


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

Likelihood	Consequence	Systemic issue	Category	Risk assessment
Almost Certain	High	Yes	Reporting	 High

Observation

Council did not record rural fire-fighting equipment in the financial statements. This resulted in a \$2.2 million understatement of assets at 30 June 2021.

Rural fire-fighting equipment, specifically the red fleet vehicles, is controlled by the Council and should be recognised in their financial statements. This is supported by the requirements of the *Rural Fires Act 1997* and service agreements between councils and the NSW Rural Fire Service (the RFS).

The following are indicators of 'control' by Council:

- the *Rural Fires Act 1997* vests rural fire-fighting equipment to council, giving Council the legal ownership
- the service agreement governs how the RFS can use these assets for fire mitigation and safety works in a council area
- as land owner, Council has responsibility for fire mitigation and safety works under the *Rural Fires Act 1997*
- Council is responsible for maintaining the assets but has transferred this responsibility to the RFS through the service agreement
- in the event of the loss of an asset, the insurance proceeds are used to reacquire or build a similar asset, which is again vested in Council.

The Department of Planning, Industry and Environment (inclusive of the Office of Local Government) confirmed in the 'Report on Local Government 2020' (tabled in Parliament on 27 May 2021) their view that rural firefighting equipment is not controlled by the RFS.

Implications

The financial statements are misstated as rural fire-fighting equipment is not recorded.

Recommendation

We recommend council should:

- perform a full asset stocktake of rural fire-fighting equipment that it controls, including assessing the condition of these assets
- record the rural fire-fighting equipment in the asset register and the financial statements.

Management response

Disagree

We disagree with the view that RFS assets (not only equipment) should be recognised on council's financial statements. Council has de-recognised RFS property, plant and equipment in its 2016 accounts followed by a formal position paper issued in 2018 to support lack of control from the perspectives of Australian Accounting Standards (AAS). At the moment, this position is also supported by majority of the councils in NSW who do not recognise RFS assets "vested" with them. Furthermore, the recently released technical analysis of this matter performed by an independent international Big 5 accounting, audit and advisory firm at the request of another council also supports a position that there should be no any values related to RFS assets in councils' books.

Since the Audit Office stepped in as an auditor five years ago, this matter has never been treated as high risk and was always reported as unadjusted audit difference... until now. Even though we always disagreed with the Audit Office's view on the subject matter, we accepted treating it as unadjusted audit difference. This was a compromise which satisfied both sides. However, given that this year

Audit Office decided to change the course of action and consider the subject matter as high risk with the possibility of qualification of financial statements starting 2022, council has to respond accordingly.

The financial accounting under AAS is based on the predominant principal of the prevalence of substance over form in presenting facts in a fair and true manner. Council is accountable to the public through financial reporting. It is not possible for the management of the council to be accountable for something which can't be justified in the realm of the generally accepted accounting principles or in the common-sense perspectives.

We are surprised that after five years of acting as an official auditor of NSW local government, Audit Office has not made an in-depth assessment of the subject matter to support the conclusion the RFS assets are controlled by councils. As will be demonstrated in the Attachment to this MLP, the "indicators of control" mentioned in the MLP above are not sufficient audit evidence to say that council controls assets from the perspectives of the Australian Accounting Standards (AAS) and users of the financial statements.

We understand that the subject matter is highly judgmental. It is therefore possible to have different views on the same issues between councils and auditors. Furthermore, as practice shows, it is also possible to have different views on the same issue between different audit firms and other professional public practices. In this case the consensus should be based on the analysis supported by the most reliable and relevant evidence documented as required by the professional accounting and auditing standards. Plus, if the position is supported by other qualified accountants, then there is more support in favor of this position.

Therefore, in order to make it clear to the users of the financial statements and interested stakeholders, we prepared a detailed response to your management letter points in the Attachment to this MLP. The Attachment is considered as an integral part of this response. It is divided into three main sections. In section one we quoted your MLP. In section two we provided detailed response to each of the "indicators of control" from your MLP. The Attachment ends with some critical aspects which needs to be taken into consideration in section three.

As was mentioned earlier, management is accountable for the stewardship of the council through reported financial statements. In case Audit Office would still stand on the same position and would insist on qualifications of FS should council disagree, we would kindly ask you to provide your insight to each of our response and comment presented in the Attachment - so management will be able to explain the position to councilors and other stakeholders.

Tenterfield Shire Council

Management Letter on the Final Phase of the Audit for the Year Ended 30 June 2021

I. Rural fire-fighting equipment not recognised in the financial statements

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II. Management’s analysis and responses on each of the sentence from the above MLP

AO_1: “Council did not record rural fire-fighting equipment [including “red fleet”] in the financial statements.”

TSC_1: AO refers to “equipment” only. This is surprising because RFS assets also include “premises”. Indeed, according to RFS Agreement (p.1(d)) the “District Equipment” means fire-fighting apparatus and other vehicles and equipment. The "Fire Fighting Apparatus" means all vehicles, equipment and other things used for or in connection with, the prevention or suppression of fire or the protection of life or property in case of fire, by the Members of the Rural Fire Service operating in the Districts (p. 1(g) of the RFS Agreement). The land and buildings used in RFS activity on the other hand lay under term “Premises” (p. 1(k)) of RFS Agreement. Why would premises not be included in the MLP as well? What is the difference in terms of the control from the perspectives of the AO?

AO_2: “...the Rural Fires Act 1997 vests rural fire-fighting equipment to council, giving Council the legal ownership”.

TSC_2: This statement represents the AO’s view that the term “vested” automatically leads to “legal ownership”. We can’t see rationale for this as well as we have never seen AO’s clear justification for such a conclusion. Instead, we can provide evidence when this is not the case. In particular,

- The RFS Service agreement refers to “District equipment” as “Owned by the State; Owned by the Council; or Vested in the Council” (p. 1(d) of the RFS agreement). That means that the term “owned” and “vested” are different in nature. Furthermore, we even can’t say that “vested in council” and “owned by council” have the same meaning in terms of legal ownership, because along with these two, there is also equipment “owned by the State”. So, the all three categories are “District equipment” but have different legal status. The only thing which is clear is that District equipment is an equipment which is characterised by the location.
- Finally, in light of the issue of Crown land accounting. Back in 2019 council prepared a sophisticated position paper on analysis of control of two different types of Crown land: Crown reserves managed by councils; and Crown land devolved to council. The purpose of the position paper was to justify not recognition of both categories of land on council’s books on the ground of lack of control from the perspectives of the Australian Accounting Standards (AAS). What is important is that, Crown Reserves managed by councils that are “vested” with councils (see TSC position paper on page 2) as well as land “devolved” to councils are legally owned by the Crown (s. 2.23(2); s 2.24 (4)(a); s. 5.3 of CLM Act 2016) (see TSC position paper on page 3). This is clear argument that term “vested” has nothing to do with legal ownership as per regulations.

AO_3: “...the service agreement governs how the RFS can use these assets for fire mitigation and safety works in a council area”.

TSC_3: we have no issues with this statement. However, we do not see how this statement indicates that council controls the RFS assets? In contrast, this would be rather a clear evidence that the assets are transferred to the RFS for their purposes (delivering RFS) which would lead to a conclusion that the assets are under finance lease where council is a lessor. This is analysed in more details in the BDO report (explained in section three under subsection “Leases”).

AO_4: “...as land owner, Council has responsibility for fire mitigation and safety works under the *Rural Fires Act 1997*”.

TSC_4: This statement is very confusing. According to AO, if council is a land owner (which, as we understand, is meant to be a “legal owner”) then council bears responsibility under the *Rural Fires Act 1997*. This statement would lead to the following critical questions:

- Some land where RFS assets are located are not owned by the council. They are on Crown land which is legally owned by the State Government as explained earlier in **TSC_2**. Does that mean that council does not have responsibility for fire mitigation here then?
- What clause of the *Rural Fires Act 1997* Audit Office refers to? Where is in the *Rural Fires Act 1997* this exact link and this responsibility is stipulated?
- What we clearly see in the *Rural Fires Act 1997* is that the Commissioner is the only one who is responsible for the RFS. Indeed, based on *Rural Fires Act 1997*, cl. 12, “The Commissioner is responsible for managing and controlling the activities of the Service and has such other functions as are conferred or imposed on the Commissioner by or under this or any other Act”. According to s. 12(A), without limiting S12, commissioner may enter into a rural fire district service agreement with any local authority or authorities responsible for a rural fire district. The agreement may specify functions and obligations imposed on the local authority or under this act that are to be exercised by the Commissioner. As you know, the RFS agreement does not imply any responsibilities on the council in regard to rural fire services. The only responsibilities and obligations for the council according to the RFS Agreement are:
 - ✓ provide certain administrative works (Recitals (E))
 - ✓ Allow commissioner to use district equipment and premises (Recitals (E) and (F))
 - ✓ have assets insured
 - ✓ granting licence to Commissioner to enter and use premises (cl. 6.5 (a))
 - ✓ maintain Premises (not equipment).
- Finally, council does not have an objective of providing RFS services. There is a special organisation which was specifically set up to deliver this - RFS. Just because its activity is spread across the state and is held on the property owned by the councils, the parties had to make some legal arrangements in the form of RFS Agreement. If providing rural fire services was one of council’s objective, then you would see RFS line of service in the community strategic plan or annual report which is not the case.

AO_5: “...Council is responsible for maintaining the assets but has transferred this responsibility to the RFS through the service agreement”.

TSC_5: This requirement is explicitly stipulated in the RFS Agreement for premises only. Indeed, based on cl. 6.5 (c) of the RFS Agreement, “Council will maintain Premises in good repair.” However, there is nowhere in the agreement a legal requirement that Council has a responsibility for maintaining RFS “equipment”. We found only that the commissioner agreed to maintain district equipment on behalf of the council (cl. 5.2). However, it is not enough to say that Council is “responsible” for that – there is no legal reference that council bears this responsibility.

AO_6: “...in the event of the loss of an asset, the insurance proceeds are used to reacquire or build a similar asset, which is again vested in Council.”

TSC_6: First, council affects insurance on buildings only. As was confirmed with our manager responsible for communication with RFS, council has nothing to do with insurance of vehicles or “District Equipment”. This change in insurance arrangements occurred long time ago and was also conformed by the Local Government Association of NSW (LGSA) as part of the “Review of Local Government Engagement with the NSW Rural Fire Service” Discussion Paper in 2012. The LGSA

specifically mentioned that: “ Previously, the insurance for vehicles was the responsibility of the council. Since July 2011, the Treasury Managed Fund (TMF) has taken over the insurance for council owned RFS vehicles. The new insurance arrangements are centralised and managed by the RFS with the insurance costs distributed to RFS areas where the vehicles are based. Councils contribute 11.7% to the insurance costs. This change has partially addressed the insurance problems referred to above.” (page 5). We attach this paper for your information and reference.

Second, the last part of the statement from **AO_6** “...which is again vested in Council ...” is confusing. We believe that AO confuses term “vesting” with “control” and “legal ownership”. As we explained earlier, vesting is not defined in the legislation clearly. It is also not a legal ownership term. Vesting is more like an “assigned because of the physical location”. We can consider this only when AO provides enough evidence that term “vested” is the same as “legal ownership” from the perspectives of relevant law or “controlled” from the perspectives of Australian Accounting Standards.

AO_7: “The Department of Planning, Industry and Environment (inclusive of the Office of Local Government) confirmed in the ‘Report on Local Government 2020’ (tabled in Parliament on 27 May 2021) their view that rural firefighting equipment is not controlled by the NSW Rural Fire Service.”

TSC_7: We are not sure what this statement relates to and what is the value of it in contribution to the AO’s position that RFS equipment is controlled by the council. It is not included in the list of indicators of control in the MLP. What was the purpose of mentioning it as a separate statement given that it does not have any legal authority over councils? This could be an indication of future action but until this is authorised, it can’t be referred to as an evidence or indicator. However, assuming that AO still considers it as an extra evidence of control, it has two critical issues.

First, it does not represent an appropriate and sufficient audit evidence that the control exists under AAS. Indeed, the report itself has following paragraphs in regard to the RFS (on page 14 of the Report to Parliament):

“In 2017, we recommended that OLG should address the different practices across the Local Government sector in accounting for rural fire fighting equipment.”

In 2019–20, 68 councils did not record rural fire fighting equipment in their financial statements worth \$119 million.

The financial statements of the NSW Total State Sector and the NSW Rural Fire Service do not include these assets. NSW Treasury and the NSW Rural Fire Service have stated that rural fire fighting equipment is not controlled by the State.

The non-recording of rural fire fighting equipment in financial management systems increases the risk that these assets are not properly maintained and managed.

OLG should communicate the State’s view that rural fire fighting equipment is controlled by Councils in the Local Government sector, and therefore this equipment should be properly recorded in their financial statements.

The Department of Planning, Industry and Environment, which includes OLG, has confirmed that the NSW Rural Fire Service does not control rural fire fighting equipment. It is now the responsibility of

the OLG to determine what action will be taken to ensure that \$119 million of assets held by 68 councils are properly recorded and accounted for.”

The response from the DPIE on the above statements is summarized in one paragraph:

“The Department will communicate to the local government sector the State position that the RFS should not recognize these assets notwithstanding that councils generally enter into agreements with the RFS for the management of this council owned fire fighting equipment.”

As we see it, all these statements do not give any indication that there is a clear position on:

- Why RFS does not recognize the equipment; and
- Why councils should recognise it and on what grounds.

All we see is that there is a “view” of the Department that RFS assets should not be recognized by RFS. There were no any specific justifications for that. Furthermore, there were no authoritative issues to support recognition of RFS assets by councils.

Finally, we would like to draw your attention on the RFS policy note in the New Code 2022 which also quotes the Department’s view followed by the following paragraph: *“Councils need to assess whether they control any rural firefighting equipment in accordance with Australian Accounting Standards and recognise in their financial statements any material assets under their control and state the relevant accounting policy in relation to the treatment.”*¹ Council’s assessment has been done in 2018 followed by the detailed analysis above and more critical assessments performed in Section three below.

In this case, until clear legal directive on recognition of RFS assets by councils is issued as part of the LG Act, Regulations or the Code, there is no any justification for the recognition of RFS assets by councils.

III. Other critical matters

Control

The financial accounting under AAS is based on the predominant principal of the prevailence of substance over form in pursue to present facts in a fair and true manner to the users of financial statements. Council is accountable to the public through financial reporting. Council is not accountable to the Audit Office or State Government in particular, through general purpose financial statements. How council can explain users of the financial statements why RFS assets are recognised if there is no substantiated explanation in the form of substance. As was demonstrated in section two, the MLP points are questionable and in many cases inadequate.

In respect of the question of who controls the assets and, 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

¹ See page 54 of the new Code 2022 GPFS available on [Local Government Code of Accounting Practice and Financial Reporting - Office of Local Government NSW](#)

assets”². 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.

Finance Lease

If the above considerations are not enough for the Audit Office, then we encourage you to seriously consider Technical Advice prepared by BDO for the Leeton Shire Council. The Leeton Shire Council is under the same service district RFS agreement as Tenterfield Shire Council. BDO concluded that the subject agreement is in fact a finance lease agreement based on AASB 16. Given nominal fee RFS has to pay to the Council for the access to the premises and usage of equipment, the associated receivable will be zero. We also concur with this conclusion. Again, this is the substance over the form principle which is critical.

Industry practice

Audit Office should consider industry practice if the issue seems complicated. There are 68 councils which do not recognize RFS assets. We know for sure that many of them do have strong position papers similar to ours. We also know that many CFOs and finance managers are either CA or CPAs.

In sum, we have 68 councils³ plus support from an international Big-5 accounting and audit firm. Why would AO still stand on their insufficient grounds is a big question to us.

Materiality

Audit Office assigned a high risk to this issue with a potential for qualification in 2022 financial year in case the RFS assets are not recognised (as we were informed on one of our audit meetings).

No doubt that the subject matter is highly judgmental. That means council and auditors; various auditors may have different views depending on their professional judgement and evidence gathered to support that judgement. In this case, it is clear that the mutually acceptable approach to treatment should be achieved based on the most reliable and supportive evidence which can be gathered as well as industry practice.

²Under the AASB Revised Conceptual Framework (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.”

³ Page 7 of NSW Auditor-General's Report to Parliament | Report on Local Government 2020 | Audit results

Council has de-recognised RFS property, plant and equipment in its 2016 accounts followed by the formal position paper issued in 2018. The formal position paper demonstrated lack of control from the perspectives of AAS and common sense. Since the Audit Office stepped in as an auditor, this matter has never been treated as material and was always reported as unadjusted audit difference... until now. Now we see a dramatic change of the course from the Audit Office and treatment of this issue as a high risk with the potential of qualification of financial statements.

This can be considered only if Audit Office demonstrates us that there was new information or change of circumstances which would cause the change of the status of this matter as material. We are not aware of any changes occurred since 2011 when the RFS agreement was signed. We still operate within the same arrangement with RFS unless Audit Office tells us what has changed to say that the issue became material and would cause material misstatement to the financial statements.