REGULATION IMPACT STATEMENT

Regulation Impact Statement – Enhanced Scrutiny of the Financial Viability of Large Long Day Care Providers

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1. Introduction

In late 2008, the largest childcare service provider in Australia, ABC Learning Centres Limited (ABC Learning), went into voluntary administration. This was followed by the appointment of receivers and managers over the company by its banking syndicate. The unanticipated collapse of ABC Learning Centres raised questions around the regulatory framework for child care centres, with both State and Commonwealth governments moving swiftly to understand the impact the collapse may have on child care places and the viability of child care operators around Australia.

The unanticipated collapse of ABC Learning put at risk the provision of child care for over 120,000 children in more than 1,000 centres. The Australian Government acted with a commitment of $58 million on a support package to keep these centres open and support the transition through a review of the centres' operator.

In May 2010, the Australian Government announced that it would invest $273.7 million to support the introduction of the new National Quality Framework (NQF) for early childhood education and child care. $1.9 million of the announced funding was to support new regulatory measures to help achieve ongoing stability in the child care industry following the ABC Learning crisis.

This Regulation Impact Statement (RIS) provides an assessment and information from the consultation process conducted with the child care sector on the two regulatory measures below:

- Developing enhanced measures that required large child care providers to provide financial information in order to assess and monitor their financial viability on an ongoing basis; and
- Creating a new legislative power to enable an independent audit (audit power) of a child care provider to be commissioned where there are concerns about its financial viability and the failure of the provider could have a material impact on the market or a section of the market.

These proposed measures aim to increase the scrutiny of the financial viability of large child care providers by requiring providers, above a size threshold to demonstrate that they are financially viable at the time they apply for Child Care Benefit (CCB) approval and each year thereafter. The Financial Viability Framework has been developed for the purpose of assessing and monitoring the financial health of large Long Day Care (LDC) providers.

2 Assessing the problem

The options canvassed in this RIS address the problem, which was highlighted by the ABC Learning insolvency, that a large child care provider may experience financial difficulties and be unable to continue to operate, thereby affecting continuity of care for children and families.

2.1 Significance of the problem to be addressed

The experience with the insolvency of ABC Learning in late 2008 and during 2009 shows that there can be a significant level of business risk associated with some large child care providers. It also shows that insolvency can disrupt child care arrangements leading to anxiety among parents about the stability of care arrangements and potentially undermine workforce participation by parents, particularly women. Children require reasonably stable care arrangements to maximise the developmental benefits of formal care. Research suggests that stability in care is associated with higher quality child care and positive child outcomes.[1]

Business viability in the child care sector

As in any industry, risks to provider solvency can arise from a number of sources in the child care sector. Some risks may affect any provider, examples include: economic conditions or population demographic changes affecting demand, corporate fraud, increasing costs that are not offset by increased revenue, loss of liquidity, or the occurrence of a major event for which there is no insurance.

Other risks will vary according to the size and type of provider. Smaller providers may face issues about access to financial management skills, maintaining service viability given their small size or obtaining access to capital to fund maintenance and upgrades to their facilities. Some services may rely on regular payments from government to maintain a positive cash flow.

Providers in some regional and remote areas where demand is limited or costs are higher can qualify for additional assistance designed to support access to child care for children and families in areas or in circumstances where the market would otherwise fail to provide child care services. This assistance is funded through the *Child Care Services Support Program* and can include:

- Sustainability Assistance, which supports small child care services in areas of need approved by Department of Education, Employment and Workplace Relations (the Department) and helps communities retain access to child care where the operation of a child care service is not likely to be financially viable without it; and
- Budget Based Funding to support non-mainstream services in areas of need, particularly in regional, remote and indigenous communities.

Larger providers may be better placed to deal with these risks in some ways, for example, through more professional management, having easier access to capital, centralising some overhead functions or sharing staff and resources across centres. However, they may also be exposed to additional risks by virtue of being larger and more complex organisations to manage. Large for-profit providers may be exposed to additional risks depending on how they are financed, for example, loss of confidence may lead to a sudden fall in share prices (if Australian Stock Exchange (ASX) listed), shifts in the financial market may affect the availability of credit or the performance of other investments. Larger providers may also be exposed to greater risk if they also

[1] Council of Australian Governments, Early Childhood Development Steering Committee, *Regulation Impact Statement for Early Childhood Education and Care Quality Reforms*, COAG Consultation RIS, July 2009, p 6.

operate child care services in other countries or are part of business conglomerates also operating in other industries.

Size of child care providers

Providers of child care services range from small, single-entity crèches servicing a highly specific region (and possibly an age group of children), to large firms with multiple establishments nationwide that offer services for all ages of children and all levels of education. Most child care providers are small, operating one or a few services at most.

In June 2010 there were 13 899 child care services of all types approved for the purposes of the family assistance law. The largest numbers were Outside School Hours Care (OSHC) services (7 495) and LDC services (5 930). However in terms of the numbers of children cared for (869 770 in total as at June 2010), the majority were in LDC (60.7%), followed by OSHC (29.5%) and Family Day Care (FDC) (12.1%).

In the LDC sector, the largest single provider is the GoodStart syndicate which purchased 678 centres. GoodStart has been established by four non-profit organisations; Social Ventures Australia, Mission Australia, the Brotherhood of St Laurence and the Benevolent Society. To support the diversification of the child care market following the collapse of ABC Learning, the Government agreed to lend GoodStart $15 million over seven years to assist its acquisition of the centres.

Currently, in addition to GoodStart, there are another five organisations that run LDC services that will be affected by the proposed measures to enhance scrutiny of the financial viability of large LDC providers at this time. The total number of services that are run by these six organisations is around 900 services which is 14% of the LDC market.

ABC Learning's insolvency

The experience with ABC Learning makes it clear that the collapse of a large provider can occur and, when it does, can present significant risks to continuity of care. At the time it became insolvent ABC Learning owned or operated just over 1,000 child care centres in Australia caring for around 120,000 children. It was the largest single provider of child care in Australia with up to 20% of LDC centres and 24% of LDC places in Australia, having grown rapidly since it was first listed on the ASX in 2001. ABC Learning had also expanded into the United States of America (USA), the United Kingdom (UK) and New Zealand, acquiring a further 1,300 child care centres in those countries.

A range of factors appear to have played a part in ABC Learning's insolvency. An Australian Securities and Investments Commission (ASIC) investigation into ABC Learning's collapse is continuing. A public examination of former ABC Learning executives by the ABC Learning Administrator (Ferrier Hodgson) is underway and may also cast further light on the causes of the insolvency.

Consequences of ABC Learning's insolvency

ABC Learning's insolvency had significant consequences for both parents and Government.

For parents, there were widespread concerns that ABC Learning could cease to provide child care with minimal notice. The banking syndicate, which was ABC Learning's principal creditor, appointed a receiver on 6 November 2008. The banks and their advisors had established that, although the information available to them was imperfect, a significant number of ABC Learning centres were running at a loss and, in order to stem the already significant financial exposure of the banks, they would ordinarily have been closed. It became apparent at this point that there was a real risk that up to 400 ABC Learning centres could have ceased operating at the commencement of the receivership had normal commercial processes taken their course. This could have disrupted the care arrangements for around 44,000 children and up to 30,000 families.[2]

Following discussions with ABC Learning's banks and the receiver, the Government announced an initial support package of $24 million to ensure the centres could continue to operate to the end of 2008 while the receiver carried out a proper assessment of the viability of each centre, through an analysis of ABC Learning's complex records. Consequently, centres were classified into three groups in December 2008, with the resulting action being:

- 55 confirmed unviable centres were closed at the end of 2008 with children accommodated in neighbouring centres;
- 262 unviable centres were transferred into the ABC2 group, and sold through a process managed by a Court Appointed Receiver (PPB) at the request of the Commonwealth. Up to an additional $34 million was allocated in total to keep these centres operating until the final completion of that process in August 2009. A further 26 of these centres closed before being sold;
- 720 centres continued to operate into 2009 as ABC Learning (the ABC1 group), with 705 of these remaining sold by the receiver appointed by ABC Learning's major debtors (McGrathNicol) through a process which commenced in August 2009. From this process, GoodStart emerged as the preferred purchaser of the majority of the centres. The transfer of these services began in mid-2010 and was completed in April 2011.

This was a lengthy and expensive intervention by the Government in an environment where the final outcomes were very difficult to predict. Less than 100 ABC Learning centres closed at various stages of the process. The ultimate cost of direct Government support to keep the ABC2 group of non-viable centres open was around $58 million including the two announced support packages, legal and insolvency expenses and net of some monies yet to be repaid to the Commonwealth from the ABC2 sale. Additional to this, $2.6 million has been paid under the General Employee Entitlements and Redundancy Scheme (GEERS) to former ABC Learning employees

[2] The estimate of children is based on an average of 110 children per ABC centre as at March 2008 and the number of families is based on the average number of families per service for all services at March 2009.

up to February 2010. In addition, $15 million was loaned to the GoodStart as part of the arrangements for the ABC2 sale, to be paid back in full, at no cost to taxpayers.

Future risks

As a result of the ABC1 and ABC2 sale processes there will continue to be one large LDC operator and a number of medium sized operators in the future. It is unclear whether future conditions will favour the rapid growth of another large provider, although this cannot be ruled out. ABC Learning grew rapidly largely by acquiring existing services, although it did establish some new services. Some operators continue to seek opportunities to increase their business through mergers and acquisitions.

It is debatable whether the economics of the child care industry is likely to lead to increasing aggregation of services over time into large providers. It could be argued that the required staffing per child ratios limit the scope for large providers to become more efficient by getting bigger. However, even a small reduction in other costs, if translated into higher profitability, may confer a significant competitive advantage on a larger firm. The high number of remaining small providers and the rapid growth in the sector in recent decades has created opportunities for consolidation to occur. Demand for child care is likely to grow if fertility rates and female labour force participation rates continue to increase over time.

While the buyer of the ABC1 group is a not-for-profit provider, large for-profit, stock exchange listed and global companies are increasing players in comparable socially regulated and funded sectors (e.g. residential aged care, private health insurance) and may well have a continuing interest in child care in future. Other parties who were reported to be interested in bidding for the ABC1 group included Knowledge Universe, an international child care conglomerate with around 3,700 child care centres across the USA, UK, Canada and Singapore. Knowledge Universe purchased the formerly ABC Learning owned BusyBees chain in the UK early in 2009. Other interested parties were reported to be Navitas (an Australian-based international education and higher education provider listed on the ASX) and Archer Capital (an Australian private equity manager, specialising in management buyouts and leveraged buyouts).

2.2 Existing regulation

Commonwealth Regulation - under the family assistance law

The Australian Government supports the child care sector by assisting families with the cost of care through the availability of timely CCB and Child Care Rebate (CCR) payments. CCB and CCR are available only to eligible families accessing approved child care services. Most CCB payments are made to families through their approved child care service following the service's submission of the child's attendance record through the Child Care Management System (CCMS) on a weekly or fortnightly basis. The CCR is a separate payment that provides assistance for working families who use approved child care by covering half of all their out of pocket fees (after CCB), up to a maximum limit per child per year.

In order to receive CCB on behalf of families in the form of fee reductions, a child care service must receive Commonwealth Government approval (service approval). In order to gain this approval and remain approved, under family assistance law, a

child care service is required to meet various conditions. Among others, the conditions that a service must meet include that a service's key personnel and staff must be suitable people to operate a child care service. The operator must be a fit and proper person, including that they have not been subject to administration, receivership, liquidation, bankruptcy or debt recovery proceedings over the last five years; and they have no convictions or criminal charges pending.

The current service approval process does not capture the detailed financial information required to make a comprehensive assessment of the organisations' financial viability. The financial viability framework that has been developed by the Department is intended to cover this gap in information through assessing services' financial statements and examining the company structure of large LDC centres aiming to provide the Government with early warning of any potential financial issues with these large providers.

A number of steps have already been taken since the collapse of ABC Learning to improve regulation in this area. In particular, all new applications for CCB approval now specifically ask questions about the applicant's financial background and whether they, or any person involved in the management of the organisation, have been previously associated with an insolvency in the child care sector. Legislation to enhance the child care compliance framework and strengthen civil penalties for non-compliance has been passed and the notice period before services can cease operating was changed from 30 days to 42 days in 2010.

There are powers under the *A New Tax System (Family Assistance) (Administration) Act 1999* (the Act) to investigate an individual provider through the appointment of an authorised officer who can enter premises with the provider's consent and inspect certain records relating to eligibility for CCB and the service's compliance with conditions for continued approval. An authorised officer can include an employee of the agency (that is, the department) or any other person engaged by the agency, under contract or otherwise, to exercise the agency's powers. If the service consents to the entry by the authorised officer, they are obliged to co-operate with the authorised officer and produce records and provide all reasonable assistance. If they do not consent to entry, they may be subject to a sanction under section 200 of the Act. If, while consent to entry continues, they fail to produce the records, or fail to provide reasonable assistance and facilities to the authorised officer, they may incur a civil penalty. However, the scope of records that may be inspected does not extend to broader questions of financial viability.

A review of the *Child Care Benefit (Eligibility of Child Care Services for Approval and Continued Approval) Determination 2000* (the Eligibility Determination) has been undertaken in response to the insolvency of ABC Learning Centres and in recognition of the changing nature of the child care sector in Australia.

The key changes proposed to the Eligibility Determination are the broadening of the definition of 'key personnel' and expanding and strengthening the criteria for assessing the suitability of an applicant and their 'key personnel' (as newly defined) in relation to an application for approval, and for the continued approval, of a child care service for CCB purposes. These changes will allow the delegate to consider the suitability of any person or entity connected with the applicant in the past, present or future; as well as any person or entity with whom any of the applicant's previous,

current or proposed key personnel has a connection. The changes will also give the Secretary or her delegate the discretion to consider the financial viability of the applicant and key personnel, as one of the factors the Secretary may take into account in assessing 'suitability'.

Pending the endorsement of the Minister for Child Care, it is planned to register the Eligibility Determination by early May 2011, with these changes commencing upon Royal Assent of the *Family Assistance and Other Legislation Amendment (Child Care and Other Measures) Bill 2011*, which is currently before Parliament. This Bill proposes amendments to section 195 of the Act to broaden the powers of the Secretary to refuse a service's application for CCB approval where that service does not meet the eligibility rules, including the suitability assessment, set out in the Eligibility Determination.

Cross-industry Regulation

There are other types of cross-industry regulation that apply to all industries to regulate their conduct. For entities which are registered under the *Corporations Act 2001*, ASIC is the corporate regulator responsible for ensuring that company directors and officers carry out their duties honestly, diligently and in the best interests of their company. Under its Act, ASIC has powers to initiate its own investigations into the affairs of corporations in certain circumstances and the responsible Minister may also direct ASIC to investigate a matter. Other cross industry regulation includes the *Competition and Consumer Act 2010* with the Australian Competition and Consumer Commission (ACCC) being responsible for regulating unfair market practices and mergers and acquisitions of companies to promote competition in the market place.

Although these regulating measures exist they do not allow for the ability for regular monitoring and assessment of a child care provider's financial viability or the power to conduct an audit of a large long day care provider. Also, not all large long day care providers are companies registered under the *Corporations Act 2001* and different regulatory arrangements apply to such providers, but these also do not allow for regular monitoring and assessment of a child care provider's financial viability or the power to conduct an audit of a large long day care provider.

Quality assurance

In relation to regulation for quality in the provision of child care, the Council of Australian Governments agreed on 7 December 2009 to the introduction of a National Quality Framework (NQF) covering LDC, FDC, OSHC and preschool services. The NQF will begin to be implemented from 1 July 2010, with staff to child ratio and qualification changes being progressively implemented from 1 January 2012.

The National Quality Standard includes a requirement that all providers are fit and proper persons with a sound financial reputation to operate a child care service. This will involve a basic check of a provider's record as to whether there are any major indicators of previous financial problems. Discussions are under way with the States and Territories on how to integrate these processes as part of the streamlined national regulatory system so that providers only have to supply this information once.

2.3 Need for Government action

Government action is needed because, as the ABC Learning insolvency shows, there are potentially significant risks to continuity of care and the achievement of the Government's early childhood education and care objectives from large child care providers which become insolvent.

The occurrence of the ABC Learning insolvency suggests that the level of business risk in child care and its potential effects on continuity of care for children has been underestimated in the past. Early in the ABC Learning insolvency there were concerns that up to 400 ABC Learning centres could have ceased operating at the commencement of the receivership. This could have disrupted the care arrangements for around 44,000 children and up to 30,000 families. That the number of centres which eventually closed was much smaller was due to a protracted and costly intervention in the market. While successful in cushioning the impact on most families, such interventions are not without risks and may not be effective on a future occasion.

Large child care providers becoming insolvent can also undermine achievement of the Government's early childhood education and care objectives. The Australian Government provides significant funding, directly and indirectly to child care providers to promote quality child care and labour force participation. In 2009-10 estimated expenditure on CCB is $1,987 million and on CCR is $1,091 million. Most parents currently elect to receive CCB by way of an offset to fees, with benefits paid direct to providers. The introduction of fortnightly CCR payments in the same way as CCB will also allow parents in future to receive CCR as an offset to fees. Consequently a greater proportion of Commonwealth assistance is likely to be paid directly to providers in the future.

In other sectors there is scope to undertake a detailed audit where there are concerns about a provider's financial standing. For example:

- Under section 19-80 of the Higher Education Support Act 2003, the Minister may require a provider to be audited as to their compliance with the financial viability requirements and certain other specified requirements. The provider must co-operate fully with the auditor;
- Under Division 214 of the Private Health Insurance Act 2007, the Private Health Insurance Administration Council may appoint an inspector if the Council suspects the affairs of an insurer are not being carried on in the interests of policy holders, or the insurer has contravened the prudential standards for funds and provisions relating to restructures, mergers/acquisitions and termination of funds. The inspector's report to the Council must include recommendations with respect to: whether the insurer should be permitted to continue to conduct a particular health benefits fund; whether the insurer's affairs should be reorganised to enable it to better conduct the fund and, if so, the way in which they should be reorganised; and such other matters as the inspector thinks fit.

However, in the childcare sector the Government's ability to assess the financial viability of significant operators is not able to be undertaken for a number of reasons. These include: deficiencies in the current service approval process which does not capture the detailed financial information required to make a comprehensive

assessment of the organisation's financial viability; the lack of legislative power to require detailed financial information from large LDC providers; and the ability to conduct an audit of a large provider where there are concerns about its financial position. Further, the current provisions in the Act do not provide for records that may be required on broader questions of the entities financial viability.

3 Objectives of government action

When the Commonwealth Government first became financially involved with child care in 1972, the primary policy rationale was to support workforce participation, particularly by women. Promoting child care is now seen to have a wider range of general objectives including, supporting early childhood development through access to high quality programs and enhancing access to early childhood education and care opportunities for social inclusion groups. In these ways, child care is a key policy mechanism to support the Government's wider participation and productivity agenda, which seeks to develop and retain human capital to improve Australia's future success and prosperity. Achieving this requires child care to be provided in a way that: is affordable; provides continuity and sustainability of supply; is adequate and appropriate for most reasonable needs; and is flexible, economically efficient and competitively priced.

The proposals assessed in this RIS specifically seek to improve the continuity of care, to help reduce the risk of a future insolvency of a large child care provider as occurred in the case of ABC Learning. The collapse of ABC Learning highlights the real possibility that, from time to time, a large child care provider may become insolvent and ceases to operate. A large scale insolvency can potentially threaten the continuity of care for many children and families. Continuity of care and a reasonably stable child care market is a necessary part of the Government's plans to improve early childhood education and care access and outcomes in Australia and to ensure that child care is available to support working parents. In this context, it is important to recognise the social and economic importance of early childhood education and care and its interconnections with other policies. The importance of the child care market to workforce participation and other objectives and its substantial reliance on Government subsidies supports a greater degree of scrutiny than currently applies to markets more generally.

4 Options that may achieve the objectives

The options assessed in this RIS are:

- Option 1: No change
- Option 2: Legislate for the ongoing annual assessment of financial viability, and independent audit in certain circumstances.

Self-regulatory and quasi-regulatory options are not explored for several reasons. Although the probability of another large insolvency is difficult to quantify, it is likely to be more than just a low risk and the consequences may well be more than low impact. A self-regulatory approach would be inappropriate given that the ABC Learning collapse attracted strong public interest and concern and that the incentives for market participants to self-regulate are weak. In addition, the fragmented nature of the child care industry would work against effective self- or quasi-regulation.

Option 1: No change

This option would involve taking no specific action following the collapse of ABC Learning. However, it would still be possible, should another large provider emerge or become insolvent in the future, for the government to utilise existing mechanisms to respond. This could include:

- Regulators such as the ACCC and ASIC investigating matters within their existing powers. The Competition and Consumer Act would also continue to apply to future mergers and acquisitions in child care – noting that the existing powers apply to companies and are not applicable to all child care providers operating in the market;
- should a large provider cease to operate, the Commonwealth intervening in the market as it did with ABC Learning, to keep services open in the short term and assist families to locate alternative care, while longer term continuity of care issues are managed as best as possible according to the circumstances; and
- using existing financial information that companies are required to report to ASIC – noting that the range of information reported to ASIC is limited to certain entity types and does not allow for the range of financial information proposed under option 2.

Option 2: Legislate for the ongoing annual assessment of financial viability and independent audit in certain circumstances

Under this option, amendments would be made to the family assistance law to enable the Department to undertake ongoing annual financial viability assessments of large LDC providers, and a power to enable an independent audit of a child care provider in certain circumstances.

There are no legislative powers to do this at present under the family assistance law. This new legislative power would enable the Department to seek financial information from large LDC providers in order to assess the viability of the provider, as specified in the Financial Viability Assessment Framework (the Framework). This information would be in the form of:

(i) a request for audited financial statements ; and
(ii) a requirement to complete a short questionnaire regarding operational and organisational information.

In addition, a new power to commission an independent audit of a particular provider where there were concerns about its ongoing financial viability is proposed.

An independent audit may be triggered by concerns about the immediate or ongoing financial viability of a large LDC provider identified through departmental monitoring from the annual financial viability assessment process. It would allow a range of issues to be investigated in greater depth, based on relevant information sourced for the audit. The audit would draw on appropriate expertise to assess the outlook for a provider and develop strategies to minimise the financial issues or manage it in such a way as to protect continuity of care for families utilising the service. Any large LDC provider required to undergo the annual financial viability assessment process would be obliged to cooperate.

Where an audit made recommendations in relation to a particular provider's governance or financial affairs, the Secretary may, if appropriate, require the large LDC provider to comply with additional conditions of continued CCB approval (under section 199 of the Act).

5 Impact analysis — costs, benefits and risks

Option 1: No change

Affected stakeholders

As with the other option canvassed below, the affected stakeholders for this option are children and their families using child care, child care providers and governments at the Commonwealth, State and Territory level.

In September 2010 there were 14 075 child care services of all types approved for the purposes of the family assistance law. The largest numbers were OSHC services (7 567) and LDC services (6 027). However in terms of the numbers of children cared for (910 810 in September 2010), the majority were in LDC (61%), followed by OSHC (29%) and Family Day Care (FDC) (12%).

Currently, there are six organisations that run LDC services that are initially expected to be affected by the application of the financial viability framework. The total number of services that are run by these six large LDC providers is around 900 services which is 14% of the total number of LDC services.

Expected types of costs and benefits

The no change option would have minimal costs and benefits for families in the short term. However, in the longer term, the risk that another large child care provider might emerge and become insolvent would remain. While the immediate outcome of the ABC Learning receivership has been to restore diversity and stability to the child care market, some operators continue to seek opportunities to increase their business through mergers and acquisitions.

Under this option, businesses would not face additional costs and there would be no short-term costs for Government. However, the Government would need to rely on currently available financial and business information to assess the risks of a large provider ceasing to operate. As previously stated, the current financial information available to the Government will not cover all organisations operating in the child care market, and is not to the level of detail required to undertake a comprehensive assessment of the organisation's financial health. Further, the Act does not allow for the consideration of an entity's financial viability on an ongoing basis, or the ability to further audit an entity where there are concerns about its financial viability. Given these deficiencies there is a risk that, as a comprehensive assessment of financial viability cannot be undertaken, another large provider may collapse with little or no warning for the Government.

There could be subsequent costs for Government if ASIC or the ACCC were to investigate or inquire into an issue. There could also be costs should a large provider cease to operate at some point and the Government decided to intervene to keep services open in the short term and manage the transition to a new provider, as occurred with ABC Learning where the total costs of intervention was $58 million.

Assessment of costs and benefits

In the event that another large child care operator collapses, the Government could develop a response similar to that when ABC Learning collapsed. This might include providing funding support to a receiver so that centres do not close immediately and proactively helping families find alternate care in affected areas. The availability of vacancies on the MyChild website from November 2009 has assisted parents to access reliable information and reduce the need for the Government to actively identify available places on an ad hoc basis. An increase in the notice period required to be given before a centre can close from 30 to 42 days was implemented through legislative amendments in 2010 and is designed to give parents more time to locate alternative care if providers adhere to that requirement.

However, the effectiveness of a future ABC Learning style intervention cannot be taken for granted. Circumstances are highly likely to be quite different and much would depend on the particular characteristics of the provider, the factors which prompted its collapse and the state of the broader child care market and economy at the time. Moreover, experience with the ABC Learning insolvency points to the cost, complexity and risk involved in intervening in the market in such circumstances. As noted earlier, the ultimate cost of direct Government intervention as a result of the ABC Learning collapse was $58 million. The costs incurred in a future scenario would depend on the size of the provider, the number of unviable centres and the capacity of the Government to support continuity of care for what may be an uncertain period of time.

Option 2: Legislate for the ongoing annual assessment of financial viability and independent audit in certain circumstances

Affected stakeholders

This option would primarily affect providers who might at some future point attract scrutiny through such a process. The affect on parents and children using their services is expected to be negligible. The Government would be affected as the body responsible for undertaking the annual assessment process and initiating any audits.

Expected types of costs and benefits

In the event that concerns emerged from departmental monitoring or from the annual financial viability assessment process about the financial viability of a large LDC provider, there would need to be a capacity to address those concerns further in a formal way. A new power under the family assistance law to commission an audit of a large LDC operator would allow issues to be explored through appropriate processes leading to recommendations for the Government and the provider to consider which might ultimately reduce the risk of provider insolvency and continuity of care for families using the services.

Benefits for families would include greater confidence in the stability of the market and continuity in the provision of care due to greater transparency and monitoring undertaken by the Department. An independent audit may allow a provider’s financial viability to be assessed at an earlier stage and could enable strategies to be developed that may minimise, or give earlier warning in order to minimise, the adverse outcomes experienced in the case of ABC Learning. Moreover, an audit of a provider’s financial viability might assist in restoring confidence in the continuity of care or lay the basis for an orderly transition to more sustainable and secure arrangements.

Where an audit makes recommendations in relation to a particular provider's governance or financial affairs, the Secretary, if appropriate, would have the power to require the provider to consider the implementation of those recommendations as a condition of continued CCB approval. Options for intervention could include: working with the provider to understand their financial viability issues; recommending to the provider to seek independent expert advice; and identifying potential parties who may be able to step in and provide management services.

The new financial viability assessment process and audit power would be expected to have little impact on most child care businesses for two reasons. First, the financial viability assessment process has been designed to have minimal impact on the resourcing requirements of a provider, as the financial information supplied by providers is largely information the entity would provide to meet its financial reporting obligations. Second, the intention is that the power, though broad, would be used only in exceptional circumstances so that an audit would occur relatively infrequently.

Where a business was directly affected, then depending on the circumstances, the business could face some additional compliance costs. These costs would be in the form of co-operating with the auditor by providing access to the provider's financial statements, financial systems and other more detailed records and responding to requests for information by modifying existing reports or collecting additional data. Providers might also incur costs for accounting, legal and other professional advice on their rights and responsibilities under the legislation. As stated above, these costs are expected to be minimal due to the design of the financial viability assessment process.

Depending on the recommendations of an audit the Secretary may require a large LDC operator to report more frequently or to report additional information on their financial performance and business arrangements. The Government could incur additional costs relating to the recommendations of an audit. Benefits to Government could include:

- Sending a clear signal to providers that maintaining financial viability is regarded by Government as a critical pre-condition for operating in the market and maintaining CCB approval. This could help to modify the pursuit of higher risk business strategies by some child care providers and so reduce the likelihood that continuity of care will be affected by another large insolvency in future or the cost of intervention in the market after an insolvency;
- Give more reliable advance warning to the Government of trends in the market and emerging risks to continuity of care so that events can be better anticipated and planning for possible eventualities can commence. In particular, the capacity to audit a provider's financial situation would give the Government a better understanding of the real state of a business rather than place reliance on public speculation which may not be well informed. It could also help to crystallise choices for the Government about the likelihood of the business becoming insolvent, whether this can reasonably be prevented or delayed and how continuity of care for families can best be achieved in the circumstances; and
- Together with enhanced scrutiny of financial viability, the power to audit a provider would give Government additional options to consider if at some future point another large child care provider encountered financial problems.

A number of risks would need to be considered before the audit power was exercised:

- There is a risk that the appointment of an auditor may occur too late or may not be able to delay or prevent an insolvency given the scale of an operator's debts and the economic and financial conditions at the time;
- There is also a risk that public knowledge of the appointment of an auditor could precipitate insolvency if perceptions of a provider's financial soundness translate into a drop in share prices or withdrawal of credit. Markets may already be aware that a company is in some financial difficulty; and
- Depending on what type of Government intervention is chosen in response to a finding that a provider is in financial difficulties, there may also be public expectations that the Government may be willing to "bail out" large providers. While this is not the intent of these measures, the implications of this would need to be considered carefully as part of any intervention strategies that were developed as a result of an audit.

Assessment of costs and benefits

Under option two there are two types of compliance costs for large child care providers. These are: costs associated with annual reporting requirements of the Framework; and the costs associated with providing additional information and assistance to an independent auditor.

Although the costs associated with annual reporting for a provider cannot be estimated with any certainty, the majority of stakeholders consulted in the development of the Framework indicated that they could address the requirements using existing financial systems and resources. Of the eight submissions received from the twenty largest LDC providers relating to option 2, only two providers indicated that they would have an issue providing audited financial information in the timeframes required. That is, there may be an issue with the provision of financial statements by a certain date, if the entity is required to meet internal approval processes. It should be noted that, at the time of consultation, these providers did not fit the criteria of a large LDC provider, and would therefore not be required to comply with the proposed framework. The Department received feedback from four of the large providers who currently operate 25 or more centres. Those providers indicated that they already prepare audited financial statements and that the requirement to provide these to the Government will involve minimal cost.

In relation to the framework questionnaire, one provider advised that they had conducted a 'dummy-run' and it took approximately an hour for the provider to complete. This indicates that the additional compliance costs for providers who are initially expected to be required to comply with the reporting requirements are not substantial. Providers might incur costs for accounting, legal and other professional advice on their rights and responsibilities under the legislation, but these cannot be estimated readily - noting that the Government would cover the costs of the auditor appointed by the Department.

It is not possible to prepare a comprehensive financial analysis of an organisation by focussing solely on the financial information that is currently available. For this reason, the proposed framework requires the provider to complete a questionnaire which takes into consideration qualitative factors that can impact an organisation's

financial viability. These factors include information such as changes to structure and ownership, ability of an organisation to meet its financial obligations, and other key financial information that can have a significant impact on the continuity of a large LDC provider. The results from this questionnaire together with the financial analysis will provide the Government with an indication of the risk that the organisation will not remain viable in the short and medium term.

In the event that an audit was commissioned, the likely costs incurred by a provider would depend heavily on the circumstances and the scope and purpose of the investigation as well as any recommendations emerging from it. From consultation with the largest LDC providers, while two providers opposed the legislation amendments relating to the audit power, no providers raised issues of costs or impost resulting from a commissioned audit.

Similarly, it is not feasible to quantify the costs and benefits for the Government of appointing an independent auditor to audit a provider's financial affairs. Costs would only be incurred if the powers were exercised and it is intended that they would only be exercised in exceptional circumstances where the Government was seriously concerned about developments in the child care sector. Based on the collapse of the ABC Learning centres, the benefits could be the prevention of collapse through supporting stability in the sector.

Assessment Summary

The costs and benefits of these options are summarised in Table 1 below. On balance, Option 2 is the preferred way to address the underlying issue of reducing the risk that a potential future large child care insolvency poses to continuity of care.

No change (Option 1) avoids immediate costs to providers and the Government, but does not reduce the risk that another large child care provider could emerge and collapse in future. As shown by the ABC Learning experience, ad hoc interventions after collapse can be risky and costly.

Legislating for the ongoing assessment of financial viability and independent audit in certain circumstances (Option 2) would:

- Send a clear signal to providers that maintaining financial viability is regarded by Government as a critical pre-condition for operating in the market and maintaining CCB approval; and
- Give more reliable advance warning to Government of trends in the market and emerging risks to continuity of care so that events can be better anticipated and planned for.

While affected providers could face some additional compliance costs with an audit, the power would be used only in exceptional circumstances and in relation to larger LDC providers (whose failure could have a material impact on the market or a section of the market). This would limit the number of providers who might be affected directly by the audit power.

Table 1: Summary assessment of options

<table>
<tr><td rowspan="2">Option</td><td colspan="3">Impacts, costs and benefits</td><td rowspan="2">Overall impacts</td></tr>
<tr><td>Families</td><td>Businesses</td><td>Government</td></tr>
<tr><td rowspan="2">Option 1 – No change</td><td><u>Benefits</u>
• No immediate impact.</td><td><u>Benefits</u>
• No immediate impact.</td><td><u>Benefits</u>
• No short term cost.</td><td rowspan="2">• Avoids short term costs, but risk remains another large provider could emerge and collapse in future.
• Ad hoc interventions after collapse can be risky and costly.</td></tr>
<tr><td><u>Costs</u>
• Risks of future insolvency would remain.</td><td><u>Costs</u></td><td><u>Costs</u>
• Effectiveness and cost of future ad hoc interventions highly uncertain.</td></tr>
<tr><td>Option 2 – Legislate for the ongoing assessment of financial viability and independent audit in certain circumstances</td><td><u>Benefits</u>
• Potentially some greater market stability and continuity of care.

<u>Costs</u>
• nil</td><td><u>Benefits</u>
• Supporting stability in the sector

<u>Costs</u>
• Costs of providing financial information should be low as existing financial reports would be used
• Costs associated with an independent audit should be low as the power would be used sparingly</td><td><u>Benefits</u>
• Provides a formal mechanism to address issues arising about financial viability.
• Could reduce the risk of another large insolvency, or the need for or cost of other types of intervention.

<u>Costs</u>
• Direct costs in conducting an audit.
• May increase expectations of government intervention.
• Some costs in developing and implementing a financial monitoring framework.</td><td>• Not possible to quantify with certainty.
• Provides a formal mechanism to follow up on concerns about the financial viability of a specific provider and develop strategies to avoid or minimise adverse outcomes.
• Would bring child care regulation closer into line with other sectors e.g. non-government schools.
• Would require careful management of public expectations.</td></tr>
</table>

6 Consultation

In developing the proposals in Option 2, the Department conducted a multi-phase consultation process with national peak bodies representing the child care sector and the top 20 largest LDC providers (those with 25 or more services and those providers on the threshold of owning 25 services). These stakeholders represent or manage a mix of for-profit and community-managed or not-for-profit LDC services.

<u>Annual assessment of financial viability</u>

The Framework has been developed for use by the Department to assess the financial viability of large LDC providers (a large LDC is considered to be those which operate 25 or more services). The objectives of the Framework are to:

- Address the risk of sudden and wholesale closure of child care services by monitoring the financial viability of relatively large scale operations, so the risk of financial collapse may be identified early and steps taken to reduce the potential impact on families and business through workforce participation and the child care sector; and
- Minimise the financial and intervention cost to the Government.

The Framework includes appropriate indicators, benchmarks and processes for collecting data and conducting assessments and has been designed to minimise compliance and other impacts on providers. The scrutiny will involve all new and existing providers above the size threshold (operating 25 or more LDC services) submitting annual financial reports to the Department and undergoing an annual financial assessment against the benchmarks in the Framework on an ongoing basis. These assessments will provide the Department with a closer understanding of the large providers operating in the sector and of current issues in the market that might affect financial viability.

Legislation to enable an independent audit in certain circumstances

Stakeholders were also consulted on the proposed measure to allow for an independent audit of a particular large LDC operator.

The Department has taken into account a range of stakeholder views from written submissions and direct contact in relation to the proposed new regulatory measures.

In addition to this formal consultation, the Department also conducted a presentation to Peak Bodies at the National Children's Services Forum on 16 November 2010 to provide information on the new measures and explain the process for developing the Framework.

First phase of Stakeholder consultation

The first phase of the consultation process was undertaken by *McGrathNicol* – consultants engaged by the Department to develop a draft framework. The purpose of the first phase was to obtain an understanding of the financial systems in place at the larger LDC providers and seek information from those providers on the key financial viability risks that affect their operations.

At the time of consultation, *McGrathNicol* informed stakeholders that the framework would likely comprise of:

(i) a request for audited financial statements; and
(ii) a requirement to complete a short questionnaire regarding operational and organisation information.

Nine of the fourteen organisations invited to face-to-face or teleconference meetings in relation to the development of the proposed Framework participated. Participants agreeing to the consultation included four of the six largest LDC providers (those with 25 or more services). The following comments from these consultations were provided:

- All providers (with 25 or more services) advised that they already prepared audited financial statements for an existing reporting requirement (either by

their board, the ASX or State legislation). As such, these providers commented that the requirement to provide audited financial statements would require minimal administrative work or resources from them;

- Providers who did not prepare audited financial statements (none of which were providers that operated 25 or more services) indicated that requiring them to prepare audited financial statements would be a large burden on their financial and administrative resources and indicated that they would be resistant to this. However, these providers stated that they had financial systems in place (such as commercial accounting systems) that could produce unaudited financial statements with minimal administrative work or resources. These providers also indicated that they would be able to obtain director sign-off on these statements;
- All providers indicated that the completion of the questionnaire would require some administrative resources. Whilst comments were made that the administrative impact of the requirement to complete the questionnaire would be minimal, most commented that they would be able to make a more accurate assessment once they have been provided with the draft framework and questionnaire;
- Some for-profit providers commented that they were wary that the framework would have unintended consequences such as the Government reducing the funding of those providers who make significant profits;
- Some providers were concerned about the confidentiality of information provided to the Department in accordance with the proposed framework; and
- Some providers commented that, had this framework existed prior to the collapse of ABC Learning, it wouldn't have captured the financial viability risk of that organisation in advance.

As a result of the responses from stakeholders that were gathered during the consultation process, the Department has effected changes to the framework which are presented below.

<u>Second Phase of Stakeholder Consultation</u>

The key documents for the draft framework were sent to all National Peak Bodies who represent child care services in Australia (10 in total) and the top 20 LDC child care providers seeking feedback on both the proposed framework and amendments to the legislation which will provide a power to commission an audit of a large LDC operator. Responses to the draft framework were received from eight providers and two National Peak Bodies - *Australian Community Children's Services* and *Early Childhood Australia*.

<u>General Comments</u>

The majority of feedback from stakeholders received indicates:

- Overall support for the implementation of the framework;
- That the framework will not be difficult or overly onerous to comply with;
- Financial statements are already prepared for existing reporting requirements and therefore there would not be any increase in accounting and legal costs of providing information to the Department;

- Support for the changes to the legislation to provide a power to commission an independent audit of a particular LDC operator.

Furthermore, a number of stakeholders recommended that the Framework be applied to other large service types (eg OSHC). It is not intended to extend the framework at this time.

Changes to the Financial Viability Assessment Framework

Large LDC providers with 25 or more services are required under the Framework to submit financial and non-financial information to the Department to enable financial viability assessments to be undertaken.

The Framework has been designed to enable the Department to conduct a meaningful assessment of a provider's financial health, primarily from financial information that the provider would ordinarily produce as part of it general business practise. Providers are also required to complete a questionnaire about their business operations.

Based on the current structure of the industry, only six LDC providers would need to comply with the requirements of the Framework. Some concerns which were raised in relation to the proposed new measures to enhance scrutiny of large LDC providers have been addressed through the consultative process and have been highlighted below.

a. *A number of stakeholders did not believe that the financial viability framework would have identified the risk of ABC Learning's financial collapse.*

   In their response, the Department advised that it is aware through discussions with McGrathNicol of the limitations of the Framework. McGrathNicol has highlighted that it is difficult to assess financial viability when fraudulent reporting occurs. The Department has assessed this risk and believes that given the importance of the child care market to supporting workforce participation and other social inclusion objectives and its substantial reliance on the Government's child care assistance, the ability to have a greater degree of scrutiny than currently applies to the market is warranted.

b. *Child care fees may increase to meet costs in providing financial viability assessment information*

   The majority of stakeholders indicated that they could address the requirements of the framework using existing financial systems and resources. One provider advised that they had conducted a 'dummy-run' on the framework questionnaire and it took approximately an hour to for them to complete. There appears to be no evidence that implementation of the framework will lead to child care fee increases.

c. *Providers unable to meet timeframes for submitting financial Information.*

   Some providers expressed concern relating to the timing of the financial information in that the information is generally out of date by the time of the assessment.

   McGrathNicol has discussed the limitations of the Framework with the Department and has indicated the timing of the reports is an inherent risk. The Department has

considered and assessed this risk and believes it is necessary to obtain audited financial information which is considered more reliable than unaudited financial statements and that delays in the provision of audited information is an acceptable risk.

d. *Is there provision to extend timeframes to meet Framework Requirements?*

   Two providers, which are not required to comply with the Framework as they are not considered large providers in accordance with the definition set by the Framework, expressed concern that they may not meet the current timeframe for submitting financial statements due to internal information consolidation and approval processes.

   The Department will implement a process for considering applications for extension of submission of information under the Framework on a case-by-case basis to ensure that relevant material is accessed in a timely way.

e. *Duplication of effort as some information requested is already available in other government departments*

   The vast majority of stakeholder feedback received indicates that providers do not consider that the Framework will be overly difficult or overly onerous to comply with. The Department is aware that some providers which are required to comply with the Framework may also be required to provide financial information to other government agencies in order to comply with existing cross-industry regulations.

   In the Framework, the Department has specified dates for the provision of financial information by large LDC providers to coincide with the end of an entity's financial reporting period. The Department considers this approach to be more efficient than seeking to secure confidential financial information from other government agencies or third parties on behalf of large LDC providers.

f. *What happens if an LDC provider with 25 or more services that is required to submit financial and non-financial information under the framework does not comply*

   All providers with 25 or more LDC services are required to comply with the Financial Viability Assessment Framework. If an approved child care provider contravenes any obligation imposed on it, sanctioning or financial penalties are applicable under the family assistance law. The guidelines for the framework will assist all providers to understand their compliance obligations, particularly when their circumstances change and they become subject to the framework.

Stakeholders raised some concerns about the definitions of 'operator', 'organisational structure' and 'owners' in the draft framework. Additionally, some providers considered the benchmarks indicated in the Financial Viability Assessment Template to be lower than expected. The Department is responsive to stakeholder views presented in the consultation and have made changes to the Framework where appropriate. These changes include (but are not limited to):

- Clarifying definitions or terminology which some providers have expressed as being unclear such as:
    - '*operators*' is '*entities responsible for financially supporting the LDCs*';

- '*organisational structure'* is *'ownership organisational structure'* as opposed to *'employee/staff organisational*';
- *'owners'* are *'directors'* in the case of publicly listed companies.

- Including a list of the documentation that falls within the definition of financial statements;
- Incorporating a statement to ensure providers are aware that provided benchmarks are not targets but rather reference points for assessors.

As part of the implementation process, the Department will consult with the sector to develop guidelines to assist providers to comply with the Framework. The guidelines will be released before the implementation date of the Framework.

Legislation Amendment

There was strong support for the legislation changes from *Australian Community Children's Services* and *Early Childhood Australia* (National Peak Bodies representing the child care sector) with both representatives submitting that:

> *..... it is crucial that the public interest is protected in the provision of services to young children and families*

However, two of the LDC providers opposed the legislation amendments relating to the audit power submitting concerns that:

> *.....we are required to operate in accordance with the Corporations Law.....we do not believe it is appropriate to impose other quasi-regulatory requirements on a company*

and

> *....the provider may become bogged down in the investigation thereby reducing their involvement in the day to day running of the business*

Taking these concerns into consideration, the Department maintains that the change to the legislation is warranted due to:

- The Australian Government is the primary funder of child care through paying CCB to families using approved child care services and registered care and payment of CCR to eligible families using approved child care. These payments are estimated at over $3.1 billion for 2009-10. In addition, the Government funds organisations to provide information, support and training to approved service providers. Operational and capital funding is also made available to some providers.
- An independent audit of a provider would provide greater market stability and continuity of care for families and a formal mechanism to address issues arising about provider financial viability where the insolvency of a provider could have a material impact on the market or a section of the market.
- Implementation of the Framework signals to the child care market that the Government is taking a strong role in monitoring the strength of the market and will take appropriate action via an investigation of a provider where warranted. Where the Department identifies that further investigation of a provider should be undertaken, depending on the severity of the issues identified, the

Department intends, in the first instance, to work with the provider to understand the financial viability issues.

Financial implications of commissioning an independent audit

The costs to the Government in conducting an independent audit is dependent on the circumstances, length and expertise required and therefore on cannot be quantified in advance with any certainty. If an audit is required it will be funded via the Child Care Services Support Program.

The costs to the provider of an audit (that is, the cost of engaging an independent auditor)are not expected to be significant for the provider as the Government will make provision for the engagement of the independent auditing expertise. The audit will primarily draw upon existing financial information from the provider.

7 Conclusion and recommended options

The proposed introduction of an ongoing annual assessment of financial viability for large LDC providers will require the provision of financial and non-financial information to the Department to enable monitoring of an entity's financial health. This will allow the Government access to more detailed financial information than is presently available in order to provide an overall financial viability assessment.

An audit power will allow the commissioning of an independent audit of a large LDC operator where there are concerns about its financial viability.

The ongoing annual assessment of financial viability together with the legislative power to audit could:

- send a clear signal to providers that maintaining financial viability is regarded by Government as a critical pre-condition for operating in the market and maintaining CCB approval; and
- give more reliable advance warning to Government of trends in the market and emerging risks to continuity of care so that events can be better anticipated and planned for.

The preferred option has been designed largely to assess and monitor the financial health of large LDC providers on an ongoing basis. While it is not possible to quantify with certainty the overall impact of the changes, given the preferred option is a relatively light-handed approach to prudential regulation it is unlikely to materially change outcomes in the sector however the changes will support stability in the sector. While the benefits may be low, however, the preferred option is very low cost.

The financial viability assessment process is not intended (and not able) to detect fraudulent reporting of results. However, given the importance of the child care market in supporting families and workforce participation objectives and its substantial reliance on the Government's child care assistance, the Government's ability to have a greater degree of scrutiny than currently applies to the market is warranted.

The Department's consultation provided evidence of support from child care stakeholders for both measures announced in the 2010-11 Budget relating to enhanced scrutiny of the financial viability of child care providers. Moreover, a number of

stakeholders expressed support for the regulatory approach to be extended to other large child care providers.

The Department has made changes, as outlined earlier in this statement, to the Framework to assess financial viability of large LDC providers in direct response to stakeholder concerns during the Department's consultation.

It is recommended that the proposed new measures under Option 2 be implemented after 1 July 2011, subject to the passage of legislation, as the proposals have:

- Received strong stakeholder support,
- Can be applied on a practical basis,
- Are cost-effective; and
- Seek to minimise undue regulatory burden on child care providers.

8 Implementation and review

The Department intends to review the extent to which the objectives and principles of the framework have been achieved in 2012-13 following implementation.

The audit power to allow the commissioning of an independent audit of a large LDC operator where there are concerns about its financial viability would be implemented by the Australian Government through amending the family assistance law in early 2011. Legislative amendments could come into effect from immediately after Royal Assent, which is anticipated in mid-2011 if the proposed bill is passed by the Parliament in the Winter Sittings. The effectiveness of the measure would be reviewed each time it is exercised, bearing in mind that the powers proposed are not likely to be utilised frequently.