

## **Inquiry into the Provision of Childcare**

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### **Summary**

Since this Senate Inquiry is precipitated on the collapse of ABC Learning, it is important that the committee gains a broad understanding of the circumstances surrounding the collapse of ABC Learning. The author's experience in the community-based sector of the industry provided valuable experience and knowledge of the Childcare business model. Early in 2006, the author submitted a complaint to ASIC, querying the accounting treatment of licences (attached), however, at the time, ASIC determined that the issues raised were not "material", relative to the overall value of the balance sheet. This submission suggests that ABC Learning's accounting treatment of Childcare Licences in the financial reports made an important contribution to the company's growth, since the Licences were a significant proportion of the total value of the balance sheet during a strong growth period for the company around 2005 to 2006.

It's recommended that the committee should gain a complete understanding of the circumstances surrounding the collapse of ABC Learning, so that it can make recommendations to Government about implementing measures to ensure that companies are not able to use similar accounting techniques to those used by ABC Learning where those techniques are seen to be misleading. It's proposed that the accounting techniques used by ABC Learning were a significant contributor to the company gaining substantial funding, however, they may have misrepresented the true financial position of the company to potential investors, thereby allowing the company to reach unsustainably high levels of debt.

## **Introduction**

The first point in the “Terms of Reference” for this inquiry, indicates that one of the aims is to produce recommendations to the government on the future direction for Australian Childcare, in light of the collapse of ABC Learning Pty Ltd.

Given that this inquiry is precipitated on the recent events surrounding the collapse of ABC Learning, it’s important that the committee has a full understanding of the circumstances surrounding the collapse, to ensure that future policy is not formed on the basis of a misunderstanding of events that led to the current situation.

This submission aims to provide the committee with some background information about the collapse of ABC Learning, in order to provide a better perspective of the circumstances surrounding the current situation in the Childcare industry.

## **Background**

My interest in the Childcare industry began around 1997 when my daughter was first enrolled in the local Community-based childcare centre in the northern suburbs of Adelaide. In January 1999, this service needed to appoint an executive committee, and when I was approached by some of the members, I obliged by volunteering my services as the Treasurer on their management committee. Over the following 7½ years I contributed to the service, initially as Treasurer, and later as Chairman.

In my role as Treasurer, I was particularly active in my level of contribution, and as a result, I learned a great deal about the day-to-day operations of the service, whilst gaining a good appreciation for the governance issues and other big-picture issues surrounding the industry. I enjoyed being involved with the service in this way, because it provided an invaluable source of experience in operating a business, and financial management. In the last 3 years of serving on the management committee, I was the Public Officer for the organisation.

This service is comprised of 2 childcare centres, and 2 Out of School Hours Programs, which become Vacation Care programs during the school holiday periods.

Playing such an active role in the management of the service allowed me to gain a close understanding of the issues involved in running a childcare centre, including budgeting and financial management, staffing issues and marketing. In particular, I learned a great deal about the cost-drivers within the business, and I developed a good understanding of the relationships that exist between utilisation, staffing and profitability.

My professional career has involved 25 years working in the steel manufacturing industry, and I have a Degree and Masters Degree in Engineering. I have spent the last 10 years as the Product Costing manager in a National Building Products manufacturing firm. Although I have no formal qualifications in accounting or commerce, my experience in industry has provided me with a good understanding of accounting and business principles.

## **ABC Learning**

As Treasurer of the Childcare Service I strived to ensure that the centre was being operated to its full potential, and aimed to ensure its ongoing viability, both for the sake of the parents, children, staff and the broader community in the Northern suburbs of Adelaide. In order to achieve this, I recognised that its often a useful exercise to benchmark and compare your organisation against other, similar organisations, to ensure that you are operating your business in a competitive manner. This also helps the manager to achieve “World’s Best Practice” in the operation of the company.

To this end, I started to investigate publicly available information about companies in the Childcare industry, and naturally enough, my attention was quickly drawn towards the publicly listed, ABC Learning. Since the company is listed on the ASX, the accounting records and annual report are readily available via the internet, and so I began comparing some of the key financial elements of my Childcare organisation with those of ABC Learning. My initial comparisons around 2001 yielded total and utter confusion, as I was seeing ABC Learning reporting profit levels of 35.4% in 2001 and 41.1% in 2002, with employee benefits shown as 8.6% of revenues in 2001 and 7.5% in 2002. As I further investigated the notes and underlying assumptions behind these figures, my confusion grew, because I had a good understanding of my centre’s business, and the variation in key figures between my service, and those of ABC Learning were so wide, I found it hard to reconcile that we were both operating similar business models in the same industry.

The main cause for my concern was my understanding that my service operated with staffing costs typically at 80% to 90% of operating revenues, and without the need to pay rent, but with a similar fee structure to that of ABC Learning, we were barely able to generate a surplus, whereas ABC Learning were somehow able to generate operating “profits from ordinary activities” in the vicinity of 30% to over 40%. This was a huge discrepancy, and it caused me much concern. I was aware that it meant that either my service was operating so poorly that the management could possibly be accused of being negligent in its ability to manage, or ABC Learning was misrepresenting their financial position in its accounts. Either of these scenarios was a serious problem!

At the time I resolved to myself that the ABC Learning figures must somehow represent a business model that was far different to the Childcare business for which I was the

Treasurer, and therefore, the ABC Learning figures were not an appropriate basis for forming a comparison. Although I applied this rationale at the time, I was never truly happy that this was actually the case, and I continued to closely monitor the ABC Learning results, hoping to find a sign that confirmed that the ABC Learning business model was fundamentally different to that of a typical Community-based childcare centre.

The significant differences I could discern between the ABC Learning business model and that of my childcare service were as follows:

1. ABC Learning costs included significant values for building rental and in later years advertising, that were not applicable in my community-based service
2. ABC Learning paid dividends to share-holders, whereas we were a not-for-profit organisation, and aimed to operate on a break-even basis

These differences only exacerbated my concern, because they should have resulted in my service achieving a higher net cash flow compared to ABC Learning, and therefore allowed greater expansion and upgrades to my service. However, I knew that we were barely able to fund the minimal maintenance, and cover our staff wages at the appallingly low levels prescribed by the Industrial awards at the time.

Naturally, I recognised that there were many other differences that existed between a public corporate, and a not-for-profit community-based business, but I considered these to be relatively minor in terms of the macro-approach that I was considering. I still believed that something was wrong, but I couldn't work out the problem. I assumed that the application of accounting standards, the audit process and the corporate regulations would ensure that the ABC Learning financial statements were essentially correct, and they gave a proper representation of the operations of the company.

With the publication of the 2003 ABC Learning Financial report, I began to notice a significant new phenomenon emerging in the figures – an asset known as “Licences”. I began to track the valuation of these in the balance sheet, and over the following years, noticed that they seemed to grow significantly in value.

I was concerned about this for the following reason. My understanding of operating Childcare centres, meant that centres applied for a licence to operate a facility, and once approved, the regulatory authority in each state, would issue the centre with a licence to operate the centre, subject to certain conditions. These conditions, typically

relate to the operating hours, the number of children at the centre, staffing levels, and other aspects of quality and service. I viewed the issuing of the licence for each centre to be similar to that of a driver's licence, that required the holder to prove to the regulator, in the first instance, that the holder had the skills and systems required to operate the service to a required standard. And on an on-going basis, failure to abide by the rules attached to the licence would result in the licence being removed or revoked in some way, thereby disqualifying the parents from being able to claim Childcare Benefit (CCB) and other government subsidies. I viewed the centre's licence to be like a qualification to operate the Service. You can imagine my surprise, therefore, when I not only saw "Licences" begin to emerge in the balance sheet of ABC Learning, but then I began to notice that the directors were somehow able to attribute value to the licences, and then re-value those licences, on the basis of the Directors' view of future earning. I could see that if this was legal, this was a sure-fire way of generating value on the balance sheet, without any justification or outlay by the company, other than the opinion of the Directors.

Once I became aware of this technique of financial manipulation, I began to perform simple calculations to reconcile the changes in value of the licences, with other entries within the financial reports, however, I was unable to reconcile changes in the asset revaluation account with changes in the value of the "Licences", nor could I reconcile the values paid and the carrying values of the Licences with the final valuations attributed to the "Licences" in the balance sheet. In short, nothing added up, however, I knew that the overall value of the balance sheet was growing rapidly, mainly driven by the value of "Licences" and seemingly without any justification, other than the Director's valuations of those "Licences"

## **ASIC Complaint**

In the 2005 Annual report the value of “Licences” grew to such an extent that I could no longer sit back and let this go on. They were shown as \$772.7m in a balance sheet with total Net Assets of \$845.5m. After discussing my concerns with a number of acquaintances with an Accounting background, I came to the conclusion that the ABC Learning financial reports were seriously deficient either in terms of their accuracy, or their transparency. I thought they were either misleading or failed to show the underlying justifications for some of the important elements, such as the value of the “Licences”. As a result I lodged a formal complaint with ASIC, on 14<sup>th</sup> May 2006, outlining my concerns, and asking them to investigate.

Although I only mentioned the issue of the accounting treatment of “Licences” in my complaint, I was hopeful that a thorough investigation of the accounts by ASIC would resolve other issues mentioned earlier in this submission. I didn’t mention my other concern to ASIC, such as the very low proportion of employee wages as a percentage of revenues, because I wasn’t confident of my technical accounting knowledge on this point, but I was hopeful that a thorough investigation of the financial reports by ASIC would uncover any major issues surrounding the reporting of Cash Flows, if they were present.

At the time of sending my complaint to ASIC, ABC Learning were in the process of a significant capital-raising exercise, and between December 2005 and June 2006, they raised over \$900m in capital via an number of share placements. I was naturally concerned that the investors were making their investment decisions at the time, on the basis of the 2005 financial reports, which showed an apparently healthy balance sheet. You will notice from my complaint that I queried the appreciation of \$390m in the value of Childcare Licences that I was unable to reconcile.

ASIC replied to my complaint exactly 4 months later. In their letter they said that although they had “made a number of inquiries into the issues ... (they) ... will not be taking any further action ... at this time”. They also commented that “the amount of increase in valuation of Childcare Licenses is not material in relation to the net assets of the Company as at 30 June 2006”.

After receiving this response from ASIC, I noticed that the company became more specific in its reporting of asset revaluations, however, I'm also aware that the 2006 reports coincided with the adoption of new accounting standards, AFIRS. In addition, I noticed that in 2006 the company showed an increase in Licence valuation of \$169.6m due to "Acquisitions through business combinations". I would now question the validity of this extra value effectively added to the Licences, over and above what was paid.

Naturally, I would suggest the accounting treatment of Childcare Licenses in the financial reports was an important factor that allowed ABC Learning to secure almost \$1 billion of funding during the financial year ended 30<sup>th</sup> June 2006. By calling them Assets and inflating those assets at the whim of the Director's, the company was effectively able to represent itself as being much better off than it really was. Tighter controls over the accounting treatment of Assets, along with a better understanding from investors about what they represent, could have minimised or avoided the whole situation, because it would not have allowed the company to grow to the extents that it did.

As the committee is no-doubt aware, the issues surrounding Licence valuations are expected to be investigated by a range of stake-holders, and it's been reported in the media, that ASIC may now be undertaking a more thorough investigation of the accounting practices within the company. I think it's widely accepted that some of these issues will result in court proceedings against the company, and possibly the auditors of the company. I would suggest that this indicates there may have been an element of malice and/or deceitfulness on the part of the Directors of the Company, in their representation of the financial state of the organisation, though this is probably to be determined by the courts.



## **Recommendations for the Committee**

I understand many submissions will be put before the committee, and most of these will address serious, structural problems that currently exist within the childcare industry in Australia. I understand and appreciate that there are many changes that could be made to improve the sector, both in the short term, and in the long term. Many of these will relate to the inter-relation that exists between the Federal Government's funding, the State Government regulations and the complex Industrial Relations environment that exists on a National basis.

I also understand that the collapse of ABC Learning has opened a "can of worms" in terms of litigation opportunities surrounding the accounting practices of the company. Judging from media reports, it seems that short-comings in the accounting standards of the company extend far beyond those issues which I have outlined above. It will now be up to the regulators and the courts to determine the extent of the improper actions of the Directors, the auditors and the regulators themselves.

To date my concerns, as presented to ASIC, have not been formally validated, however, judging by media reports, and from discussions that I've had, I am confident that the issues I raised with ASIC in 2006, are an important element in the current situation.

When framing policy, it's important that we don't let the demise of ABC Learning skew our perception of how the private sector business model operates, or should operate, if that demise was brought about by misleading or deceptive accounting practices. We need to understand the Childcare business model as it's supposed to work, when the business is reported using factual and transparent accounting standards.

My recommendations for the committee focus on the committee becoming properly informed of the real facts surrounding the collapse of ABC Learning. This will ensure it is able to recommend changes to policy and regulations that prevent the future collapse of a company which achieves such a significant role in Australian society. I am not proposing that the committee should investigate and pass judgement on the Directors and associates of ABC Learning, there are already others pursuing this approach. Rather, the committee needs to gain an understanding of the accounting and regulatory framework in which the growth was allowed to occur, and the drivers of the subsequent demise. To this end I would recommend the following further actions:

1. The committee should receive a brief account from the Directors of ABC Learning, its auditors, Ernst & Young, and receivers, McGrath Nicholls, outlining the broad circumstances which led to the company being placed into receivership.
2. The committee should obtain from ASIC a complete explanation of the “inquiries” it made between March 2006 and September 2006, in order to gain an understanding of the basis for their conclusion that there was nothing which was “materially” wrong with the accounting treatments in 2006.
3. The committee should also obtain from ASIC a briefing which details recommendations that the Commission would make in terms of changes to accounting standards and corporate law, in order to reduce the possibility of a recurrence of events, such as those surrounding ABC Learning. Especially in relation to the financial treatment of Childcare Licences as a form of asset in company’s balance sheets.

On the basis of these enquiries, I am confident that the committee will be able to produce a series of specific recommendations to Parliament, with regards to improvements in Accounting Standards and the Accounting treatment of Assets as they relate to the Childcare Industry, which will ensure the collapse of another significant company, such as ABC Learning, is unlikely to occur in the future.

Steve Trzcinski

2<sup>nd</sup> February 2009