



FINANCIAL VIABILITY

What is it?

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1.0 Introduction

The purpose of this paper is to set out the expectations of the Department of Internal Affairs (“the Department”) in determining whether a Class 4 applicant’s proposed gambling operation is “financially viable”, as that term is used in the Gambling Act 2003 (“the Act”).

Financial viability in this context is important because it is one of the matters that, if not satisfied, require the Secretary to refuse to grant a class 4 operator’s licence. Section 52 of the Act clearly states that the Secretary **MUST** refuse to grant a class 4 operator’s licence unless the Secretary is satisfied (among other matters) that a society’s proposed gambling operation is financially viable.

This paper discusses the key elements of financial viability and proposes a set of parameters and guidelines so that class 4 operators and their financial advisors/accountants can understand how the Department will be assessing financial viability.

2.0 Limitations of Scope

This paper considers the concept of financial viability intended by the Act as it relates to class 4 gambling. It does not seek to introduce viability concepts relevant to other industries. Societies must seek their own financial and legal advice in relation to other legislative matters.

3.0 Essential Elements for Determining Financial Viability

The Department proposes considering three essential disciplines in determining financial viability.

- **Profitability** – Is there potentially adequate profitability in the forecast? In other words, are a society's costs structures such that it will derive a surplus enabling a distribution to the community of at least 37.12% of the year's gross proceeds.
- **Liquidity** – Is there potentially adequate liquidity in the forecast? In other words, even if the society attains an appropriate surplus, does it have the necessary cash to distribute the surplus? It is not acceptable to consider meeting today's costs out of tomorrow's income as each future dollar of gross proceeds has implicit within it its own exposure to costs and distributions that leave little, if anything, to meet 'catch up costs' incurred in an earlier time frame.
- **Equity** – Is there potentially the appropriate level of equity in the forecast? If this is too low (or even negative) it could imply that, in its attempts to distribute at least the minimum requirement, a society has effectively borrowed from future surpluses. Conversely if this is too positive the society has not distributed all available net proceeds and is inappropriately retaining surpluses to present a healthier Statement of Financial Position.

The Department's analysis of a society's financial viability will consider the above three elements holistically, with the overall picture of all three elements being of greater importance than each individual element. The three elements incorporate the criteria the Secretary is required to consider when determining whether a society's proposed gambling operations are financially viable.

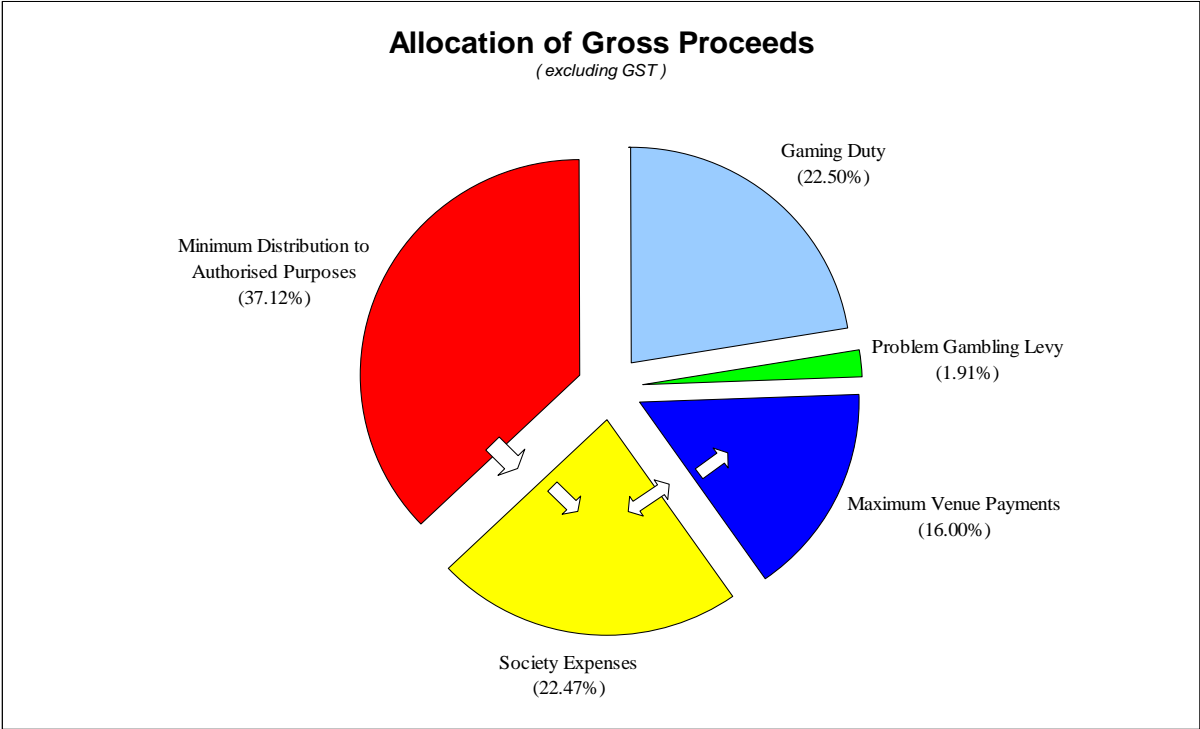
4.0 Legislative Allocation of Gaming Machine Funds

There are three main groups involved in the class 4 gambling sector:

- **Community** – as individuals who partake in the gambling activities and recipients of grants which fund community needs, and;
- **Government** – as the recipient of taxes and the Department as the regulator of the industry, and;
- **Operators** (including societies, clubs and venues) – who facilitate, administer and host the operation of gaming machines.

Each group has a financial interest in the money derived from the operation of gaming machines. Legislation dictates that as each dollar of gross proceeds (turnover less return to players) is derived, a corresponding responsibility is placed on societies to allocate it in accordance with *Figure One*. These include the fixed amounts towards gaming duty and the problem gambling levy, and the variable amounts relating to the maximum percentages available for venue payments and society expenses and the minimum percentage return to authorised purposes. All societies have an obligation to minimise expenses and maximise their return to authorised purposes.

Figure One



It is important to state whether the amounts are GST inclusive or GST exclusive, and for comparative purposes, to use a consistent base. The following table outlines the comparative allocation percentages/rates on a GST inclusive and a GST exclusive basis.

| Allocation of Gross Proceeds | GST Inclusive | GST Exclusive |
|---|----------------------|----------------------|
| GST | 11.11% | - |
| Gaming Machine Duty | 20.00% | 22.50% |
| Problem Gambling Levy | 1.70% | 1.91% |
| Venue Payments (Maximum) | 14.22% | 16.00% |
| Authorised Purpose Distribution (Minimum) | 33.00% | 37.12% |

The majority of financial reporting relevant to this industry occurs on a GST exclusive basis. Accordingly, this paper will use the GST exclusive percentages outlined above.

5.0 Assessing Financial Viability

Section 52 of the Act clearly states that the Secretary **MUST** refuse to grant a class 4 operator’s licence unless the Secretary is satisfied (among other matters) that a society’s proposed gambling operation is financially viable.

The Secretary is required to consider five matters/facets when assessing an applicant’s proposed gambling operation for financial viability. The five criteria are:

1. **The ability** of the applicant to *reward winners*, and;
2. **The ability** of the applicant to *pay levies and taxes*, and;
3. **The ability** of the applicant to *pay other costs*, and;
4. **The ability** of the applicant to *apply or distribute the net proceeds from class 4 gambling to or for authorised purposes*, and;
5. To consider these facets *among other things*.

The assessment of whether a society’s proposed gambling operation is financially viable will involve a careful analysis of the assumptions implicit in the society’s financial forecasts. This may, at times, require some form of corroborative evidence as to the basis for some of the

assumptions. It does not mean, for example, the unchallenged acceptance of the detail of each application.

Assessing financial viability involves consideration of a society's current working capital position, and specifically how the society expects that position to change over the course of its next licence period. The historical financial performance of a society will also be considered as an indication of the adequacy, appropriateness and integrity of its financial forecasts.

Some applicants invite the Department to consider their position in three or four years (or more) into the future, arguing that, given sufficient time, there is no doubt that they will come right. However, the focus for the Secretary must be on the year for which the licence is sought.

The number of venues scheduled to come 'off contract' during the course of a renewal year will also be relevant to a consideration of financial viability. If those venues remain part of the society's forecasts, the Department expects an indication as to why the society believes the venue will re-sign. Similarly, if the forecasts are based on the acquisition of additional venues during the year, an explanation of the basis for this assumption is required.

5.1 Ability to Reward Winners

Gaming machines are configured so that over an infinite series of games, player losses will always outnumber player wins. A society can expect to cover players' winnings from the amount of turnover from its machines. The rewarding of winners takes place either automatically on the machines or at individual venues through a float system.

The ability to reward winners through a float system is the responsibility of the venue. Societies should not be involved in funding the floats of individual venues, in accordance with Game Rules 13, 14 and 15.

To satisfy the ability to reward winners a society must be able to demonstrate the ability to pay players' winnings from the cashflows derived from its class 4 gambling operations.

5.2 Ability to Pay Levies and Taxes

Once a society has rewarded all winners they are left with an amount of money that is gross proceeds. From this figure, taxes and levies are calculated and must be paid on a periodic basis to the Inland Revenue Department. The applicable taxes and levies are as follows:

| | |
|-----------------------|---------|
| GST | 12.50 % |
| Gaming Duty | 22.50 % |
| Problem Gambling Levy | 1.91 % |

A society’s liability to pay taxes and levies arises once gross proceeds have been derived and banked. In this respect no society should ever be in a position of having insufficient cash on hand to fund tax and levy payments. Therefore, as a general rule, tax and levy payments should be funded from the gross proceeds that resulted in the society incurring the tax or levy debt. If tax or levy payments need to be funded from other sources, such as overdrafts or loans, this calls into question the ability of the society to pay its taxes and levies from the proceeds of class 4 gambling, and therefore, the society’s financial viability.

To satisfy the ability to pay levies and taxes a society must be able to demonstrate the ability to pay levies and taxes from the cashflows derived from its class 4 gambling operations.

5.3 Ability to Pay Other Costs

A significant part of the Department’s financial viability analysis involves considering the costs a society expects to incur in the future. The **maximum** amount of gross proceeds available to be used for society costs is 38.47%. This is the most that can be left over after paying taxes and levies, and meeting at least the minimum distribution to authorised purposes, ie if a society forecasts operational costs of more than 38.47% of gross proceeds it would have insufficient gross proceeds to pay taxes and levies, and meet the minimum authorised purpose distribution requirement. If a society incurs other costs which amount to more than 38.47% of gross proceeds it cannot be financially viable.

5.3.1 *Fixed versus Variable Costs*

If gross proceeds go down, so does the cashflow available to a society for its operational purposes. Therefore, the mix of costs incurred by a society will help determine whether it is financially viable.

If the majority of a society's costs are fixed, such as salaries, office and equipment leases, financing costs etc, then it is very important that the quantum of fixed costs does not encroach too closely on the amount forecast to be available for operational costs. Where a society is heavily weighted with fixed costs and experiences a drop in gross proceeds, this may affect its ability to meet the requirements outlined in paragraphs 5.2, 5.3, and 5.4, as fixed and other costs taken together may suddenly represent a figure greater than 38.47% of gross proceeds.

The nature of fixed costs means they have to be paid regardless of any changes in cash flowing into a business. Unlike a normal business, finding extra funding to pave over a lean period is not an available option in this industry, as there is no mechanism to recoup such funds in the future. It is therefore extremely important that a society's expense profile is flexible enough to respond to fluctuations in gross proceeds, and accordingly the Department will need to be satisfied about this before it considers a society financially viable.

To satisfy the ability to pay other costs criterion, a society must forecast costs of no more than 38.47% of forecast gross proceeds, and forecast fixed costs must be such that it leaves room to accommodate other non-fixed costs included in its forecasts.

5.4 **Ability to apply or distribute proceeds to authorised purposes**

A society must have the ability to apply or distribute from its *current year net proceeds* a **minimum** amount equivalent to 37.12% of the gross proceeds to or for authorised purposes. This requirement goes to the heart of the existence of every society, and is to ensure that funds from gambling benefit the community. In assessing a society's proposed gambling operation for financial viability, it is the ability of the society to apply or distribute that is paramount, not the actual paying out of net proceeds. In this respect a society must forecast net proceeds equal to or greater than the minimum distribution percentage. If it cannot reasonably forecast net proceeds of this quantum it indicates that it plans to incur too many costs, and its operation as a whole cannot come within the parameters outlined in this paper.

Actual distributions to authorised purposes go toward the assessment of whether a society can meet regulatory requirements [section 52(1)(f)] and past compliance [section 52(4)].

Societies should note that as part of the Department's financial viability analysis, the integrity of an applicant's financial forecast will be assessed by considering its historical record of forecasting, and subsequently demonstrating the ability to achieve at least the statutory minimum distribution target.

To satisfy the ability to apply or distribute criterion a society must forecast net proceeds of at least 37.12% of gross proceeds for distribution to or for authorised purposes.

5.5 Among Other Things

Section 52 of the Act provides some clear guidelines about what factors must be considered when assessing financial viability. It also provides some scope to factor the realities of the class 4 gambling industry into the Department's financial viability analysis. In this respect, one of the most critical additional elements assessed is a society's undistributed net proceeds.

6.0 Undistributed Net Proceeds

Regulation 11 of the Gambling (Class 4 Net Proceeds) Regulations 2004 requires a society to distribute *all or nearly all* of its net proceeds from conducting class 4 gambling activities to authorised purposes during the financial year in which the net proceeds are derived. In the event this is not possible, whatever residual amount is left over at balance date (the undistributed net proceeds) must be distributed before the end of the first quarter of the next financial year. For example, the money received in the couple of weeks preceding balance date may be difficult to distribute to the community in the short timeframe between receipt and balance date, but must be paid out within the first quarter of the next financial year.

In addition, the interpretation of the phrase “*all or nearly all*” as it is used in Regulation 11 does not mean once a society has reached the minimum distribution requirement it can use any residual funds for its own purposes, such as establishing an equity base sufficient to indemnify trustees in the event of failure of a society’s financial affairs. Net proceeds must be used solely for each society’s distributions to authorised purposes.

This requirement for a society to distribute all or nearly all of its net proceeds within a limited timeframe has an impact on a society’s ability to stay financially viable. Absolute compliance will effectively see the society operating without a cash buffer, whereas non-compliance jeopardises a society’s ability to hold a licence. Therefore, a balance needs to be found between the requirement to stay financially viable and the requirement to comply with Regulation 11.

There are two issues. Firstly, how should undistributed net proceeds be treated in the financial statements – as Equity or as a Liability? Secondly, what is an acceptable level of undistributed net proceeds?

6.1 Treatment of Undistributed Net Proceeds

6.1.1 Undistributed Net Proceeds as Equity

Gaming machine societies are, by virtue of the Gambling Act, non-commercial and typically operate without equity. In business terms, equity represents the financial interest an owner

has in their business. Equity acts as the foundation for investment and development of a business, but also as a buffer where operational cash inflow does not keep pace with costs. Without any equity, and coupled with the defined allocation of gross proceeds (refer 5.2, 5.3 and 5.4 above), societies continually operate in an environment that literally stretches operational cash flow to break even point, and therefore encroaches on operating while insolvent.

The last few years' evidence suggests that some societies have been purposely building reserves of undistributed net proceeds and using them as quasi-equity primarily as a response to the threat of trading while insolvent (a breach of company law, with the potential for directors to be held liable for the societies' debts).

Indeed in some cases societies are operating on the basis of no external funding at all but with high levels of undistributed net proceeds (termed "Trust equity") and contend that such an approach is laudable in that external interest costs are eliminated and, therefore, higher levels of net proceeds are being generated for distribution to the community. In this context though, high levels of undistributed net proceeds are in fact a substitute for external funding. The society is in effect 'borrowing' from the community interest-free and preventing the community from accessing those funds on a going-concern basis.

The operational practice of retaining undistributed net proceeds as equity is at odds with the intention of legislation. Net proceeds are the property of the community. A society is effectively holding them in trust until a suitable recipient is found. Both past and present law requires net proceeds to be distributed in totality to the community. Nowhere has there ever been a provision allowing net proceeds to be withheld from the community for the purpose of funding the operation of a society.

6.1.2 Undistributed Net Proceeds as a Liability

As undistributed net proceeds are owed to the community they should be recognised as a current liability, not as equity. However, consider the implications on a society of recording undistributed net proceeds as a current liability. Its previously disclosed equity position would disappear and its current liabilities would skyrocket. Its working capital ratio would

typically reduce to the point of liabilities exceeding assets, but of greatest concern, its balance sheet would indicate that the society is probably insolvent.

Therefore, the industry finds itself in a curious position. Realistically, if a society complies with the law and distributes all the net proceeds it derives, it will be left in a position where the Department would have to question its financial viability. Similarly, if a society withholds a portion of its net proceeds it gives the appearance of financial viability, but when undistributed net proceeds are recast as a debt to the community, the working capital ratio is likely to become negative. This also renders the society potentially insolvent.

There is obviously a need for the Department, as regulator, to allow societies to legitimately establish an equity base to ensure their continued financial viability without frustrating the requirement of the Act to distribute net proceeds to authorised purposes.

6.2 Guidelines for the Treatment of Undistributed Net Proceeds

The Department considers it important to operate within the intentions of the Act, specifically maintaining financial viability and compliance with Regulation 11. Therefore, in order to provide societies with direction on how to address both the ongoing financial viability of a society and the necessity to comply with Regulation 11, the Department provides the following guidelines on the treatment of undistributed net proceeds:

1. Each society may retain as a form of quasi-equity an amount no greater than 7% of that financial year's gross proceeds, to be recognised in the equity section of its Statement of Financial Position as "Community Equity". This is conditional upon a society first meeting the minimum distribution percentage (37.12% of gross proceeds) to authorised purposes. Community Equity does not include the value of other equity (if any), e.g. gaming machines, held by the society.
2. Community Equity will need to be accompanied by a note in a society's financial statements stating this is within the maximum amount allowed by the Department to be on hand at balance date in order to comply with the *all or nearly all* requirement of Regulation 11.

3. Each society who recognises an amount of Community Equity must have a distribution round within the month preceding balance date. In this distribution round it must distribute as much as practically possible of its identifiable current year net proceeds on hand.
4. If a society's balance of undistributed funds on hand at the adoption of this policy is greater than 7% of its current year's gross proceeds the society will be subject to a reduction agreement to be reached between the Department and the society.
5. All residual undistributed net proceeds on hand other than those recognised as community equity described in 1 above will be categorised as a current liability. However, when a reduction agreement is entered into, the amount of any excess greater than that due in the next year may be expressed as a term liability.

[The amount of 7% of gross proceeds is a rounded approximation of 2 months worth of net proceeds where a society's costs are such that it derives net proceeds of 40% of gross proceeds. (slightly above the minimum)]

The essence of this proposal is that the community, through net proceeds, would in effect contribute a fixed percentage of capital to societies to provide a basis for consideration of their ongoing financial viability. However, as this percentage would represent undistributed net proceeds accruing, then being distributed on a rolling basis under Regulation 11(a), it is considered a reasonable interpretation which in the circumstances helps achieve the purposes of the Act.

Note that in the event a society is sold to or merges with another society, the community equity of the sold/merged society must retain its character in the new entity. If however, a society closes and ceases its gambling activity the community equity funds are available in satisfaction of all legitimate debts (including repaying loans) and only after all such debts are discharged should any remainder be distributed to authorised purposes.

7.0 Compliance

This paper is intended to identify the Secretary's approach to assessing financial viability and includes an indication as to his intentions where there are excessive levels of net proceeds being retained as a form of equity. To ensure compliance, the Secretary may:

- Refuse to renew a licence; or
- Renew a licence, but suspend compliance action in view of a society's actions toward achieving compliance; or
- In some cases, seek an appropriate order for a Court sanctioned distribution of excess undistributed net proceeds, under Section 112 of the Act.

8.0 Conclusion

In its simplest form the concept of financial viability can be viewed as the capacity of a society to meet the costs of its operations as they arise. This simply requires income to exceed costs within the parameters required by the Act, outlined in 5.0 above. Unfortunately it isn't that simple. Societies need to ensure their operation is sufficiently efficient to meet the cost and distribution responsibilities placed upon them by the Act, but to also ensure there is enough flexibility in their operations to withstand potentially significant fluctuations in their incomes, the measure from which every other figure is obtained.

To do so, the Department will be considering three essential disciplines in determining financial viability: profitability, liquidity, and equity. These will be considered as a whole, with the overall picture being of greater importance than each individual element. It will be based on the forecast financial statements of the society for the next licence period and will involve an analysis of the assumptions underlying the forecasts.

The Department recognises the need for societies to establish an equity base, while also ensuring compliance with the requirement to distribute *all or nearly all* of the net proceeds in the financial year they are derived. The Department considers enabling a quantum of 7% of gross proceeds to be retained and recorded as 'Community Equity' in a society's financial statements achieves a reasonable balance between the financial viability and distribution to authorised purposes requirements of the Act.

9.0 Appendix – Financial Viability Legislation

Gambling Act 2003

Section 50 Application for a class 4 operator’s licence

- (1) A corporate society may apply to the Secretary for a licence to conduct class 4 gambling.
- (2) An application must be on the relevant standard form and be accompanied by –
...
 - (b) information about the financial viability of the proposed gambling operation and the means proposed to maximise the net proceeds from the class 4 gambling to be applied to or distributed for authorised purposes; and

Section 51 Secretary must investigate applicant for class 4 operator’s licence

- (1) The Secretary must undertake any investigations the Secretary considers necessary to determine whether the applicant and the key persons are eligible and suitable for the applicant to be granted a class 4 operator’s licence.

Section 52 Grounds for granting class 4 operator’s licence

- (1) The Secretary must refuse to grant a class 4 operator’s licence unless the Secretary is satisfied that, –
...
 - (c) the applicant’s proposed gambling operation is financially viable; and...
- (2) In assessing financial viability under subsection (1)(c), the Secretary must consider, among other things, the ability of the applicant to reward winners and pay levies, taxes, and other costs, as well as apply or distribute the net proceeds from the class 4 gambling to or for authorised purpose.

Section 56 Renewal of class 4 operator’s licence

- (1) A corporate Society may apply to the Secretary for a renewal of its class 4 operator’s licence before the expiry of the licence.
...
- (4) Sections 51 and 52 apply to an application for renewal as if it were an application for a class 4 operator’s licence.

Gambling (Class 4 Net Proceeds) Regulations 2004

Regulation 10 Minimum amount of net proceeds to be distributed for authorised purposes

- (1) The minimum amount of net proceeds that a licence holder must distribute for authorised purposes is the proportion equivalent to 37.12% of its GST exclusive gross proceeds for each of its financial years.

...

- (3) This regulation is subject to regulation 11.

Regulation 11 Timing requirements for distribution of proceeds for authorised purposes

- (1) A licence holder must distribute for authorised purposes, –
 - (a) during each of its financial years at least every quarter, all or nearly all of the net proceeds from the class 4 gambling during the financial year; and
 - (b) within 3 months after the end of each of its financial years, any remainder of the net proceeds from the class 4 gambling during the financial year.