TRANSCRIPT

STANDING COMMITTEE ON THE ENVIRONMENT AND PLANNING

Inquiry into rate capping policy

Melbourne — 22 March 2017

Members
Mr David Davis — Chair
Ms Harriet Shing — Deputy Chair
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Mr Cesar Melhem
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Mr Greg Barber
Mr Jeff Bourman
Ms Colleen Hartland

Mr James Purcell
Mr Simon Ramsay
Ms Jaclyn Symes

Witness
Mr George Reynolds (affirmed), Bayside Ratepayers Association.
The CHAIR — Welcome. I am going to ask you to give some evidence with respect to our inquiry on rate capping, first getting the secretariat to swear you in. Evidence given here is protected by parliamentary privilege, but what you say outside is not.

Mr Reynolds, we have got your submission. If you wanted to briefly talk to that and give us a synopsis of what you want to convey.

Mr REYNOLDS — Chair, members, I have been working on this subject of rate capping ever since the Essential Services Commission sent out its useful comment, things like that, on behalf of ratepayers of Victoria and on behalf of Bayside Ratepayers Association. Rate capping imposes a responsibility on the Essential Services Commission to find a sound method of dealing with the issue. The ESC was entitled to the assumption that municipal accounts were true and fair and free from error and fraud. This assumption was backed by the certification of an auditor appointed by the Auditor-General of Victoria, the highest accounting office of the state.

It is the purpose of this presentation to indicate which parts of the accounts of the City of Bayside are untrue and identify which elements of the accounting standards have not been followed. It is highly probable that the flaws in the Bayside accounts are repeated in other municipalities with a consequent possibility that there has been a scheme or other arrangement to construct a flawed accounting outcome. If I could have the first of the PowerPoint slides, please.

Visual presentation.

Mr REYNOLDS — This is just a simple diagram of a limited liability company. We have the cash flow, which starts with the financial capital and goes into the cash supply, which is the operating cost, and that is the cost of doing business. When the assets are transferred over to the sales department the exterior source of funds chips in, and the cost of sales, which is the operating cost, is taken out of that stream and passed back into the financial capital. The cash supply provides the capital funds, and only a part of those funds are pulled out of the cash flow, and that is depreciation. That is how the financial capital in a limited liability company sorts itself out. What is left after the cash supply and the cost of capital is taken away is your EBIT — your earnings before interest and tax. That particular model does not account for the peculiarities of the local councils.

If we can have the next slide, this is the municipal council. They have an exterior source of funds, which is not capital. It is contributions from those who supply the rates and the charges. The prepayment goes into the opex, is then used to supply goods, which are given in specie in terms of services to the council. The capex element is paid for completely out of those contributions in that year when it is purchased, so it goes into the assets at valuation. The reason it goes into the assets at valuation is that council does not pay for it. The asset is assembled from the contributions, and if you look at AASB 116, between section 25 and section 38, the mechanics of that are fairly clear. The cash payment for the capital is taken as an expense at that time, and the asset is given to the council rather than sold to the council. So it is given to the council at zero cost, and it then transfers into the capex in the balance sheet at valuation. So there is no cash flow associated with that contribution in relation to the assets. The assets in the valuation section are appreciated to value, and the value is then depreciated. It is the value that is depreciated, and in effect it is the replacement value of the capital which stays in the balance sheet.

The cost method of depreciation, which is identified in AASB 116.29, which is in a limited liability company, is not appropriate to a municipal council. They have to use the valuation method. When the valuation method is used in the comprehensive income statement, it does not exist. So you cannot use the method of providing for the income set out in AASB 102; you must use the method set out in AASB 103.

If we can go to the PDF, this is the second formal analysis. It is the functional expense or the cost of sales method. This is the appropriate method for a municipal council. What we have here is revenue and cost of sale. Generally gross profit is income minus expenditure. We all use that. In this instance revenue is not income because it cannot be recognised as income unless it meets the triple test in AASB 1004.20, and the triple test is in my submission. Council needs to be able to get its hands on the money. In other words, if a parking meter man gives you a ticket, council cannot use that as income until they collect the money, so that is the first element of the triple test.
The second element of the triple test is that it should be known. In other words, you basically have to have the bill before you can take from the rates, which is a revenue, and convert it to income to pay the bill. So the triple test shows at the certainty level that this gross profit here is not a margin of income minus expenditure; it is a margin of revenue minus expenditure, which is the same as revenue minus income. And revenue minus income is surplus revenue.

So we have got to the situation where, if you use this form of accounting, you very quickly get to the point where this is surplus revenue, and if you go through the other income — and we will talk about other incomes and things like that shortly — if you go down to the profit before tax at the bottom, that is net revenue which is not being spent. Essentially what you need to do is you tuck it into the other expenses and send it back to the supplier. That is the major source of error in council’s accounts. That is because council is a non-profit organisation. Now this applies only to the rates.

The CHAIR — Can I just cut to the chase here? Essentially, if I can summarise what you are saying, the model that is being used for the accounting approach of councils — you are using Bayside as an example, but you think it is actually more general than that —

Mr REYNOLDS — Oh, yes.

The CHAIR — has an depreciation component which you think is inappropriate.

Mr REYNOLDS — Well, no, it is appropriate to find out essentially whether you are spending enough money on infrastructure.

The CHAIR — Yes.

Mr REYNOLDS — It says: this is the replacement cost of the assets. You should know what their value is. You should know how much the present value has depreciated —

The CHAIR — And when you are likely to need to replace it.

Mr REYNOLDS — That is right — when you need to replace it — but it has got nothing to do with charging the cost of the capital against the revenue.

The CHAIR — So you are bringing depreciation to book is in effect what you are saying.

Mr REYNOLDS — Yes, I am putting depreciation to book in the balance sheet, but it is not a cash flow and it does not enter the income account.

The CHAIR — To further understand this, if a capital item was purchased or was leased rather than purchased so there was a revenue or an expenditure item that went out, that would capture something and you would say that would be correctly brought to book year by year?

Mr REYNOLDS — And it would be. If you look at Glen Eira, they borrowed about $40 million to build a sports complex, and they took the advice of Treasury as to how they were going to finance it. They actually financed it by a form of hire purchase, and they had enough income coming from the revenue earned by that sports complex to actually pay the bill. The bill had an element of capital payment in it and an element of interest in it, and they had a very, very simple way of funding that $40 million complex. Unfortunately they mucked it up last year — and I will come to that later on — because they restructured the loan.

The CHAIR — I have got your point. Now why does the auditor not jump on this, because the accounts of all councils are audited by the Auditor-General. Why does his office not have a —

Mr REYNOLDS — I have had a four-month discussion with the office of the Auditor-General on this subject. The outcome was purely unsatisfactory from my point of view, because they just gave me what I would term ‘flannel answers’ to my questions. I asked the Auditor-General at the end of 2014 why I could not reconcile from the budget to the account, which I could not and I still cannot, and the outcome in the Auditor-General’s office was that the person I had found who began to understand it was suddenly moved on.

The CHAIR — To just follow that, these are national standards?
Mr REYNOLDS — They are the Australian accounting standards.

The CHAIR — So what do the other states do in terms of — —

Mr REYNOLDS — I do not know. I have not examined that. I have not even examined more than three councils in Victoria.

The CHAIR — Yes, that is a big task.

Mr DALLA-RIVA — Can I go back to the first slide? You will have to minimise that.

The CHAIR — Just while you are doing that, your point is not that Bayside is out on its own on this. It is, on the contrary, that they are part of the general pattern.

Mr REYNOLDS — I have not looked at the others, but the argument that the council put back to me is that every other council does it this way, but that is not necessarily an argument that is correct.

Mr DALLA-RIVA — Chair, the underlying assumption for all this is that the councils are a limited liability company —

Mr REYNOLDS — No, no.

Mr DALLA-RIVA — because that is the basis. Is that my understanding?

Mr REYNOLDS — No, that first slide is to show that it is necessary to have financial capital which is replaced by the operating cash flow plus the capital repayment. It is necessary to have that financial capital in order to use this method of depreciation, which is the method that council uses. My view, which I have strongly put to the Auditor-General’s office is that it is wrong to do your accounts in the manner of AASB 101 and AASB 101.102, which is the way they do it.

Mr DALLA-RIVA — So they are doing, I think, from your letter — what is it?

Mr REYNOLDS — The cost method.

Mr DALLA-RIVA — The cost method, whereas you say they should be doing the — —

Mr REYNOLDS — If you go AASB 116.29 — —

Mr DALLA-RIVA — So the cost method is what councils are using, and I did read it, because I was trying to work — —

Mr REYNOLDS — It is more complicated than that.

Mr DALLA-RIVA — I am trying to get an understanding. There is the cost method or the valuation method. Is that right?

Mr REYNOLDS — Yes. If you go to AASB 116.29 — —

Mr DALLA-RIVA — So there are two forms of depreciation: cost method and the value method.

Mr REYNOLDS — Yes.

Mr DALLA-RIVA — So you are saying they are using the cost method when they should be using the valuation method.

Mr REYNOLDS — They use the valuation method in their depreciation calculation —

Mr DALLA-RIVA — And you are saying that is not correct.

Mr REYNOLDS — and they use the cost method in their income account, okay? But they use the number that the valuation method produces in their income account. They do it in that way. Basically it renders the form of the income account immaterial.
Mr DALLA-RIVA — Okay. That makes sense.

Mr MELHEM — So where would that sort of fit in with the rate capping?

Mr REYNOLDS — I am jumping a few steps, but if we go to the third slide on that one, this is a cash flow chart for a municipal council if they did their accounts in accordance with the accounting standards. Rates and charges are the contribution. They go into the prepayment section and through the opex, and they supply the goods in specie. The municipal charges do not go through the same process as the rates system. The municipal charges go through a process where any surplus is actually put into provisions for future use, and it is highly specific in that section. But it ends up where you have the prepayments as a single block that comes in from the contributions — from the state and from the ratepayers — and they go through the opex, and any money that is left over, that is not yet spent, goes into accrued provisions. And there are loan repayments which are part of that opex, and they go into an accrual account to repay the loan. The capex takes no part in that, but there are prepayments, which is the surplus from the rates that I have just said is not council’s. It has to be sent back to the contributors.

So there are two units there which council does not account for, so essentially it inflates the general rate because they do not pay back the prepayments. As you can see, the cycle takes the prepayments back around into the rates and charges section, and one of the more important ones is that the loan receipts are added to an extra charge on the general rate. So the loan repayments are taken from the general rate, whereas there is something I will come to shortly where they must be taken from the asset that is provided by these things.

If we go to the next slide, which is the source of funds, there is a source and application requirement in the regulations, and it applies to all charges, all capital charges, but it is particularly noticeable in the service rates. The service fees are fixed fees. They are charged as a fee for service, so if you go to the parking meter and you park your car on the meter, you have a contractual obligation to put whatever is necessary in that parking meter.

So all the money that comes in from a particular item of capital is looked at — is it a grant, is it a contribution, does it come from council cash or does it come from borrowings? You have to have an application that is going to use this money, and the money that is spent to buy that capital good, whether it is a car park or something like that, has to be funded by one of those four things. The grants and the contributions are self-obvious. The council cash comprises of provisions and any other capital amounts which council manages to get its hands on, like sale of an asset.

So only two things go in there, and borrowings — if there is too much in grants and contributions, you take out of that to balance the thing and put that in your provisions for that piece of capital. If there is too little, you have to go and borrow so that you can balance the source and application of the funds. This may be a bit foreign to people who deal with limited liability companies, but my industrial background has been in the mining industry, where joint ventures are always the preferred way to go because of the size of the capital involved, and in the mining industry we use this method.

Mr MELHEM — Sorry to jump in. So would rate capping make council more accountable? Would having no capping at all make them less or more accountable? I am trying to get the link too, because this inquiry is about — —

Mr REYNOLDS — If they did the accounts correctly, they would naturally cap. The problem they have is they have got this amount of money which they take from the surplus of the rates, and they can fiddle it while they are doing their estimates. That amount of money is a flexible amount which they are using for the wrong purpose. This source and application of funds document is the thing I first queried with the Auditor-General in November 2014 just after the new regulations came into action, because I could not reconcile through this chart, which they had to put in it for the first time then, that source of funds document, which is in the estimate, back to the accounts. The Auditor-General just sent me a letter and said, ‘We are not interested; it’s in the estimates’.

Mr DALLA-RIVA — I am trying to get my head around it, because it makes sense what you are saying. So $100 comes in, in total. Let us assume a figure — through grants, through contributions, through council cash and through borrowings — $100. So they have got that $100 sitting there. Then the applications of the funds are staff costs, which might be $60, site costs, which I assume is just operational costs of certain — —
Mr REYNOLDS — Site costs are actually important. As you see on here on the right-hand side, the purchase price of buying the machine, as it were, the staff costs are the costs of the council staff and the consultants and people like that. They are all in this AASB 116.

Mr DALLA-RIVA — So you know, for example, that if a grant is given from a government, councils and not-for-profits — because I have been in those as well — will take part of those grant funds to purchase the item but will also take an administrative component for their time and effort. So that is part of the staff costs.

Mr REYNOLDS — Then with the site costs there is a particular move on in the accounting world at the present time to make sure that people provide for their site costs, particularly rehabilitation. I do not know if you have heard of the Blair Athol coalmine, which was sold for $1 and had about $500 million worth of liabilities on it.

Mr DALLA-RIVA — Some of the councils have greatly expanding communities, and you are not going to get a grant that will be used for future growth in communities. Some communities have substantial growth. The evidence we have had is that councils like Casey and the outer suburbs are growing exponentially, so councils are finding it difficult to keep enough reserves to ensure that they are able to build kindergartens and their local roads and provide assistance through a whole range of other things.

I am not spinning them; I am just trying to get a feel. This application that you are looking at is purely on the basis of, I guess, the status quo, but to use your analogy — you having been in mining — what happens if the mining company all of a sudden discovers it needs to do something in a mine nearby that it had not planned for? It had not received the income, had not received any account, and all of a sudden there is a $100 million expected expenditure. Where do they get that?

Mr REYNOLDS — If they have got a successful mine, they will have put some money away in what we call the sinking fund.

Mr DALLA-RIVA — Is that not what councils are doing, though — putting money aside for that anticipated mine?

Mr REYNOLDS — Only if they have got it. You see, it is coming in for a specific purpose.

Mr DALLA-RIVA — Well, I would argue it is not. You are saying that councils know exactly what is going to be on the horizon.

Mr REYNOLDS — No, I am not saying that at all. I am saying councils make an estimate of what has to be done, okay? The capital goods are costed in whatever best way they can, and when they go to spend the money the council has to account for it. If there is not enough money being collected from the grants and the contributions, they have got to find a place for it, so they go and borrow it.

Mr DALLA-RIVA — Correct. And we heard evidence that, I think, it is about $100 million that they have got borrowed.

Mr REYNOLDS — Yes. The borrowing comes in because of a problem with rate capping. If they borrow suddenly $100 million, that is okay provided someone will lend it to them. But if they pay back $100 million without having accrued it, that has to come from the general rate, and that is what councils did in 2016 to up the level of the general rate that they felt justified in charging. If you look at them — and I have not looked at them all, but certainly I looked at Bayside — they suddenly had a revised budget. I did not quite understand that that was what they were doing at the time, but they revised the budget to pay back $6 million in loan funds. Glen Eira council restructured their loan, which cost them $5 million in a break fee. These amounts all lifted the amount of money that had to come from the rates, and that was where they are locking in all this expenditure on things that they are not really allowed to do in order to push the rate base up for the capping process. They have locked the whole thing up. I would suggest that — —

Mr DALLA-RIVA — So do you support rate capping?

Mr REYNOLDS — I certainly support rate capping, but I would say that it is — —
The CHAIR — So essentially what you are saying is through these mechanisms you are arguing they gamed the system in that early period.

Mr REYNOLDS — They gamed it before rate capping came in — before rate capping came along. In fact the mayor at the time said to me, ‘Oh, rate capping is not going to bother us. We’ve found a way’. She has gone now. She has left the council. This is what makes me think that this whole thing is not an accident. I think there is a guiding hand, and I put the matter in a slightly different context to IBAC, because Bayside City Council could not balance their cash account — this thing here, council cash. They did not balance their cash account last June. It was at a certain way and distribution on 30 June, and when they opened on 1 July, in the next year’s accounts, there was an entirely different set of figures. When you start working through that, there would appear to be money missing, but that is a matter for IBAC.

The CHAIR — The auditor should comment on these matters too.

Mr REYNOLDS — Well, that is a dispute I am having with the Auditor-General’s department at the moment.

The CHAIR — We are going to draw this to a close, but I do thank you for your contribution. The secretariat will need to be in contact in the next period as they may want to follow up some points.

Mr REYNOLDS — Can I just show an audit path for the council? Can we look at the Excel account?

The CHAIR — Briefly, yes.

Mr RAMSAY — George, can I just ask: what are your credentials in this area? Are you a certified practising accountant?

Mr REYNOLDS — No, I am a scientist.

Mr RAMSAY — Where does your expertise in this area come from?

Mr REYNOLDS — My expertise is that I am a mining engineer, I am a mechanical engineer, I am a chemical engineer. I have got an associateship of the Securities Institute of Australia, which is now a diploma in applied finance and investment, and I taught for about 15 years with Securities Institute education. One of my lecture subjects was cash flow analysis.

It is a bit difficult to see this from here, but if you can follow that particular chart, that is your audit path. Everything on that chart has to be in line balance, in annual balance. If you see the red at the top, which is the source of funds, you have got the grants and the contributions. I have broken the contributions into three separate fields: contributions from the rates, contributions from the charges and contributions from the special rates, like building a road and things like that.

All of them have different groups of people who have different reciprocal obligations. If you look at the concept of reciprocal obligations in AASB 116, you find that the benefit of the contribution in the general rate must go to the council on behalf of the community, the benefit of the contribution in the special rate must go to the subset of people, and the benefit of the contribution in the service rate must go to the provision of the service. The difference between the two, where the contributions are targeted to the individuals — when they are targeted into the service rate — the people who rent the property from the council have to pay the bill. And it is this element which is not happening. You will find this chart in the Bayside accounts. It is just a load of nonsense. Everything is in council cash, and very, very little is in contributions.

Mr DALLA-RIVA — So they put it in one bucket, do they?

Mr REYNOLDS — They put it in one bucket. That is correct. When you go through the standards — it is a very complex thing going through the standards and trying to find out what they are not complying with — they are not compliant with AASB 1004.20, and they are not compliant with the regulations which say that you have got to break things up into the four elements of supply. That is what I have been on about for about three years. I have been chasing that surplus that should have been sent back through section 165 or section 141(c) of the Local Government Act and has been retained.
The final thing at the Bayside City Council is that they cannot balance their cash account. There are two possible ways, but no matter what way it is there is some money missing. I cannot reconcile all the money that they have taken that they should not have taken to the amount which is in their cash account as unrestricted and — —

Mr DALLA-RIVA — Have you had an estimation of what it is?

Mr REYNOLDS — Well, I cannot get into the accounts. I cannot get this thing out of council. I tried two section 223 meetings in a row, and they will get it again this time.

Mr DALLA-RIVA — What about FOIs?

Mr REYNOLDS — What about what?

Mr DALLA-RIVA — Freedom of information. Have you tried that?

Mr REYNOLDS — You have got to work in Bayside to know how freedom of information works in Bayside. I did one a few weeks ago on some trees, and I asked for all the reports that had been prepared, and when I got the reports it was plain that they had been fabricated to answer my questions.

The CHAIR — I am going to draw this to a close. Thank you for all of this. We will have a discussion about how we proceed, but I am thankful. As I said, the secretariat may be in contact to follow up some details.

Mr REYNOLDS — Yes. That would be good because we did not get through the sequence that I had prepared.

The CHAIR — Thank you.

Mr REYNOLDS — Thanks very much.

Committee adjourned.