Mr Daryl Buckingham
Chief Executive Officer
Tenterfield Shire Council
PO Box 214
TENTERFIELD NSW 2372

Contact: Chris Harper
Phone no: 02 9275 7374
Our ref: D2223277/1794

6 February 2023

Dear Mr Buckingham

Management Letter on the Final Phase of the Audit for the Year Ended 30 June 2022

The final phase of our audit for the year ended 30 June 2022 is complete. This letter outlines:

- matters of governance interest we identified during the current audit
- unresolved matters identified during previous audits
- matters we are required to communicate under Australian Auditing Standards.

We planned and carried out our audit to obtain reasonable assurance the financial statements are free from material misstatement. Because our audit is not designed to identify all matters that may be of governance interest to you, there may be other matters that did not come to our attention.

For each matter in this letter, we have included our observations, risk assessment and recommendations. The risk assessment is based on our understanding of your business. Management should make its own assessment of the risks to the organisation.

We have kept management informed of the issues included in this letter as they have arisen. This letter includes management's formal responses, the person responsible for addressing the matter and the date by which this should be actioned.

I consider this Management Letter to fall within the definition of 'excluded information' contained in Schedule 2(2) of the *Government Information (Public Access) Act 2009*. It may not be distributed to persons other than Management and those you determine to be charged with governance of the Council.

The Auditor-General may include items listed in this letter in the Report to Parliament. We will send you a draft of this report and ask for your comments before it is tabled in Parliament.

If you would like to discuss any of the matters raised in this letter, please contact me on 02 9275 7374 or Jacob Sauer on 02 6773 8400.

Yours sincerely

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Chris Harper
Director, Financial Audit

cc: Cr Bronwyn Petrie, Mayor
Mr Peter Sheville, Chair of the Audit Risk and Improvement Committee
Ms Kylie Smith, Chief Corporate Officer
Mr Roy Jones, Manager Finance and Technology
Mr Jacob Sauer, Principal, Forsyths

Final management letter

for the year ended 30 June 2022

Tenterfield Shire Council

FINANCIAL AUDIT

INSIGHTS FOR BETTER GOVERNMENT

We have rated the risk of each issue as 'Extreme', 'High', 'Moderate' or 'Low' based on the likelihood of the risk occurring and the consequences if the risk does occur.

The risk assessment matrix used is based on principles within the risk management framework in TPP12-03 'Risk Management Toolkit for the NSW Public Sector'.

This framework may be used as better practice for councils.

LIKELIHOOD \ CONSEQUENCE	Low	Medium	High	Very high
Almost certain	M	M	H	E
Likely	L	M	H	H
Possible	L	M	M	H
Rare	L	L	M	M

The risk level is a combination of the consequences and likelihood. The position within the matrix corresponds to the risk levels below.

RISK LEVELS	MATRIX REFERENCE
Extreme:	E
High:	H
Moderate:	M
Low:	L

For each issue identified, the principles within the consequence and likelihood tables, which are based on the principles within TPP12-03 have been used to guide our assessment.

Consequence levels and descriptors

When assessing the consequence of each issue, we have regard to the length of time the issue remains unresolved. The lack of timeliness in resolving issues may indicate systemic issues and/or poor governance practices, which warrant an increase in the consequence level. As such, unresolved or unaddressed issues from prior periods are re-assessed annually. This re-assessment may lead to an increase in the risk rating adopted.

Consequence level	Consequence level description
Very high	• Affects the ability of the entire entity to achieve its objectives and may require third party intervention; • Arises from a fundamental systemic failure of governance practices and/or internal controls across the entity or across a critical/significant part of the entity; or • May result in an inability for the auditor to issue an audit opinion or issue an unqualified audit opinion, and/or significant management work arounds and substantive tests of details was required in order to issue an unqualified opinion.
High	• Requires coordinated management effort at the executive level; • Arises from a widespread failure of governance practices and/or internal controls affecting most parts of the entity or across a significant/important part of the entity (eg. As demonstrated through a lack of timely resolution of unresolved/repeat issues); or • May result in an inability for the auditor to issue an unqualified audit opinion, and/or significant management workarounds and substantive tests of details was required in order to issue an unqualified opinion.
Medium	• Requires management effort from areas outside the business unit; or • Arises from ineffective governance practices and/or internal controls affecting several parts or a key part of the entity (eg. As demonstrated through a lack of timely resolution of unresolved/repeat issues).
Low	• Can be managed within normal management practices; or • Arises from isolated ineffective governance practices and/or internal controls affecting a small part of the entity that are largely administrative in nature.

Likelihood levels and descriptors

When assessing the likelihood of each issue, we have regard to the length of time the issue remains unresolved because the longer the risk remains unresolved the greater the chance the weakness could be exploited, or an adverse event or events could occur. As such, unresolved or unaddressed issues from prior periods are re-assessed annually. This re-assessment may lead to an increase in the risk rating adopted.

Likelihood level	Frequency	Probability
Almost certain	The event is expected to occur in most circumstances, and frequently during the year	More than 99 per cent
Likely	The event will probably occur once during the year	More than 20 per cent and up to 99 per cent

Possible	The event might occur at some time in the next five years	More than 1 per cent and up to 20 per cent
Rare	The event could occur in exceptional circumstances	Less than 1 per cent

Summary of issues

Issue	Detail	Likelihood	Consequence	Risk assessment
Prior year matter not resolved by management				
1	Rural fire-fighting equipment not recognised in the financial statements	Almost Certain	High	High
2	Recognition of intangible assets	Likely	Medium	Moderate

Appendix
Review of matters raised in prior year management letters that have been addressed and management have committed to addressing in a future period

Prior year matter not resolved by management

Issue 1: Rural fire-fighting equipment not recognised in the financial statements

Likelihood	Consequence	Systemic issue	Category	Risk assessment
Almost Certain	High	No	Reporting	! High

Observation

The Council has not recognised rural fire-fighting equipment and buildings as assets within 'Infrastructure, property, plant and equipment' in the Statement of Financial Position at 30 June 2022. In my opinion, these assets are controlled by the Council and should be recognised as assets in accordance with AASB 116 'Property, Plant and Equipment'.

Australian Accounting Standards refer to control of an asset as being the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

Rural fire-fighting equipment is controlled by the Council as:

- these assets are vested in the Council under section 119(2) of the *Rural Fires Act 1997* (Rural Fires Act), giving the Council legal ownership
- the Council has the ability, outside of emergency events as defined in section 44 of the Rural Fires Act, to prevent the NSW Rural Fire Service from directing the use of the rural fire-fighting equipment by either not entering into a service agreement, or cancelling the existing service agreement that was signed on 14 December 2011
- the Council has specific responsibilities for fire mitigation and safety works and bush fire hazard reduction under Part 4 of the Rural Fires Act. The Council obtains economic benefits from the rural fire-fighting equipment as these assets are used to fulfil Council's responsibilities
- in the event of the loss of an asset, the insurance proceeds must be paid into the New South Wales Rural Fire Fighting Fund (section 119(4) of the Rural Fires Act) and be used to reacquire or build a similar asset, which is again vested in the Council as an asset provided free of charge.

While Council has undertaken procedures to confirm the fair value of this equipment, including assets vested in it during the year, it has not recognised these assets in the financial statements. When these assets are vested, no financial consideration is required from the Council and as such these are assets provided to Council free-of-charge.

The effect of the non-recognition is:

- rural fire-fighting equipment assets and buildings located on land that is controlled and recognised by the Council are understated by $5.4 million in the Statement of Financial Position and related notes as at 30 June 2022
- 'Accumulated surplus' is understated by $5.4 million in the Statement of Changes in Equity and Statement of Financial Position
- 'Grants and contributions provided for capital purposes' income, representing the fair value of rural fire-fighting equipment that have been vested as assets received free of charge, and 'Depreciation, amortisation and impairment of non-financial assets' expense in the Income Statement is understated by $255,000 and $345,000, respectively for the year ended 30 June 2022. 'Depreciation, amortisation and impairment of non-financial assets' expense is recognised over the useful lives of these assets, which is offset by 'Grants and contributions provided for capital purposes' income recognised at the point the assets are vested as an asset received free of charge
- the 'Operating performance' and 'Own source operating revenue' ratios in Note G5-1 'Statement of performance measures – consolidated results' is 12.5% instead of 12.8% and 32.7% instead of 32.8%, respectively

- the 'Operating performance' and ‘Own source operating revenue’ ratios in Note G5-2 'Statement of performance measures by fund' is 10.6% instead of 10.9% and 25.7% instead of 25.8%, respectively.

This has resulted in the audit opinion on the Council’s 30 June 2022 general purpose financial statements (GPFS) to be modified.

Implications

The financial statements are misstated as rural fire-fighting equipment is not recorded. We issued a modified audit opinion on the Council’s 30 June 2022 GPFS.

Recommendation

Management should record the rural fire-fighting equipment in the asset register and the financial statements.

Management response

Disagree

Council de-recognised RFS assets from financial statements in 2016 financial year. This has not resulted in a modified audit opinion or a reference to in the management letter point.

Council has officially explained weaknesses of the evidence of control suggested by the Audit Office in the response to the Management Letter on the final phase of the audit for the year ended 30 June 2021. In that response, every sentence of the management letter was critically analysed and substantiated with relevant accounting standards and industry practice. As a result, we provided crucial evidence that the observations mentioned by the Audit Office do not represent sufficient audit evidence as required by the Australian Standards of Auditing. This was done for the purpose of seeking a constructive response from the Audit Office. Unfortunately, we have not seen any feedback.

Without a feedback or constructive counterarguments from the Audit Office by way of a normal communication between the parties, council therefore had all the cons and substantiated evidence for moving a resolution to stand on the same position of not recognition of RFS assets. This has been done by way of a council resolution on 27 July 2022.

Further to that, we have noticed that the observation points in this management letter were updated compared to the ones provided in the 2021 management letter. We have not been informed about new developments as well as we have never been asked by auditors to clarify these points during the course of the final phase of the audit. This again demonstrates lack of commitment from the Audit Office toward constructive relationships. Therefore, similar to the last year, we provide below critical analysis of the new observation points for our records and for your information.

AO: Australian Accounting Standards refer to control of an asset as being the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

Council: It seems that AO refers to AASB Revised Conceptual Framework (2021) (para 4.20) : “An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it. Control includes the present ability to prevent other parties from directing the use of the economic resource and from obtaining the economic benefits that may flow from it.”

However, councils are not under this framework. Instead, councils follow another framework which is AASB Framework for the Preparation and Presentation of Financial Statements (2020).This is also documented in the Code. The framework councils follow has a different definition of control which is "ability to control the benefits arising from using the asset (Framework, 2020, para 57)". In relation to councils, this is also interpreted as ability to control achievement of council’s objectives (Framework, 2020, para Aus54.1). But the point is that the provision of fire services is not in council’s objectives – this is a purpose and objective of the RFS.

AO: the Council has the ability, outside of emergency events in section 44 of the Rural Fires Act, to prevent the NSW Rural Fire Service from directing the use of the rural fire-fighting equipment by either not entering into a service agreement, or cancelling the existing service agreement that was signed on 14 December 2011.

Council: If council does not enter into this agreement, then all red fleet will be taken from council (i.e. there will be no assets to argue about at all). Regarding buildings - this is not an issue at all. Assets can be taken off the books if they are under finance lease (which is the case with councils as was proved by BDO analysis) and then brought back once lease is expired.

AO: the Council has specific responsibilities for fire mitigation and safety works and bush fire hazard reduction under Part 4 of the Rural Fires Act. The Council obtains economic benefits from the rural fire-fighting equipment and buildings as these assets are used to fulfil Council's responsibilities

Council: As was said earlier, this is not a council's primary objective to deal with fire issues. Yes, councils can be involved, but that is more of one-off emergency issues. Otherwise, what RFS was created for?

AO: in the event of the loss of an asset, the insurance proceeds must be paid into the New South Wales Rural Fire Fighting Fund (section 119(4) of the Rural Fires Act) and be used to reacquire or build a similar asset, which is again vested in the Council as an asset provided free of charge.

Council: That is up to RFS to decide if they would want to buy or not. This is not at councils' discretion at all.

Just a reminder from our earlier response in 2021, in regard to the question of who controls the assets. Following the principle of the substance over the form, we need to answer the main question of who "controls the benefits which flow from the assets". To answer this question, we need to keep in mind that, in respect of the not-for-profit entities, the benefits can be achieved by utilising service potential of assets in order to achieve entity's objectives. Council's objectives do not cover provision of Rural Fire Services. This is a responsibility and the objective of the RFS as an organisation under S12 of the Rural Fires Act 1997.

Due to restrictions imposed on those assets (equipment, vehicles and premises) to be used only for the purposes of delivering RFS, the only organisation which controls those benefits is RFS. Council does not have rights or power to direct the usage of those assets and hence does not control the benefits embodied in the service potential of those assets. Council is not responsible for insurance of RFS equipment.

We understand that a qualified audit opinion is the way an independent auditor expresses its view on the financial statements. We respect that. However, as we have shown in the critical analysis earlier in 2021 and now in 2022 above, we do not see the criteria of control suggested by the NSW Audit Office represents sufficient audit evidence. We regret this issue has been escalated to this point, but we have to report in accordance with the requirements of the Australian Accounting Standards to present our financial statements in a fair and true manner.

Person responsible:	**Date (to be) actioned:**
Roy Jones, Manager Finance & Technology	N/A - resolved as far as council concerned

Issue 2: Recognition of intangible assets

Likelihood	Consequence	Systemic issue	Category	Risk assessment
Likely	Medium	No	Reporting	Moderate

Observation

Council's recognition of intangible assets does not meet the requirements of AASB 138 'Intangible Assets'.

AASB 138 states an asset is a resource controlled by an entity and paragraph 13 specifies an entity controls an asset if it has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits.

In April 2021, the International Financial Reporting Standards Interpretations Committee's (IFRIC) issued an agenda decision on 'Configuration or customisation costs in a cloud computing arrangement' (the Decision). The Decision discusses whether configuration or customisation expenditure relating to cloud computing arrangements can be recognised as an intangible asset and if not, over what time period the cost is expensed.

The Software as a Service (SaaS) agreement does not provide control of the software configuration or customisation activities to Council, therefore expenditure related to the software cloud computing activities is not considered to be an intangible asset for Council, as the supplier controls the software. This resulted in an immaterial overstatement of intangible assets of $582,000 at 30 June 2022, including an immaterial overstatement of accumulated surplus of $572,000.

Implications

There is risk intangible assets are overstated.

Recommendation

Council should:

- review its intangible assets register and reclassify items in accordance with AASB 138
- implement controls to ensure future software as a service arrangements are recognised as an expense in accordance with AASB 138.

Management response

Agree

Hence all council's intangible assets represent cloud-based solutions in one way or another, management will consider de-recognition of all those assets in 2023 financial statements through equity as a prior period error. This will be supported with a position paper which will be available for audit by end of March 2023.

Person responsible:	Date (to be) actioned:
Roy Jones, Manager Finance & Technology	31 March 2023

Appendix

Review of matters raised in prior year management letters that have been addressed or management have committed to addressing in a future period

The issues in this appendix were raised in previous management letters. For each of these issues, we have determined how management has addressed the issue in the current year.

Prior issues raised	Risk assessment	Assessment of action taken	Recommendation
Addressed			
Compliance with *the Local Government Act 1993* (the Act) - use of externally restricted funds for purposes other than their intended use	High	Refer to the Emphasis of Matter in our audit opinion on the Council's 30 June 2022 GPFS. At 30 June 2022 the balance of the Council's unrestricted cash (before internal allocations) was positive $5.5 million. During 2021-22 management has: • implemented internal controls to monitor unrestricted cash balances on a quarterly basis • established a loan facility for operational need purposes which was available for use at 30 June 2022.	Nil as matter addressed.
To be addressed			
Infrastructure, property, plant and equipment	Low	Management has committed to addressing the issue by 31 March 2023.	We will review and assess this as part of the 2022-23 interim audit.