have prepared consideration points to prevent key control breakdown during this period.

It is vitally important that entities are aware that times of disruption present a heightened risk environment. Those who are dishonestly inclined will be keen to take advantage of any sense of crisis. Good control over finances and key decisions during this period means that entities and senior decision-makers will be better prepared to resume normal operations when the crisis is over. It also means they won't be left dealing with the ramifications of fraud, error or decisions taken in haste that may be regretted when conditions are calmer. Importantly, public trust will be upheld.

Management should ensure staff maintain good controls, particularly over cash, expenditure and assets. Good controls are also important for any regulatory or non-financial decisions that bind the entity, or the State, into the future, such as for approvals, concessions, operating permits, or conditions.

Some contextual considerations for entities

- Consider if there is an exaggerated sense of urgency that may persuade or permit staff to override important controls.
- Recognise that existing gaps in controls, which in normal times may not be exploited, can become gaping holes when staff are not overseen as closely when working from home or key people are distracted by other matters.
- Have you explicitly promoted a culture encouraging staff to speak if they see something that poses a risk during this period? If staff or stakeholders see something, they should say something, are they aware of fraud control reporting, including public interest disclosures.
- Are credentials (for example, qualifications, working with children checks and police checks) and references still checked before on-boarding new personnel?
- Are delegations and authorisations valid, and changes to delegations approved (for example, if there are senior management absences due to illness or secondments)?
- Are licenses and/or permits lawfully issued/approved, and with due probity? A sense of urgency or chaos may override due process as well as bring opportunistic requests. Be cautious, weigh risks and benefits with probity to prevent conflicts of interest and good record keeping.
- Are debt waiver/acts of grace authorised in accordance with law?
- Are purchasing/corporate credit cards issued in line with policy? [For better practice guidance see our March 2020 report *Controls over Purchasing Cards* (for State government) and May 2018 report *Controls over Corporate Credit Cards* (for local government).]
- Are senior management continuing to monitor and scrutinise spending against the budget, with genuine understanding of the reasons for variances? And monitoring cash flow and balances?
- Is there timely cancellation of automatic/periodical payments for services that are no longer being provided?
- Are working from home conditions clearly defined and approved? [See our better practice guidance on *Security considerations for remote working arrangements*]

Assets – *Risk of misappropriation, unauthorised purchases or disposals*

Entities should ensure:

- all purchases are in line with their procurement policy and any temporary divergence from the policy is approved by the DG or CEO and recorded in a central registry
- asset acquisitions are approved in line with the delegation of authority
- asset reconciliations between the register and the general ledger are prepared and reviewed on a timely basis
- asset disposals/write-offs are appropriately authorised
- loans of assets to other entities are properly recorded and authorised
- where necessary, key responsibilities continue to be segregated in relation to asset acquisition, recording, custody, disposal and reconciliation
- appropriate records of portable and attractive assets are maintained, particularly those that staff may take home to use when working from home.

Cash – *Risk of misappropriation*

Entities should ensure:

- regular bank reconciliations are prepared and reviewed, reconciling items are investigated and resolved
- all bank accounts have at least 2 signatories
- online purchasing policies are reviewed to reflect the current period
- increases in purchasing card limits are appropriately approved
- there are appropriate and timely reviews of credit card usage.

Expenditure – *Risk of unauthorised or invalid payments, incorrect or invalid suppliers, and increased risk of fraudulent payments*

Entities should ensure:

- all purchases are in line with their procurement policy and any temporary divergence from the policy is approved by the DG or CEO and recorded in a central registry
- changes to vendor master files are documented and approved (for better practice guidance see our March 2019 report *Management of Supplier Master Files*)
- there is separation between the vendor creation and payment approval functions
- a 3-way match is performed of invoices, receipt of goods and purchase orders
- payment authorisation is made in line with the delegation of authority and requires 2 to sign. Signatories should pay particular attention to the delivery addresses of goods received
- purchase orders are prepared and appropriately authorised
- appropriate security and checks are in place over EFT payment data
- there is segregation of duties between officers performing the functions of ordering, receiving, incurring and certifying (for State government entities, in line with Treasurer's Instruction 304)

Queries

If you have any queries please contact your OAG financial audit engagement leader or our general enquiries via info@audit.wa.gov.au or phone (08) 6557 7500. For information on making a Public Interest Disclosure (PID), phone (08) 6557 7500 and ask to speak to a PID officer.

3	**SUBJECT:**	Office of the Auditor General 2019 Audit
	CONTACT OFFICER/S:	Jarred King/ Casey Mihovilovich
	AUTHOR:	Jarred King

Summary

The Office of the Auditor General (OAG) responsibility for the audits of local governments began in the 2017/18 financial year with a four-year transition. For the 2018/19 year, the OAG audited 112 of 148 WA local governments. Accordingly, they have released their report on the audits for the 2018/19 year to State Parliament. As the OAG now audits the majority of local governments, their report includes finding and recommendations that are relevant for the City to consider. OAG will undertake the City's financial audits with the OAG in the 2020/21 year.

It is recommended that the Audit and Risk Committee note the City officer's comments to the OAG recommendations.

Disclosure of Interest

N/A

Previous Relevant Documentation

N/A

Background

The OAG was given responsibility for the audit of local governments following proclamation of the *Local Government Amendment (Auditing) Act 2017*. The 2018/19 financial year audit marks the second year of a four-year transition of local government auditing to the OAG. The report was tabled in State Parliament in March 2020.

Comment

From the OAG's report, there were 93 material matters of non-compliance in 48 entities, 823 significant or moderate weaknesses in financial management and information systems controls and five auditor's reports included a qualified opinion. If these issues are not addressed there is an increased risk of financial loss, error or fraud.

The following is the excerpt of the key findings in the OAG's Audit Results Report – Annual 2018-19 Financial Audits of Local Government Entities, detailed in Attachment 1:

- *Issued auditor's reports for 106 entities by 3 March 2020 for the 2018-19 financial year. (page 10)*
- *All but 5 auditor's reports included clear (unqualified) audit opinions on the financial reports (page 10). However, we reported 93 material matters of non-compliance with the Local Government Act 1995, Local Government (Financial Management) Regulations 1996, or other written law in 48 of our auditor's reports. If not addressed, these non-compliance matters may result in significant financial loss, inefficiency, financial misreporting or fraud. (page 12)*
- *At 13 entities, required related party disclosures were not made by all councillors and other key management personnel. Three entities currently do not have a related party declarations policy in place and at some entities there were several non-disclosures. (page 23)*
- *In addition to material matters of non-compliance reported in auditor's reports, the OAG reported the following to entity management and the Minister for Local Government:*
    - *766 financial management control weaknesses at 104 entities, of which 74% related to expenditure, financial management, payroll and human resources, and revenue. The OAG considered 85% to be significant or moderate risk if not resolved in the short term (page 16)*

  - *202 information system (IS) control weaknesses at 38 entities. This includes 125 weaknesses identified at 9 of the 10 entities subjected to a specific IS audit. (page 19)*
- *The audits of 16 entities were not completed by 31 December 2019, mainly because the entities were still investigating or correcting errors in their financial reports. (page 9)*
- *The quality of financial reports submitted for audit varied significantly across entities, from good to very poor, including some that did not balance and required significant levels of additional audit work.*
- *During the second year of performing annual financial audits in the local government sector, the OAG have made further general observations and included these in the report, with a view to minimising the cost of financial reporting and auditing in the future. These relate mainly to:*
  - *opportunities to reduce the financial reporting burden on small and medium sized entities, as the quantity of detail that is being reported is onerous and exceeds that reported by most WA State government entities (page 8 and 26)*
  - *concern that there are reporting inconsistencies in the sector as a variety of valuation methodologies are being used for property and infrastructure (page 20)*
  - *the costs and benefits of requiring all asset classes to be valued. (page 26)*
- *The OAG have also commented on the low proportion of entities that have an internal audit function and continue to identify significant opportunities to increase the effectiveness of audit committees and enhance auditor/entity communications. (page 27)*
- *Entities are preparing for upcoming changes to Australian Accounting Standards on revenue, income and leases for 2019-20, and we have recommended this be completed by 30 June 2020.*

The report contained recommendations for both local governments and the Department of Local Government, Sport and Cultural Industries.

City officers have provided comments to the recommendations made by the OAG in the report:

Recommendation One

Local government entities should ensure they maintain the integrity of their financial control environment by:

a. *periodically reviewing and updating all financial, asset, human resources, governance, information systems and other management policies and procedures, and communicating these to staff*
b. *conducting ongoing reviews and improvement of internal control systems in response to regular risk assessments*
c. *regularly monitoring compliance with relevant legislation*
d. *promptly addressing control weaknesses brought to their attention by our audits, and other audit and review mechanisms.*

Officer Comment - The City is undertaking a review of all treatment of financial transactions, policies and procedures to ensure compliance with legislation. The financial team implemented a new staffing structure in October 2019 to gain efficiencies and ensure a greater knowledge of the business is shared by all. The Audit and Risk Committee has been presented with the City's internal audit strategy for endorsement, which will periodically review and identify weaknesses in internal controls and compliance. When reports such as this OAG report are received, the City intends to review the report and implement any recommendations that are necessary to ensure there is continuous improvement.

Recommendation Two

Entities should ensure that reports from their valuers clearly explain key aspects of the valuations, and that management has a comprehensive understanding of the reports.

Officer Comment - The City's revaluation of assets occurs every three to five years. Valuation reports are reviewed by City officers and management for correctness and any issues are raised with the valuer prior to the final report being issued.

Recommendation Three

Management should annually review the estimated useful lives of assets used for calculating depreciation, if necessary in consultation with their valuers or other experts. In addition, for greater consistency across entities, the Department of Local Government, Sport and Cultural Industries (DLGSC) should review its guidance regarding potential ranges for useful lives of assets, and entities should consider the guidance when doing their annual reviews.
Officer Comment - City Officers are preparing an Asset Depreciation and Capitalisation Council Policy that will outline the useful lives of assets. The City also supports the OAG's view that the Department should review its guidance for local government.

Recommendation Four

Entities who have not yet done so, should implement the recommendations of our local government position paper number 1 'Accounting for work bonds, building bonds and hire bonds'.
Officer Comment - The City is currently implementing the recommendations in this position paper for the 2020 year.

Recommendation Five

Local government entities should, where necessary, seek advice in advance of year end if uncertain about appropriate accounting treatments.
Officer Comment - The City does occasionally seek advice if uncertain about appropriate accounting treatments. The City has five professional qualified accountants (either Chartered Accountant or Certified Practising Accountant memberships) with considerable experience in interpreting accounting standards.

Recommendation Six

To facilitate timely preparation of annual financial reports, and to minimise the additional audit costs associated with Australian Accounting Standards on revenue, income and leases (AASB 15, AASB 1058 and AASB 16), entities should complete preparations for those new standards by 30 June 2020.
Officer Comment - The City is close to completing the preparation for the new accounting standards and they will be in place by 30 June 2020.

The recommendations from the report for the Department of Local Government, Sport and Cultural Industries are detailed below:

1. DLGSC should consider extending existing declaration processes to include annual related party declarations for councillors and key management personnel that assist compliance with Australian Accounting Standard AASB 124 and that are fit-for-purpose to the local government environment.
2. To improve the quality of financial reports and achieve greater consistency across entities, DLGSC should consider providing an accounting advice helpdesk to the local government sector.
3. DLGSC should re-assess the amount of detail required to be included in annual financial reports, in particular for small and medium sized entities.
4. DLGSC should re-assess the potential advantages and disadvantages if smaller local government entities reported some asset classes such as plant and equipment using the cost model, rather than periodically re-valuing those assets.
5. Entities and DLGSC should monitor the progress of the Australian Accounting Standards Board (AASB) and the International Public Sector Accounting Standards Board (IPSASB) public sector fair value projects relating to the valuation of assets.
6. DLGSC should consider facilitating a shared internal audit service for the local government sector, as a service available to small and medium entities who do not have their own internal audit function.

The City supports the OAG's recommendations to the DLGSC.

Consultation

N/A

Statutory Environment

Section 2.7(2)(a) and (b) of the *Local Government Act 1995* states:

> *(2) Without limiting subsection (1), the council is to —*
> *(a) oversee the allocation of the local government's finances and resources; and*
> *(b) determine the local government's policies.*

Regulation 11(1)(a) of the *Local Government (Financial Management) Regulations 1996* states:

> *11. Payments, procedures for making etc.*
> *(1) A local government is to develop procedures for the authorisation of, and the payment of, accounts to ensure that there is effective security for, and properly authorised use of —*
> *(a) cheques, credit cards, computer encryption devices and passwords, purchasing cards and any other devices or methods by which goods, services, money or other benefits may be obtained;*

Policy Implications

N/A

Economic Implications

N/A

Risk Analysis

Continually reviewing the findings and recommendations from OAG reports against the City's current practice will reduce the risk of non-compliance with the accounting standards and relevant legislation.

Strategic Implications

The following strategy from the *City of Mandurah Strategic Community Plan 2020 – 2040* is relevant to this report:

Organisational Excellence:
- Ensure the City has the capacity and capability to deliver quality services and facilities through accountable and transparent business practices, governance, risk and financial management.

Conclusion

The OAG's report on the local government financial audit results for the 2018/19 financial year contained several recommendations for local governments to consider. It is recommended that the Audit and Risk Committee note the Officer's responses in relation to the OAG's recommendations.

NOTE:

- Refer ***Attachment 3.1*** ***OAG* Audit Results Report – Annual 2018-19 Financial Audits of Local Government Entities**

RECOMMENDATION

That the Audit and Risk Committee note the officer's responses to the Office of the Auditor General's (OAG) recommendations in the OAG's Audit Results Report – Annual 2018-19 Financial Audits of Local Government Entities.

Western Australian Auditor General's Report

Audit Results Report – Annual 2018-19 Financial Audits of Local Government Entities

Office of the Auditor General
Western Australia

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The Office of the Auditor General acknowledges the traditional custodians throughout Western Australia and their continuing connection to the land, waters and community. We pay our respects to all members of the Aboriginal communities and their cultures, and to Elders both past and present.

WESTERN AUSTRALIAN AUDITOR GENERAL'S REPORT

Audit Results Report – Annual 2018-19
Financial Audits of Local Government Entities

Report 16: 2019-20
March 2020

THE PRESIDENT LEGISLATIVE COUNCIL WESTERN AUSTRALIA	**THE SPEAKER LEGISLATIVE ASSEMBLY WESTERN AUSTRALIA**

AUDIT RESULTS REPORT – ANNUAL 2018-19 FINANCIAL AUDITS OF LOCAL GOVERNMENT ENTITIES

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

This report on the 2018-19 financial audits of 112 local government entities includes:

- results of the audits of local government entities' annual financial reports, and their compliance with applicable legislation for the financial year ending 30 June 2019
- issues identified during these annual audits that are significant enough to bring to the attention of the Parliament.

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

CAROLINE SPENCER
AUDITOR GENERAL
11 March 2020

Contents

Auditor General's overview

The 2018-19 financial year marked the second year of a 4-year transition of local government financial auditing to the Office of the Auditor General, following proclamation of the *Local Government Amendment (Auditing) Act 2017*. We performed the 2018-19 audits for 112 of the State's 148 local government entities, of which 106 were completed by 3 March 2020 and are included in this report.

In addition to summarising the results of the audits for Parliament, I have taken the opportunity to provide Parliament and the local government sector with further insight to our approach for performing financial audits. We have also highlighted opportunities for streamlining accounting practices and the preparation of annual financial reports and their audit, with a view to reducing annual reporting costs.

Five auditor's reports included a qualified opinion on the financial report (page 10). Despite this low number of qualifications, there is little room for complacency, as a clear audit opinion is the minimum we should all expect. Although some entities had good audit outcomes, it is concerning that we reported 93 material matters of non-compliance in the auditor's reports of 48 entities, and 823 significant or moderate weaknesses in financial management and information systems controls in our management letters. Some of these were unresolved from the previous year. If not addressed, these omissions and exposures increase the risk of financial loss, error or fraud.

Most entities need to implement a more robust quality review process to ensure that their financial reports are complete and accurate and the working papers adequately support the figures in their financial reports. Many entities also need to maintain an effective internal audit function, supported by an active audit committee, to improve the level of accountability and integrity of reporting and operational activities.

As we have taken on more financial audits for the sector, we have actively engaged with key governance officers and operational staff in local government entities. We have found this very rewarding. In particular, attending zone meetings and participating in audit entrance and exit meetings of our local government clients has enabled valuable exchanges of information on audit expectations and matters of accountability in the sector. In addition to undertaking our audit work, fostering an open dialogue in this manner assists my office to deliver enhanced audit outcomes for the sector and Parliament.

I am however concerned that a small number of local governments do not recognise the need for council to be involved with the external audit. A few have attempted to avoid councillors being consulted by our auditors. Australian Auditing Standards require auditors to consider whether any matters need to be communicated with management, those charged with governance, or others. In some instances, it is essential that I and my staff liaise with council or council members and we will continue to do so, to avoid a restriction on the scope of the audit, and in recognition that under section 2.7 of the *Local Government Act 1995* the role of the council is to govern.

I am encouraged that the sector is embracing changes suggested during our audits. I also support future action to streamline preparation for changes in accounting standards and policies, particularly those relating to the valuation of assets.

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

Executive summary

This Audit Results Report contains findings from the annual financial audits of the local governments and regional councils that we audited for the 2018-19 financial year.

Following proclamation of the *Local Government Amendment (Auditing) Act 2017* (Amendment Act), the Auditor General has been progressively assuming responsibility for the audits of the annual financial reports of local government entities. This report covers the annual financial audits of 112 entities, with the remaining 36 due to transition to the Auditor General by 2021.

Under the Amendment Act, the Auditor General also assumed responsibility for performance audits of the local government sector. We report to Parliament on those audits when they are completed.

Key findings

- We issued auditor's reports for 106 entities by 3 March 2020 for the 2018-19 financial year. (page 10)
- All but 5 auditor's reports included clear (unqualified) audit opinions on the financial reports (page 10). However, we reported 93 material matters of non-compliance with the *Local Government Act 1995,* Local Government (Financial Management) Regulations 1996, or other written law in 48 of our auditor's reports. If not addressed, these non-compliance matters may result in significant financial loss, inefficiency, financial misreporting or fraud. (page 12)
- At 13 entities, required related party disclosures were not made by all councillors and other key management personnel. Three entities currently do not have a related party declarations policy in place and at some entities there were several non-disclosures. (page 23)
- In addition to material matters of non-compliance reported in auditor's reports, we reported the following to entity management and the Minister for Local Government:
  - 766 financial management control weaknesses at 104 entities, of which 74% related to expenditure, financial management, payroll and human resources, and revenue. We considered 85% to be significant or moderate risk if not resolved in the short term (page 16)
  - 202 information system (IS) control weaknesses at 38 entities. This includes 125 weaknesses identified at 9 of the 10 entities subjected to a specific IS audit. (page 19)
- The audits of 16 entities were not completed by 31 December 2019, mainly because the entities were still investigating or correcting errors in their financial reports. (page 9)
- The quality of financial reports submitted for audit varied significantly across entities, from good to very poor, including some that did not balance and required significant levels of additional audit work. (page 24)

- During our second year of performing annual financial audits in the local government sector, we have made further general observations and included these in the report, with a view to minimising the cost of financial reporting and auditing in the future. These relate mainly to:
    - opportunities to reduce the financial reporting burden on small and medium sized entities, as the quantity of detail that is being reported is onerous and exceeds that reported by most WA State government entities (page 8 and 26)
    - concern that there are reporting inconsistencies in the sector as a variety of valuation methodologies are being used for property and infrastructure (page 20)
    - the costs and benefits of requiring all asset classes to be valued. (page 26)
- We have also commented on the low proportion of entities that have an internal audit function and continue to identify significant opportunities to increase the effectiveness of audit committees and enhance auditor/entity communications. (page 27)
- Entities are preparing for upcoming changes to Australian Accounting Standards on revenue, income and leases for 2019-20, and we have recommended this be completed by 30 June 2020. (page 29)

Recommendations

1. Local government entities should ensure they maintain the integrity of their financial control environment by:
    a. periodically reviewing and updating all financial, asset, human resources, governance, information systems and other management policies and procedures, and communicating these to staff
    b. conducting ongoing reviews and improvement of internal control systems in response to regular risk assessments
    c. regularly monitoring compliance with relevant legislation
    d. promptly addressing control weaknesses brought to their attention by our audits, and other audit and review mechanisms. (page 18)
2. Entities should ensure that reports from their valuers clearly explain key aspects of the valuations, and that management has a comprehensive understanding of the reports. (page 20)
3. Management should annually review the estimated useful lives of assets used for calculating depreciation, if necessary in consultation with their valuers or other experts. In addition, for greater consistency across entities, the Department of Local Government, Sport and Cultural Industries (DLGSC) should review its guidance regarding potential ranges for useful lives of assets, and entities should consider the guidance when doing their annual reviews. (page 21)
4. Entities who have not yet done so, should implement the recommendations of our local government position paper number 1 '*Accounting for work bonds, building bonds and hire bonds*'. (page 23)

5. DLGSC should consider extending existing declaration processes to include annual related party declarations for councillors and key management personnel that assist compliance with Australian Accounting Standard AASB 124 and that are fit-for-purpose to the local government environment. (page 23)
6. Local government entities should, where necessary, seek advice in advance of year end if uncertain about appropriate accounting treatments. (page 25)
7. To improve the quality of financial reports and achieve greater consistency across entities, DLGSC should consider providing an accounting advice helpdesk to the local government sector. (page 25)
8. DLGSC should re-assess the amount of detail required to be included in annual financial reports, in particular for small and medium sized entities. (page 26)
9. DLGSC should re-assess the potential advantages and disadvantages if smaller local government entities reported some asset classes such as plant and equipment using the cost model, rather than periodically re-valuing those assets. (page 27)
10. Entities and DLGSC should monitor the progress of the Australian Accounting Standards Board (AASB) and the International Public Sector Accounting Standards Board (IPSASB) public sector fair value projects relating to the valuation of assets. (page 20)
11. DLGSC should consider facilitating a shared internal audit service for the local government sector, as a service available to small and medium entities who do not have their own internal audit function. (page 28)
12. To facilitate timely preparation of annual financial reports, and to minimise the additional audit costs associated with Australian Accounting Standards on revenue, income and leases (AASB 15, AASB 1058 and AASB 16), entities should complete preparations for those new standards by 30 June 2020. (page 29)

Introduction

Under the *Local Government Amendment (Auditing) Act 2017* (Amendment Act), proclaimed in October 2017, a staged program commenced for local government annual financial audits to transition to the Auditor General as and when existing audit contracts between audit firms and entities expire. The Office of the Auditor General (OAG) was responsible for 112 audits for 2018-19, the second year of the transition. All financial audits will fall under the OAG by 2020-21.

OAG audit staff performed 13 of the 112 financial audits, with the others performed by contract audit firms on our behalf. Our oversight of these audits, coupled with in-house OAG audits, has provided our staff with valuable insight and understanding of the sector. We will be increasing the number of audits performed using in-house audit teams, however we anticipate a large proportion will continue to be performed by contract audit firms, under our oversight. These will be periodically re-tendered to provide open and fair competition, and to ensure value for money.

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

Over $39.6 billion of total assets were audited for the 106 entities. Their combined total operating revenue was $3.6 billion, of which rates contributed $2 billion (56%) and fees and charges $945 million (27%). The combined total operating expenditure was $3.6 billion.

Annual financial reporting framework, timeline and audit readiness

Reporting framework and content

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

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

The quantity of detail that is being reported is onerous and exceeds that reported by most WA State government entities and includes details not included by local governments in other jurisdictions. On page 26 we have recommended that DLGSC re-assess the amount of detail in annual financial reports.

Financial reporting timeliness

Under section 6.4(3) of the *Local Government Act 1995* (LG Act), entities must submit their annual financial reports for audit to the OAG by 30 September. (See appendix 3 on page 37 for full timeline.) Many of the entities we audited for 2018-19 submitted their financial reports for audit in advance of this deadline. However, 16 of the 112 we audited did not meet the statutory deadline, and sought approval from the Minister to instead submit for audit by various deadlines, the latest being 30 November. There were a variety of reasons for these delays, including staffing shortages in some entities and a few instances of illness.

We completed 96 of the audits by 31 December 2019 as required by section 7.9 of the LG Act. The main reasons for delays finalising the audits included the abovementioned late submission by entities, problems with asset valuations that entities only received after year end and which required various clarifications, insufficient evidence to support the financial report, and numerous errors requiring correction.

Overall, while there are some entities whose financial management procedures are sound and their teams are well prepared for audit, we found the quality and timeliness of information provided for local government audit purposes is lower than for the State public sector.

By 3 March 2020 we had completed a further 10 of the 16 audits that were incomplete at 31 December 2019.

Summary of auditor's reports issued

At 3 March 2020, we had issued auditor's reports for 106 entities for the financial year ending 30 June 2019.

The auditor's report includes:

- the audit opinion on the annual financial report
- any significant non-compliance in relation to the financial report or other financial management practices
- any material matters that indicate significant adverse trends in the financial position of the entity.

Under the Amendment Act, an entity's chief executive officer (CEO) is required to publish their annual report, including the audited financial report and the auditor's report, on the entity's website within 14 days of the annual report being accepted by the local government council. Appendix 1, from page 32, is a table of all local government entities' auditor's reports issued by the Auditor General for 2018-19.

Audit opinions on annual financial reports

An unqualified audit opinion in the auditor's report indicates the annual financial report was based on proper accounts and records, and fairly represented performance during the year and the financial position at year end. All but 5 entities received unqualified (clear) audit opinions.

We issue a qualified opinion in our auditor's report on an annual financial report if we consider it is necessary to alert readers to material inaccuracies or limitations in the financial report that could mislead readers. The following 5 entities received a qualified opinion:

Shire of Bruce Rock

Other than for roads, the Shire's 2017-18 valuation of infrastructure assets including bridges, footpaths, drainage, other infrastructure and the airstrip, was a desktop valuation and did not include an assessment of the condition of assets. We therefore issued a qualified audit opinion because we were unable to obtain sufficient appropriate audit evidence to confirm the value reported for infrastructure assets, other than roads, at 30 June 2019 and 30 June 2018.

Shire of Goomalling

We issued a qualified opinion as the Shire recognised rates revenue from properties owned by the Shire, along with a corresponding expense. This is not in accordance with the requirements of Australian Accounting Standard AASB 101 – *Presentation of Financial Statements*, and overstated the total revenue and total expenses by $110,140 for the year ended 30 June 2019 and by $112,403 for the previous year. The Shire identified this incorrect practice during the year and advised that it has taken steps, during its 2019-20 budget process, to ensure correct rating for the future.

Shire of Ravensthorpe

The audit opinion for the year ending 30 June 2018 was qualified because the Shire's infrastructure assets had not been revalued since 30 June 2015.

An appropriate valuation was performed for 2018-19, and the amount of $124,591,608 reported at 30 June 2019 is considered to represent fair value. However, in accordance with Australian Auditing Standards, we have issued a qualified opinion to alert users of the annual financial report that the balance at 30 June 2019 may not be comparable to the balance reported for 30 June 2018, because of the uncertainty over the 2018 balance.

Shire of Sandstone

A qualified audit opinion was issued as the Shire's roads and footpaths infrastructure were last valued in June 2014. Because the assets have not been re-valued with sufficient regularity or in accordance with Regulation 17A of the LG Financial Management Regulations, we were unable to determine whether infrastructure of $38,203,388 in the Statement of Financial Position represents fair value.

Shire of Wagin

The Shire's previous auditor issued a qualified audit opinion in relation to infrastructure assets for the year ended 30 June 2018 because drainage assets had not been valued for several years. The drainage assets were valued during 2018-19 at $3,416,594. However, in accordance with Australian Auditing Standards, we have issued a qualified opinion to alert users of the annual financial report that the balance of infrastructure assets at 30 June 2019 may not be comparable to the balance reported at 30 June 2018, because of the uncertainty over the 2018 balance.

Prior year qualified opinions removed in 2018-19

Two entities revised their financial reporting or took necessary action resulting in the 2017-18 matters in their qualified opinions being resolved and the qualification removed for 2018-19.

Shire of Brookton

In 2018-19, the Shire recognised its grant revenue in accordance with the accounting standards and disclosed the correction of the 2017-18 figures in the notes. The qualified opinion has therefore been removed.

Town of Cambridge

During 2018-19, the Town transferred bond moneys held into the Municipal Fund. Interest earned on the bond moneys whilst they were previously held in trust has been calculated and a refund process has commenced. The Town's previous qualified opinion on this matter has been removed.

Emphasis of Matter paragraphs included in auditor's reports

If a matter is appropriately presented or disclosed in the financial report but, in our judgement, is of such importance that it should be drawn to the attention of financial report users, we may include an Emphasis of Matter paragraph in our auditor's report.

This year, we again included an Emphasis of Matter in every auditor's report to highlight the inconsistency between Regulation 16 of the LG Financial Management Regulations and the Australian Accounting Standards. The regulation does not allow a local government entity to recognise some categories of land, including land under roads, as assets in the annual financial report.

The following were other noteworthy matters that we highlighted through Emphasis of Matter paragraphs:

City of Cockburn – correction of prior period errors

We included an Emphasis of Matter to highlight the City's disclosure that several account balances previously reported in 2017-18 have been restated in the comparative information reported in the 2018-19 annual financial report.

City of Karratha – liability to remediate waste disposal site

We included an Emphasis of Matter to highlight the City's disclosure of a contingent liability for the rehabilitation of its Seven Mile Waste Disposal site. The City has indicated it is obtaining a reliable estimate of its liability with a view to reporting it in the 2019-20 annual financial report. Provisional estimates indicate that the liability is likely to be significant. There is $20.1 million in funds in its Waste Management Reserve which the City has advised exceeds the provisional estimate of the liability and can be used for the rehabilitation of this site.

Material matters of non-compliance with legislation

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

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

Some of the matters we have reported relate to non-compliance with specific sections of the LG Act or regulations. We consider regulation 5(1) of the LG Financial Management Regulations to be particularly important, because failure to effectively apply those requirements can result in significant financial loss, inefficiency, financial misreporting or fraud. We considered many of the findings that we reported to represent non-compliance with this important section of the LG Financial Management Regulations.

Our individual findings are included in our auditor's reports which become part of the annual report of each entity and are presented on their websites. There was no discernible trend regarding the type or size of entity to which these findings relate. For the convenience of Parliament and the public, we have summarised in Table 1 the more notable matters we reported:

Issue	Finding
Controls over accounting journal entries	At 22 entities we found that accounting journal entries were often posted with no evidence of independent review and approval by another person. Accounting journals can represent significant adjustments to previously approved accounting transactions, and could result in, for example, one type of expenditure being re-coded to another type of expenditure. If not closely controlled, unauthorised journals could result in errors in financial reports, or fraud. Journals should therefore be subject to independent review.
Bank reconciliation process incomplete	At 1 entity the municipal and trust account bank reconciliations provided at 30 June 2019 had no evidence of who prepared them and were not independently reviewed. In addition, the municipal bank reconciliation included numerous uncleared reconciling items more than 12 months old. At 6 other entities

Issue	Finding
	bank reconciliations were not independently reviewed by management. While we considered these instances to warrant reporting in the auditor's report, we have also reported in our management letters, several other less significant control shortcomings in relation to bank reconciliations.
Quotes not obtained or no evidence retained	At 9 entities between 17% and 75% of purchase transactions sampled had inadequate or no evidence that a sufficient number of quotations was obtained to test the market and no documentation to explain why other quotes were not sought. This practice increased the likelihood of not receiving value for money in procurement, or favouritism of suppliers.
Procurement without purchase orders	At 6 entities purchase orders were not prepared or were prepared after the suppliers' invoices were received.
Financial ratios not reported	Nineteen entities did not report the Asset Renewal Funding Ratio, mostly for the 3 years, 2019, 2018 and 2017, in their annual financial report as required by regulation 50(1)(c) of the LG Financial Management Regulations. Reasons for non-reporting included: • planned capital renewals and required capital expenditures were not estimated as required to support the long term financial plan and asset management plan respectively • management could not confirm the reliability of the available information on planned capital renewals and required capital expenditure • the assets management plan was not current • information on planned capital renewals and required capital expenditure over a 10 year period was not available • the asset renewal program had not been updated due to the proposed divestment of an asset. In addition, 1 entity did not report the Asset Consumption Ratio for 2017 in the annual financial report, as required by regulation 50(1)(c) of the LG Financial Management Regulations, as current replacement cost of depreciable assets was not estimated in 2017.
Review not performed of financial management systems and procedures	At 7 entities a review of the financial management systems and procedures was not completed at least once every 3 financial years, as required by section 5(2)(c) of the LG Financial Management Regulations.
Review not performed of risk management, internal control and legislative compliance	At 3 entities a review of systems and procedures in relation to risk management, internal control and legislative compliance was not completed at least once every 3 years as required by Regulation 17 of the LG Audit Regulations.
No review and authorisation of changes to masterfiles	There was no evidence of independent review and authorisation of changes made to the creditor masterfile at 5 entities, the payroll masterfile at 4 entities and the debtors master file at 3 entities. This increased the risk of unauthorised changes to key information, although our audit sampling did not identify any.

Issue	Finding
Miscellaneous findings	We also reported several isolated instances of non-compliance: • Bonds and other monies incorrectly held in the trust fund which are not held in trust, or required to be credited to the trust fund under section 6.9(1) of the LG Act. • Two entities continued to procure goods and services from suppliers after their contracts had expired, without a valid extension. This practice increases the likelihood of not receiving value for money in procurement. • At 2 entities some services were procured where the total spend for each supplier during the year exceeded $150,000, however tenders were not called. In 1 of these instances, there was also no written contract in place. Section 11(1) of the Local Government (Functions and General) Regulations 1996 requires public tenders to be invited for services that are above $150,000. • Rates adjustment entries were posted by 1 employee, without being reviewed by a senior staff member independent of preparation. This increases the risk of errors or fraud passing undetected. • An entity transferred money from the building reserve via a transfer from cash backed reserves to unrestricted cash in excess of the amount approved within the entity's annual budget. • The unrestricted cash position at 30 June 2019 was a negative balance as the entity had transferred funds into reserves that exceeded the balance of unrestricted cash that was in the Municipal Fund. • At 1 entity monitoring and control activities for revenue and receipting processes were inadequate. Furthermore, internal controls relating to purchases of goods, fundraising activities, staff discounts and review of attendance fees at a child care centre were inadequate during the period.

Source: OAG

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

Adverse trends in the financial position of local government entities

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

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

Entities report these ratios for the current year and the preceding 2 years. Our trend analysis is therefore limited to these 3 years of information. We reported that 106 ratios at 72 entities indicated adverse trends.

Most of the ratios are useful indicators. However, we note that DLGSC is reviewing the ratios. We support the intent to simplify this reporting, as some ratios are more robust than others. For example, the definition of 'current ratio' in the regulations excludes restricted assets and liabilities associated with restricted assets. This means that the ratio is directly affected by the amount of funds that management and council decide to transfer to and hold in reserves. This appears to render the ratio more complex than common business practice and may make it more difficult to compare different entities. Also, reporting the operating surplus ratio may be unnecessary as users of the financial report can get similar information about any deficit from the Statement of Comprehensive Income.

Financial management controls

In addition to the material non-compliance matters reported in our auditor's reports (see Table 1 on pages 12 to 14), we reported other matters to management, including less material non-compliance as well as financial management and information system control weaknesses identified in our audits. These management letters, together with the auditor's report, form part of the overall audit report that we provide under section 7.12AD of the LG Act to the mayor, president or chairperson, the CEO and the Minister for Local Government on completion of the audit.

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

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

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

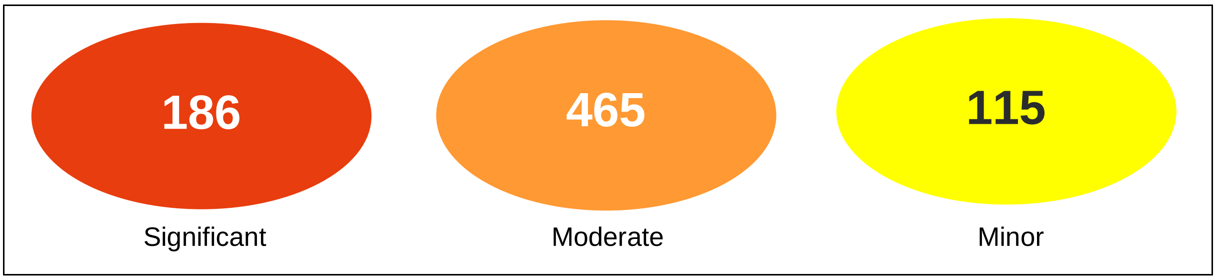
Source: OAG

Table 2: Risk categories for matters reported to management

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

Of the 290 control weaknesses we reported at 40 entities in our report 15: March 2019, 251 recommendations had been addressed or substantially addressed for 2018-19.

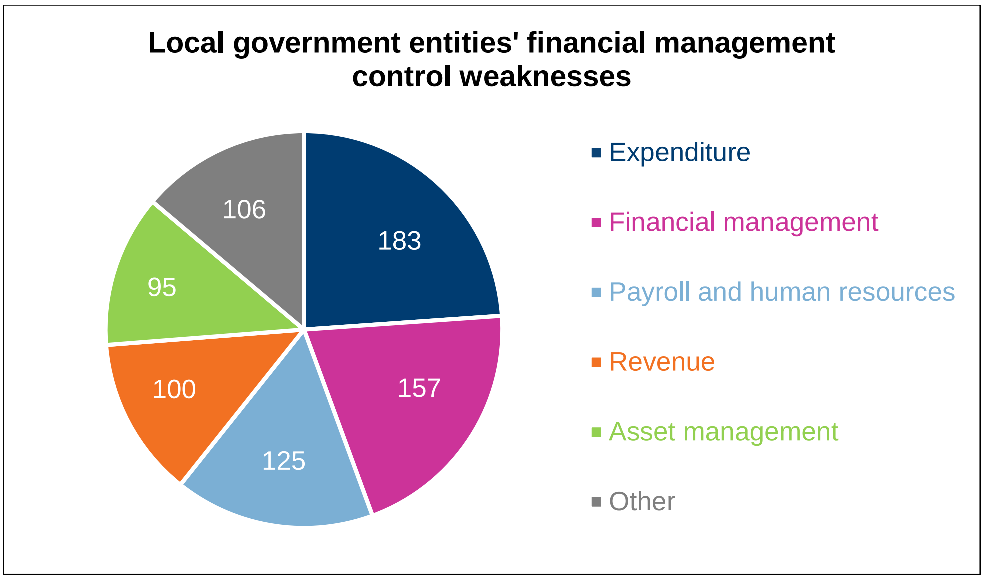
During 2018-19, we alerted 104 entities to control weaknesses that needed their attention. We reported 766 control weaknesses across the 3 risk categories as follows:



Source: OAG

Figure 1: Number of control weaknesses reported to management in each risk category

The 766 control weaknesses identified in our 2018-19 management letters are presented in their different financial management control categories in Figure 2. The control weaknesses relating to expenditure, financial management, payroll and human resources and revenue accounted for 565 or 74% of the control weaknesses reported.



Source: OAG

Figure 2: Financial management control weaknesses reported to entities

Examples of the weaknesses are reported below. We recommend that entities take timely action to improve their current practices and procedures to strengthen the accountability and integrity of their financial reporting and also comply with their legislated requirements.

Expenditure

- Quotes were not obtained as required by entities' policy guidelines. This increases the risk of favouring specific suppliers and/or not obtaining value for money. There were also instances where evidence of quotes was not retained for items purchased.
- Purchase orders were raised after the goods had been supplied and often after the suppliers' invoices had been received. At a few entities, a number of purchases were not supported by appropriately approved purchase orders. This increases the risk of inappropriate purchases.
- Supplier masterfile changes were not supported or not independently reviewed to confirm checking for related party interests, authorisation, completeness and accuracy. This increases the risk of fraud.
- Purchasing card expenditures by cardholders were not undertaken and acquitted in accordance with the approved policies and procedures.
- Supporting documentation for payments was incomplete, not authorised by an appropriately authorised or delegated officer or incorrectly cost coded.

Financial management

- Journal entries were made without supporting documentation or were not reviewed by an independent officer. These can represent significant adjustments to previously approved accounting transactions, and unauthorised journals could result in errors in financial reports, or fraud. They should therefore be clearly explained and subject to independent review.

- Bank reconciliations were not routinely prepared on a monthly basis or were not reviewed by a second officer. The bank reconciliation is a key control. If not performed regularly and independently reviewed, there is a risk of erroneous or unusual (including fraudulent) reconciling items not being detected and investigated in a timely manner.
- User password access to financial management, payroll and human resources systems was not restricted to appropriate staff. Monitoring of access privileges was not completed by a senior staff member on a regular basis.
- Daily cash summaries were usually prepared at the cash collection point but often were not reviewed and signed by a second officer to verify that all money received was recorded and submitted for banking. This increases the risk of theft.

Payroll and human resources

- Commencement and termination processes were not completed promptly to ensure timely and accurate processing and payment of staff.
- Employee masterfile changes were not always supported by related records. This is contrary to good recordkeeping practices, and makes verification of transactions more time consuming. Some masterfile changes were also not reviewed for accuracy and completeness, increasing the risk of payroll errors or fraud.
- Some employees were not taking annual and long service leave entitlements and therefore accumulating excessive leave balances. Infrequent taking of leave and associated rotation of staff roles, increases the likelihood of any frauds remaining undetected.
- Payroll reports were not reviewed by cost centre or business managers, increasing the risk of errors or fraud passing undetected.

Revenue

- No evidence was available that rates and charges were checked before ratepayers were billed.
- Daily receipts listings were prepared by 1 person, often unsigned, and in many instances there was no evidence of review by a second officer.
- Trust funds were not banked separately or interest was incorrectly recorded and treated (refer page 22).

Recommendations

Local government entities should ensure they maintain the integrity of their financial control environment by:

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

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

c. regularly monitoring compliance with relevant legislation

d. promptly addressing control weaknesses brought to their attention by our audits, and other audit and review mechanisms.

Information system controls

Information systems (IS) underpin most aspects of government operations and services. It is important that entities implement appropriate controls to maintain reliable, secure and resilient information systems.

Audits of general computer controls help to support our financial audits, and are a major part of the IS audit work we undertake. These audits provide insights about the extent to which entities' IS controls support reliable and secure processing of financial information. In 2019, we performed IS audits at 9 metropolitan and 1 regional local government entities.

We identified 125 IS control weaknesses across 9 entities where our IS audits have been completed. We rated 10% of the weaknesses as significant, 76% as moderate, and the remainder as minor.

Of the weaknesses identified:

- 49% related to information security issues. These included system and network vulnerabilities and unauthorised and inappropriate access to systems and networks
- 30% related to information technology (IT) operations issues. In particular, poor controls over the processing and handling of information, inadequate monitoring and logging of user activity, and lack of review of user access privileges
- 8% related to business continuity. For example, inadequate disaster recovery and business continuity plans
- 13% related to inappropriate IT risk management, poor environmental controls for the server room, and a lack of change management controls.

In addition to these findings, our financial audit teams also identified 77 IS control issues at 29 entities during the financial audits. Our IS team did not perform general computer controls audit at these entities.

As these issues have the potential to compromise the confidentiality, integrity and availability of key computer systems, and the information they contain, entities should take prompt corrective action to address them.

More information on these IS audit results will be included in our first IS audit report of local government entities which is expected to be tabled in the second quarter of 2020.

Specific financial reporting issues arising from 2018-19 audits

Financial reporting of non-current assets

Quality of valuation documentation

For the 66 entities that we audited for the first time in 2018-19, we reviewed opening balances, as required by Australian Auditing Standards. As part of our review, we considered the reliability of re-valuations of infrastructure and of property that occurred in 2017-18 (the comparative reported amounts). Several of these asset balances had experienced significant increases or decreases in 2017-18.

We experienced some difficulty in obtaining explanations for these large differences in value. We expected that valuers' reports and internal records would have clearly documented the main reasons for such large changes in value. In several instances, management and our audit teams concluded that the large changes were because the previous valuations, generally performed between 2013 and 2015, were less robust. We were able to confirm that most of the assets revalued in 2018 and 2019 were now reported at amounts that materially represented fair value. However, some required adjustments which were made during the audit process, (refer to page 24).

Inconsistent valuation methods

As reported in our Report 15: March 2019, our 2017-18 financial audits noted that a variety of valuation methodologies were used for property and infrastructure in the WA local government sector. We continue to have concerns about the inconsistencies of valuation methods.

Different valuers are applying different interpretations of some principles of the Australian Accounting Standards, in particular those relating to restricted use assets, resulting in significant differences in values across entities. This impacts comparability of the assets of local governments. Both the Australian Accounting Standards Board (AASB) and the International Public Sector Accounting Standards Board (IPSASB) currently have projects under way relating to fair value of public sector assets.

Most entities revalued these assets in 2017 or 2018 and, in accordance with LG Financial Management Regulation 17A(4), their next valuations are not imminent. It is therefore anticipated that the accounting standards boards will by then provide guidance that could be consistently and efficiently applied when these assets next require a valuation.

Recommendations

1. Entities should ensure that reports from their valuers clearly explain key aspects of the valuations, and that management has a comprehensive understanding of the reports.
2. Entities and DLGSC should monitor the progress of the AASB and IPSASB public sector fair value projects relating to the valuation of assets.

Significant changes in estimated useful lives of assets, and associated depreciation rates

At some entities, we noted significant changes in the amount of depreciation expense recognised in 2019 compared to 2018. To confirm the validity of the mostly lower depreciation, we made further audit inquiries. We established that the entities' valuers had, while performing the 5-yearly re-valuations, recommended revised remaining useful lives for the assets. After further consideration, we were able to confirm that the estimates were reasonable and that depreciation expense for 2019 was appropriate.

However, as depreciation expense is dependent on the estimated useful life of assets, it is of concern that:

- in most instances, there was no evidence that management had assessed the remaining useful life of assets over the intervening period since the last valuation. AASB 116 - *Property, Plant and Equipment* states 'the useful life of an asset shall be reviewed at least at each financial year-end'. If the useful lives of assets had been reviewed by management annually as required by AASB 116, the large one-off adjustments to depreciation expense that we observed in 2019, could have been avoided at those entities.
- a depreciable asset has to be depreciated over its useful life. AASB 116 defines useful life as 'the period over which an asset is expected to be available for use by an entity'. It is therefore essential that entity management considers whether the valuer's estimate of useful life matches management's expectation of how long the asset will be used by the entity. There was however no evidence that management had discussed the valuers' useful life estimates or taken into account management's expectation of how long the entity expected to continue using the assets.

Recommendation

Management should annually review the estimated useful lives of assets used for calculating depreciation, if necessary in consultation with their valuers or other experts.
In addition, for greater consistency across entities, DLGSC should review its guidance regarding potential ranges for useful lives of assets, and entities should consider the guidance when doing their annual reviews.

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

Regulation 17A(5) of the LG Financial Management Regulations required, with effect from 2018-19, assets with a value below $5,000 at the time of acquisition, to be excluded from the assets reported in the financial report. This is consistent with the State sector and also reduces financial administration costs. These assets will instead be reported as an expense in the Statement of Comprehensive Income in the year of acquisition.

The vast majority of entities successfully implemented this change.

Accounting for bond monies

During the 2017-18 annual financial audits and the planning phase of the 2018-19 audits, we noted significant variation in the accounting treatment for bond moneys, such as work bonds, building bonds and hire bonds. This included:

- Some entities held bond moneys in the Municipal Fund and therefore retained any interest income on those moneys.
- A small number of entities held bond moneys in the Trust Fund and, in accordance with section 6.9(3)(a) of the LG Act, repaid interest together with the principal amount to the developer/hirer.
- Some entities held bond moneys in the Trust Fund but retained any interest earnings as revenue of the entity.
- Some entities held bond moneys in the Trust Fund, and in a non-interest bearing bank account.

Section 6.9(1) of the LG Act states:

> *A local government is to hold in the trust fund all money or the value of assets —*
>
> *(a) that are required by this Act or any other written law to be credited to that fund; and*
>
> *(b) held by the local government in trust.*

Section 6.9(3)(a) states:

> *Where money or other property is held in the trust fund, the local government is to —*
>
> *(a) in the case of money, pay it to the person entitled to it together with, if the money has been invested, any interest earned from that investment.*

To help achieve an appropriate, consistent accounting approach, we carefully considered the matter and sought independent legal advice. We concluded that:

- there are no provisions in the Act or any other written law that specify that work bonds, building bonds and hire bonds are to be credited to, or held in, the Trust Fund, and
- unless agreements between developers/hirers and the local government entity require bond moneys to be held in the Trust Fund, they should not be held in the Trust Fund.

On 1 July 2019, we issued our local government position paper number 1 '*Accounting for work bonds, building bonds and hire bonds*'. While some entities were already appropriately accounting for these monies, the vast majority of other entities have now also followed this guidance. Apart from achieving consistent reporting, other outcomes included:

- the monies are now held in the Municipal Fund and are therefore included in the Statement of Financial Position
- entities that previously held the monies in non-interest bearing bank accounts, can now earn and retain interest on these monies for the benefit of the community
- although our position paper mainly addressed bond monies, entities have also applied the principles of the position paper to more consistently identify whether other monies should continue to be held in the Trust Fund or in the Municipal Fund. Importantly, monies that are required to be held in the Trust Fund will continue to be subject to the additional provisions of relevant sections of the LG Act.

Recommendation

Entities who have not yet done so, should implement the recommendations of our local government position paper number 1 '*Accounting for work bonds, building bonds and hire bonds*'. This is available on our website.

Related party disclosures

Australian Accounting Standard AASB 124 – *Related Party Disclosures* requires not-for-profit public sector entities to disclose material transactions with related parties in the notes to the annual financial report. This is important to help identify known or unknown extraction of value from an entity, as well as potential bias in procurement, recruitment or other operational activities. The objective of the standard is to draw attention to the possibility that the financial position and profit or loss may have been affected by related party transactions, or by outstanding balances with related parties. Open disclosure of any related parties and related party transactions by councillors and other key management personnel (KMP) helps financial statement preparers and CEOs to report transparently.

Under AASB 124, related parties in a public sector context include councillors and other KMP of the reporting entity, their close family members, and entities controlled or jointly controlled by any of them.

Citizen transactions, where KMP or their close family members or their related entities are interacting with a public sector entity under the same terms and conditions as a public citizen, are not required to be disclosed. Examples include motor vehicle registration, rates, electricity or water charges.

To assist accounting staff and the CEO when preparing the annual financial report, entities generally require councillors and KMP to complete a declaration regarding their related parties and any related party transactions they may have had with the entity.

There is some overlap between the conflict of interest declarations made by councillors under the LG Act and the disclosures required for purposes of AASB 124. However, it was of significant concern that at 13 entities, related party declarations to address the requirements of AASB 124 were not made by some councillors and/or KMP. Three entities currently do not have a related party declarations policy in place and at some entities there were several councillors or KMP failing to complete declarations. Our annual financial audit process cannot identify all undeclared related parties or instances of payments to those parties. Therefore, it is important entities have strong frameworks in place with rigorous safeguards for disclosure of private interests and related parties in order to support and demonstrate probity in decision-making.

Recommendation

DLGSC should consider extending existing declaration processes to include annual related party declarations for councillors and key management personnel that assist compliance with AASB 124 and that are fit-for-purpose to the local government environment.

Quality of financial reports submitted for audit

The quality of financial reports submitted for audit varied significantly across entities, from good to very poor, including some that did not balance. Our audits also noted that various entities were often accounting differently for the same accounting transactions, balances or disclosures.

We identified numerous errors that were corrected by the entities during the audit process. In addition, 29 of the 106 entities had errors made in prior reporting periods that required correction in 2018-19. Some of these were identified by entity management while others were identified by our audit teams. These prior period errors included:

- property assets not previously recognised
- property assets incorrectly recognised as being controlled by the entity
- asset valuations not correctly taken up in the financial report
- asset valuations not comprehensive
- entities' share in Local Government House, which they had not previously recognised in their financial reports
- entities' investment in regional councils not consistently accounted for
- share of joint ventures overstated.

In most entities a more robust quality review process needs to implemented to ensure that their financial reports are complete and accurate and the working papers adequately support the figures in their financial reports.

To ensure timely and accurate financial reports it is important that management in each reporting entity keeps proper accounts and records. Management should undertake various best practice initiatives throughout the financial year and after year end to improve the quality of their financial reporting.

At the beginning of the financial year, entities should confirm the accounting policies to be applied for the ensuing year.

Before year end, entities need to:

- prepare a project plan of human and financial resources, assign responsibilities for tasks and set time frames for financial reporting
- avoid receiving asset valuations late in the financial year or after year end and ensure that management reviews the valuations before they are included in the financial reports
- identify and review changes to accounting standards and reporting requirements and confirm the approach to any changes with the auditors.

After year end:

- analyse variations between actual and budget as well as previous year results to identify and correct omissions and/or errors
- ensure the draft financial report has received an internal quality assurance review, preferably by internal audit or other suitably qualified professionals.

There is also an opportunity to improve the quality of financial reports and achieve greater reporting consistency across entities, through a helpdesk provided by DLGSC. This would be similar to the service provided by Department of Treasury to the State government sector.

Recommendations

1. Local government entities should, where necessary, seek advice in advance of year end if uncertain about appropriate accounting treatments.
2. To improve the quality of financial reports and achieve greater consistency across entities, DLGSC should consider providing an accounting advice helpdesk to the local government sector.

Opportunities to improve the efficiency of financial reporting, and the effectiveness of internal audit

Our annual financial audits focus on providing assurance over an entity's annual financial report. During the audit we also make related recommendations in respect of compliance, financial management and information system controls, as reported above.

This section of the report includes other opportunities that may contribute to savings in financial reporting costs, and improved governance. It is important to note that while some of these issues may relate to all entities, others may only be applicable to some.

Reduced disclosure reporting by local government entities

As noted on page 8, the quantity of detail that is being reported in the annual financial reports of WA local government entities is onerous and exceeds that reported by most WA State government entities. WA entities also include several disclosures that are not common practice in other states. This contributes to the cost of, and delays in preparing annual financial reports, and to audit costs.

The AASB has a project to revisit the financial reporting framework for public sector entities, which may reduce the reporting burden on local government. Currently the accounting standards do not provide local government entities as much opportunity to reduce financial report disclosures as State government entities.

However, opportunities already exist to reduce the amount of detail in local government financial reports without impacting their usefulness and understandability for users. Wherever it does not impair usefulness, accountability and transparency, we encourage efforts to streamline financial framework obligations, particularly for small and medium sized entities.

Recommendation

DLGSC should re-assess the amount of detail required to be included in annual financial reports, in particular for small and medium sized entities.

The cost and benefit of performing valuations of non-current assets

The cost of periodically revaluing infrastructure and property, plant and equipment assets can be significant. For some smaller entities, the benefits of valuations for the entity and for users of the annual financial report may not always justify the cost.

AASB 116 – *Property, Plant and Equipment* requires entities to choose to measure property, plant and equipment, including infrastructure, using either a re-valuation model (at fair value) or a cost model. WA local government entities are required however, by Regulation 17A of the LG Financial Management Regulations, to choose the fair value method, which requires periodic re-valuations.

WA State government entities are required to perform periodic re-valuations because their financial results are consolidated into the Annual Report on State Finances at fair value. This is not applicable to local government entities, as they are not consolidated into State financial reports.

The opportunity therefore exists to allow some local government entities, particularly smaller entities where re-valuation costs can take up a significant portion of rates income, to make savings by not re-valuing all assets. For example, plant and equipment could be reported at cost less accumulated depreciation. This would be consistent with the State government sector, and would save costs without reducing the amount of useful information for users of the annual financial report.

Recommendation

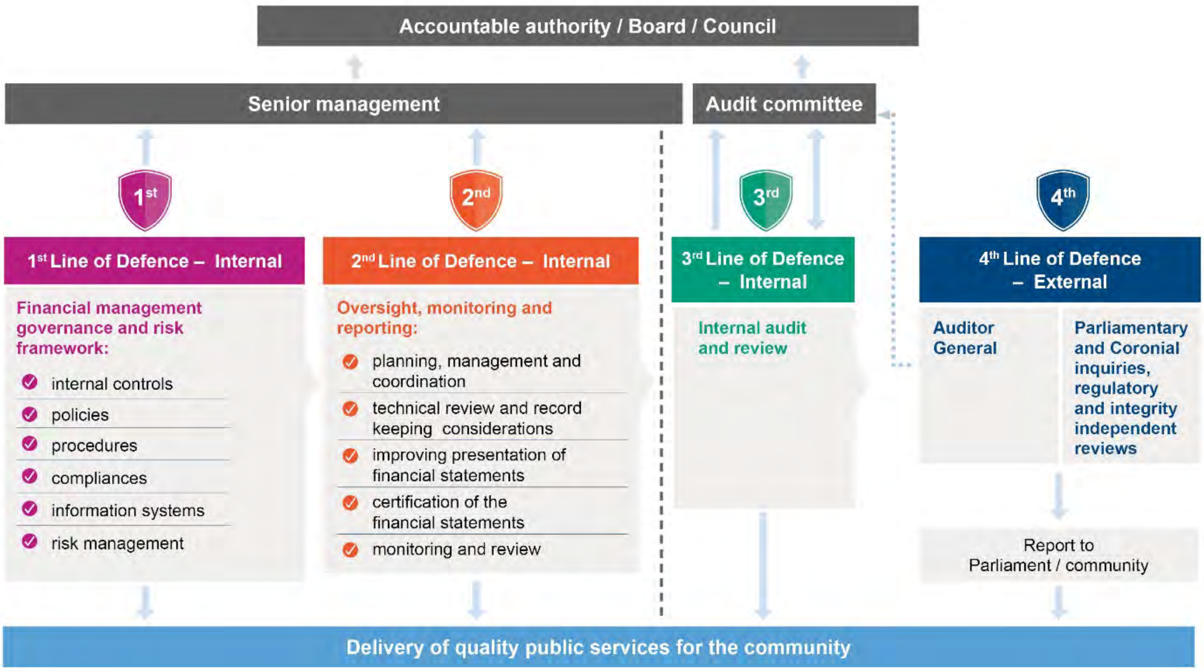
DLGSC should re-assess the potential advantages and disadvantages if smaller local government entities reported some asset classes using the cost model, rather than periodically re-valuing these assets.

Internal audit

In our report number 15: March 2019, which reported on our 2017-18 financial audits of the sector, we noted that only 11 of the 42 entities we surveyed had an internal audit function. Although we did not do a formal survey this year, overall this low implementation of internal audit continued.

An effective internal audit function is important for ongoing maintenance and improvement of risk management, internal control overseen by an effective audit committee, and governance processes. The internal audit function acts as the independent eyes and ears for council on administration and controls in key areas of risk.

As shown in the 4 lines of defence model below, internal audit is a key component of the defence against fraud, including misrepresentation. Although an entity's financial management governance and risk framework, and management oversight and monitoring are the initial lines of defence against fraud or error, internal audit is also a crucial component.



Source: OAG

Figure 3: Four lines of defence model

We recognise the challenges for some regional entities in particular to maintain an effective, independent internal audit function. A shared internal audit service, should be considered for voluntary use by the local government sector. We propose to cover this topic further in future performance audits.

Recommendation

DLGSC should consider facilitating a shared internal audit service for the local government sector, as a service available to small and medium entities who do not have their own internal audit function.

Disclosure of audit communications

We have noted that, historically, sometimes details in audit management letters have included the names of suppliers. The reports have also sometimes included the names or system logon-ids of local government staff. These findings, reported in accordance with regulation 10(4) of the LG Audit Regulations, form part of our report under section 7.12AD of the LG Act to the CEO, mayor/president and the Minister.

Although the CEO is required to include our auditor's report on the annual financial report in the entity's annual report, there is no legislative requirement for entities to publish our management letters. They are however sometimes made public as part of the proceedings of council meetings.

As this personal/security information could potentially be misused if made public, we have adopted a practice of omitting or redacting a limited amount of this sensitive information from our management letters. We also encourage entities, when providing management comments for inclusion in our management letters, to apply these principles. It is our view that this provides an appropriate balance between transparent reporting and security of information, in the event that an entity decides to make our management letters public.

Upcoming changes to accounting standards and the local government regulations

A number of significant changes to Australian Accounting Standards will be applicable over the next few years, some commencing for local government entities in 2019-20. These, and a change to the LG Financial Management Regulations, are expected to require close attention by entities' finance officers and our audit teams.

Future impact of changes to accounting standards

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

- AASB 15 – *Revenue from Contracts with Customers* – This standard requires revenue to be recognised by entities on the fulfilment of the performance obligations of an enforceable contract at a point in time or over time, as applicable. An example is receiving grant moneys. Entities need to allocate the grant amount to each performance obligation in the contract and recognise the revenue only when the related performance obligations are satisfied. This will be consistent with current practice for the private sector.
- AASB 1058 – *Income of Not-for-profit Entities* – This standard, in combination with AASB 15, establishes new principles for income recognition for not-for-profit entities from 1 January 2019 reporting and will therefore apply to entities for the 2019-20 reporting year. AASB 1058 applies to transactions where assets are acquired at significantly less than fair value, including rates and grant moneys. It is anticipated that the implementation of these 2 standards will result in more delayed income recognition.
- AASB 16 – *Leases* – For lessees, this standard removes the distinction between operating leases and finance leases, and requires all leases (except short-term leases and leases of low-value assets) to be recognised as lease assets and lease liabilities on the balance sheet. This will result in the grossing-up of the balance sheet and higher expense in the early years of the lease term. This standard applies from 1 January 2019 and will therefore apply to local government entities for the 2019-20 reporting year.
- AASB 1059 – *Service Concession Arrangements: Grantors* – This standard is applicable to public sector entities (grantors) that enter into service concession arrangements with operators (generally from the private sector). It requires grantors to recognise a service concession asset and, where applicable, a service concession liability on the balance sheet. The initial balance sheet accounting, as well as the ongoing income statement impacts, will have implications for grantors. AASB 1059 will apply for years beginning on or after 1 January 2020 and will apply to local government entities for the 2020-21 reporting year.

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

Recommendation

To facilitate timely preparation of annual financial reports, and to minimise the additional audit costs associated with Australian Accounting Standards on revenue, income and leases, AASB 15, AASB 1058 and AASB 16, entities should complete preparations for those new standards by 30 June 2020.

Financial performance of local government entities

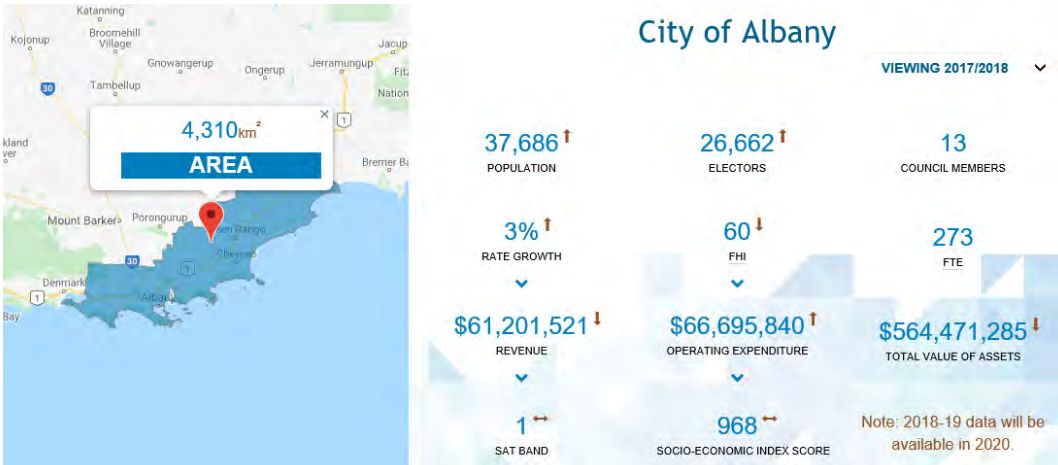
The Amendment Act requires that each entity's annual report, including the audited financial report, be available on the entity's website within 14 days of the annual report being accepted by the local government council.

A central source of financial information and ratios for each entity is the MyCouncil website. This website is maintained by the DLGSC and includes information, including audited financial data, about each entity.

DLGSC uses audited financial information for MyCouncil, however we do not check the website for the accuracy of information and do not propose to report similar financial information in our Audit Results Report.

The information on the MyCouncil website can be viewed in tables or graphically for a number of years for each entity. The website also enables readers to compare aspects of the financial operations of different entities in Western Australia over a number of years.

As an example, the first entity on the site is City of Albany. Some examples of the information available on the MyCouncil website for the City of Albany are show below:



Source: DLGSC's MyCouncil Website

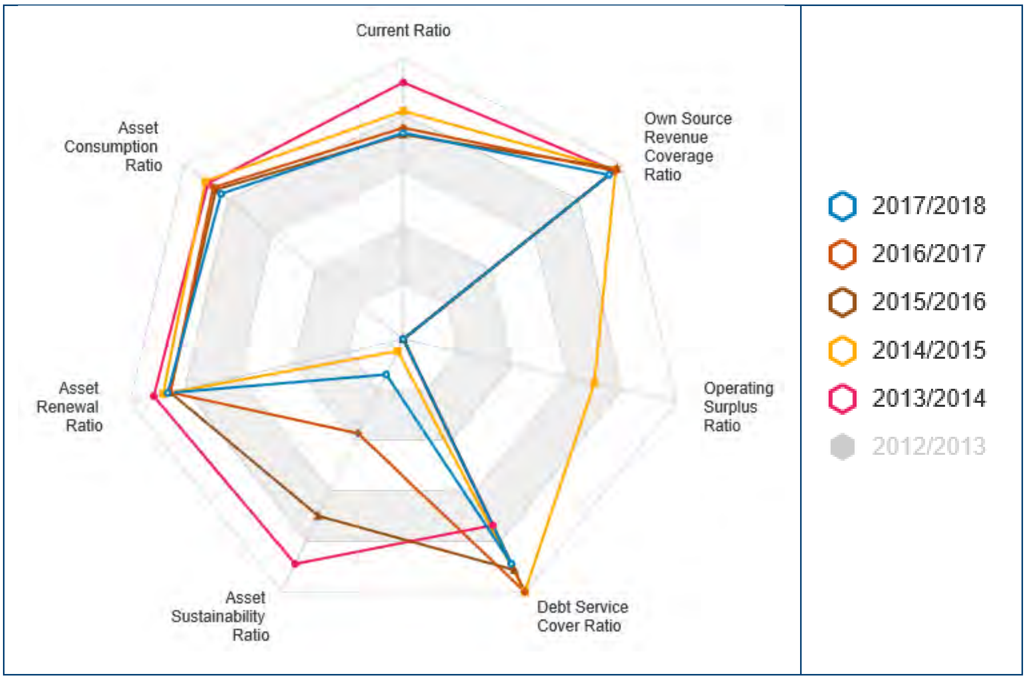
Figure 4: City of Albany, example of local government entity information on MyCouncil website

Financial Year	This council	Current Score	Asset Consumption Score	Asset Renewal Score	Asset Sustainability Score	Debt Service Cover Score	Operating Surplus Score	Own Source Revenue Coverage Score
2012/2013	90.0	10.0	7.5	8.8	7.0	10.0	7.9	10.0
2013/2014	69.0	9.2	8.9	9.1	8.9	7.4	0.0	9.6
2014/2015	79.0	8.1	9.0	8.8	0.5	10.0	7.0	9.7
2015/2016	65.0	7.3	8.6	8.5	7.0	9.1	0.0	9.8
2016/2017	65.0	7.5	8.7	8.5	3.7	10.0	0.0	9.6
2017/2018	60.0	7.4	8.3	8.6	1.4	8.9	0.0	9.4

Source: DLGSC's MyCouncil Website

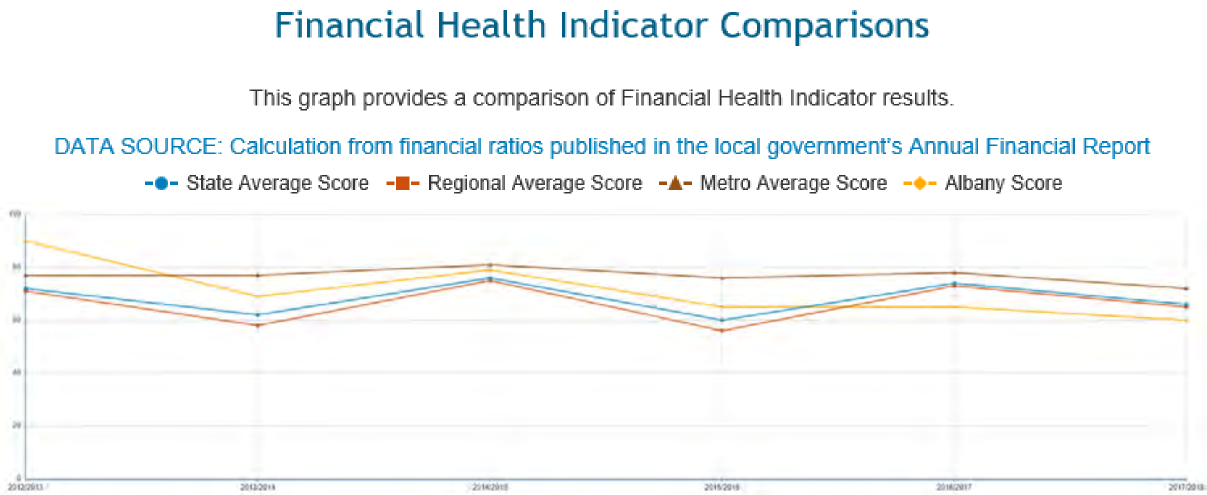
Figure 5: Table of financial health indicator scores for City of Albany

Explanations of indicators are available on the MyCouncil website



Source: DLGSC's MyCouncil Website

Figure 6: Graph of financial health indicator scores for City of Albany



Source: DLGSC's MyCouncil Website

Figure 7: Comparison of City of Albany to State average, regional average and metropolitan average

Further tabs, see below, can be used to access other information for each local government entity. However, readers of the DLGSC's MyCouncil website need to be aware that not all information for each entity is audited information.

Source: DLGSC's MyCouncil Website

Figure 8: Other MyCouncil tabs to access further information for each local government entity

Appendix 1: Local government entities audited by OAG

We completed 106 of the 112 audits for 2018-19 by 3 March 2020. The auditor's reports issued are listed by entity in alphabetical order in the table below.

Local government	Opinion issued
Bunbury-Harvey Regional Council	29/11/2019
City of Albany	12/11/2019
City of Bayswater	27/11/2019
City of Belmont	06/11/2019
City of Bunbury	08/11/2019
City of Busselton	29/10/2019
City of Canning	29/11/2019
City of Cockburn	13/12/2019
City of Fremantle	09/12/2019
City of Gosnells	26/11/2019
City of Greater Geraldton	29/10/2019
City of Joondalup	05/11/2019
City of Kalamunda	13/11/2019
City of Kalgoorlie - Boulder	19/12/2019
City of Karratha	17/02/2020
City of Kwinana	29/11/2019
City of Melville	04/12/2019
City of Nedlands	15/11/2019
City of Perth	02/12/2019
City of Rockingham	14/11/2019
City of South Perth	21/11/2019
City of Stirling	03/10/2019
City of Subiaco	15/11/2019
City of Swan	05/11/2019
City of Vincent	29/11/2019
City of Wanneroo	22/11/2019
Eastern Metropolitan Regional Council	25/11/2019
Murchison Regional Vermin Council	20/12/2019
Pilbara Regional Council	Not finalised
Rivers Regional Council	07/11/2019
Shire of Ashburton	20/12/2019
Shire of Boddington	11/12/2019
Shire of Boyup Brook	27/11/2019

Local government	Opinion issued
Shire of Bridgetown-Greenbushes	22/11/2019
Shire of Brookton	16/12/2019
Shire of Broome	09/10/2019
Shire of Bruce Rock	18/02/2020
Shire of Capel	27/11/2019
Shire of Carnamah	26/11/2019
Shire of Christmas Island	30/10/2019
Shire of Cocos (Keeling) Islands	19/11/2019
Shire of Coorow	05/12/2019
Shire of Corrigin	18/12/2019
Shire of Cranbrook	11/12/2019
Shire of Cuballing	Not finalised
Shire of Cue	12/12/2019
Shire of Cunderdin	10/12/2019
Shire of Dalwallinu	29/11/2019
Shire of Dandaragan	22/10/2019
Shire of Denmark	05/12/2019
Shire of Derby-West Kimberley	12/12/2019
Shire of Donnybrook-Balingup	11/02/2020
Shire of Dowerin	19/12/2019
Shire of Dundas	18/10/2019
Shire of Exmouth	21/11/2019
Shire of Gnowangerup	02/12/2019
Shire of Goomalling	20/02/2020
Shire of Halls Creek	10/12/2019
Shire of Irwin	15/10/2019
Shire of Jerramungup	11/12/2019
Shire of Katanning	16/12/2019
Shire of Kellerberrin	22/11/2019
Shire of Kojonup	Not finalised
Shire of Kondinin	16/12/2019
Shire of Koorda	30/10/2019
Shire of Kulin	Not finalised
Shire of Lake Grace	30/11/2019
Shire of Laverton	Not finalised
Shire of Meekatharra	13/12/2019
Shire of Menzies	19/12/2019
Shire of Merredin	15/10/2019

Local government	Opinion issued
Shire of Mingenew	24/11/2019
Shire of Moora	18/12/2019
Shire of Morawa	13/12/2019
Shire of Mount Magnet	12/12/2019
Shire of Mukinbudin	05/12/2019
Shire of Mundaring	29/11/2019
Shire of Murchison	27/02/2020
Shire of Nannup	11/12/2019
Shire of Narrogin	28/11/2019
Shire of Northam	05/12/2019
Shire of Northampton	10/12/2019
Shire of Nungarin	11/12/2019
Shire of Peppermint Grove	13/12/2019
Shire of Perenjori	11/02/2020
Shire of Pingelly	25/11/2019
Shire of Ravensthorpe	11/12/2019
Shire of Sandstone	19/12/2019
Shire of Serpentine-Jarrahdale	18/11/2019
Shire of Tammin	12/12/2019
Shire of Three Springs	04/12/2019
Shire of Upper Gascoyne	27/11/2019
Shire of Victoria Plains	17/12/2019
Shire of Wagin	11/02/2020
Shire of West Arthur	05/12/2019
Shire of Westonia	12/12/2019
Shire of Wickepin	18/12/2019
Shire of Williams	13/11/2019
Shire of Wiluna	Not finalised
Shire of Woodanilling	18/12/2019
Shire of Wyalkatchem	14/02/2020
Shire of Yalgoo	31/01/2020
Shire of York	09/12/2019
South Metropolitan Regional Council	04/12/2019
Town of Bassendean	29/11/2019
Town of Cambridge	10/12/2019
Town of Claremont	06/12/2019
Town of Cottesloe	09/12/2019
Town of East Fremantle	13/12/2019

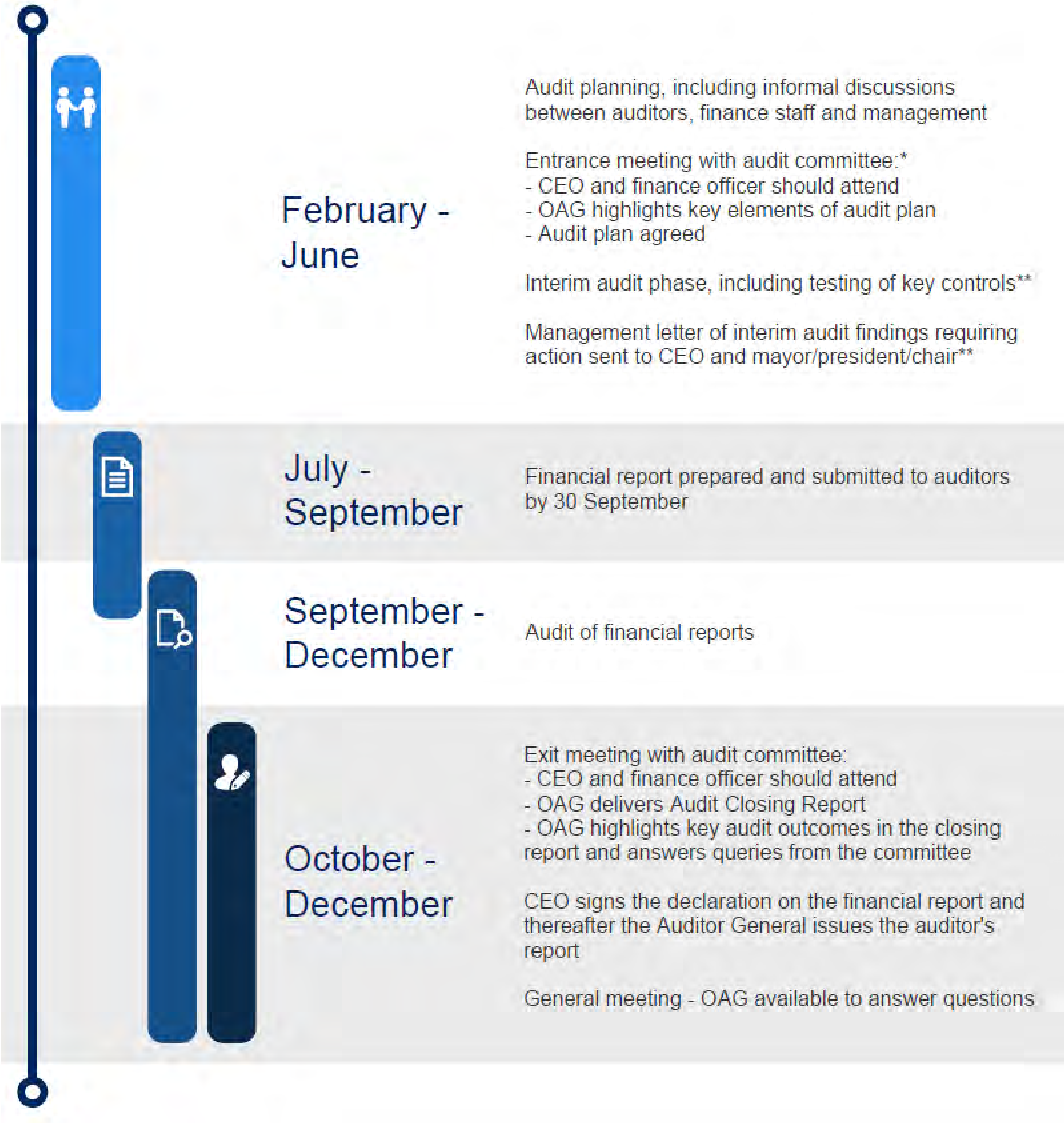
Local government	Opinion issued
Town of Mosman Park	21/11/2019
Town of Victoria Park	06/02/2020
Western Metropolitan Regional Council	06/12/2019

Appendix 2: Local government entities' certifications issued

In addition to annual auditor's reports, some entities needed to acquit moneys received from other sources under grant agreements or other legislation. We issued the following 16 certifications on statements of income and expenditure of entities, to help them discharge their financial reporting obligations, some being for Commonwealth grants.

Local government certifications	Certifications issued
Claims by administrative authorities – Pensioner deferments under the *Rates and Charges (Rebates and Deferments) Act 1992*	
City of Belmont	31/10/2019
City of Joondalup	21/10/2019
City of Kalamunda	06/12/2019
City of South Perth	28/10/2019
Shire of Brookton	19/12/2019
Shire of Dandaragan	01/11/2019
Town of Cambridge	10/12/2019
Roads to Recovery Funding under the *National Land Transport Act 2014*	
City of Joondalup	25/10/2019
City of Kalamunda	28/10/2019
City of South Perth	28/10/2019
Shire of Dandaragan	30/10/2019
Town of East Fremantle	31/10/2019
Other certifications	
City of Joondalup – Department of Fire and Emergency Services Mitigation Activity Fund Emergency Services Levy Funding	17/07/2019
City of Kalamunda – Development Contribution Area 1 – Forrestfield Light Industrial Area – Stage 1	06/12/2019
Shire of Dandaragan – Bushfire Risk Management Plan	04/11/2019
Shire of Dandaragan – Jurien Bay Civic Centre Outgoings for Department of Biodiversity, Conservation and Attractions Tenancy	04/11/2019

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



Source: OAG

Notes

Meetings with some remote local government entities are conducted by teleconference due to cost and logistical reasons.

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

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

Glossary and acronyms

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

Auditor General's reports

Report number	2019-20 reports	Date tabled
15	Opinion on Ministerial Notification	28 February 2020
14	Opinion on Ministerial Notification	31 January 2020
13	Fee-setting by the Department of Primary Industries and Regional Development and Western Australia Police Force	4 December 2019
12	Audit Results Report – Annual 2018-19 Financial Audits of State Government Entities	14 November 2019
11	Opinion on Ministerial Notification	30 October 2019
10	Working with Children Checks – Follow-up	23 October 2019
9	An Analysis of the Department of Health's Data Relating to State-Managed Adult Mental Health Services from 2013 to 2017	9 October 2019
8	Opinions on Ministerial Notifications	8 October 2019
7	Opinion on Ministerial Notification	26 September 2019
6	Opinions on Ministerial Notifications	18 September 2019
5	Fraud Prevention in Local Government	15 August 2019
4	Access to State-Managed Adult Mental Health Services	14 August 2019
3	Delivering Western Australia's Ambulance Services – Follow-up Audit	31 July 2019
2	Opinion on Ministerial Notification	26 July 2019
1	Opinions on Ministerial Notifications	19 July 2019

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4	**SUBJECT:**	Audit 2020 considerations
	CONTACT OFFICER/S:	Jarred King/ Casey Mihovilovich
	AUTHOR:	Jarred King

Summary

The City's auditor, Deloitte, have asked City officers to review certain assumptions and considerations used in the financial reporting process for this year's financial statements (financial year ending 30 June 2020). City officers have reviewed the supplied document and determined that while many of these issues are not reflected in local government, there are several that need consideration.

Disclosure of Interest

N/A

Previous Relevant Documentation

N/A

Background

Deloitte have been the City's auditors for 15 years. The contract is due to expire after the 2020 financial year audit. From 2021, the City's audit will move under the Office of the Auditor General. Certain assumptions and considerations are made during the financial statement process that impacts the values.

Comment

From the International Financial Reporting Standards (IFRS) in focus report, the following points require consideration:

- Preparation of forecast cash flow estimates
  - The City has prepared a COVID-19 budget adjustment to account for the loss in revenue and consequent decrease in expenditure as a result. This report will be presented to the May Ordinary Council Meeting as part of the April monthly financial report.
- Recoverability and impairment of assets
  - The City's asset values are not expected to be impaired from the COVID-19 pandemic as the majority are infrastructure assets such as roads, drainage and parks. Under AASB 13 *Fair Value measurement*, these classes of assets are valued using replacement cost less depreciation as there are no available market participants to obtain a value that the asset would sell for.
- Accounting for financial assets
  - Under AASB 9 – *Financial Instruments* the City needs to assess trade debtors, loans receivables and rent\lease receivables to establish the expected credit losses for each category. The City does not calculate expected credit losses on rate debtors as these charges are statutory and a charge on land is eventually recoverable with the sale of that land. This recognition came into effect in the 2019 financial year and replaces the accounting treatment for doubtful debts provision.
    As part of the end of financial year planning the expected credit loss calculations will be undertaken and included as a note in the financial statements.
- Contract Modifications
  - The pandemic has resulted in contract variations for the City. These changes will result in financial adjustments that will be made in the budget and the COVID-19 budget adjustments. The City is expecting a delay in the roll out of the new Enterprise Resource Planning (ERP) software and are in discussions with the supplier to determine if the City can position itself in a more advantageous position. This may impact the lease asset and liability amounts.

- *Going Concern*
    - The City has assessed the budget for the COVID-19 pandemic and have identified reduced expenditures to match the loss in revenue. The City's cashflow position remains viable and it is expected that the City will be operating well into the future.

All other issues raised in the document, detailed in Attachment 4.1, have been assessed by City officers and do not apply to the City's business, as a local government.

Consultation

N/A

Statutory Environment

Section 2.7(2)(a) and (b) of the *Local Government Act 1995* states:

> *(2) Without limiting subsection (1), the council is to —*
> > *(a) oversee the allocation of the local government's finances and resources; and*
> > *(b) determine the local government's policies.*

Policy Implications
N/A

Economic Implications

N/A

Risk Analysis

Assessment of international standard compliance prior to the audit being undertaken reduces the impact of non-compliance. It also assists City officers in end of year financial planning, in that, certain transactions must be considered and included in the financial statements.

Strategic Implications

The following strategy from the *City of Mandurah Strategic Community Plan 2020 – 2040* is relevant to this report:

Organisational Excellence:
- Ensure the City has the capacity and capability to deliver quality services and facilities through accountable and transparent business practices, governance, risk and financial management.

Conclusion

The City's auditors require City officers to assess a range of issues for the year end accounts. While most of the issues raised relate to corporate entities, the issues facing the City have been assessed and considered by City officers.

NOTE:

- Refer ***Attachment 4.1 Deloitte IFRS in Focus***

RECOMMENDATION

That the Audit and Risk Committee note the City officer responses outlined in the Comment section of the report.

Deloitte.

IFRS in Focus

Accounting considerations related to the Coronavirus 2019 Disease

Contents

Introduction

The coronavirus 2019 (COVID-19) pandemic is affecting economic and financial markets, and virtually all industries are facing challenges associated with the economic conditions resulting from efforts to address it. For example, many entities in the travel, hospitality, leisure, and retail industries have seen sharp declines in revenues due to regulatory and organisational mandates (e.g. "shelter in place" mandates, school closures) and voluntary changes in consumer behaviour (e.g. "social distancing").

As the pandemic increases in both magnitude and duration, entities are experiencing conditions often associated with a general economic downturn. This includes, but is not limited to, financial market volatility and erosion, deteriorating credit, liquidity concerns, further increases in government intervention, increasing unemployment, broad declines in consumer discretionary spending, increasing inventory levels, reductions in production because of decreased demand, layoffs and furloughs, and other restructuring activities. The continuation of these circumstances could result in an even broader economic downturn which could have a prolonged negative impact on an entity's financial results. This *IFRS in Focus* discusses certain key IFRS accounting considerations related to conditions that may result from the COVID-19 pandemic. The significance of the individual issues discussed below will of course vary by industry and by entity, but we believe that the following topics will be the most pervasive and difficult to address.

- *Preparation of forecast cash flow estimates*—The use of forecast information is pervasive in an entity's assessment of, among other things, the impairment of non-financial assets, expected credit losses, the recoverability of deferred tax assets and the entity's ability to continue as a going concern. Unique complexities associated with preparing forward-looking information as a result of the pandemic and economic downturn include the following:
  - There is an extremely wide range of possible outcomes, resulting in a particularly high degree of uncertainty about the ultimate trajectory of the pandemic and the path and time needed for a return to a "steady state."
  - The associated economic impact of the pandemic is highly dependent on variables that are difficult to predict. Examples include the degree to which governments prohibit business and personal activities, the associated level of compliance by citizens, the degree to which "flattening the curve" is successful, and the nature and effectiveness of government assistance.
  - Each entity must then translate the effect of those macro conditions into estimates of its own future cash flows.

Nevertheless, entities will need to do their best to make reasonable estimates, prepare comprehensive documentation supporting the basis for such estimates and provide robust disclosure of the significant judgements exercised, the key assumptions used and, potentially, their sensitivity to change.

- *Recoverability and impairment of assets*—Perhaps the most acute example of the increased challenge associated with forecast information is the impairment testing for non-financial assets (for example, property, plant and equipment (PP&E), right-of-use assets, intangible assets and goodwill). The impairment test for these assets often requires the development of cash flow projections that are subject to the significant uncertainties noted above.

- *Accounting for financial assets*—There has been a severe decline in the fair value of many financial assets, particularly equity securities. Likewise, the ability of debtors to comply with the terms of loans and similar instruments has been adversely affected. Entities will need to carefully consider and apply the appropriate measurement and impairment loss recognition requirements.

- *Contract modifications*—Changes in the economic activity caused by the pandemic will cause many entities to renegotiate the terms of existing contracts and arrangements. Examples include contracts with customers, compensation arrangements with employees, leases and the terms of many financial assets and liabilities. Entities will need to ensure that the relevant requirements in IFRS Standards are applied.

- *Events after the end of the reporting period*—It may be challenging for an entity to determine if an event after the end of the reporting period is adjusting or non-adjusting in a global marketplace that is extremely volatile and in which major developments occur daily (e.g. announcements of government stimuli and restrictions) and the stock market's daily reaction to new information. Although entities may not have all facts "on hand" at the reporting date, once such facts are gathered an assessment must be based on conditions as they existed at the reporting date. The amounts in the financial statements must be adjusted only to reflect subsequent events that provide evidence of conditions that existed at the reporting date. With respect to reporting periods ending on or before 31 December 2019, it is generally appropriate to consider that the effects of the COVID-19 outbreak on an entity are the result of events that arose after the reporting date, for example decisions made in response to the COVID-19 outbreak, that may require disclosure in the financial statements, but would not affect the amounts recognised. For subsequent reporting periods, the effects of the COVID-19 pandemic may affect the recognition and measurement of assets and liabilities in the financial statements. This will be highly dependent on the reporting date, the specific circumstances of the entity's operations and the particular events under consideration.

- *Going concern*—As a result of COVID-19 and its associated effects, entities need to consider whether, in their specific circumstances, they have the ability to continue as a going concern for at least, but not limited to, 12 months from the reporting date. Management's assessment of the entity's ability to continue as a going concern involves making a judgement, at a particular point in time, about inherently uncertain future outcomes of events or conditions. This will require an entity to consider, among other things, (1) the extent of operational disruption; (2) potential diminished demand for products or services; (3) contractual obligations due or anticipated within one year; (4) potential liquidity and working capital shortfalls; and (5) access to existing sources of capital (e.g., available line of credit, government aid). In making its going concern assessment, IAS 10 *Events after the Reporting Period* requires an entity to consider events up to the date of authorisation of the financial statements. In certain jurisdictions, regulations may extend this period (e.g. until presentation of the financial statements at an annual shareholders' meeting).

Entities must carefully consider their unique circumstances and risk exposures when analysing how recent events may affect their financial statements. Specifically, financial statement disclosures will need to convey the material effects of the COVID-19 pandemic.

Material judgements and uncertainties

As a result of the uncertainty associated with the unprecedented nature of the COVID-19 pandemic, entities are likely to face challenges related to selecting appropriate assumptions and developing reliable estimates. Nevertheless, they will still be required by IFRS Standards to develop estimates that underlie various accounting conclusions. To develop estimates, entities will need to consider all available information as well as whether they have met all applicable disclosure requirements, including those in IAS 1 *Presentation of Financial Statements*.

A number of assumptions or estimates may be required for more than one purpose (e.g. forecast revenues may be relevant to impairment tests and recognition of deferred tax assets). Consistent assumptions should be used for all relevant assessments.

When reporting in uncertain times, it is particularly important to provide users of the financial statements with appropriate insight into the entity's resilience in the face of the current uncertainty and to understand the key assumptions and judgements made when preparing financial information.

Depending on an entity's specific circumstances, each of the areas discussed in this publication may be a source of material judgement and uncertainty that requires disclosure applying IAS 1. Where this is the case, the entity should provide disclosures, distinguishing between:

- Significant judgements (disclosure required by IAS 1:122), i.e. judgements other than estimations made in applying an entity's accounting policies, often as to how an item is characterised; and
- Significant sources of estimation uncertainty (disclosure required by IAS 1:125, if the source of estimation uncertainty results in a significant risk of material adjustment to assets or liabilities within the next financial year), i.e. assumptions or other sources of estimation uncertainty (including judgements involving estimation), primarily over the carrying amount of an item.

In the current situation, it would appear reasonable for entities not to be bound by a narrow interpretation of what constitutes a significant source of estimation uncertainty and provide as much context as possible for the assumptions and predictions underlying amounts recognised in the financial statements, in line with the spirit of the requirements of IAS 1:125.

Relevant judgements and assumptions might include the:

- availability and extent of support through government support measures that have been announced;
- availability, extent and timing of sources of cash, including compliance with banking covenants or reliance on those covenants being waived;
- duration of social distancing measures and their potential impacts.

There is not a single view on how the COVID-19 pandemic will evolve and its impact on the economy. This lack of consistency makes the need for full disclosure of judgements, assumptions and sensitive estimates significantly more important than usual.

A Deloitte IFRS in Focus publication provides more detail on the disclosure of significant judgements and sources of estimation uncertainty.

Going concern

COVID-19 is disrupting operations of many businesses. Entities will need to consider whether such disruption will be prolonged and result in diminished demand for products or services or significant liquidity shortfalls (or both) that, among other things, cause management to assess whether the entity may be able to continue as a going concern for at least, but not limited to, 12 months from the reporting date.

Financial statements are prepared on a going concern basis unless management intends either to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When making its assessment, if management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity must disclose those uncertainties.

If management identify events or conditions (other than those with a remote probability of occurring) that could lead to corporate failure, these should be disclosed. In identifying such events or conditions, management should consider both the uncertainty and the likely success of any realistic possible response to mitigate this uncertainty.

An entity's current facts and circumstances may challenge the going concern basis of preparation. Assessing whether an entity is a "going concern" typically requires the following factors to be considered:

- Whether the forecast performance would result in an adequate level of headroom over the entity's available borrowing facilities and compliance with relevant loan covenants; and
- The availability of sufficient committed borrowing facilities for the foreseeable future and whether there are indicators that the lending counterparty will be unable to provide this funding.

In the current situation, the assessment is made more difficult given the uncertainties about the impact of the COVID-19 pandemic, the extent and duration of social distancing measures in effect in many jurisdictions and the impact on the economy. Management should consider the impact of these matters on the *entity's specific circumstances*, in particular current and potential cash resources including access to existing and new financing facilities, and factoring and reverse factoring arrangements. Access and use of such facilities and arrangements should be disclosed.

The assessment as to whether the going concern basis is appropriate takes into account events after the end of the reporting period. For example, for 31 December 2019 reporters that are severely affected by COVID-19, even though the significant impact on operations occurred after year-end, will need to consider the appropriateness of preparing financial statements on a going concern basis.

In making this assessment, management will need to take into account all information available up to the date of authorisation of the financial statements (in certain jurisdictions, local regulations may extend this period). The information to be considered includes government announcements affecting the ability of an entity to operate and of any government assistance programmes to which the entity may be entitled. When management is aware of material uncertainties that cast a significant doubt on the entity's ability to continue as a going concern, IAS 1:25 requires the entity to disclose those material uncertainties in the financial statements. The disclosure should be specific to the entity's own situation, for example explaining how and when the uncertainty may crystallise and its impact on the entity's resources, operations, liquidity and solvency.

When an entity has applied significant judgement in the process of concluding that no material uncertainty exists that meets criteria for disclosure, that circumstance requires disclosure under IAS 1:122 on disclosures of significant judgements in order to provide users of the financial statements with sufficient information to understand the pressures on liquidity, viability and solvency.

Events after the end of the reporting period

Given the economic environment and the likelihood that events may occur rapidly or unexpectedly, entities should carefully evaluate information that becomes available after the end of the reporting period but before the date of authorisation of the financial statements. The amounts in the financial statements must be adjusted to reflect events after the end of the reporting period that provide evidence of conditions that existed at the end of the reporting period. Events that are indicative of conditions that arose after the reporting period are non-adjusting events. They are not reflected in the recognition or measurement of items in the financial statements, but require disclosure when material.

Often the "events" are (1) company-specific; and (2) associated with a specific account that permits a more precise analysis. However, sometimes the "events" are macroeconomic in nature (such as those resulting from COVID-19) and have a pervasive impact on many estimates in a set of financial statements which may make it difficult to ascertain whether such conditions "existed" at the reporting date. The full impact of the COVID-19 pandemic on short-term, medium-term, and long-term economic activity is still unknown, and major developments are occurring frequently. However, COVID-19 will be a factor in an entity's analysis of estimates made in the preparation of the financial statements, including those related to the expected credit loss on receivables, inventory obsolescence, impairment analyses, variable and contingent consideration estimates, and other factors. Whilst the events stemming from COVID-19 are extremely volatile, entities will nevertheless be required to consider conditions as they existed at the reporting date when evaluating subsequent events.

With respect to reporting periods ending on or before 31 December 2019, it is generally appropriate to consider that the effects on an entity are the result of events that arose after the reporting date that may require disclosure in the financial statements but would not affect the amounts recognised.

For subsequent reporting dates, entities will need to judge how much of the impact of COVID-19 should be considered to arise from non-adjusting events. This will be highly dependent on the reporting date, the specific circumstances of the entity's operations and the particular events under consideration. In other words, there is no universal 'flip' point at which entities should view all COVID-19 related impacts to be adjusting events. Instead, each event should be assessed to determine whether it provides evidence of conditions that existed at the end of the reporting period or whether it reflects a change in conditions after the reporting date.

If non-adjusting events are material, an entity is required to disclose the nature of the event and an estimate of its financial effect. The estimate does not need to be precise. It is preferable to provide a range of estimated effects as an indication of impact to not providing any quantitative information at all. However, where quantitative effect cannot be reasonably estimated, qualitative description should be provided, along with a statement that it is not possible to estimate the effect.

Impairment of non-financial assets

Assets subject to the requirements of IAS 36

Entities will need to assess whether the impact of COVID-19 has potentially led to an asset Impairment. Financial performance, including estimates of future cash flows and earnings, may be significantly affected by the direct or indirect impacts of recent and ongoing events.

IAS 36 *Impairment of Assets* seeks to ensure that an entity's assets are carried at not more than their recoverable amount (i.e. the higher of fair value less costs of disposal and value in use). Entities are required to conduct impairment tests when there is an indication of impairment of an asset at the reporting date. The test is conducted for a 'cash-generating unit' (CGU) when an asset does not generate cash inflows that are largely independent of those from other assets. The CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

The scope of assets subject to the requirements in IAS 36 is broad. It includes property, plant and equipment (carried at cost or revalued amount), intangible assets (carried at cost or revalued amount), goodwill, right-of-use assets (if carried at cost), investment property (if carried at cost), biological assets (if carried at cost) and investments in associates and joint ventures accounted for using the equity method. Note that interests in associates and joint ventures not subject to the equity method, such as loans, are subject to the impairment requirements in IFRS 9 *Financial Instruments*. In an entity's separate financial statements, investments in subsidiaries, associates and joint ventures (other than those accounted for in accordance with IFRS 9) are also subject to the requirements of IAS 36.

Indicators of impairment include (but are not limited to) significant changes with an adverse effect on the entity that have taken place during the period, or will take place in the near future in the market or economic environment in which the entity operates. An entity will also need to consider the extent to which, or the manner in which, an asset is used or is expected to be used (for example, an asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs or plans to dispose of an asset before the previously expected date).

Factors resulting from the COVID-19 pandemic which indicate that the carrying amount of a CGU may not be recoverable may include (1) decreased demand for the entity's products or service; (2) increased costs/business interruptions due to supply chain issues; (3) cancellations or postponements of orders by customers; (4) need to provide significant concessions to customers; (5) significant customers experiencing financial difficulties or cash flow difficulties. These factors may indicate that the entity may be forced to liquidate some of its assets rapidly.

In addition, given recent stock market price declines, the carrying amount of net assets of an entity may exceed its market capitalisation. IAS 36 notes that this situation is a further indicator of impairment.

As a result of the impact of COVID-19, certain entities may need to perform an impairment assessment of assets in addition to the requirement to perform an impairment test at least annually of goodwill and intangible assets with an indefinite useful life.
Entities often rely on discounted cash flows in estimating recoverable amounts. Careful consideration of the cash flow projections, growth rate(s) and discount rate(s) will be critical in terms of the supportability and reasonableness of the calculations given the current market conditions. In particular, the projected cash flows should be based on what could have reasonably been known at the reporting date of the conditions that existed at that date. However, in a value in use calculation, they should not reflect the effects of restructuring plans that are not committed at the reporting date or the benefits of the possible government assistance as this would be inconsistent with the requirement to determine the value in use of the CGU in its current condition at the end of the reporting period.

The discount rate to be used is an estimate of the rate that a market participant would expect on an equally risky investment. Hence, to the extent that risk and uncertainties about the future impact of the COVID-19 pandemic are not reflected in the projected cash flows of the CGU being tested, they should be reflected in the discount rate applied.

In these uncertain times, management may face significant challenges in preparing the budgets and forecasts necessary to estimate the recoverable amount of an asset (or CGU). Management may determine that using an expected cash flow approach is the most effective means of reflecting the uncertainties of the COVID-19 pandemic in its estimates of recoverable amount. This approach reflects all expectations about possible cash flows instead of the single expected outcome. For example, a cash flow might be CU100, CU200 or CU300, with probabilities of 10 per cent, 60 per cent and 30 per cent, respectively, giving an expected cash flow of CU220, i.e. (CU100 × 10%) + (CU200 × 60%) + (CU300 × 30%). While an expected cash flow approach is highly dependent on assigning probabilities to estimates of future cash flows, such judgements on the inputs may nevertheless be more transparent and more readily tied to underlying commercial expectations than the addition of a "COVID-19" risk premium to the discount rate that may be more arbitrary and for which there is no evidential base to support the quantum of the adjustment.

Key principles to bear in mind are:

- Estimated cash flows and discount rates should be free from both bias and factors unrelated to the asset in question.
- Estimated cash flows should reflect a range of possible outcomes, rather than a single expected outcome.
- Cash flow projections should reflect the conditions in existence at the reporting date and be based on the most recent financial budgets/forecasts, approved by management at the appropriate level of authority, covering a maximum period of five years, unless a longer period can be justified. In these uncertain times, reliable detailed budgets may only be available for a shorter period.
- Projections of cash flows beyond the period covered by the most recent budgets/forecasts should be estimated by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified based on objective information about patterns over a product or industry lifecycle. This growth rate should not be overly optimistic and should not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified. In some cases, it may be appropriate for the growth rate to be zero or negative.

- Future cash flows should be estimated for the asset in its current condition and should not include estimated future cash inflows or outflows expected to arise from improving or enhancing the asset's performance or future restructuring to which the entity is not yet committed (when the recoverable amount is determined as the value in use).
- The entity's weighted average cost of capital (WACC) may be used as a starting point for estimating a market discount rate, but this should then be adjusted to reflect the way the market would assess the cash-generating unit's cash flows (unless that risk is already included in the estimated cash flows). When considering the underlying individual inputs into a traditional capital asset pricing model ("CAPM") consideration must be given to the interplay between inputs (i.e. the risk free rate assumption and the equity risk premium) and how the changes in some inputs may be offset by the change in other inputs. The expectation of a falling risk free rate environment does not necessarily translate into a lower cost of capital.
- Care should be taken as to consistency of the data being prepared and compared to avoid double counting or omission of some data.

If information is received after the end of the reporting period, but before the financial statements are authorised for issue, indicating that an asset is impaired, management should consider whether that information is indicative of impairment that existed at the end of the reporting period. If so, an impairment review (or a re-performance of any impairment test already performed) should be carried out. If the information received after the reporting period is not indicative of conditions existing at the end of the reporting period, it should not trigger an impairment test (or the re-performance of any impairment test already carried out). Rather, the information should be disclosed as a non-adjusting event after the reporting period when it is of such importance that non-disclosure would affect decisions of users of the financial statements.

If there is indication that the asset may be impaired, the underlying facts should be kept in mind when performing the annual reviews of the useful life of the asset, the depreciation or amortisation method used and the estimated residual value. These items may need to be adjusted even if no impairment loss is recognised.

Information about asset impairments will be critical in helping users of the financial statements understand the impact of the COVID-19 pandemic on an entity's financial performance and position. Disclosure of the key assumptions used to determine the recoverable amount, together with a description of management's approach to determining the value assigned to each key assumption, must be provided in sufficient detail. These include assumptions on the duration and intensity of effects of the suspension of activities and of the recovery phase. Key assumptions used in performing impairment tests are likely to represent a source of significant estimation uncertainty and therefore the information required by IAS 36 may need to be supplemented by the information required by IAS 1:125-133, such as a sensitivity analysis.

Valuation of inventories

The COVID-19 pandemic may affect the recoverability of inventory balances. Some entities with inventories that are seasonal or are subject to expiration may have to assess whether a write-down for obsolescence or slow-moving stock may be necessary at an interim or annual period as a result of a slower sales pace. Other entities may have to assess whether a decline in their future estimated selling price is expected, which may require a write-down in the cost of inventory in an interim or annual period.

Applying IAS 2 *Inventories*, inventories are measured at the lower of their cost and net realisable value (NRV). In a difficult economic environment, the NRV calculation may be more challenging and require more detailed methods or assumptions. Interim inventory impairment losses should be reflected in the interim period in which they occur, with subsequent recoveries recognised as gains in future periods.

In addition, manufacturing entities may have to reassess their practices for fixed overhead cost absorption if production volumes become abnormally low during the year as a result of plant closures or lower demand for their products. IAS 2 requires that variable production overhead costs should be allocated to each unit of production based on the **actual use** of the production facilities. It also calls for the allocation of fixed overhead costs to each unit of production based on the **normal capacity** of the production facilities. The COVID-19 pandemic may affect manufacturing entities in a number of ways (e.g. shortages of labour and materials or unplanned factory downtime) that, if sustained, may result in an abnormal reduction of an entity's production levels. In such circumstances, an entity should not increase the amount of fixed overhead costs allocated to each inventory item. Rather, the unallocated fixed overhead costs are recognised in profit or loss in the period in which they are incurred.

Costs to obtain or fulfil a revenue contract and up-front payments to customers

An entity may have recognised costs to obtain or fulfil a contract as an asset in accordance with IFRS 15 *Revenue from Contracts with Customers*. IFRS 15 provides guidance on determining the appropriate amortisation period and on recognising any impairment loss on such an asset. An entity may need to update its amortisation approach to reflect any significant changes in the expected timing of the transfer of the related goods or services. In addition, an entity must recognise an impairment loss if the carrying amount of the asset exceeds (1) the sum of the amount of consideration expected to be received and the amount of consideration already received but not yet recognised as revenue, less (2) the costs that are directly related to providing the remaining promised goods or services under the contract that have not been recognised as expenses. The consideration determined in (1) above should be adjusted to account for the customer's credit risk, and the amounts determined under both (1) and (2) should include the effects of expected contract renewals from the same customer. An entity may also need to consider whether contract modifications or changes in expectations regarding customer renewals affect the amortisation or recoverability of these revenue-related costs.

An entity may also have recognised up-front payments to customers as an asset that are reflected as a reduction in the transaction price. If so, it would be reasonable for the entity to perform similar analyses for any asset recognised for such up-front payments.

Further, an entity should evaluate contract assets for impairment by using the same model as customer receivables. See Financial Instruments for more information.

Financial Instruments

Allowance for expected credit losses (ECL)

COVID-19 can affect the ability of borrowers, whether corporate or individuals, to meet their obligations under loan relationships. Individual and corporate borrowers may have a particular exposure to the economic impacts in their geography and industry sector. More broadly, reductions in forecasts in economic growth increase the probability of default across many borrowers and loss rates may increase due to the fall in value of collateral evident more generally by falls in prices of assets.

Applying IFRS 9 *Financial Instruments*, an entity should measure ECL in a way that reflects:

- an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- the time value of money; and
- reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

The impact of COVID-19 on ECL will be particularly challenging and significant for banks and other lending businesses. The effect could also be significant for non-financial corporates. This is because ECL does not only apply to loans but also applies to many investments in interest bearing financial assets (e.g. bonds and debentures), trade receivables, contract assets, lease receivables, issued loan commitments and issued financial guarantee contracts. The extent of these exposures in non-financial corporates may also be greater in individual company financial statements due to intra-group transactions such as intra-group loans or guarantees provided by the reporting entity on other entities' debt obligations.

Under the general model for impairment ECL is recognised for 12-month ECL or lifetime ECL dependent on whether there has been a significant increase in credit risk ("SICR") of a financial asset (or other exposure) since initial recognition (a "staging" analysis). This analysis requires the estimate of lifetime probability of default at initial recognition of a financial asset and at each reporting date thereafter, based on an assessment of forward-looking information which is particularly challenging given uncertainties of the eventual impact of COVID-19. Despite the challenges, entities are still required to make estimates based on reasonable and supportable information that is available without undue cost or effort at the reporting date. Sources of such information can include information used in the entity's ongoing credit evaluation processes and financial forecasts for economies or industries that are becoming available over time. It is not expected that the difficulties associated with making estimates and assumptions in these uncertain times would be a basis for entities not to update ECL measurements.

Trade receivables

For entities with certain financial assets such as short term trade receivables and contract assets the complexity of the estimate of ECL is reduced due to the application of the simplified approach. Under this approach there is no requirement for a complex staging analysis to be performed as lifetime ECL is recognised from the date of initial recognition. However, measurement of lifetime ECL follows the same principles as under the general model.

In practice the measurement of ECL for portfolios of trade receivables does not usually require complex analysis. The average historical credit losses on a large group of trade receivables with shared risk characteristics may until now have been a reasonable estimate of the probability-weighted expected loss amount. A common example of a loss rate approach used for trade receivables is a provision matrix developed using historical credit loss experience. IFRS 9 requires that historical loss rates are adjusted as appropriate to reflect current conditions and estimates of future economic conditions. However, until now such adjustments may have been limited.

COVID-19 will require entities to revisit the provision matrix approach and consider the following:

- The amount and timing of the expected credit losses as well as the probability assigned to alternative scenarios must be based on reasonable and supportable information that is available without undue cost or effort at the reporting date without the use of hindsight. Entities will need to reconsider their previous credit loss expectations if these are based on unadjusted historical experience that is not reflective of the current market conditions and forward looking information. In many cases, this may require significant judgement given the uncertainties present (e.g. financial viability of debtors, levels of government support, etc.).
- There may be a lack of relevant historical data reflecting sufficiently adverse economic conditions on which to base the estimate. An entity may already be observing the default of debtors and will need to determine the impact that these observations have on expectations of recoveries and future default of other debtors.
- Operational disruption experienced by both customers and suppliers as well as moratoriums on debt repayments or enforcement actions may result in delays in the processing and settlement of transactions. Short-term trade receivables are recognised at their transaction price and consequently have an effective interest rate (EIR) of nil, and therefore a delay in collection will not result in an increase in the reported loss allowance (measured by discounting expected shortfalls at the asset's EIR). However, these delays introduce uncertainty as to whether the full amount will be recovered and this uncertainty is required to be reflected in the ECL measurement. In some cases the delays may be considered temporary. This may mean that previously determined loss rates for the individual "days-past-due" categories included in an entity's provision matrix may not be reflective of expected recoveries.
- Greater volatility in potential economic conditions, even over the relatively short exposure period of trade receivables, will increase the importance of considering multiple economic scenarios in determining expected loss rates.
- With greater incidence of individual receivables in default, loss rates may need to be applied to individual receivables or sub-portfolios of receivables if the receivables in the overall portfolio no longer exhibit similar credit risk characteristics. This may result in a requirement to apply the provision matrix at a more granular level or to assess a greater number of receivables on an individual basis. Entities should ensure that any estimate of ECL on an individual debtor reflects a probability-weighted outcome and that an appropriate loss allowance continues to be recorded on a collective basis for all receivables that are not assessed individually.

The above considerations also apply to contract assets.

Other receivables

Although a staging analysis may not be required for trade receivables and contract assets, most entities will have some financial assets that are accounted for under the general model rather than the simplified model for which a staging analysis will be needed. For example, intercompany receivables, lending balances with entities outside the group and receivables relating to business disposals. The impact of forward-looking information and multiple economic scenarios is also likely to be more significant for such assets.

Low probabilities of default may have meant in the past that ECL for these has not been material. This may no longer be the case given the increased weighting to negative economic scenarios and exposures to specific industry sectors or geographical areas that are most significantly affected by COVID-19. Entities will therefore need to reconsider the appropriateness of past methods for assessing ECL and ensure up to date inputs are used.

Credit Enhancements

Credit enhancements may become increasingly prevalent, particularly as a result of various central government and central bank programmes designed to support debtors and/or creditors. Such schemes should be carefully analysed to assess whether they affect the measurement of ECL. Only credit enhancements integral to the receivable and that are not separately recognised should be reflected in the measurement of the ECL. Amounts receivable from non-integral credit enhancements are not included in ECL measurement and are recognised separately.

Support of the economy in general or that is expected to be given directly to a debtor to assist them with repaying the amounts owed does not represent a credit enhancement but could nevertheless affect the ECL measurement (e.g. through reduced probability of default or reduced loss given default).

Issued financial guarantee contracts

Parent entities sometimes issue financial guarantee contracts (FGC) to lenders of their subsidiaries, associates or joint ventures that allow the lender to claim any losses suffered due to non-payment of those entities. These parent entities are required to recognise a liability for the issued FGC for the higher of the unamortised premium and the ECL determined in accordance with IFRS 9. When COVID-19 results in a higher risk of default this will lead to increased ECL amounts.

Fair value measurements

Fair value measurements of financial instruments should reflect market participant views and market data at the measurement date under current market conditions. Observable market data cannot be ignored even if depressed prices are considered temporary. Entities will need to pay particular attention to fair value measurements based on unobservable inputs (sometimes referred to as level 3 measurements) and ensure that the unobservable inputs used reflect how market participants would reflect the effect of COVID-19, if any, in their expectations of future cash flows, discount rates and other significant valuation inputs related to the asset or liability at the reporting date.

Liquidity risk management

Disruptions in production and reduced sales can have implications on an entity's working capital and could lead to a breach of a debt covenant resulting in the liability becoming current.

Entities may look for ways to manage this risk, including the use of alternative sources of funding, such as later payment to suppliers and arrangements with financial institutions such as supplier finance and reverse factoring which may permit the entity to draw down on finance in exchange for the financial institution paying the entity's suppliers. When entities have previously determined that liabilities to banks in these scenarios are presented as trade or other creditors rather than as borrowings, any increase in the repayment term will require a reassessment of the classification to ensure it remains appropriate. Disclosure of these facilities will be critical particularly when they are material to the entity's funding or viability.

Entities may also seek to obtain early settlement of their trade receivables via a financial institution buying the receivables at a discounted amount to the invoice amount. Such transactions should be carefully assessed to determine if derecognition of the factored receivables is appropriate.

Concentration risk may be particularly significant to some entities when customers are concentrated in an adversely affected industry such as the hospitality and tourism and airline industries. Such entities will need to give clear disclosure of the potential impact on liquidity if significant.

Entities should consider how the use of working capital enhancement or management techniques is reflected in the entity's disclosure of its liquidity risk management as required by IFRS 7 *Financial Instruments: Disclosures*. Entities should also consider the specific disclosure requirements for transfers of financial assets as required by IFRS 7 when financial assets are sold to fund working capital needs, and the accounting policies and judgements applied in determining the balance sheet and cash flow statement presentation of amounts due and paid when supplier finance and reverse factoring arrangements are used.

Entities may also need to reconsider the existing classification of certain investments as cash equivalents under IAS 7 *Statement of Cash Flows*. To be classified as a cash equivalent, an investment, for example in a money market fund, must be held for the purpose of meeting short-term cash commitments and must be readily convertible to known amounts of cash and subject to insignificant changes in value. Current economic conditions are likely to increase the volatility in prices of many investments and reduce their liquidity.

Classification of financial assets

Some entities may decide to sell receivables as part of their strategy to manage their credit and liquidity risks. Where such receivables are treated as "held to collect" and measured at amortised cost an increase in frequency and value of sales may result in the need to consider whether there has been a change in the entity's business model or whether a new business model has been initiated.

Entities should analyse any increase in sales to determine, among other things, whether the increase is expected to persist (for example if the sales are in response to temporary increases in credit or liquidity risk) or whether future sales volumes will be lower in frequency or value. Irrespective of their frequency and value, sales due to an increase in the assets' credit risk are not normally considered to be inconsistent with a held to collect business model because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows. Credit risk management activities that are aimed at minimising potential credit losses due to credit deterioration are integral to such a business model.

Some entities that have assets that are held under a "held to collect and sell" or "held to sell" business model may find that previously anticipated sales are no longer expected to take place due to a reduction in asset values or in the liquidity of the relevant market. IFRS 9:B4.4.3 states that neither a change in intention related to a particular asset (even in circumstances of significant changes in market conditions), nor a temporary disappearance of a particular market represent a change in an entity's business model.

Reclassifications triggered by a change in business model are expected to be highly infrequent and to incur only when the activity is significant to the entity's operations; they are applied prospectively from the reclassification date.

Debt modifications

In response to liquidity challenges, an entity's debtors may seek to renegotiate the terms of their arrangements with the entity. Where the entity grants such concessions and modifies the related contractual arrangements, the accounting impact of the modification must be assessed. Similarly, a reporting entity may itself experience liquidity or solvency challenges and seek to renegotiate terms of its borrowings or other liabilities resulting in amendments to existing agreements (either amendments to the cash flows or related covenants).
In respect of financial liabilities the entity must consider whether the modifications are substantial which typically involves qualitative factors as well as an assessment of whether the modifications result in a change in the net present value of the instrument's cash flows of more than 10 per cent (the "10 per cent test"). When a modification is substantial the existing financial liability is derecognised and the new liability is recognised at fair value resulting in a gain or loss. It is particularly important to note, however, that an adjustment to the carrying value will result even when the modification is not substantial (determined by discounting the revised cash flows at the original EIR).

Although IFRS 9 includes no specific guidance on accounting for modifications of financial assets and when they should result in derecognition, some entities have an accounting policy of applying the 10 per cent test to financial assets and accounting for a substantial modification as the extinguishment of the old asset and recognition of a new asset.

IFRS 9:5.5.12 provides specific guidance on how to apply the impairment requirements to scenarios when a modification of a financial asset does not lead to derecognition.

When intragroup funding arrangements are modified, consideration should be given to the identification of intergroup capital contributions or distributions. Entities should determine whether there has been impairment of a financial asset in advance of its modification. Thereafter, the difference between the carrying amount of the financial instrument derecognised and the fair value of the new financial instrument recognised may need to be allocated between a derecognition gain or loss and a capital contribution or distribution between parties under common control.

Changes in estimated cash flows

COVID-19 may result in a change in expectations regarding the exercise of prepayment, extension or conversion features in debt agreements. When such features are accounted for as bifurcated embedded derivatives or when the entire instrument is measured at fair value through profit or loss (FVTPL), changes in the likelihood of those features being exercised will be reflected in the fair valuation. When such features are accounted for as part of a host debt instrument that is measured at amortised cost, remeasurement adjustments recognised in profit or loss may still arise as the revised expected cash flows are discounted at the instrument's original effective interest rate. When a conversion feature is classified as equity, changes in expectations regarding its exercise would have no impact on the amount originally recorded in equity.

Hedge accounting

When a transaction has been designated as the hedged item in a cash flow hedge relationship the entity will need to consider whether the transaction is still a "highly probable forecasted transaction" and if not, whether it is still expected to occur. Hedged items in a cash flow hedge that could be affected due to COVID-19 include:

- Sale or purchase volumes that fall below the levels originally forecasted;
- Planned debt issuances that are delayed or cancelled such that interest payments fall below levels originally forecasted; and
- Business acquisitions or disposals that are delayed or cancelled.

If an entity determines that a forecasted transaction is no longer highly probable, but still expected to occur, the entity must discontinue hedge accounting prospectively and defer the gain or loss on the hedging instrument that has been recognised in other comprehensive income accumulated in equity until the forecasted transaction occurs. If the forecasted transaction is no longer expected to occur the entity must immediately reclassify to profit or loss any accumulated gain or loss on the hedging instrument.

When the expected timing of a designated hedged transaction changes, an entity is required to reassess whether the hedged transaction identified in the entity's hedge documentation is still the same hedged transaction (i.e. assess whether the hedged transaction is still expected to occur).

A change in the timing of a hedged forecast transaction when its occurrence remains highly probable may also have an effect on profit or loss. Hedge ineffectiveness can exist because a difference arises in the amount and/or timing of the hedged item and the hedging instrument. It is common for entities to determine a 'hypothetical derivative' to reflect the timing and amount of the hedged item and use the fair valuation of this to compare with the hedging instrument to determine the amount of hedge ineffectiveness to be recognised in profit or loss. As the timing and/or amount of the hedged item changes in response to economic conditions, entities should redefine the hypothetical derivative to ensure hedge ineffectiveness is appropriately recognised.
Finally, increases in credit risk may cause a hedge relationship to fail its hedge effectiveness assessment if credit risk dominates the value

changes resulting from the economic relationship between the hedging instrument and the hedged item.

Financial vs non-financial assets and liabilities

The significant disruption to supply and demand may result in net cash settlement of contracts to buy or sell commodities or other non-financial assets that were previously expected to be physically settled and were accounted for as own use contracts. The expected net cash settlement of contracts to buy/sell non-financial items (e.g. commodities) will bring those contracts in scope of IFRS 9 and may result in classification of the contracts as financial assets or liabilities.

Entities sometimes enter into transactions where cash is prepaid for the supply of non-financial items, e.g. for commodities such as oil. For the payer of the prepayment this may result in the recognition of a non-financial asset because it expects to receive the non-financial item and it meets the own use requirements in IFRS 9. Likewise, the receiver of the cash may recognise a non-financial liability because it expects to deliver the non-financial item and it meets the own use requirements in IFRS 9. Expected cash settlement of such contracts would result in them being treated as a financial instruments and classified as a financial asset or financial liabilities.

Revenue from contracts with customers

Business disruptions associated with the COVID-19 pandemic may prevent an entity from entering into customer agreements by using its normal business practices, which may make the determination of whether it has enforceable rights and obligations challenging. In addition, because many of its customers are experiencing financial difficulties and liquidity issues, an entity may need to develop additional procedures to properly assess the collectability of its customer arrangements and consider changes in estimates related to variable consideration (e.g. because of greater returns, reduced usage of its products or services, or decreased royalties). To help its customers or to provide incentives for them to continue purchasing its goods or services, an entity may (1) revise its agreements to reduce any purchase commitments; (2) allow customers to terminate agreements without penalty; or (3) provide price concessions, discounts on the purchase of future goods or services, free goods or services, extended payment terms or extensions of loyalty programmes. Further, because the entity itself may be experiencing financial difficulties and supply disruptions, it may (1) request up-front payments from its customers; (2) delay the delivery of goods or services; (3) pay penalties or refunds for failing to perform, not meeting service-level agreements, or terminating agreements; or (4) incur unexpected costs to fulfil its performance obligations. Therefore, as a result of the changes in circumstances experienced by both an entity and its customers due to the COVID-19 pandemic, an entity may need to consider the following when assessing revenue from contracts with customers:

- *Contract enforceability*—IFRS 15:9 provides criteria that need to be met to account for a contract with a customer, including the approval of the parties to the contract and a commitment to perform their respective obligations. If the criteria are not met, no revenue can be recognised until one of the following occurs: (1) the criteria are met; (2) no obligations to transfer goods or services remain and substantially all of the consideration promised by the customer has been received and is non-refundable; (3) the contract has been terminated and the consideration received is non-refundable.

  In certain circumstances, the parties may not be able to approve a contract under an entity's normal and customary business practices. For example, the entity may not be able to obtain the signatures it normally obtains when entering into a contract because personnel from the entity or customer are unavailable or otherwise unable to provide signatures. Therefore, it is important to carefully evaluate whether the approval process creates a contract with enforceable rights and obligations between the entity and its customer. In making this determination, an entity may consider consulting with its legal counsel. If enforceable rights and obligations do not exist, revenue cannot be recognised until certain conditions are met (see above paragraph).

  The effect of a "force majeure" clause allowing the parties to terminate a contract without incurring penalties in certain extraordinary circumstances will also need to be considered.

- *Collectability*—A contract with a customer does not exist unless it is probable that the entity will collect substantially all the consideration to which it will be entitled in exchange for the promised goods or services that will be transferred. The collectability of that consideration should be assessed after taking into account expected price concessions (including implied concessions), which are evaluated as variable consideration, even if those concessions are provided as a result of credit risk. In addition, whilst the collectability analysis is performed at the individual contract level, an entity may look to a portfolio of similar contracts (e.g., by risk profile, size of customer, industry, geography, etc.) in its assessment. For example, if it is probable that an entity will collect substantially all the consideration for 90 per cent of a portfolio of similar contracts, and the entity is unable to identify specific contracts for which consideration is unlikely to be collected (i.e. the risk is the same for all contracts), the entity may conclude that it has met the collectability threshold for all the contracts in the portfolio. However, an entity should not ignore evidence related to specific contracts that do not meet the collectability criterion. In that circumstance, it should evaluate those specific contracts separately.

  An entity should not reassess whether a contract meets the criteria in IFRS 15:9 after contract inception unless there has been a significant change in facts and circumstances. If the impacts of the COVID-19 pandemic result in a significant deterioration of a customer's or a portfolio of customers' ability to pay, the entity should reassess collectability. For example, if a customer experiences liquidity issues or a downgrade in its credit rating, the entity would need to carefully evaluate whether those circumstances are short-term in nature or result in a determination that it is no longer probable that the customer has the ability to pay. Because of the significant uncertainty associated with the effects of the pandemic, it is important for the entity to document the judgements it made and the data or factors it considered. If the entity concludes that collectability is not probable, a customer contract no longer exists and, thus, the entity can no longer recognise revenue under IFRS 15's 5-step model. If collectability becomes probable in a subsequent period and the other criteria in IFRS 15 are met, the entity can begin to recognise revenue again. See the discussion on contract enforceability above for conditions that need to be met to recognise revenue when an enforceable contract does not exist.

- *Contract modification*—An entity may modify its enforceable rights or obligations under a contract with a customer. For example, the entity may grant a price concession to a customer. In that circumstance, the entity should consider whether the concession is due to the resolution of variability that existed at contract inception (i.e. a change in transaction price associated with variable consideration) or a modification that changes the parties' rights and obligations. A price concession that is provided solely as a result of the COVID-19 pandemic most likely represents a modification that changes the parties' rights and obligations. In addition, an entity may modify the scope of a contract (e.g. by reducing minimum purchase commitments). If the modification adds goods or services to the contract, the entity should first evaluate whether the modification is accounted for as a separate contract in accordance with IFRS 15:20. However, if the only change to a contract is a reduction of the transaction price or the modification is not otherwise a separate contract applying IFRS 15:20, the entity should evaluate the guidance in IFRS 15:21 to determine whether the modification should be accounted for as (1) a termination of the old contract and the creation of a new contract because the remaining goods or services are distinct (which results in prospective treatment); (2) a cumulative catch-up adjustment to the original contract because the remaining goods or services are not distinct; or (3) a combination of (1) and (2). If all performance obligations have been satisfied, any price concession would be treated as a change in transaction price in accordance with IFRS 15:87-89.

- *Variable consideration*—Variable consideration includes, among other things, rebates, discounts, refunds (including for product returns), and price concessions In accordance with IFRS 15:56, an entity should only include amounts of variable consideration in the transaction price if (or to the extent that) it is highly probable that doing so would not result in a significant reversal of cumulative revenue recognised when the uncertainty related to the variable consideration is resolved. Further, an entity must update its estimated transaction price in each reporting period. The entity may need to consider any expected changes in (1) its ability to perform; and (2) customer behaviour that results from deteriorating economic conditions. For example, an entity may need to consider updating its estimated transaction price if it expects an increase in product returns, decreased usage of its goods or services or decreased royalties, or to potentially pay contractual penalties associated with its inability to perform (e.g. the inability to deliver goods or services on a timely basis or to meet service-level agreements). If there is a reduction in the estimated transaction price, a change in estimate may result in the reversal of revenue for amounts previously recognised as variable consideration (e.g. as a result of an increase in return reserves). Because of the significant uncertainty associated with the pandemic's effects on an entity and its customers, it may be challenging for the entity to make appropriate estimates of variable consideration. Therefore, in a manner similar to its assessment of contract collectability, an entity must document the judgements it made and the data or factors it considered, and ensure it has carefully considered how to constrain estimates of variable consideration.

Further, an entity may have a right to receive non-cash consideration (e.g. shares) from a customer that has declined in value. If the entity's accounting policy is to measure non-cash consideration at its estimated fair value at contract inception, any changes in the fair value of non-cash consideration after contract inception that are solely due to a decrease in value are not variable consideration and would not be reflected in the transaction price. Rather, the non-cash consideration should be accounted for under the applicable IFRS Standard.

- *Material right*—To mitigate any decline in sales, an entity may offer its customers sales incentives, including discounts on future goods or services. In this circumstance, the entity should evaluate whether a sales incentive on the purchase of future goods or services represents (1) a material right in accordance with IFRS 15:B40 that is associated with a current revenue contract (whether explicit or implicit because there is a reasonable expectation on the part of a customer that he or she will receive a sales incentive at contract inception); or (2) a discount that is recognised in the future upon redemption (i.e. when revenue is recognised for the related goods or services) in a manner consistent with IFRS 15:72.

  In addition, an entity may need to update its estimates for new contracts of the stand-alone selling price of a material right (e.g. because the entity extended the periods for use or provided additional incentives to a customer) or to reassess its breakage assumptions (e.g. because of extensions or changes in expected usage patterns). For example, an entity may modify its loyalty programme by extending customers' ability to use points; this change may require the entity to reassess the breakage assumptions it uses.

- *Significant financing component*—To assist customers that are experiencing liquidity issues in purchasing goods and services, an entity may provide extended payment terms. Similarly, an entity with liquidity issues may require its customers to make an up-front payment in order for the entity to fulfil its promised goods or services. In those circumstances, an entity should evaluate whether a significant financing component exists in accordance with IFRS 15:60-65. If an entity modifies payments terms for an existing customer contract, it should consider the guidance on price concessions discussed above.

- *Implied performance obligations*—An entity may assist its customers by providing them with free goods or services that are not explicitly promised in the contract. In a manner consistent with IFRS 15:24, an entity should determine whether its contracts with customers contain promised goods or services that are implied by its customary business practices or published policies or by specific statements that create a reasonable expectation of the customer that the entity will transfer those goods or services.

  There may also be instances in which an entity provides free goods or services to its customer that are not part of a prior contract with that customer (i.e. when the prior contract was entered into, there were no explicit or implicit obligations to provide those goods or services). An entity must carefully evaluate whether the additional promised goods or services are a modification of a pre-existing customer contract or a cost incurred that is separate from any pre-existing contracts. In these situations, it may be helpful to consider the contract combination guidance in IFRS 15:17, which specifies that contracts with the same customer (or related party of the customer) are combined, if (1) they are negotiated as a package with a single commercial objective; (2) the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or (3) there are goods or services in one contract that would be a single performance obligation when combined with the goods or services in another contract. In addition, an entity should consider the substance of the arrangement to provide the free goods or services and whether accounting for the arrangement as a separate transaction or as a contract modification would faithfully depict the recognition of revenue related to the goods or services promised to the customer in a pre-existing contract. In many cases, free goods or services provided to a customer solely as a result of the COVID-19 pandemic (that are not part of another newly entered contract with that customer) will not be considered a contract modification. However, an entity may need to determine whether it has developed a practice that creates an implied promise in future contracts.

- *Recognition of revenue*—Because of potential supply disruptions or other circumstances, an entity may need to reconsider the timing of revenue recognition if it is unable to satisfy its performance obligations on a timely basis. In addition, the entity must determine whether there are any contractual penalties that would affect the transaction price. In some cases, an entity may be completely unable to satisfy its performance obligation, which could result in (1) the termination of the contract, (2) a reversal of any revenue it previously recognised for a performance obligation that was not fully satisfied, and (3) the recognition of a refund liability (or additional liability due to a payment of penalties) instead of deferred revenue.

An entity may also incur unexpected costs in fulfilling a performance obligation that is satisfied over time. If the entity is using costs incurred to date as an input method to measure progress towards complete satisfaction of its performance obligation, it should be careful to ensure that revenue attributed to work carried out is not increased to offset additional costs incurred when abnormal or excessive costs arise as a result of inefficiency or error. In particular, IFRS 15:B19(a) states that, when using a cost-based input method, entities may be required to adjust the measure of progress when costs are incurred that are "attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract".

- *Disclosure requirements*—Many of the circumstances described above could affect an entity's disclosures. These include, but are not limited to, disclosures of significant changes in the contract asset due to an impairment, significant payment terms (including any significant financing component), and the timing of when an entity expects to recognise revenue for its remaining performance obligations (which would exclude terminated contracts or transactions that do not meet the criteria in IFRS 15:9 to be accounted for as a customer contract). Given the level of uncertainty caused by the COVID-19 pandemic, an entity may find it challenging to make certain critical estimates. Therefore, it is important for the entity to disclose any significant judgements and estimates it makes in accounting for its revenue contracts (e.g. assessing collectability; estimating and constraining variable consideration; measuring obligations for returns, refunds, and other similar obligations; measuring progress toward completion of a performance obligation recognised over time; and determining the stand-alone selling prices and breakage assumptions for material rights).

Restructuring plans

In a difficult economic environment and facing difficulties in obtaining financing, an entity may be considering or implementing restructuring plans such as the sale or closure of part of its businesses or the downsizing (temporarily or permanently) of operations. Plans such as these may require consideration of a number of issues, including whether:

- the entity has a detailed formal plan for the restructuring and has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it. If, and only if, both of these criteria are met a restructuring provision should be recognised; and
- any part of the business is available for immediate sale in its present condition and completion of such a sale within one year is highly probable. If so, the assets and liabilities to be disposed of are classified as held for sale applying IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and written down to their fair value less costs to sell if this is lower than their carrying amount.

Onerous contracts provisions

At the inception of an executory contract, both parties to the contract expect to receive benefits that are equal to or greater than the costs to be incurred under the contract. Because of the impacts of COVID-19, unavoidable costs of meeting the obligations under the contract may exceed the benefits expected to be received, resulting in an onerous contract. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires recognition of a provision in respect of an onerous contract.

Examples of contracts for which an onerous contract provision may be required include:

- Revenue from contracts with customers containing penalties for late or non-delivery;
- Increased costs of fulfilling a customer contract due, for example, to the replacement of staff who are infected, subject to quarantine or are otherwise restricted from travel; or having to purchase alternative raw materials at a higher price due to supply chain issues; and
- Lease contracts prior to the commencement date.

The provision recognised for an onerous contract should reflect the least net cost of exiting from the contract, i.e. the lower of:

- The cost of fulfilling the contract; and
- Any compensation or penalties arising from failure to fulfil the contract.

When assets dedicated to a contract are involved, however, a separate provision is recognised only after any impairment loss has been recognised in respect of those assets.

In determining the least net cost of exiting the contract, an entity should pay attention to terms of the contract that allow the entity to terminate the contract without incurring penalties in certain extraordinary circumstances ("force majeure"). If a contract includes such a force majeure provision that can be enacted by the COVID-19 pandemic, it may be that the contract is not onerous because the entity can avoid any further obligations.

Provisions should not be recognised in respect to:

- Penalties for failure to respect the terms of a contract when the event that triggers the penalty has not yet occurred: for example, a late delivery penalty may be incurred when goods are not supplied by a specified delivery date. Even though, at the reporting date, an entity may expect to deliver the goods late, the obligation to pay the penalty should not be recognised before the delivery due date. However, if the remaining part of the contract has, as a whole, become onerous as a result of the penalty clause, a provision should be recognised for any overall net loss expected to result.
- Leases (other than short-term leases and leases of low value assets accounted for in accordance with paragraph 6 of IFRS 16 *Leases*) that become onerous after their commencement date: these leases are dealt with instead applying the general requirements of IFRS 16. For example, an entity will determine and recognise any impairment of ROU assets applying IAS 36. However, an onerous contract provision may need to be recognised for non-lease components that are accounted for separately.
- Future operating losses: IAS 37 sets out two prohibitions on the recognition of provisions for future operating losses:
  - A general prohibition, on the grounds that there is no present obligation and thus no liability (albeit the expectation of future operating losses may indicate a need to test whether assets have been impaired).
  - A specific prohibition in respect of future operating losses up to the date of a restructuring (again on grounds that there is no present obligation, unless the losses relate to an onerous contract).

Insurance recoveries

Entities that incur losses stemming from the COVID-19 pandemic may be entitled to insurance recoveries. For example, losses associated with increased medical claims, asset impairments, or shareholder litigation may be considered insured losses by many entities. Furthermore, entities may have a business interruption insurance that provides coverage for lost profits due to a suspension of their operations. It may also be the case that an entity with a present obligation can seek reimbursement of part or all of the expenditure from another party, for example via an insurance contract arranged to cover a risk, an indemnity clause in a contract or a warranty provided by a supplier.

The basis underlying the recognition of a reimbursement is that any asset arising is separate from the related obligation. Consistent with the requirements of IAS 37 on contingent assets, such a reimbursement should be recognised only when it is virtually certain that it will be received if the entity settles the obligation.

Note that it is the existence of the reimbursement asset that must be virtually certain, rather than its amount. An entity may be virtually certain that it has insurance to cover a particular provision, but it may not be certain of the precise amount that would be received from the insurer. Provided that the range of possible recoveries is such that the entity can arrive at a reliable estimate, it will be able to recognise this as an asset, even though the amount ultimately received may be different.

However, a conclusion that potential insurance recovery is virtually certain will involve significant judgement and should be based on all relevant facts and circumstances. In determining whether the threshold for recognition of a reimbursement asset is met, an entity will most likely, among other factors, need to understand the solvency of the insurance carrier and have had enough dialogue and historical experience with the insurer related to the type of claim in question to assess the likelihood of payment. Other potential challenges an entity may encounter when evaluating whether a loss is considered recoverable through insurance include, but are not limited to, (1) the need to consider whether losses stemming from a pandemic are specifically excluded as a covered event; (2) the extent of coverage and limits, including multiple layers of insurance from different carriers; and (3) the extent, if any, to which the insurance carrier disputes coverage. Consultation with legal counsel may also be necessary.

When a reimbursement asset is recognised, its presentation is as follows:

- In the statement of financial position, a separate asset is recognised (which must not exceed the amount of the provision).
- In profit or loss, a net amount may be presented, being the anticipated cost of the obligation less the reimbursement.

Lease contracts

As a result of the COVID-19 pandemic, certain entities are experiencing significantly reduced consumer traffic in retail stores and shopping areas, or indefinite closures due to quarantine measures and other government directives.

Impairments to right-of use (ROU) assets could occur as a result of business closures, supply chain disruption, or other consequences of the pandemic that negatively affect the future cash flows expected to be derived from the use of the underlying asset. ROU assets measured applying a cost model are carried at cost less any accumulated depreciation and any impairment losses (and adjusted for specific remeasurement of the lease liability). Impairment is assessed applying the requirements in IAS 36 discussed above.

Lessees in some affected markets are receiving rent abatements or other economic incentives.

Generally, the accounting treatment for lease rent concessions will depend on whether (1) the lessee was entitled to the economic relief (i.e. the contractual arrangement or jurisdictional laws provide an enforceable right) or (2) the relief was given or negotiated outside the original agreement. In determining whether the lease contained an entitlement to relief, an entity should consider contractual provisions governing the occurrence of extraordinary events (e.g. a force majeure clause or similar provision). Depending on the complexity of the arrangement and the legal framework in the applicable jurisdiction, the entity may need assistance from legal counsel.

Economic relief that was given or negotiated outside the original agreement most likely represents a lease modification, in which case the lessee applies the requirements in IFRS 16:44-46 and the lessor applies the requirements in IFRS 16:79-80 if the lease being modified is a finance lease and in IFRS 16:88 if it is an operating lease.

For the lessee, this means that if the economic relief affects only the lease payments but does not change the scope of the lease (i.e. there is no change in the assets leased or in the duration of the lease term), the lease liability would be remeasured by discounting the revised lease payments using a revised discount rate, and a corresponding adjustment would be made to the right of use asset.

If the lessee was entitled to the economic relief because of either contractual or legal rights, the relief would be treated as variable rent (i.e., negative variable rent) in the period incurred. The lessee would then recognise variable lease payments in profit or loss when the associated variability or conditionality is resolved.

The above discussion addresses relief received from a lessor (either contractually or through negotiation). In some jurisdictions, tenant relief is provided by governments as subsidies in support of the economy. If the lessee receives the relief directly from the government, the tenant relief is accounted for as a government grant applying IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. If the government relief is provided to the lessor who then passes it to the lessee, careful assessment is needed to establish whether the lessor is acting as an agent and the relief to the lessee is a government grant or whether the relief to the lessee is provided by the lessor and thus is a lease modification.

Consolidation

The COVID-19 pandemic may give rise to specific transactions or events that could change a reporting entity's governance rights over other legal entities and thereby affect accounting conclusions for consolidation.

In particular, loan agreements will commonly confer upon the lender rights that can be exercised in the event of the borrower breaching a loan covenant and/or defaulting on payments due under the loan agreement (e.g. the right to seize an asset provided by a borrower as collateral). Frequently, such rights are regarded as 'protective rights' and, consequently, are not considered to give the lender power over (and consequently control of) the borrower. However, in some circumstances, the rights are not merely protective and may give the lender power over the borrower on the occurrence of a breach or default.

When a lender's rights under a loan agreement are enforceable upon default or breach of a loan covenant by the borrower, in some circumstances the lender will have obtained control of the borrower. In determining whether it has obtained power over a borrower defaulting on a loan or breaching a covenant, a lender should consider:

- Whether the lender's rights are regarded as protective in nature both before and after the default or breach and hence do not give the lender power over the borrower;
- Whether the lender's rights have been amended as a result of the default or breach to give the lender power over the borrower; or
- Whether the terms of the loan agreement were originally designed to give power in the event of a default or breach.

When the rights give the lender power over the borrower in the event of a default or breach, if the other two elements of control exist (i.e. the exposure or rights to variable returns and the ability to use the power to affect the investor's returns), the lender has control over that entity.

Defined benefit plans

The significant economic uncertainty associated with the COVID-19 pandemic will affect the measurement of defined benefit obligations and plan assets.

IAS 19 *Employee Benefits* requires an entity to determine the present value of defined benefit obligations and the fair value of plan assets at the end of each reporting period. It encourages an entity to involve a professionally qualified actuary in measuring the obligations.

An entity's considerations related to the fair value measurement of financial and non-financial assets also apply to the measurement of plan assets under IAS 19. Pension plans may hold significant amounts of assets that do not have an active market, such as investments in hedge funds, structured products, and real estate assets that may become more illiquid, making their valuation more complex. Appropriately determining the fair value of such assets is important in the determination of the funded status of a defined benefit plan.

Share-based payments

Some businesses may cease operations or operate at reduced capacity as a result of the impacts of COVID-19, which could affect the probability that vesting conditions for share-based payments with performance conditions will be met. IFRS 2 *Share-based Payment* requires entities to recognise compensation expense for a share-based payment arrangement with a performance condition in situations in which the outcome of the performance condition is probable. For example, if an award contains a performance condition that affects vesting (such as an award that vests if a certain growth in profit is met) and it is not probable that the performance condition will be satisfied, any previously recognised compensation expense should be reversed.

In addition, entities may decide to modify the terms or conditions of an equity-settled award, for example a change in the fair value-based measure, vesting conditions, or classification of the award. As a result of the modification, entities may need to recognise additional compensation expense for any incremental value provided (if the modification increases the fair value of the awards or additional awards are granted), or adjust the probability that the awards will vest in measuring compensation expense (if the vesting conditions are changed in a manner beneficial to the employees).

Other employee benefits (including termination benefits)

Entities may be considering (or implementing) restructuring plans to mitigate their exposures associated with unforeseen consequences of the COVID-19 pandemic. Immediate actions may include measures to reduce their workforce through temporary employee layoffs. Further, entities may be forced to consider subsequent restructuring actions as information becomes available on the long-term effects of the pandemic on an entity's operations. In addition, in certain jurisdictions, governments may facilitate programmes to alleviate some or all of those costs (see the Government Assistance below discussion for further detail). In determining how to account for these measures, entities must start by identifying the nature and characteristics of each proposed action that is being considered because it may affect the timing of the recognition of the benefits provided to employees:

- *Stay bonus*—Some entities may offer special bonuses to employees as a reward for them working in these difficult conditions. Payments of these bonuses may be contingent on the employees continuing to provide services until a certain date. In such circumstances, the plan creates a constructive obligation as employees render service that increases the amount to be paid if they remain in service until the end of that specified period. The fact that some employees may leave without receiving payments offered under the bonus plans is reflected in the measurement of the obligation. It is not appropriate to defer recognition of the obligation until the employee completes the entitlement period.

- *Salary continuation, temporary suspension of employment*—Some entities may offer to continue to compensate employees even though they are not actively working during the suspension period, keeping the right to call employees back to work as necessary and preventing employees from taking up work elsewhere during the suspension period. When an entity uses a temporary suspension arrangement of this nature in order to reduce its employment costs during periods of reduced activity, the costs of the temporary suspension should be classified as a short-term benefit similar to a paid absence (e.g. holiday or leave pay). Short-term paid absences only give rise to a liability when they are accumulating, as discussed in IAS 19:13 and 18. This is not the case in the circumstances described, because the employees only have a right to receive payments as suspension occurs and for as long as suspension lasts. The entity has the discretion to ask some or all of its employees to return to work when the conditions will permit and revert to normal working arrangements and remuneration. Therefore, in these circumstances, the costs of suspension should be recognised over the suspension period and should not be accrued at the outset. Note that, in the circumstances described, the payments should not be classified as termination benefits; they are paid in exchange for suspension of the employees' employment rather than in exchange for termination of the employees' employment (as would be required under the definition of termination benefits in IAS 19:8)

- *Termination benefits*—If benefits are provided by the entity as a result of termination of employment, the entity should recognise its obligation at the earlier of either the date when it can no longer withdraw the offer of those benefits or the date when it recognises costs for a restructuring that is within the scope of IAS 37 and involves the payment of those termination benefits. IAS 19 provides further guidance to establish the date when the entity can no longer withdraw the offer. In particular, IAS 19:167 specifies that when the termination benefits are payable as a result of an entity's decision to terminate an employee's employment, the entity can no longer withdraw the offer when the entity has communicated to the affected employees a plan of termination meeting all of the following criteria:
  - Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made;
  - The plan identifies the number of employees whose employment is to be terminated, their job classifications or functions and their locations (but the plan need not identify each individual employee) and the expected completion date; and
  - The plan establishes the termination benefits that employees will receive in sufficient detail such that employees can determine the type and amount of benefits they will receive when their employment is terminated.

The measurement requirements for termination benefits are determined in accordance with their nature. Accordingly, as indicated in IAS 19:169, an entity should measure termination benefits as follows:

- If the termination benefits are an enhancement to post-employment benefits, IAS 19's requirements for post-employment benefits should be applied; otherwise

- If the termination benefits are expected to be settled wholly before 12 months after the end of the annual reporting period in which the termination benefit is recognised, IAS 19's requirements for short-term employee benefits should be applied; and

- If the termination benefits are not expected to be settled wholly before 12 months after the end of the annual reporting period, IAS 19's requirements for other long-term employee benefits should be applied.

Long-term intra-group foreign investments

Paragraph 48 of IAS 21 *The Effects of Changes in Foreign Exchange Rates* provides an exception that allows gains and losses on certain intra-group foreign currency items of a long-term investment nature to be recognised in other comprehensive income instead of being recognised in profit or loss. For an item to qualify as a long-term investment, the entity must be able to assert that “settlement is neither planned nor likely to occur in the foreseeable future”. An entity that has characterised an intra-group item as part of its net investment in the entity may need to reassess whether that designation is still appropriate in the current economic environment. For example, an entity that plans to undergo restructuring because of the COVID-19 pandemic may need to reassess whether certain intercompany loans that had previously been determined to be of a “long-term investment nature” should continue to be accounted for as such if the loans could now be settled in the “foreseeable future” in connection with the restructuring plan.

Government assistance

In response to the COVID-19 pandemic, governments in many jurisdictions are considering, or have implemented, legislation to help entities that are experiencing financial difficulty stemming from the pandemic. Such assistance may be in the form of income-based tax credits that are dependent on taxable income or other forms of relief that is not dependent on taxable income (e.g. payroll tax credits, tenant reliefs and other similar subsidies).

IAS 20 has a broad scope exemption encompassing “government assistance that is provided for an entity in the form of benefits that are available in determining taxable income or are determined or limited on the basis of income tax liability”. Additionally, IAS 12 *Income Taxes* excludes from its scope government grants and investment tax credits. Therefore, a first step in accounting for the various measures offered by a government is determining whether they should be accounted for applying IAS 20 or IAS 12.

Some relief programmes will clearly be in the scope of IAS 20 because they are calculated and distributed to an entity without any link to taxable income (this may be the case for subsidies granted with respect to salaries of employees on temporary suspension). Other relief programmes will be clearly in the scope of IAS 12, for example, deferral of payment of income tax or temporary changes in the income tax rate applicable to an entity.

When a government provides support to an entity through investment tax credit, it is a matter of judgement under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to determine the most appropriate accounting treatment. It may be appropriate to analogise to IAS 12 or IAS 20. Generally, if an approach similar to IAS 12 is adopted, a credit will be recognised in profit or loss as part of income tax expense/income, and the related asset in the statement of financial position, when the entity satisfies the criteria to receive the credit (and the government measure is substantively enacted). If the substance of the arrangement is considered to be closer to a government grant, and an IAS 20 approach is adopted, the credit will be recognised in profit or loss over the periods necessary to match the benefit of the credit with the costs for which it is intended to compensate.

Government support may also be provided as forgivable loans or low interest loans. A forgivable loan from government, for which the government has undertaken to waive repayment under certain prescribed conditions, is treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan. The benefit of a government loan at a below-market rate of interest is also treated as a government grant. The loan is recognised and measured in accordance with IFRS 9. The benefit of the below-market rate of interest is measured as the difference between the initial carrying amount of the loan determined in accordance with IFRS 9 and the proceeds received. This benefit is accounted for in accordance with the general principles of IAS 20. The entity is required to consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

The effect of a government grant in the scope of IAS 20 is recognised when, and only when, there is reasonable assurance that the entity will comply with the conditions attaching to it and that the grant will be received. A grant related to income (e.g. reimbursement of employment costs) is recognised as part of profit or loss either, as an accounting policy choice:

- Separately or under a general heading such as ‘other income’; or
- As a deduction in reporting the related expense.

A grant related to the acquisition of an asset is recognised in the statement of financial position either, as an accounting policy choice:

- Recognising the grant as deferred income, which is recognised in profit or loss on a systematic basis over the useful life of the asset; or
- Deducting the grant in calculating the carrying amount of the asset, in which case the grant is recognised in profit or loss over the life of a depreciable asset by way of a reduced depreciation expense.

An entity that has benefited from government assistance will need to consider the disclosure requirements in IAS 20. In particular, it should disclose the nature and extent of the government grants recognised and provide an indication of the other form of government assistance from which it has benefited. Any unfulfilled conditions and other contingencies attaching to the government assistance should also be disclosed.

Income tax

Entities should consider how profitability, liquidity, and impairment concerns that could result from the impacts of COVID-19 might also affect their income tax accounting under IAS 12. For example, a reduction in current-period income or the actual incurrence of losses, coupled with a reduction in forecasted income or a forecast of future losses, could result in a reassessment of whether it is probable that some or all of an entity's deferred tax assets can be recovered. Such assessments will be particularly challenging in situations in which the changes in current and projected future profitability actually result in, or are expected to result in, cumulative losses and the entity has not had a stable earnings history before the impacts of COVID-19. If declining earnings or impairments generate losses, entities also need to evaluate whether there is sufficient income of the appropriate character to fully realise the related deferred tax asset.

The rate and tax base used to calculate the deferred tax balances should reflect the manner in which the entity expects, at the end of the reporting period, to recover the asset or settle the liability. Accordingly, entities will need to consider whether strategies considered to address the challenges brought by the COVID-19 pandemic have an effect on the recognition and measurement of deferred tax amounts. This may be the case for example, if an entity plans to sell an asset to improve liquidity and the tax consequences of selling an asset are different from those resulting from using the asset in operations (the original intent of the entity).

Deferred tax consequences of adjustments to the carrying amounts of assets and liabilities (for example, as a result of impairment losses or decreases in the value of a pension surplus) will also need to be considered.

As permitted by IAS 12, an entity may have not recognised deferred tax liabilities for taxable temporary differences associated with subsidiaries, branches and associates, and interests in joint arrangements, because it controls the timing of the reversal of the temporary difference and it has been probable until now that the temporary difference will not reverse in the foreseeable future. Conversely, it may have recognised deferred tax assets for deductible temporary differences associated with such investments because it was probable that the temporary difference would reverse in the future (and it was probable that the deferred tax asset could be recovered). It may be appropriate to reconsider these conclusions if there is a change in intent with respect to repatriation of undistributed earnings in an investee to help with liquidity issues.

Tax relief and credits determined to be in the scope of IAS 12 should be reflected in the recognition and measurement of tax amounts only when the tax measure is substantively enacted. The assessment of whether a measure is substantively enacted depends on the relevant local legislative process. When an entity is uncertain of whether it will meet the conditions to be eligible for a substantively enacted tax measure, it should apply the requirements of IFRIC 23 Uncertainty over Income Tax Treatments. If an entity concludes that it is not probable that a taxation authority will accept its tax treatment, the entity should reflect the effect of the uncertainty in determining the related tax balances.

Other uncertain tax positions may also arise as a result of the consequences on the entity of the COVID-19. This may be the case for tax positions related to transfer pricing arrangements, where previously prepared benchmarking studies to support the policy may no longer be valid. Here again, the requirements of IFRIC 23 would apply.

Some jurisdictions establish whether an entity is subject to taxation in a jurisdiction based on residency, often determined by a "central management and control" test, which is determined based on factors such as physical attendance at board meetings. Travel restrictions may require entities to consider whether they have met all of the requirements to be subject (or not subject) to taxation in a jurisdiction.

Breach of covenants

Unstable trading conditions and shortages of cash flows in the affected regions may increase the risk that entities breach financial covenants. Entities should consider how the breach of a loan covenant may affect the timing of repayment of the related loan and other liabilities (e.g. it becomes repayable on demand) and how it affects the classification of the related liabilities at the reporting date.

If a breach occurs on, or before, the reporting date and the breach provides the lender with the right to demand repayment within 12 months of the reporting date, the liability should be classified as current in the entity's financial statements in the absence of any agreements made prior to the reporting date that give the entity a right to defer payment beyond 12 months after the reporting date.

In contrast, a breach of loan covenants after the reporting date is a non-adjusting event that should be disclosed in the financial statements if the information is material (including the stage of the discussions with lenders to address the breach, if applicable). A breach after the reporting date could create uncertainty that raises substantial doubt about the entity's ability to continue as a going concern.

Distributable profits

Entities operating in jurisdictions where distributable profits are established on the basis of profits determined in accordance with IFRS Standards, will need to consider how the effect of the COVID-19 pandemic on their financial statements may affect their ability to declare dividends.

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5	**SUBJECT:**	Strategic Internal Audit Plan 2020/21- 2022/23
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Summary

Internal audit is a dynamic function involved in helping an organisation achieve its objectives. It is concerned with evaluating and improving the effectiveness of risk management, control and governance processes. Although it is not an activity required by the *Local Government Act 1995* (Act), it is considered to be an essential part of achieving best practice in risk management and effective and efficient internal controls.

The City of Mandurah's (the City) internal audit function has now been established and is due for implementation in 2020/21 financial year.

The Audit and Risk Committee are requested to review the City's Strategic Internal Audit Plan 2020/21 - 2022/23, Internal Audit Charter, Internal Audit Plan and amendments to the Audit and Risk Committee Terms of Reference before the documents are presented to Council for adoption.

Disclosure of Interest

Nil.

Previous Relevant Documentation

- G.8/11/18 November 2018 Part Implementation of Internal Audit Function
- AR.7/5/17 May 2017 Internal Audit Function: Proposed Approach
- G.20/5/16 May 2016 Implementation of an Internal Audit Function
- G.11/11/14 November 2014 Development of an Internal Audit Function
- G.17/7/14 July 2014 Role of Internal Audit

Background

Establishment of Internal Audit Function

A report from the Chief Executive Officer and Financial Manager to the Audit and Risk Committee (Committee) on 9 May 2016 resulted in Council endorsing the establishment of an Internal Audit function within the City during the 2017/2018 financial year subject to approved funding.

A further report was presented to the Audit and Risk Committee on 4 November 2018, whereby, the Committee received the Audit and Risk Committee Terms of Reference, Internal Audit Charter and the Internal Audit Manual. At the Ordinary Council Meeting held on 8 November 2018, Council resolved to implement an internal audit function for the 2017/2018 financial year. However, due to a restructure of the organisation and removal of the budget, the establishment of the internal audit function was delayed.

External Audit

In accordance with section 7.3 of the Act, if a local government has an audit contract in force, Council is required to appoint auditors on the recommendation of the Audit and Risk Committee. The auditors referred to in the Act are external auditors appointed for the purposes of conducting an external audit providing assurance of the accuracy of the City's Annual Financial Report. The City has an audit contract in force until 30 June 2020. From 1 July 2020, the City will fall under the Office of the Auditor General audits and the Committee will no longer be required to recommend to Council the appointment of auditors.

Whilst some testing is conducted on the effectiveness of the City's internal controls and other policies and procedures, the tests are primarily performed to satisfy the needs of external stakeholders and do not necessarily consider the goals and objectives of the organisation.

From 2020/21, the City will be audited by the OAG and will follow the same audit regime applied to Western Australian public authorities for the preparation of the annual financial statements.

Legislative Audit Framework

Regulation 17 of the *Local Government (Audit) Regulations 1996* (Audit Regulations) requires a triennial review of the appropriateness and effectiveness of a Local Government's systems and procedures in relation to risk management, legislative compliance and internal control. Internal audit is an essential function in meeting the requirements of this regulation.

Regulation 14 of the Audit Regulations requires the City to carry out a compliance audit each year and submit a Compliance Audit Return to the Department of Local Government, Sport and Cultural Industries (DLGSC). The auditable areas are determined by the DLGSC, however they focus on compliance by City staff and Elected Members with the Act, concentrating on areas of compliance considered 'high risk'.

Regulation 5(2)(c) of the *Local Government (Financial Management) Regulations 1996* (Financial Management Regulations) requires the CEO to undertake a review of the appropriateness and effectiveness of the financial management systems and procedures of the local government regularly (and not less than once in every 3 financial years) and report to the local government the results of those reviews.

Comment

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

In addition to supporting good internal governance and ongoing improvements to the City's operations, internal audit should also help to instil public confidence in the City's ability to operate effectively.

An effective internal audit function should evaluate and monitor the adequacy and effectiveness of the internal control framework as a minimum. Risk management is also an essential part of the City's management and internal control function. It looks at what risks the City may face and the best way to address these risks. Assessment and management of risk is central to determining internal audit activities.

The purpose of the City's internal audit function is to:

- Provide independent, objective assurance and consulting services designed to add value and improve the City's operations;
- Enhance and protect organisational value by providing risk-based and objective assurance, advice and insight; and
- Help the City accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management and control processes.

The three-year Strategic Internal Audit Plan (SIAP) (refer ***Confidential Attachment 5.2***) provides an outline of the areas the City considers to be a priority for review, using a risk-based approach. The SIAP is based on a risk assessment of the City's key strategic and operational areas to determine the appropriate timing and frequency of coverage of each of these areas. The auditable areas extend beyond traditional areas of audit such as financial or Occupational Safety and Health (OSH) into areas such as internal governance, broader regulatory risk and asset management.

The SIAP identifies 15 Internal Audit areas:

1. Financial Management Systems and Procedures
2. Risk Management, Internal Controls and Compliance
3. Statutory Compliance – Governance and Elected Members
4. Statutory Compliance – Compliance Services, Building Services, Public Health

5. Procurement
6. Contract Management
7. Information Technology
8. Records Management
9. Human Resources
10. Community Grants and Sponsorships
11. Lease, licences and agreements
12. Asset Management
13. Natural and Built Environment
14. Project and Program Management
15. Occupational Safety and Health

The SIAP has been developed by:

- Reviewing relevant parts of the Council's strategic and operational risk profile;
- Consultation with Executive Leadership and Management Team;
- Assurance mapping activity to consider the key risks to the City in achieving its objectives and performance expectations;
- Implementing recommendations from internal audit activities undertaken by the City in the 2019/20 financial year; and
- Considering financial audits or performance audits performed by the OAG since 2017.

Underpinning the SIAP is an annual Operational Internal Audit Plan (OAIP) which establishes the auditable areas for each financial year, the audit objectives, indicative scope, estimated hours/costs and the proposed audit timeframe. Dependant on budget availability, the City will aim to conduct between five and seven internal audits per financial year.

For the 2020/21 financial year six auditable areas have been identified. These consist of audits/reviews required by legislation including the Compliance Audit Return as per Regulation 14 of the Audit Regulations and the Financial Management Review required to be conducted every three years in accordance with Regulation 5(2)(c) of the Financial Management Regulations.

Four other areas have been identified and are considered to have a high inherent risk rating. These include procurement, contract management, Occupational Health and Safety and information security.

An overview of the rationale for selecting each auditable area for 2020/21 financial year is set out in the table below:

Auditable area	Rational for Selection	Audit Inherent Risk Rating
Financial Management Review	Review is required to be undertaken every three years in accordance with regulation 5(2)(c) Financial Management Regulations. This review will be undertaken by an internal audit service provider.	High
Procurement	The City procures $129,864,000.00 from suppliers each financial year. Compliance audit is necessary to ensure procurement is being conducted in accordance with Council policies and City procedures, ensuring that the City achieves best value for money from procurement, while maintaining probity and public confidence. There have been limited procurement audits conducted in previous years. This review will be undertaken by an internal audit service provider.	High

Contract Management (City-wide)	Contracts, if not managed consistently are susceptible to scope creep, cost blowouts and poor supplier management resulting in substandard deliverables. A compliance audit is required to ensure that the City's contract management practices are being conducted in accordance with the regulations and Council Policy. There have been limited contract management audits conducted in previous years. This review will be undertaken by an internal audit service provider.	High
Compliance Audit Return	Audit required to be completed once per year in accordance with regulation 14 of the Audit Regulations. The audit will be undertaken in-house by Governance Services.	High
Information Technology Cyber Security Audit	The threat of cyber attacks continues to be a challenge for the City. The internal audit will test systems to ensure adequate cyber preparedness. This audit will be undertaken by a specialised consultant.	High
OSH	Follow-up audit to ensure the City is on track for delivering three-year OSH audit objectives. Audit will be undertaken by the Local Government Insurance Scheme.	High

The internal audit activity will include:

- Review of the internal control structure, monitoring how efficient the use of operations of the information system and providing recommendations for improvements;
- A risk assessment with the intention of minimising exposure to all forms of risk on the local government;
- Examination of financial and operating information that includes detailed testing of transactions, balances and procedures;
- Consider misconduct and fraud risk mitigation;
- A review of the efficiency and effectiveness of operations and services including non-financial controls of a local government;
- A review of compliance relevant legislation, Council and CEO policies and procedures and any other internal requirements; and
- Specific tasks requested by Executive Leadership Team and Management.

As the Internal Audit Function is a new a deliverable for the City, it is appropriate that the internal audit plan seeks to adapt to the changing environment the City operates and be flexible and responsive to the City's needs. The SIAP will be reviewed by Executive Leadership Team on a yearly basis to ensure that the internal audit function is delivering upon the established objectives and the function will be further strengthened and adjusted in subsequent years. Any recommended changes will be presented to the Audit and Risk Committee for consideration.

Adding Value

It is envisioned that the Internal Audit Function will generate significant improvements to internal controls, risk management and systems across all business areas. The establishment of this function also recognises the importance of good governance and aims to build a strong culture of the benefits for continuous improvement and best practice.

One of the primary objectives of the internal audit function is to add value to the City's operations. Adding value involves taking a proactive approach with a focus on risk, organisational concerns and effective controls at a reasonable cost.

By focusing audit work on high risk areas, the City will benefit from independent assessments of systems and controls and gain independent assurance on whether those systems are operating efficiently and effectively. The City will aim to deliver a preventative auditing approach, rather than relying on internal audits to detect issues and exceptions after they have already eventuated.

Delivery of the Internal Audit Function

Pursuant to section 5.41 of the Act, the CEO is responsible for the day-to-day management of the City's activities including the direction of staff and implicitly the internal audit function.

The CEO may choose to delegate this responsibility to the Chief Audit Officer (Director of Corporate Services) provided that the delegation does not directly or indirectly interfere with the ability of the internal auditor to conduct an internal audit function free from interference.

To ensure an objective and independent approach to internal audit, the audits and reviews will be conducted for the most part, by internal audit service providers or specialised consultants. A clear and properly defined reporting relationship ensures that the internal auditor is empowered to perform their role working with management.

Reporting

A key role of the Audit and Risk Committee is to receive and review reports of internal audits, review the extent to which management reacts to matters raised by those internal audits, and monitor the implementation of action plans developed in response to those matters.

Reports from internal auditor service providers or specialised consultants will be provided to the Audit and Risk Committee for review of the recommendations. This reporting line to the Audit and Risk Committee acts as an adequate safeguard in the event of a serious breakdown in internal controls or internal control culture at senior levels in the organisation.

The auditor's report will be accompanied by a management comment against each of the areas identified for improvement, the proposed actions to be taken and the timeframe for implementation.

Reporting on the progress of the implementation of improvements, is a crucial component of the internal audit function. It enables both the Audit and Risk Committee and the Executive Leadership Team the ability to review the actions taken by the business areas and monitor the City's implementation of improved controls and systems relating to the particular auditable area.

Two levels of reporting are proposed:

1. Audit and Risk Committee will receive a SIAP Monitoring Report on a quarterly basis. This report will set out the internal audit findings, recommendations, City's actions and progress update.

2. Executive Leadership Team will receive an OIAP Monitoring Report on a monthly basis which is approved by the CEO. The responsible Director will ensure business areas provide a monthly update on the implementation of the agreed action plans.

Role of Audit and Risk Committee

As prescribed in section 16 of the Audit Regulations, the Audit and Risk Committee is to provide guidance and assistance to Council on matters relevant to the Audit and Risk Terms of Reference.

The Audit and Risk Committee Terms of Reference adopted by Council on 29 October 2019, states that the Committee has the responsibility for the *appointment of any internal audit service provider*.

This role is considered not necessary if the Audit and Risk Committee has extensive oversight and approves the Internal Audit Charter, Internal Audit Manual, setting direction of the Strategic and Internal Audit Plans (which includes the scope) and reviewing recommendations arising from internal audit services.

The sourcing of internal audit service providers will be conducted in accordance with the City's Procurement Policy and the appointment will be approved by ELT.

Minor amendments to the Committee's role in the internal audit function are recommended. In the context of internal audit, the Committee's role and functions is outlined below:

- Monitor and receive reports concerning the development, implementation and on-going management of the City's internal audit function;
- Receive and review reports from the CEO under regulation 17(3) and report to Council the results of its review;
- Approve the Internal Audit Charter, Internal Audit Manual, Strategic and Operational Internal Audit Plans and recommendations arising from internal audit services; and
- Receive and review reports of internal audits, review the extent to which management reacts to matters raised by those internal audits, and monitor the implementation of action plans developed in response to those matters.

Refer to ***Attachment 5.1*** Audit and Risk Committee Terms of Reference, whereby minor amendments have been tracked.

Internal Audit Charter and Manual

The City's internal audit function is developed in accordance with the Institute of Internal Auditors' (IIA) International Professional Practices Framework (IPPF).

It is noted that the Office of the Auditor General recognises the IPPF as the appropriate standards for internal audit and due to this and a number of other reasons, takes into consideration internal audit activities of the organisations it audits with respect to the conduct of performance audits.

The Internal Audit Charter and the Internal Audit Manual were developed in 2018 by an external specialised consultant and both documents have been reviewed to ensure relevancy. Minor amendments have been made to these documents to ensure consistency with the SIAP, role of the Audit and Risk Committee and the establishment of improved monitoring and reporting processes.

The Internal Audit Charter defines the activities purpose, authority and responsibility. It establishes the activities position within the organisation; authorises access to records, personnel and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities. The amended Internal Audit Charter is located at ***Attachment 5.3.***

The Internal Audit Manual establishes the process for delivering an internal audit. The amended Internal Audit Manual is located at ***Confidential Attachment 5.4.***

Consultation

N/A

Statutory Environment

As stated in the report, there is no requirement for a local government to establish an internal audit function, however it is recommended by the Department of Local Government, Sports and Cultural Industries and the Office of the Auditor General for local governments.

Policy Implications

Relevant CEO Policies and Council Policies.

Economic Implications

It is envisaged that between five and seven programmed audits would be conducted each year. An approximate cost of $150,000 per annum can be anticipated for the service. This amount is budgeted for in the 2020/21 financial year.

Risk Analysis

Internal audit is an essential part of an organisation's risk management strategy. The function both reports on financial, compliance and operational controls as well as adding value to an organisation through identifying areas of improvement in systems and processes.

Strategic Implications

The following strategy from the *City of Mandurah Strategic Community Plan 2020 – 2040* is relevant to this report:

Organisational Excellence:
- Ensure the City has the capacity and capability to deliver quality services and facilities through accountable and transparent business practices, governance, risk and financial management.

Conclusion

The Audit and Risk Committee is requested to consider the Strategic Internal Audit Plan 2020/21 -2022/23, Internal Audit Charter, Internal Audit Plan and amendments to the Audit and Risk Committee Terms of Reference before the documents are presented to Council for adoption.

NOTE:

Refer
- ***Attachment 5.1*** ***Audit and Risk Committee Terms of Reference***
- ***Attachment 5.2 Confidential*** ***Strategic Internal Audit Plan 2020/21 to 2022/23***
- ***Attachment 5.3 Confidential*** ***Internal Audit Charter***
- ***Attachment 5.4 Confidential*** ***Internal Audit Manual***

RECOMMENDATION

That the Audit and Risk Committee recommend that Council adopts the:

1. **Amended the Audit and Risk Committee Terms of Reference as per Attachment 5.1.**

2. **Strategic Internal Audit Plan 2020/21 – 2022/23 as per Confidential Attachment 5.2.**

3. **Amended Internal Audit Charter as per Confidential Attachment 5.3.**

4. **Amended Internal Audit Manual as per Confidential Attachment 5.4.**

Audit and Risk Committee

Terms of Reference

Document Control

Effective date	Next review due	Amendment Details	Prepared by	Endorsed by	Approved by
October 2019	October 2021	Expanded description of Committee function, purpose, membership and role of City staff, plus recognition of the new role of the Office of the Auditor General	Manager Governance Services	Chief Audit Executive	Council
May 2020	October 2021	Removal of the ability for Audit and Risk Committee to approve the appointment of any internal audit service provider.	Manager Governance Services	Chief Audit Executive	Council

1. Committee's authority and purpose

Authority

In accordance with section 7.1A of the *Local Government Act 1995* (**the Act**), the Council of the City of Mandurah (**the City**) has established an Audit and Risk Committee (**the Committee**). The Committee will operate in accordance with all relevant provisions of the Act, the *Local Government (Audit) Regulations 1996* and the *Local Government (Administration) Regulations 1996*.

As prescribed in Section 16 of the *Local Government (Audit) Regulations 1996*, the Committee is to provide guidance and assistance to Council on matters relevant to its terms of reference. This role is designed to facilitate informed decision-making by Council in relation to its legislative functions and duties that have not been delegated to the CEO.

The Committee is a formally appointed committee of the Council and is responsible to the Council. The Committee does not have executive powers or authority to implement actions in areas over which the CEO has legislative responsibility and does not have any delegated financial responsibility. The Committee does not have any management functions and cannot involve itself in management processes or procedures.

Purpose

The purpose of the Committee is to:

- Provide advice and assistance to Council as to the carrying out of the function of the City in relation to annual audits of the City's financial statements (**external audit**);
- Monitor and receive reports concerning the development, implementation and on-going management of a City-wide risk management plan;
- Monitor and receive reports concerning the development, implementation and on-going management of the City's internal audit function;
- Review the annual Compliance Audit Return and report to Council the results of that review; and
- Receive, consider and review reports from the CEO under regulation 17 of the *Local Government (Audit) Regulations 1996* and report to Council the results of its review.

2. Committee's responsibilities

The Committee is to:

- Meet with the City's external auditor at least once in every year and provide a report to Council on the matter discussed and the outcomes of those discussions;
- Support council in fulfilling its governance and oversight responsibilities in relation to financial reporting, internal control structure, risk management systems, internal and external audit functions and ethical accountability;
- Examine reports of the external auditor after receiving a report from the CEO on the matter, and:

    - Determine if any matter raised requires action to be taken by the City;
    - Ensure that appropriate action is taken in respect of those matters; and
    - Review the report prepared by the CEO in respect of any matters raised in the report of the external auditor and presenting the report to Council for adoption.
- Approve the following:
    - Internal Audit Charter;
    - Internal Audit Manual;
    - Strategic and Operational Internal Audit Plans; and
    - Recommendations arising from internal audit services.
- Review the level of resources allocated to internal audit and the scope of the functions authority;
- Receive and review reports of internal audits, review the extent to which management reacts to matters raised by those internal audits, and monitor the implementation of action plans developed in response to those matters;
- Review the City's annual compliance audit return and report the results of that review to Council; and
- Receive and review biennial reports from the CEO regarding the appropriateness and effectiveness of the City's risk management, internal controls and legislative compliance.

3. Committee membership

Composition

The Committee shall comprise of up to six members, consisting of:

- Five Elected Members; and
- One external independent member.

The Council can appoint one or more deputies to the Audit and Risk Committee at any time.

Members of the Committee shall be appointed by Council in accordance with section 7.1A of the Act, which states:

- *The members of the audit committee are to be appointed by the local government and at least 3 of the members, and the majority of the members, are to be council members.*
- *A CEO is not to be a member of an audit committee and may not nominate a person to be a member of an audit committee or have a person to represent the CEO as a member of an audit committee.*
- *An employee is not to be a member of an audit committee.*

The Council shall appoint one of the five Elected Members as Committee Chairperson.

The tenure of members' appointment to the Committee must be compliant with Section 5.11 of the Act, being up to two years terminating on the day of the Ordinary Council elections, at which time all Elected Members will be eligible for reappointment.

Committee members who are Elected Members must declare conflicts of interest in accordance with section 11 of the *Local Government (Rules of Conduct) Regulations 2007*, in a written notice given to the CEO before the meeting or at the meeting immediately before the matter is discussed.

Appointment of external independent persons will be made following a public advertisement. The evaluation of potential members will be reviewed by the CEO and appointments will be approved by Council on the basis of the potential member's experience and qualifications in any or all of the following:

- Internal audit;
- Risk management;
- Financial management/reporting;
- Understanding of complexities associated with the City of Mandurah.

An external independent member will be a person with no operating responsibilities with the City of Mandurah, nor will that person provide paid services to the City either directly or indirectly.

Any instance where an external member has a commercial interest, or is closely associated with an organisation that has an interest in the business of the City which represents a conflict of interest or pecuniary interest, or there is a risk or perception of conflict of interest, should be declared to the Chief Executive Officer before or at the relevant Committee meeting.

Termination of appointment

Council may terminate the appointment of any member prior to the expiry of their term, if:

- The Committee Chairperson considers that the member is not making a positive contribution to the Committee.
- The member is found to be in breach of the Council's Code of Conduct or a serious contravention of the Act.
- A member's conduct, action or comments bring the City of Mandurah into disrepute.

Committee member entitlements

All Committee members will be provided with appropriate training and professional development to be determined by the Committee and provided that adequate funds are available in the City of Mandurah budget for this purpose.

External independent member(s) will receive $3,000 per annum for reimbursement of expenses.

4. Role of City staff

The following will be issued with a standing invitation to attend Committee meetings, in order to provide advice and guidance to the Committee:

- Chief Executive Officer;
- Executive Leadership Team;
- Chief Audit Executive (CAE) (or some other person as determined by the CEO to act as the CAE);
- Manager Governance Services; and
- Representative of the Office of the Auditor General.

The Internal Auditor or internal audit service provider will be invited to present reports as and when required by the Committee.

Other staff may be invited to attend meetings to discuss specific issues or reviews as and when required.

Such attendees may take part in the discussions and business of the meetings, but have no voting rights.

A Minute Officer will be appointed by the Chief Executive Officer to assist the Committee as follows:

(a) Arranging meetings, preparing agendas, preparing minutes;

(b) Taking action to implement Committee decisions as guided by the City's Governance section in relation to:

- Obtaining information for the next or future meeting;
- Preparing a paper for the next or future meeting;
- Coordinating relevant staff of the City to provide advice at the next or a future meeting;
- Promulgating decisions e.g. reporting, providing or seeking advice on significant correspondence of all kinds.

(c) Preparing background notes;

(d) Providing advice to the Chairperson, committee members and committee users on Committee policy and process matters; and

(e) Maintaining appropriate committee records in an accessible form.

5. Committee meetings

Quorum

As prescribed by Section 5.19 of the Act, the quorum for Committee meetings shall be at least 50% of the number of offices of the Committee (whether vacant or not).

In the Chairperson's absence, Committee members who are present will select a Chairperson for that particular meeting.

Frequency

Meetings will be scheduled where necessary to allow the Committee to discharge its functions up to ten times per year.

Agenda

An agenda will be distributed at least 72 hours prior to the meeting, along with the minutes of the previous meeting, reports and other attachments or information to be addressed.

Public Attendance at Meetings

The Committee meeting will be open to the public.

In accordance with Section 5.23 of the Act, the Committee may close to members of the public the meeting or part of the meeting, if the meeting or the part of the meeting deals with a number of aspects as defined by Section 5.23 of the Act.

Voting

Voting is in accordance with Section 5.21 of the Act.

Minutes and matters arising

All meetings shall be minuted by the Minute Officer, and minutes shall be approved by the Committee at the next committee meeting.

Reporting

Recommendations of each Committee meeting shall be presented to the next ordinary meeting of the Council.

Confidentiality

All Committee members will be required to adhere to the City's confidentially requirements. In particular, no confidential information received or generated by the Committee will be disclosed to unauthorised persons.

6	**SUBJECT:**	CEO Review of Risk Management, Internal Controls & Compliance
	CONTACT OFFICER/S:	Tahlia Jones/Casey Mihovilovich
	AUTHOR:	Tahlia Jones

Summary

In accordance with Regulation 17(1) of the *Local Government (Audit) Regulations 1996* (Regulations), the Chief Executive Officer (CEO) is required to review the appropriateness and effectiveness of the City of Mandurah (the City) systems and procedures in relation to risk management, internal controls and legislative compliance at least once every three calendar years.

An independent internal audit service provider was appointed by the CEO to undertake the review in April 2020. The findings from the review represent an opportunity for continuous improvement to the City's governance systems. Over the next 18 months the review improvements will be implemented and the progress monitored in accordance with the City's Internal Audit Function.

The report (***Confidential Attachment 6.1***) is now being presented to Audit and Risk Committee for consideration and review of the improvement actions identified.

In accordance with Regulation 16, the Audit and Risk Committee is required to receive the review report and report to Council the results of the Committees review.

Disclosure of Interest

Nil.

Previous Relevant Documentation

- G.7/3/20 24 March 2020 Compliance Audit Return
- G.26/5/17 8 May 2017 Risk Management, Internal Controls & Legislative Compliance - CEO Biennial Report
- G.12/11/14 25 November 2014 Review of Internal Controls: Risk Management

Background

In 2013, regulation 17 of the Regulations were amended to include the requirement for the CEO to review the appropriateness of and effectiveness of risk management, internal control and legislative compliance of a biennial basis. In 2018, regulation 17 was amended to change the frequency of the review requirements form biennial to triennial.

There is no prescribed format for the conduct of the Regulation 17 review. The Department of Local Government, Sport and Cultural Industries (DLGSC) prepared an Operational Guideline (Audit in Local Government number 9 September 2013) to assist local governments in undertaking the review. This guideline provides information to assist in determining what falls within the terms 'risk management,' 'internal control' and 'legislative compliance.'

The last two reviews were undertaken in-house by the Governance Services area and were conducted in accordance with a checklist based on the DLGSC Operational Guidelines. The previous review identified the following areas for improvement:

1. Implementation of the proposed Internal Audit Function.
2. Implementation of the Fraud, Corruption and Misconduct Management Framework.
3. Implementation of the Fit for Purpose Complaints Management Framework.
4. Continued independent validation by Governance Services against officer responses within the DLGSC Compliance Audit Return.
5. Continued maturity of the CEO Report on Risk, Controls and Compliance.
6. Maturation of Enterprise-Wide Risk Management Framework and its relationship to the above.

7. Introduction of information technology systems for key functions requiring internal controls and an ability to align these to the risk management framework and the assurance map.

Comment

To ensure that the 2020 review was delivered objectively, the City procured the services of an internal audit service provider to undertake the audit on behalf of the CEO. The review mainly considers the City's operating environment over the past three years, however for some areas of the review the audit service provider requested documentation dating back to 1997.

In accordance with the requirements under regulation 17 of the Regulations, the review included the following components:

- A review of the risk management systems policies, procedures and plans in place at the City;
- Evaluate the non-financial/operational internal control systems and procedures at the City;
- Assess systems and procedures for maintaining legislative compliance; and
- Prepare a report of matters identified during the review to assist the CEO assess the appropriateness and effectiveness of the relevant systems and procedures.

As indicated in the Review of Risk Management, Legislative Compliance and Internal Controls (***Confidential Attachment 6.1***), the City has risk management, internal controls and legislative compliance systems and procedures in place, however each element requires improvements to be implemented for the systems and controls to be considered effective.

A number of improvements identified within the report have already been significantly progressed with implementation planned for 2020/21 financial year, including:

- Review and update on the Council Risk Management Policy;
- Development of a new Risk Management Framework;
- Development of the Internal Audit Function and Strategic Internal Audit Plan 2020/21 – 2022/23;
- Development of internal governance procedures, checklists and auditing processes for areas that require a high level of legislative compliance; and
- Establishment of the new Governance Services team structure ensuring that the team are adequately experienced, skilled and resourced to develop and implement enhanced internal controls and deliver strong governance systems across the City.

The detailed City response to the internal auditors recommendations is outlined in the City's Regulation 17 Action Plan (***Confidential Attachment 6.2***).

A summary of the key improvement areas identified in the report are below:

<u>Risk Management</u>

The report noted the requirement to undertake a review of the Risk Management Policy to ensure alignment with ISO 31000:2018. For the City's risk management systems to be considered effective the review recommended the development and implementation of a Risk Management Framework to further strengthen the risk management processes and procedures across the City.

The review identified three key improvement areas for risk management.

<u>Internal controls</u>

The review supported the development of improved monitoring and compliance practices, procedures and systems.

The review identified six key improvement areas for internal controls.

<u>Legislative Compliance</u>

The review noted instances of non-compliance with legislative requirements. Where instances of the effectiveness of systems were able to be assessed, the report noted that current legislative compliance framework was considered effective.

The review identified three key improvement areas for legislative compliance.

Action Plan

In response to improvements identified in the review, the City has developed a Regulation 17 Action Plan, as detailed in ***Confidential Attachment 6.2***. This plan sets out the action and due date.

Reporting and Monitoring

Reporting on the progress of the implementation of the improvements will be undertaken as part of the City's newly established Internal Audit Function. A Strategic Internal Audit Monitoring Report will be provided to the Audit and Risk Committee on a quarterly basis to enable the Committee to review and monitor the City's implementation of improved controls and systems.

Amendment to the Compliance Audit Return

The review identified one matter of legislative non-compliance in the 2019 calendar year relating to a relevant officer's primary return. The City submitted the Compliance Audit Return (CAR) to the Department of Local Government, Sport and Cultural Industries (DLGSC) in March 2020. The Audit and Risk Committee are now requested to consider an amendment to the CAR and recommend adoption to Council. The amendment will be provided the DLGSC.

Attachment 6.3 details the amendment to the 2019 Local Government Compliance Audit Return.

Consultation

N/A

Statutory Environment

Local Government (Audit) Regulations 1996 r17 CEO to review certain systems and procedures and report results to Audit and Risk Committee

Local Government (Audit) Regulations 1995 r16 – Audit and Risk Committee is to review report prepared by CEO and report the results to Council.

Policy Implications

Relevant CEO Policies and Council Policies.

Economic Implications

The budget for this review was $25,000.

Risk Analysis

Appropriate monitoring of the recommendations and oversight by the Executive Leadership Team is required to ensure business areas implement the improvements.

Strategic Implications

The following strategy from the *City of Mandurah Strategic Community Plan 2020 – 2040* is relevant to this report:

Organisational Excellence:

- Ensure the City has the capacity and capability to deliver quality services and facilities through accountable and transparent business practices, governance, risk and financial management.

Conclusion

The regulation 17 review presents an opportunity to implement improvements to the City's risk management, internal controls and legislative compliance. Significant progress has been made in recent months on the establishment of a number of critical governance systems, including the Internal Audit Function, Risk Management Framework and the development of internal governance processes.

NOTE:

Refer:

- ***Confidential Attachment 6.1*** — ***CEO's review of Risk Management, Legislative Compliance and Internal Controls***
- ***Confidential Attachment 6.2*** — ***Regulation 17 Review Action Plan***
- ***Attachment 6.3*** — ***Amendment to the 2019 Local Government Compliance Audit Return***

RECOMMENDATION

That the Audit and Risk Committee recommend that Council:

1. **Endorses the CEO's review of risk management, internal controls and legislative compliance as per Confidential Attachment 6.1.**

2. **Notes the action plan for implementation of the improvements identified as per Confidential Attachment 6.2.**

3. **Adopts one amendment to the 2019 Local Government Compliance Audit Return for the period 1 January 2019 to 31 December 2019 as per Attachment 6.3 and submits the amendment to the Department of Local Government, Sport and Cultural Industries.**

ATTACHMENT 6.3

Amendment to the 2019 Local Government Compliance Audit Return

Disclosure of Interest

No	Reference	Question	Response	Comment	Respondent
7	s5.75(1) Admin Reg 22 Form 2	Was a primary return lodged by all newly designated employees within three months of their start date.	No	The designated employee included the incorrect start date in their primary return. The start date submitted in the primary return was the date they commenced in the position, rather than the date the employee received the delegation approved by the CEO.	Tahlia Jones