


IN THE MATTER of the Gambling Act 2003

AND of an appeal by **CONSTELLATION COMMUNITIES TRUST**

BEFORE A DIVISION OF THE GAMBLING COMMISSION

Members: G L Reeves (Chief Gambling Commissioner)
L M Hansen
R D Bell

Date of Decision: 9 November 2012

Date of Notification
of Decision:  December 2012

**DECISION
ON AN APPEAL BY CONSTELLATION COMMUNITIES TRUST**

Background

1. Constellation Communities Trust (the “**Appellant**” or “**Trust**”) appealed against a decision by the Secretary for Internal Affairs (the “**Secretary**”) to suspend its class 4 operator’s licence. The Secretary suspended the licence under section 58(1)(b) Gambling Act 2003 (the “**Act**”) for six days on the basis that it failed to comply with the requirement that it distribute 37.12% of its GST exclusive gross proceeds for each of the 2008/2009 and 2009/2010 financial years. The requirement is set out in regulation 10 Gambling (Class 4 Net Proceeds) Regulations 2004 (the “**Regulations**”).
2. The Appellant appealed the decision on the grounds that the Secretary had erred in determining the amount by which the Appellant fell short of regulation 10 and that the suspension was therefore too severe.

Relevant law

3. The relevant law is as follows:

Gambling Act 2003

58. Suspension or cancellation of class 4 operator’s licence

- (1) The Secretary may suspend for up to 6 months, or cancel, a class 4 operator’s licence if the Secretary is satisfied that—
 - (a) any of the grounds in section 52 are no longer met; or
 - (b) the corporate society is failing, or has failed, to comply with any relevant requirement of this Act, licence conditions, game rules, and minimum standards; or

...



- (2) In deciding whether to suspend or cancel a class 4 operator's licence, the Secretary must take into account the matters in section 52.

106 Corporate society must apply or distribute net proceeds from class 4 gambling to or for authorised purpose

- (1) A corporate society must apply or distribute the net proceeds from class 4 gambling only to or for an authorised purpose specified in the corporate society's licence.

4. Section 4 of the Act defines "net proceeds" as:

net proceeds, in relation to gambling, means the turnover of the gambling plus interest or other investment return on that turnover plus proceeds from the sale of fittings, chattels, and gambling equipment purchased from that turnover or investment return less—

- (a) the actual, reasonable, and necessary costs (including prizes), levies, and taxes incurred in conducting the gambling; and
- (b) the actual, reasonable, and necessary costs incurred in complying with whichever of the following apply to the gambling:
- (i) this Act or any other relevant Act;
 - (ii) an operator's licence;
 - (iii) a venue licence

5. Regulations 10 and 11 provide for the minimum amount of net proceeds distributions and timing of distributions:

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.
- (2) The first financial year in relation to which a licence holder must comply with subclause (1) is the financial year that commences after the commencement of this regulation.
- (3) This regulation is subject to regulation 11.

11 Timing requirements for application or distribution of proceeds for authorised purposes

- (1) A licence holder must apply to, or 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.
- (2) The first financial year in relation to which a licence holder must comply with subclause (1) is the financial year that commences after the commencement of this regulation.

The decision under appeal

6. In the 2008/2009 financial year, the Trust distributed \$779,242, which was equal to 37.16% of that year's gross proceeds. However, in that year, the Trust only earned net proceeds of \$751,564, or 35.84% of its gross proceeds. The balance of the distribution was made up of \$22,992 of net proceeds retained from the previous year, and another \$3,883, which the Trust borrowed.
7. In the 2009/2010 financial year, the Trust distributed \$741,265, which was equal to 37.78% of that year's gross proceeds. However, it only earned net proceeds of \$706,543, or 36.01% of its gross proceeds. The difference of \$21,716 was apparently funded by borrowing.
8. The Secretary considered that each year, the Trust had breached regulation 10 and that the total amount by which the Trust was in breach was \$48,591. The Secretary also considered that the shortfall was the result of spending \$14,231.48 in 2010 on one of its venues (Boston Bar), in altering the gaming room walls and installing an extra door, and an increase in trustees' expenses (from \$17,433 in 2008/2009 to \$30,258 in 2009/2010). The Secretary had advised the Trust of his view that the Boston Bar expenditure was not reasonable or necessary when it was proposed in the context of the imposition of a new licence condition. He regarded the decision to proceed with the expenditure, thus contributing to a regulation 10 shortfall, as aggravating (rather than as constituting its own breach). The Secretary also considered that the second breach was aggravated by the fact that it was a repeat breach.

Submissions by the Appellant

9. The Appellant submitted that there were two issues on appeal:
 - (a) Whether regulation 10 required a society to both generate and distribute net proceeds in a financial year equal to 37.12% of gross proceeds, or whether a society could use a small amount of funds retained from a previous year (and not in breach of regulation 11) to meet a future year's 37.12% requirement.
 - (b) Whether the proposed suspension was appropriate.

Proper interpretation of regulation 10

10. The Appellant submitted that it was entitled to use net proceeds generated in an earlier financial year as part of the current year's regulation 10 minimum distribution requirement, provided that the net proceeds had not been retained in breach of regulation 11. It submitted that:

- (a) Regulation 11 provided that each year a corporate society must distribute all or nearly all of its net proceeds. This means that a small amount of net proceeds can be retained from one year to the next. Having “lawfully retained” a small amount of net proceeds from 2007/2008 without breaching regulation 11, its distribution of those retained net proceeds in 2008/2009 should be counted as a 2008/2009 distribution when assessing compliance with regulation 10 in 2008/2009.
- (b) Whereas regulation 11 imposed an express requirement to distribute funds within a particular financial year, regulation 10 did not require corporate societies to generate net proceeds of 37.12% in each financial year.
- (c) The *Kiwi Community Trust* decision, GC19/09, could be distinguished on the basis that the appellant in that case had breached regulation 11 as well as regulation 10. Further, in that decision the Commission made numerous references to net proceeds “unlawfully” or “wrongfully” retained from one year to the next. This suggested that net proceeds that were not retained in breach of regulation 11 could be used towards another year’s regulation 10 minimum distribution requirement.
- (d) Regulation 10 did not say that the net proceeds must have been generated within the financial year for which they were being distributed.
- (e) What must be distributed was an “amount of net proceeds”. The definition of net proceeds made no reference to time periods and included current “profit” and any “profit” lawfully retained. Although the definition did not refer to “profit”, when read alongside regulation 11, which allows for a small amount of net proceeds to be retained, “net proceeds” must include “lawfully retained” profits from a previous year. (It is unclear to the Commission what the Trust means by “profit” and how that is distinct from “net proceeds”. No provision is made under the Act for societies to have “profits”.)
- (f) Because the “net proceeds” meant current “profits” and any “profits” lawfully retained, regulation 10(1) effectively reads:
- (1) The minimum amount of current profits and any profits lawfully retained 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.
- (g) If the Secretary’s interpretation were correct, regulation 10(1) would read:
- (1) The minimum amount of net proceeds from the class 4 gambling during the financial year 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.

Submissions on penalty

11. The Trust submitted that, based on its interpretation of regulation 10, it was \$3,388.41 short of regulation 10 in 2008/2009 and \$21,715.39 short in 2009/2010, making a total breach of \$25,598.79 (rather than the sum of \$48,591 used by the Secretary).
12. The Trust submitted that a regulation 10 breach would occur for one of two reasons: insufficient gaming machine revenue, or excessive operating expenses. It submitted that a punitive sanction should not be imposed on a society which has had its gaming revenue decline, because such a decline is usually due to factors outside a society's control.
13. The Trust submitted that the suspension imposed by the Secretary suggested that he viewed a \$48,591 regulation 10 breach more seriously than the incurring of costs of \$48,591 which were not actual, reasonable or necessary but when the regulation 10 requirement had been met. The Trust submitted that the two should be seen at least as equally serious and that, in its view, a breach involving costs that were not actual, reasonable and necessary was more serious.
14. The Trust referred to a number of decisions of both the Commission and the Secretary. The Trust submitted that the most similar decision to have been considered by the Commission was the *Blue Waters Community Trust* decision (GC01/12), in which the Commission varied a three day suspension to a one day suspension, for a breach of Limit D of the Gazette Notice: Limits and Exclusions on Class 4 Venue Costs, of \$27,351.
15. In relation to the aggravating factors relied upon by the Secretary, the Trust submitted:
 - (a) It was not aware, when it breached regulation 10 in 2009/2010 that it had breached regulation 10 the year before. The alleged breach was only brought to its attention by the Department in January 2012. A repeat breach should not be treated as an aggravating factor if it did not knowingly repeat the breach.
 - (b) The renovation costs on the venue did not negatively affect its ability to meet regulation 10 in 2009/2010, as it had sufficient cash on hand to make grant payments in excess of 37.12% of its gross proceeds. The costs did not decrease the net proceeds generated in the 2009/2010 financial year, as the work was included as an asset in the Trust's account. It only reduced the net proceeds by \$664, namely the depreciation cost for painting, carpet and building work. These costs were incurred prior to the Commission's decisions

in The Trusts Charitable Foundation (“TTCF”) and The Southern Trust (“TST”) cases, decisions GC11/10 and GC10/10 respectively, when such costs were common. It had not incurred similar expenditure since those decisions.

- (c) The increase in trustee expenses was as a result of the greater amount of work required of one of the trustees, who was contracted by the Trust to undertake a number of administrative duties, which were excluded from its contract with its management provider. They were based on an all-inclusive fee of \$95 per hour.

16. The Trust also submitted that it was relevant that:

- (a) The breaches were historical. In the years ended 30 June 2011 and 30 June 2012, the Trust had generated net proceeds of 39.49% and 46.72% respectively.
- (b) On 12 September 2012, the Department issued a press release, incorrectly (in the Trust's view) characterising the regulation 10 breach as one of \$48,500 (instead of \$25,598.79) and leaving the public with the view that its breaches were similarly serious to those of TTCF, because the press release stated that a six day suspension had been imposed.

Submissions by the Secretary

17. The Secretary submitted that the sum of net proceeds equivalent to 37.12% of gross proceeds must be derived solely from gross proceeds generated within the financial year to which the regulation 10 obligation related. If some net proceeds were retained from one year to the next, in accordance with regulation 11(3), they must be distributed within the first three months of the following financial year. For regulation 10 purposes, these net proceeds were attributed towards the year in which they were generated.

18. The Secretary made the following submissions in support of his interpretation:

- (a) This interpretation was supported by a plain reading of regulation 10 and by the Commission's decision in the Kiwi Community Trust appeal.
- (b) The purpose of regulation 10, together with limits on operating costs, was to maximise net proceeds for distribution and to minimise costs. This purpose would not be fully realised if societies were able to use net proceeds generated in other years to meet the regulation 10 requirement for a given financial year.
- (c) The fact that regulation 10 was subject to regulation 11 did not support the Appellant's argument. Rather, it meant that the obligation to distribute 37.12%

could be met within three months after the end of each of a society's financial years.

- (d) In *Kiwi Community Trust*, the Commission stated that the reference to net proceeds could only be to net proceeds generated within the relevant financial year, in the light of the prohibition of the retention of such net proceeds by regulation 11. Whether or not there was a breach of regulation 11 did not affect the discrete nature of the obligation in regulation 10 falling within the relevant financial year.
- (e) "Net proceeds" did not include "current profit and any profit lawfully retained".

19. The Secretary submitted that the Appellant's use of undistributed funds from a previous financial year and borrowing (effectively use of projected proceeds from a subsequent year).

Period of suspension

20. The Secretary submitted that a six day suspension was appropriate. He submitted, in summary, that:
- (a) As the Commission set out in the *Kiwi Community Trust* decision, one of the effects of regulation 10 was to make the distribution of 37.12% a first, not last, priority.
 - (b) Even if a society had met the minimum return of net proceeds, it was still required to continue to minimise its costs and maximise net proceeds.
 - (c) The Trust prioritised remuneration to trustees, and securing venues, above its obligations to the community. It appeared that payments to the trustee for grants administration were \$317 per grant application in the 2008/2009 financial year and \$173.24 in 2009/2010. This was excessive. A reasonable cost would be \$100-\$120 per grant application.
 - (d) A six day suspension reflected the Trust's failure to reduce its costs and reflected its repeat offending.
 - (e) The *Kiwi Community Trust* decision was available to the Trust in September 2009, two months into the 2009/2010; therefore the Trust had guidance on the proper interpretation of the Regulations.

Further memorandum for Secretary

21. Prior to the Trust filing its submissions in reply, the Secretary filed a memorandum in response to a series of requests for further information sent by the Trust to the Secretary. The queries, and responses, are summarised below.
22. *Question One* – Should a cash or accruals method be used for determining compliance with regulation 10? The Trust was of the view that, if a grant application was approved in year one, but paid out in year two, and was allocated to year one's regulation 10 total, this suggested an accruals method.
23. The Secretary responded that the timing of approvals played no part in regulations 10 or 11, which were concerned with actual distribution. In order to comply with regulation 10, a minimum of 37.12% of a year's proceeds must be distributed from the net proceeds derived solely in that financial year.
24. *Question Two* – Was it common place at licence renewal for the amount shown on the Gambling Machine Account Summary ("**GMAS**") as the authorised purpose percentage return to be identical to the net proceeds generated?
25. The Secretary responded that authorised purpose return in a financial year was not always identical to the net proceeds generated as a small amount of net proceeds could be carried over into the next financial year and distributed in the first three months under regulation 11.
26. *Question Three* – Could the Secretary's views be reconciled with the GMAS form, which makes references to a cash calculation method?
27. The Secretary responded that the reference to "cash paid out" on the GMAS form referred to distributions that had been made in that financial year. The form was not inconsistent with his view on the operation of regulation 10.
28. *Question Four* – Could the Secretary direct the Appellant to any guidance issued about compliance with regulation 10?
29. The Secretary responded that a society's obligations are set out in regulation 10, and the *Kiwi Community Trust* decision was available to the Trust in September 2009.
30. *Question Five* – Should recovered depreciation be apportioned back to prior years?
31. The Secretary responded that it should not, because this would involve re-calculating the net proceeds of those prior periods. Under the Act, proceeds of sales of equipment (recovered depreciation) formed part of the net proceeds of the financial year in which they were received. Net proceeds were defined in the Act as "turnover of the gambling

plus interest or other investment return on that turnover plus proceeds from the sale of fittings, chattels and gambling equipment purchased from that turnover or investment return less ...".

Appellant's submissions in reply

32. In reply, the Appellant submitted, in summary:

- (a) In contrast to regulation 11, regulation 10 refers simply to "net proceeds", rather than to net proceeds from the class 4 gambling during the financial year. A purposive approach, such as the Secretary's, which involved reading in the words "from the class 4 gambling during the financial year" was not required, because regulation 10 did not create any large loophole that could be exploited.
- (b) If the requirement were to generate net proceeds in each financial year equal to 37.12% of that year's gross proceeds, regulation 10 would say so.
- (c) If regulation 10 required all net proceeds generated in one financial year to be allocated to that year, even when part of the net proceeds were actually distributed in the following year, this would create bizarre consequences:
 - (i) it would unduly delay the completion of annual accounts;
 - (ii) it would defeat the purpose of a prompt distribution of a minimum amount of net proceeds; and
 - (iii) every society's authorised purpose return would be the same percentage as the amount of net proceeds generated.
- (d) If the sum of net proceeds referred to in regulation 10 was always going to be equal to the actual amount of net proceeds generated, then there was no need for regulation 10 to refer to a minimum amount of distribution.
- (e) The Secretary's approach suggested an accruals (rather than cash) method, in which grant applications approved in year one but paid out in year two (from year one's net proceeds) should be allocated back to year one's regulation 10 total. This was in contrast to the Department's practice and advice to societies.
- (f) In calculating its regulation 10 breach to be \$3,883 in the 2008/2009 financial year and \$21,715.39 in the 2009/2010 financial year, the Trust did not make any allowance for net proceeds that had not yet been generated. If it had, it would not have breached regulation 10, but rather regulation 16(g) (grants must be made from available net proceeds).

- (g) It accepted that the Commission was free to find that, if a society carried forward a small amount of funds when it had failed to distribute a sum equal to 37.12% of its gross proceeds in the prior year, some of the amount carried forward should be allocated back to the prior year for the purpose of regulation 10. The amount carried forward in breach of regulation 10 (ie the 37.12% shortfall) should be allocated back to address the breach.
- (h) The Trust did not carry any amounts forward in breach of regulation 10. The \$22,992 carried forward to 2008/2009 equated to 1.27% of the previous year's gross proceeds (an amount that clearly falls within the definition of "nearly all"). In the 2007/2008 year the Trust distributed \$677,647 (37.7% of its net proceeds) and accordingly no breach of regulation 10 occurred. Given that the funds carried forward were carried forward without a prior breach of regulation 10 or 11, the net proceeds should be allocated to the year in which they were actually distributed (2008/2009).
- (i) The trustees' costs in 2008/2009 were not solely in relation to grant administration.
- (j) An all inclusive cost of \$170 to \$175 per grant application was reasonable. Even if the Secretary's view that \$120 per grant application was accepted as the maximum permitted, the overspend on grant administration would only have been \$8,484 and was not a significant cause of the regulation 10 breach.
- (k) The Secretary's position that regulation 10 was clear was inconsistent with the fact that the issue was not raised at meetings with the Trust in 2009 and 2010, and was only raised by the Department in January 2012.
- (l) The Secretary's submission that the balance of a "nearly all" sum that was not distributed by year's end (and that was instead distributed in the first three months of the following year) was attributable to the year in which it was generated was inconsistent with the Department's licence renewal form. The form required the distribution to authorised purposes sum to be calculated expressly excluding undistributed funds earned in the year and carried forward to the next year.
- (m) The Secretary's interpretation would require an accruals method in relation to approved grants, but the Department advised societies that the regulation 10 requirement was measured on a cash basis (ie only including grants paid out in the financial year).



- (n) A regulation 10 breach due solely to a low level of net proceeds was not as blatant as paying more than 16% in venue costs or incurring costs that were not actual, reasonable or necessary.
- (o) There was no culture of excess spending. The trustees refused to accept any honoraria payment in the two years in question.
- (p) In the forecast for the 2011/2012 year, trustee costs were forecast to be \$55,000. This forecast was reviewed by the Department, which stated that the total cost budget appeared to be reasonable. In light of this, it was difficult to see how the total trustee payments in 2008/2009 (\$17,473) and 2009/2010 (\$30,258) could be the subject of criticism.
- (q) No mention was made by the Secretary of the fact that the Trust's management provider's fee remained the same over the years in question.
- (r) The Secretary had not commented on other cases raised by the Trust or identified any prior decisions which would suggest a six day suspension is consistent and fair.

Depreciation

- 33. The Trust also raised a new point, in its reply submissions, regarding depreciation. It submitted that, in 2008/2009, net proceeds were reduced by a \$188,211 depreciation allowance. In 2009/2010, net proceeds were reduced by a \$229,280 depreciation allowance. In 2010/2011, \$66,080 of previously allowed depreciation was recovered, and in 2011/2012 \$367,648 of previously allowed depreciation was recovered, by the sale of fixed assets.
- 34. If a depreciation rate which more accurately reflected later sale receipts been used, the Trust submitted, the depreciation allowances would have been reduced in the relevant years and the Trust would have generated net proceeds in excess of 37.12% of its gross proceeds in the 2008/2009 and 2009/2010 financial years. Accordingly no breach of regulation 10 would have occurred.
- 35. The Trust submitted that the depreciation recovery also meant that the Trust had recovered funds lost to the community, and that significant credit should be given for this. The Trust submitted that treating recovery of depreciation as recovery of an earlier year's net proceeds would also stop the practice of some societies adopting a very low depreciation rate in order to bolster their net proceeds generated sums, and then later incurring larges losses on a sale as a one-off cost.



Secretary's memorandum on depreciation

36. The Secretary filed a brief memorandum in response to the Trust's depreciation argument. He submitted, in summary, that:
- (a) Depreciation recovery was not a recovery of unlawful expenditure, it simply reflected the sale price of an asset on the open market, to the extent that it exceeded the written down book value of the asset.
 - (b) Directors and trustees of companies and trusts were obliged to assess fairly the working life of an asset when they acquired it and ascribe a depreciation rate to ensure that the original cost price was allocated over that working life. However, during its working life, an asset may be sold and the actual sale price may be above or below its book value. This did not necessarily mean that the depreciation formula was wrong, as market forces had a bearing on the sale.
 - (c) Depreciation recovered in a financial year formed part of the net proceeds of that financial year.
 - (d) The Trust's interpretation would allow the revisitation of depreciation allowances and mean that financial results would always be tentative until all assets had been sold.
 - (e) This would create unnecessary confusion and uncertainty for both the Secretary and corporate societies.
 - (f) He referred to the submission in his original submissions, that compliance with regulation 10 could not be manipulated by annual adjustments to depreciation rates. Although they were not "cash costs", they must nevertheless consistently be applied from year to year on the basis of a genuine assessment by trustees of the expected usage and life span of the underlying asset.

Analysis

37. The Appellant accepted that it had breached regulation 10 in the 2008/2009 and 2009/2010 financial years, but argued that the breach was not as great as assessed by the Secretary because regulation 10, properly interpreted, allowed for net proceeds generated in one year, but distributed in another, to be counted towards the regulation 10 requirement for the year in which they were distributed and that the resulting difference should be reflected in a substantially reduced suspension period. The Appellant's interpretation, if accepted, would reduce a \$48,500 shortfall over two years to a \$21,700 shortfall over the same period. Such a difference may not ultimately have

had a highly material effect on penalty but the issue is an important one as, in some cases, it may be the difference between compliance and breach.

38. Accordingly, there were two issues for the Commission to consider:

- (a) Can regulation 10 requirements for a given financial year only be met by net proceeds generated in the same financial year?
- (b) What is the appropriate consequence for the Appellant's regulation 10 breaches in all the circumstances?

Can regulation 10 requirements for a given financial year only be met by net proceeds generated in the same financial year?

39. The Commission considered regulations 10 and 11, and their relationship to each other, in some detail in the *Kiwi Community Trust* decision. *Kiwi Community Trust* was an appeal against a refusal by the Secretary to renew a class 4 operator's licence, not an appeal against a suspension. The Secretary had refused to renew the society's operator's licence because he was not satisfied (in terms of section 52) that the society was financially viable; that the net proceeds would be distributed for authorised purposes; or that the society was able to comply with applicable regulatory requirements. This was because, over a period of several years, the society had breached regulation 10, by distributing amounts less than the stipulated minimum. Further, in two years, the society had also breached regulation 11, by retaining significant proportions of its net proceeds (81% of its net proceeds in one year and 68% of net proceeds in the other). Essentially, the society had started to hoard money to create a reserve to meet future years' distribution obligations. The Commission stated, at paragraphs 21 to 23:

Regulations 10 and 11 impose obligations to distribute net proceeds in respect of the year in which the net proceeds are generated. Section 4 of the Act defines "net proceeds" by reference to turnover. Regulation 11(a) requires a licence holder to distribute "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". Regulation 10 provides that "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". The references in each of regulations 10 and 11 to "net proceeds" are to net proceeds generated within the relevant financial year. Such an approach is only to be expected in the light of the prohibition of the retention of such net proceeds by regulation 11. Even if the wording were not express, such an implication would arise.

The regulations therefore create discrete obligations in relation to net proceeds in respect of the year within which the proceeds are generated. A licence holder is not permitted to work to a cumulative total. It cannot, for example, over-distribute in one year and under-distribute in the following year to the extent of its previous over-distribution. The retention of the net proceeds in the following year would be in breach of that following year's regulation 11 requirement to distribute all of that year's net proceeds, regardless of any over-distribution in a previous year.

Similarly, the regulation 10 requirement that a licence holder distribute net proceeds equivalent to at least 37.12% of that year's gross proceeds is a requirement that relates to that same year's net proceeds. A licence holder cannot meet the regulation 10 requirement to distribute at least 37.12% of its net proceeds in a later year by using funds retained from an earlier year. Doing so would not meet the regulation 10 requirement because the licence holder would not be meeting the regulatory minimum from that year's net proceeds. It would also involve a breach of regulation 11 because the funds retained from the earlier year must have been retained in breach of the requirement to distribute all or nearly all of that earlier year's net proceeds.

40. The Commission considered that the Kiwi Community Trust had an ongoing liability in respect of its past and outstanding regulation 11 breaches. It found that the Kiwi Community Trust was not financially viable, and it was not satisfied, on the basis of the Trust's past non-compliance and its forecasts for future distributions (which involved utilising undistributed funds unlawfully retained from prior years), that the Kiwi Community Trust would meet applicable regulatory requirements. The Commission was also not satisfied that the society's purpose in conducting class 4 gambling was to raise money for authorised purposes (section 52(1)(b)), as its past practice indicated that its primary purpose was to ensure its own survival (with distributions having the lowest priority, behind meeting all other financial obligations of the society and even the creation of cash reserves). Nor was the Commission satisfied that the society would maximise net proceeds from class 4 gambling and minimise operating costs.
41. Whereas Kiwi Community Trust concerned a history of clear breaches of both regulations 10 and 11, such that the Secretary, and Commission on appeal, were not satisfied of the financial viability of the society, in this case there was no suggestion by the Secretary of breach of regulation 11. The Commission proceeded, therefore, on the basis that the \$22,992 retained from 2007/2008 was paid out in the first three months of 2008/2009 as provided in regulation 11. That is an important point of difference and it meant that the *Kiwi Community Trust* appeal did not require the Commission to address the precise question raised about the interpretation of regulations 10 and 11 in this appeal.
42. Regulation 10(1) provides:

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 (emphasis added).

43. The Regulations define gross proceeds in terms similar to the first part of the definition of "net proceeds" as follows:

gross proceeds, in relation to gambling, means the turnover of the gambling plus interest or other investment return on that turnover plus proceeds from the sale of fittings, chattels, and gambling equipment purchased from that turnover or investment return, less prizes

44. The Regulations also provide that, unless context requires otherwise, terms and expressions that are not defined in the Regulations but that are defined in the Act, have the same meaning as the Act.
45. The Trust submitted that, because regulation 10(1) was silent on when the net proceeds must be generated (it refers only to distribution), and because regulation 11 allows for a small amount of net proceeds to be retained from one year to the next, it was possible to use undistributed net proceeds from one year towards the following year's section 10 distribution requirement. For example, on the Trust's analysis, if, at the end of year one, a society had distributed 37.12% of year one's gross proceeds, and had distributed nearly all of its net proceeds, but still had \$100 at the end of the year, it could use that \$100 towards meeting the next year's regulation 10 requirement.
46. The Secretary argued that regulation 10 required the net proceeds to be distributed to be generated in the same year. The Commission agrees with the Secretary's view of the correct interpretation of regulation 10.
47. The Trust's analysis ignores the full text of regulation 10. Regulation 10 deals with the minimum amount of distribution but sets the minimum as a percentage of "gross proceeds for each of its financial years". In the Commission's view, the reference to gross proceeds in regulation 10 is to gross proceeds generated in the financial year in question. As the minimum amount of net proceeds for distribution is defined as a proportion of gross proceeds generated in each financial year, logically the reference to net proceeds should also be to proceeds generated in that financial year. This is supported by the definition of net proceeds, as the turnover of gambling (plus interest or other investment return on that turnover plus proceeds from sale) less costs. In the example given above, the additional \$100 is from turnover, or gross proceeds, in year one, and would therefore be net proceeds of year one, not year two.
48. The Commission considers that this conclusion is supported by the relationship between regulations 10 and 11. Whereas regulation 10 prescribes the minimum distribution, for each financial year, regulation 11 deals with the timing of distributions. Under regulation 11(b), the \$100 in the example at paragraph 46 would have to be distributed no later than the end of the first quarter of year two. This is because the \$100 was part of the gross proceeds, that is the turnover, generated in year one.
49. If the Appellant were correct, the \$100 in the example above could be treated as net proceeds from year one for the purposes of regulation 11, but distributable as part of year two's regulation 10 requirement. There are a number of problems with this analysis:

- (a) The Appellant's argument is premised on a society distributing its minimum regulation 10 requirement in the first year, and having a "surplus" of net proceeds (meaning funds in excess of the minimum). The Appellant accepted that if, at the end of a financial year, a society has not met regulation 10, but still has some funds undistributed, these funds must not only be distributed within the first three months of the following year (regulation 11(b)) but must also be attributed towards year one's distributions in order for the society to comply with regulation 10. However, the Appellant submitted that only the amount by which the society fell short of regulation 10 in the previous year needed to be allocated towards the previous year's regulation 10 requirement. That is, an amount of net proceeds retained from one financial year to the next could be used towards either year's regulation 10 requirement, depending on the society's performance in each year.
- (b) This approach is at odds with the apparent purpose of the Regulations. Regulation 11 is designed to require the prompt distribution of net proceeds and to ensure that all funds are distributed. The three month window is a period of grace which places a firm outer limit on a degree of inevitable delay in distribution (as the final quarter net proceeds would never be fully distributed by the last day of the quarter). But the Trust's argument seems to assume that its use is a matter of entitlement. If societies were able to withhold "surplus" net proceeds for distribution at times convenient to the societies, this would treat the minimum distribution requirement as the real target, above which societies have a considerable degree of latitude.
- (c) Using the example above, the \$100 retained into year two would not form part of the defined "gross proceeds" for year two, against which the 37.12% is calculated. The \$100 would therefore be a "bonus" amount, which the Appellant could use to meet a minimum requirement that is pegged to gross proceeds in year two. The Commission does not consider this to have been the intent of the Regulations.
- (d) Regulations 10 and 11 are sensibly capable of audit if net proceeds held over at the end of a financial year are distributed in the first three months of the following year and attributed to the financial year in which they are generated.

50. The Commission was not persuaded to take a different view because of the supposed inconsistencies which, the Trust submits, would occur on the Secretary's interpretation:

- (a) The Trust argued that, if the purpose of regulation 10 was to require all net proceeds generated in a particular year to be attributable to the year in which



they were generated, this would result in every society's authorised purpose return being exactly the same as the amount of net proceeds generated. However, the proper interpretation of regulation 10 is not affected one way or the other by the way in which the Department seeks information for the purposes of licence renewal.

- (b) The Trust argued that, if the sum of net proceeds distributed under regulation 10 were always going to be equal to the actual amount of net proceeds generated, there would be no need for regulation 10 to refer to a minimum amount of distribution. This is plainly wrong if, as the heading to regulation 10 states, the intent is to impose a minimum amount of net proceeds. The minimum is necessarily expressed as a percentage of gross proceeds. The Commission sees no practical distinction between net proceeds earned or distributed for the purposes of regulation 10, where net proceeds can only be distributed to authorised purposes (section 106).
- (c) The Trust submitted that the Secretary's approach suggests that a grant application approved in year one, but paid out in year two (from year one's net proceeds) should be allocated to year one's regulation 10 total. The Trust submitted that this suggested an accruals, rather than a cash, method for determining compliance with regulation 10, which contradicted the Department's practice. The Commission did not think the method of dealing with such approvals had a bearing on the interpretation of regulation 10. The Secretary's interpretation of Regulation 10 simply means that the year in which net proceeds are generated (or the gross proceeds pool from which they are derived) will determine the period in respect of which they are distributed for the purposes of compliance with regulation 10, regardless of when the distributions were approved or made.
- (d) The accounting difficulties raised by the Appellant seemed overstated. A corporate society would not necessarily have to wait until the end of the first three months of the following year to determine whether it has complied with regulation 10. Regulation 10 specifies a minimum amount of distribution as a percentage of that year's gross proceeds. Regulation 11 requires that nearly all of it be distributed at least quarterly and imposes a final period of grace to have distributed it all. At the end of a year, a society will know whether it has complied with regulation 10 and should know how much remains undistributed and needs to be distributed within three months.



- (e) The inconsistencies raised by the Appellant, relating to the Department's approach to date and the Secretary's submissions, are not relevant to the interpretation arguments; the Department's interpretation and treatment of the regulations do not affect the proper interpretation of the regulations. To the extent any inconsistencies are relevant, they are more likely to be relevant to the question of whether suspension is appropriate and the period.
- (f) The Appellant's argument regarding *Kiwi Community Trust* failed to take account of the issues in that appeal. The fact that the Commission referred to funds "unlawfully retained" did not necessarily mean that funds "lawfully retained" under regulation 11 will be treated differently in relation to compliance with regulation 10.

Depreciation

- 51. The Trust submitted that it had "recovered" net proceeds because, in the subsequent sale of assets, it became apparent that it had over-provided for depreciation in the 2008/2009 and 2009/2010 financial years. The Secretary submitted that recovered depreciation formed part of the net proceeds of the financial year in which it was recovered, referring to the definition of net proceeds as including proceeds from the sale of fittings, chattels and gambling equipment.
- 52. As far as the contrary contentions are concerned, the Commission considered that the Secretary was correct – that recovered depreciation in the form of receipts from sales of assets book value was attributable to the year in which the assets were sold. That is consistent with the definition of "net proceeds". The actual return on a sale of fittings, chattels and gambling equipment purchased from turnover is included in the net proceeds of the year of sale. It was immaterial what the return had earlier been projected to be.
- 53. However, the Commission was troubled, in a more general way, by the submission of the parties on depreciation, in particular their apparent comfort with the concept that adjusting for depreciation can form part of calculating net proceeds. The Commission's concerns have played no part in its consideration of appropriate consequence for the breaches which have been the subject of this appeal. However, as the Commission has not been confronted with the apparent effect of depreciation adjustments previously, it considered that it should raise its concerns, on a provisional basis, for consideration by the Secretary and the class 4 sector.
- 54. It seems to the Commission that depreciation is a notional, rather than an actual, cost at the time in which provision is made. Depreciation is used by businesses to reflect the



need to replace assets and to allow for their diminution in value over the period of their use. The purpose and effect of applying depreciation is to smooth reported periodic performance to reflect performance over the longer term. Without adjusting for depreciation, income versus expenditure might fluctuate strongly from year to year, rising in years without major expenditure and/or when assets were realised.

55. However, incorporated societies operating class 4 gambling are not ordinary businesses. They are subject to special statutory obligations which constrain their operation, particularly in the use to which they can put gaming machine proceeds:
- (a) The expenditure which they can incur using gaming machine proceeds must be "actual reasonable and necessary costs incurred in conducting the gambling" or regulatory compliance, as only such expenditure does not fall within "net proceeds". Expenditure is also constrained by the terms of approved venue agreements and the gazetted limits.
 - (b) Net proceeds can **only** be distributed or applied for the authorised purposes specified in the class 4 operators licence (section 106).
 - (c) Net proceeds must be largely distributed (all or nearly all) quarterly with a further 3 month period of grace for the balance (regulation 11).

In summary, societies are required to distribute promptly all gaming machine proceeds received, less only the expenditure permitted by the terms of the definition of net proceeds. The statutory obligations preclude the creation of actual or notional reserves or allowances outside of what is permitted.

56. In the Commission's view, the statutory definition of "net proceeds" precludes the use of a notional cost, such as depreciation, for the calculation of net proceeds. The statutory definition allows only the deduction of **actual** reasonable and necessary costs incurred in conducting the gambling in calculating net proceeds. Societies may use gross proceeds to purchase fittings, chattels and gambling equipment, provided that they are reasonable and necessary in conducting the gambling. By doing so, they would reduce the net proceeds in the years in which such expenditure were incurred. If the items purchased with gaming machine proceeds were later sold, the proceeds of sale would become part of the net proceeds in the year of sale. The result might lead to substantial variation in net proceeds from year to year depending on the cycle of purchases and sales.
57. Several of the subordinate regulatory controls, including the minimum amount of net proceeds and Limit D of the Gazetted expenditure controls (which limits expenditure overall to a percentage of net returns in the period), may have been imposed in the



expectation that net proceeds may be smoothed by the use of depreciation adjustments to remove substantial variations from year to year. If that is the case, and the view is taken that net proceeds cannot be calculated by the application of depreciation, it may be necessary for those forms of regulation to be reconsidered. Alternatively, societies may have to change the basis on which they incur expenditure on acquiring assets for use in the conduct of the gambling.

58. The Commission is conscious that it has not heard argument on the issue raised. The purpose of raising it in this decision is to ensure that an absence of comment was not taken to reflect a lack of concern about the issue.

Appropriate consequence

59. The Commission then considered the appropriate consequence. At the more serious end of suspension cases to have come before the Commission, the TTCF and TST decisions involved substantial expenditure in breach of what was reasonable and necessary for the conduct of the gambling and, in one case, of Gazetted expenditure limits but without breach of regulations 10 or 11. Therefore, despite the excessive expenditure, the appellants in those cases were, presumably, returning a greater than minimum percentage of the gross proceeds to the community. It must also be remembered that what is reasonable and necessary involves a level of judgement and potential debate not present in the more specific limits or obligations. It is also relevant that, in those cases, the Commission treated the appellants more leniently than it might otherwise have, in recognition that the conduct reflected a pattern of similar expenditure by other societies.
60. At the other end of the spectrum, the *Blue Waters* decision involved a single breach of Limit D with no apparent excessive expenditure. The breach was caused by a failure to reduce costs, which were apparently reasonable and necessary, in line with falling revenue.
61. The Trust submitted that this case was similar to *Blue Waters*, in that it involved a failure to adjust spending in accordance with falling revenue, rather than excessive costs. It argued that a regulation 10 breach occurs for one of two reasons: a reduction in gaming machine revenue or an increase in operating expenses, and that the former is the reason for its breach. It submitted that it had no increase in operating expenses (implying that the breach occurred solely because of a reduction in gaming machine revenue). It submitted that it is not fair to punish it more severely for failing to reduce its costs below what is reasonable and necessary.

62. This submission was inconsistent with other aspects of its own submissions, dealing with the increase in trustee expenses between 2008/2009 (\$17,473) and 2009/2010 (\$30,258). It also requires the Commission to accept that the spending at Boston Bar was at a cost of only \$664 (the depreciation "cost") rather than \$14,231 (the actual expenditure). Further, there was no detail provided of a reduction in gaming machine revenue and, if there were, this would need to be considered against the fact that the minimum return requirement is expressed as a percentage of gross proceeds (and accordingly, decreases when there is a decrease in gross proceeds).
63. The Commission considered that the failure to meet regulation 10 two years in a row was more serious than a single breach of Limit D. The maximisation of net proceeds for distribution is fundamental to the scheme of the Act and a failure to meet the minimum two years in a row was a matter for concern, particularly when the Trust had resorted to borrowing funds to make it appear that it had met the minimum distribution requirement. However, the amount of the shortfall each year was not substantial, either in absolute or percentage terms, and did not involve the degree of clearly excessive expenditure involved in the other cases noted above. Much of the period in question preceded the TST and TTCF appeals. In the circumstances, the Commission considered a six day suspension to be excessive. A three day suspension would more appropriately reflect the seriousness of the breach.

Decision of the Commission

64. For the reasons set out above, the Commission varies the Secretary's decision by imposing a suspension of three consecutive days with the suspension to commence on 18 December 2012.



Graeme Reeves
Chief Gambling Commissioner

for and on behalf of the
Gambling Commission

11th December 2012

