The Hon. David Davis, MLC, 19th February 2017
Chair, Standing Committee on Environment and Planning
Parliament House,
Spring Street,
East Melbourne,
Victoria 3002.

Dear Sir,

Rate Capping,

I have made two previous submissions to the Committee on this topic. Through further investigation, I have been able to refine my understanding of events related to the correct formulation of Council accounts. Accordingly, I wish to update my submission in the light of our recent work. This work, enquiring into Bayside Council finances, was based on the 2015/16 financial year accounts. The 2016 accounts are dated 13th September 2016 and certified on behalf of the Acting Auditor-General on 15th September 2016. The accounts are published on Council website.

My previous submissions indicated that there were problems related to the correctness of the Council accounts. This influenced the level of the General Rate that was needed to provide an appropriate level of service. In particular, funds were raised, using the rating process, which were:
- Surplus to needs in the year of collection, and
- Were spent for purposes which are required to be supplied from service rates and charges.

There is compelling evidence that the accounts of the City of Bayside are not true, are not fair and contain material errors. From preliminary discussion with ratepayers from two other councils, it is clear that a similar conclusion may be reached for other municipalities. As 2016 is the base year for the establishment of a fair level of the General Rate, any error (similar to a permanent exemption from the cap), is locked in for perpetuity. (refer Third Report into Rate Capping Policy, December 2016).

The nature of the error in Bayside accounts is that the General Rate is substantially inflated by:
- Collecting General Rate revenue which is surplus to the annual budget spending requirements. To be recognised as income, revenue must be applied to give a community benefit. Any surplus contribution should be returned to the contributors through the process set out in s165 or s141(c) of the LGA, and
- Using General Rate revenue to supply capital goods where the future benefit is sacrificed to individuals and clubs. Such revenue is to be properly provided from the Service Rates and Charges. (Note the requirements of AASB 1004.20.21. “For transfers to a local government... to make future sacrifices of economic benefits to external parties, the transfers must be reciprocal), i.e. THE ENTITY MUST RECEIVE CONTRIBUTIONS OF APPROXIMATELY EQUAL VALUE, FROM THE EXTERNAL PARTIES.

A more detailed examination of the errors in the accounts is shown as an attachment to this submission. A summary and conclusion to this work follows.

“SUMMARY
1. The annual accounts for the City of Bayside are defective and distort the Comprehensive Income Statement. The statement used, prepared in the manner set
out in AASB 101.102 is inappropriate to an entity which treats depreciation by the valuation method. A method of preparing the statement in the manner set out in AASB 101.103 is appropriate.

2. The method of preparing the CIS using AASB 101.103 results in the gross profit (or profit equivalent) being arrived at by subtracting the necessary expenditure from the revenue collected. Revenue and expenditure become a “matched pair”; the imbalance is described, in AASB 101.103, as “Profit”.

3. There are three different sources of revenue, in the three different forms of rates and charges. Consequently there are three different sources of profit.

4. Municipal Councils are ‘not for profit’ entities; hence the net profits, arrived at by the three different routes, must each be zero.

5. The method of preparing the CIS in the manner of AASB 101.103 allows any surplus revenue which makes up a profit, (or a profit equivalent), to be returned to the contributor via “other expenses”. There are three different sources of profit which must be considered.

6. The Local Government Act has mechanisms which require any profit equivalent to be returned to the contributor.

7. Profit which arises from one of the three sources of revenue cannot be used to meet expenditure incurred in another source group. The concept of reciprocal obligation, together with the provision set out in AASB 1004.21, force this conclusion.

CONCLUSION.

The City of Bayside has published wrongful accounts for (at least) the accounting years ending in June 2014, 2015 and 2016. It has inflated the General Rate well above that necessary to meet the required expenditure to supply goods and services to the community; it fails to credit the profit equivalent back to the ratepayers. In particular it has, instead, retained to its own use, the profit equivalent, i.e. the surplus revenue. This improperly inflates the level of the General Rate.

Bayside has also spent funds supplied from the General Rate, on services to individuals. Such funds ought to have been provided from the Service Rate. This improperly inflates the level of the General Rate.”

I trust the committee will consider our views when reviewing the operation of the rate capping system, following the experience in the base year on which the system is to be built. In its present form it has ‘locked in’ the high and improper spending rate for the City of Bayside. This is likely to be repeated by many other Councils, who follow the same accounting process as that of Bayside.

I have a Powerpoint presentation which explains the faulty accounting process followed by the City of Bayside. This presentation is in the form of a teaching aid which has been put to the last Council at a s223 meeting. I am happy to appear before the Committee, with the presentation (which takes about 30 minutes) to support this analysis.

Yours faithfully,

George Reynolds,
Acting President, Bayside Ratepayers Association.

EXAMINATION OF THE SOURCE OF WRONGFUL ACCOUNTING

CITY OF BAYSIDE 2016.

1. THE IMPROPER RETENTION OF THE ANNUAL RATE SURPLUS.

It is our view that a scheme or schemes exists to promote the wrongful preparation of municipal accounts. Based on the City of Bayside accounts, the substantive errors are:

- Depreciation is shown, in Note 24 to the accounts, to be calculated on a valuation basis; the Comprehensive Income Statement shows the amount so calculated, deducted as an expense, as though it were arrived at by the cost method of depreciation. This treatment, using the cost method, is shown in AASB 101.102. For entities where depreciation is not a cash flow (it is part of the valuation adjustment), an appropriate method of presenting the income statement is shown in AASB 101.103.

- When AASB 101.103 is used, it initially lists “Revenue v Cost of Sales”. In Local Government, Revenue largely comprises Grants and Non-Owner Contributions; cost of sales is expenditure on goods and services. Any revenue not taken up by expenditure shows as gross profit. In Local government, this becomes surplus revenue. This listing is, of course, the primary sector of the income and expenditure account. However, “Income arising from a contribution of an asset to the entity”, is recognised when, and only when, the three conditions listed in AASB 1004.12 (a), (b), and (c), are met. These are:
  1. The entity must have control of the contribution, and
  2. The economic benefit must flow to the entity, and
  3. The amount of the contribution can be measured reliably.

- Clearly, any surplus revenue that represents contributions which are not able to be expended, cannot be measured reliably. If this surplus represents contributions raised by a special rate, the surplus must be returned (proportionally) to the contributor, in cash, in the manners set out in s165 of the LGA. Similarly, if this surplus represents money “paid to the Council for a particular purpose... which has not been performed” it must be proportionally refunded to the contributor as set out in s141(c) of the LGA.

The effect of the wrongful preparation of the Comprehensive Income Statement is:

- The improper deduction of depreciation alters the magnitude of the net surplus, and
- The failure to return the surplus to the ratepayers (as a prepayment) inflates the required rate imposition in a later year, and
- The funds sequestrated, when not returned to the contributors, end up in the Cash Account (Note 34) as “Unallocated and Unrestricted” cash. This is used as a “slush fund”, to finance activities where there is a willingness to ignore the need to levy reciprocal obligations.

2. THE USE OF THE GENERAL RATE TO SUPPLY ASSETS WHERE THE ECONOMIC BENEFIT IS SACRIFICED TO EXTERNAL PARTIES AT LITTLE OR INADEQUATE RECIPROCAL CONTRIBUTION.

There are three classes of Rates and Charges. These are General Rates, Special Rates and Service Rates. All impose a mutual obligation between the payer and the payee. This mutual obligation varies between the three classes, depending on how the economic benefit is applied.

- General Rates and Charges supply a benefit to the entity on behalf of the community; the mutual obligation between the contributor and the entity is non-reciprocal. The contributors enjoy the economic benefit purchased by the contributions. The magnitude of the contribution does not supply any different benefit to large or small ratepayers.
- Rates are raised to share the actual (net) cost of supplying the benefit. Charges are different. They represent a set fee to supply an identified service. Unused rates are refunded.
to the contributor; unused charges are held in reserve and used, for the same purpose at a later time. Such surplus charges form a sinking fund.

- Special Rates and Charges supply a benefit to a sub-group of ratepayers. The obligation between the entity and the sub-group is reciprocal. The sub group (voluntarily) pay the rate or charge to receive the economic benefit from the asset created, e.g. a new road. The obligation is contractual when more than 50% of the beneficiaries (who are the payers), agree to create the asset.

- Service Rates and Charges are levied to supply a benefit to individuals or groups. The group members may or may not be ratepayers. The charges are levied on a fee for service basis. (The fees are applied in the manner shown in Appendix A to the budget document) The obligation between the parties is reciprocal and contractual, e.g. parking in a metered area brings the contractual obligation to pay the fee.

As the mutual obligation varies between different classes of endeavour, the Revenue and Cost of Sales sector of the Comprehensive Income Statement must be prepared to allow for three separate activities.

There are three sources of contributions which lead to asset formation. (Prior to March 2014, each of the three sources were required to form a “Standard Income Account”.) The Comprehensive Income Statement (CIS) consolidates the three sources, with administration and other expenditure, into a single “Income and Expenditure”, statement. The function of the “Standard Income Account” is met by a note which compares the outcome in the accounts to the intent shown in the budget. (s20(d), Local Government (Planning and Reporting) Regulations 2014).

It is important to note that the Essential Services Commission limited “rate capping” to only one of the three sources of revenue. It is thus important to recognise that it is rates only that are capped – not charges. An exception is that any Municipal Charge has a cap, consequential to the rate cap, as it has always been limited to 25% of the General Rate.

There are six possible categories of rates and charges which form the revenue provided to Municipal Councils. Added to this are general and special purpose grants, from State and Federal Government. This eclectic mix of sources of revenue must be sorted to ensure that the accounts demonstrate how each activity is funded from an appropriate source. The sorting process is initiated in the Strategic Resources Plan, followed by closer definition in the Annual Budget. The budget is, in turn, linked to the accounts, through Note 2, where the actual income and expenditure is compared with the planned income and expenditure. The sorting process is as follows:

The Local Government (Planning and Reporting) Regulations 2014, at s10 (b) sets out the requirement for sorting the funding sources into:

- **Grants.** This is self-explanatory but may vary from broad tasks to the provision of support to supply individual assets.

- **Contributions.** Each asset is assigned funds from an appropriate source. The appropriate source is controlled by the “benefit test” in AASB 1004.12

- **Council Cash.** This is cash that has been collected from specific charges, when surplus to requirements; it is (meant to be) shown as provisions in the cash reconciliation account, Note 34.

- **Borrowings.** This is cash that must be borrowed to make up the shortfall in revenue where/when the proper source runs out of funds to purchase the asset. Borrowings are used to pay for the asset over time.
The source of funds document, in the budget, clearly identifies the appropriate source of funds for each asset. It is characterised by:

- Every asset has a line in the account.
- Every line must be in annual balance.
- If an asset is decommissioned the line is deleted; the balance sheet value is transferred to the income account.
- Newly acquired assets are assigned a new line.
- Contributions must be surplus to the annual operating cost, for the asset group, for the period, as both sets of funds come from the same source.
- Grant contribution may be assigned specifically to meet part of the capital needed to supply or add to the asset.
- Intangible assets have a line in the account.
- Grants and contributions are always positive (sources); borrowings and council cash are both positive and negative as loans are drawn and repaid and reserves are built and used.
- The source of funds line is conveniently matched to an application line classified (as a minimum) into purchase price (AASB 116.16(a)), directly attributable costs (AASB 116.16(b) and costs of decommissioning (AASB 116.16(c)). This allows provisions to be correctly assigned and timed.

The source of funds documents prepared by the City of Bayside, during the budget process for 2014, 2015 and 2016 are seriously defective. Contributions are not assigned to the correct column. Indeed most revenue is reported as Council Cash. In the 2016 budget, much more revenue was shown to be spent than listed as Council Cash (provisions) in the 2015 account. It is not possible to reconcile the budget document with the available sources of funds. One must conclude that the document was fabricated and does not reflect the funding availability for the 2016/17 year.

In Bayside, it is not possible to conclude, from Note 2 to the accounts, that assets have been provided from properly sourced funds. In particular, funds needed to supply assets to sporting clubs (where a sacrifice of economic benefit has been made to the club members) have been incorrectly sourced. This improper transfer has been concealed by lack of proper accounting.

**SUMMARY .**

It is our view that:

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Conclusion.

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