STATEMENT 8: FINANCIAL REPORTING STANDARDS AND BUDGET CONCEPTS

This statement describes the financial accounting frameworks relevant to the Australian Government.

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The *Charter of Budget Honesty Act 1998* requires that the budget be based on external reporting standards. Accordingly, the major external standards used in the budget are the Australian Bureau of Statistics' (ABS) accrual Government Finance Statistics (GFS) framework and Australian Accounting Standards (AAS), being the Australian Equivalents to International Financial Reporting Standards (AEIFRS) and AAS 31 *Financial Reporting by Governments*. The major fiscal aggregates (including the fiscal and underlying cash balances) are based on the accrual GFS framework.

The Charter also requires that departures from applicable external reporting standards be identified. These are disclosed in Appendix A to Statement 2, the introduction to Statement 9, and Note 1 in Statement 10.

ACCRUAL GFS FRAMEWORK

The GFS reporting framework is a specialised accounting and financial reporting system designed to support economic analysis of the public sector. It allows comprehensive assessments to be made of the economic impact of government and is consistent with international statistical standards (the *System of National Accounts 1993* (SNA93) and the International Monetary Fund's (IMF) *Government Finance Statistics Manual 2001*).[1]

The GFS conceptual framework is divided into a number of separate statements, each of which draws out analytical aggregates or balances of particular economic significance. Together, these aggregates provide for a thorough understanding of the financial position of the public sector. The GFS statements reported in the budget are the operating statement, balance sheet, cash flow statement and statement of other economic flows.

All GFS data are recorded as either stocks (assets and liabilities) or flows (classified as either transactions or other economic flows).

A transaction results from a mutually agreed interaction between economic entities. Despite their compulsory nature, taxes are transactions deemed to occur by mutual agreement between the government and the taxpayer. Transactions that increase or

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1 Additional information on the Australian accrual GFS framework is available in the ABS publication *Australian System of Government Finance Statistics: Concepts, Sources and Methods, 2005* (cat. no. 5514.0).

decrease net worth (assets minus liabilities) are reported as revenues and expenses respectively in the operating statement.[2]

A change to the value or volume of an asset or liability that does not result from a transaction is an other economic flow. This can include changes in values from market prices, most actuarial valuations and exchange rates and changes in volumes from discoveries, depletion and destruction. All other economic flows are reported in the statement of other economic flows.

Under the accrual GFS framework, flows are recorded in the period in which they occurred. As a result, prior period outcomes may be revised where information arises that could reasonably be expected to have been known in the past, is material in at least one of the affected periods and can be reliably assigned to the relevant period(s).

GFS financial statements are contained in Statements 2 and 9.

Operating statement

The operating statement presents details of transactions in GFS revenues, GFS expenses and the net acquisition of non-financial assets (net capital investment) for an accounting period.

GFS revenues arise from transactions that increase net worth and GFS expenses arise from transactions that decrease net worth. GFS revenues less GFS expenses gives the GFS net operating balance. The net operating balance is comparable to the National Accounts concept of government saving plus capital transfers.

The net acquisition of non-financial assets (net capital investment) measures the change in the Australian Government's stock of non-financial assets due to transactions. As such, it measures the net effect of purchases, sales and consumption (for example, depreciation of fixed assets and use of inventory) of non-financial assets during an accounting period.

Net acquisition of non-financial assets equals gross fixed capital formation, less depreciation, plus changes (investment) in inventories, plus other transactions in non-financial assets.

Fiscal balance

The fiscal balance (or GFS net lending/borrowing) is the net operating balance less net capital investment. Thus, fiscal balance includes the impact of net expenditure

2 Not all transactions impact on net worth. For example, transactions in financial assets and liabilities do not impact on net worth as they represent the swapping of assets and liabilities on the balance sheet.

(effectively purchases less sales) on non-financial assets rather than consumption (depreciation) of non-financial assets.[3]

The fiscal balance measures the Australian Government's investment-saving balance. It measures in accrual terms the gap between government savings plus net capital transfers, and investment in non-financial assets. As such, it approximates the contribution of the Australian Government general government sector to the balance on the current account in the balance of payments.

Balance sheet

The balance sheet shows stocks of assets, liabilities and GFS net worth. Net debt is also reported in the balance sheet.

Net debt

Net debt is the sum of selected financial liabilities (deposits held, advances received, government securities, loans, and other borrowing) less the sum of selected financial assets (cash and deposits, advances paid, and investments, loans and placements). Net debt does not include superannuation related liabilities. Net debt is a common measure of the strength of a government's financial position. High levels of net debt impose a call on future revenue flows to service that debt.

Net worth

The net worth of the general government sector is defined as assets less liabilities. For the public financial corporations and public non-financial corporations sectors, net worth is defined as assets less liabilities less shares and other contributed capital. Net worth is an economic measure of wealth, reflecting the Australian Government's contribution to the wealth of Australia.

Cash flow statement

The cash flow statement identifies how cash is generated and applied in a single accounting period. The cash flow statement reflects a cash basis of recording (rather than an accrual basis) where information is derived indirectly from underlying accrual transactions and movements in balances. This, in effect, means that transactions are captured when cash is received or when cash payments are made. Cash transactions are specifically identified because cash management is considered an integral function of accrual budgeting.

3 The net operating balance includes consumption of non-financial assets because depreciation is a GFS expense. Depreciation also forms part of net capital investment, which (in the calculation of fiscal balance) offsets the inclusion of depreciation in the net operating balance.

Underlying cash balance

The underlying cash balance plus Future Fund earnings (GFS cash surplus/deficit) is the cash counterpart of the fiscal balance, reflecting the Australian Government's cash investment-saving balance. This measure is conceptually equivalent under the current accrual framework and the previous cash framework. For the general government sector, the underlying cash balance is calculated as shown below.

Net cash flows from operating activities

plus

Net cash flows from investments in non-financial assets

less

Net acquisitions of assets acquired under finance leases and similar arrangements[4]

equals

GFS cash surplus/deficit

less

Future Fund earnings

equals

Underlying cash balance

The Government is reporting the underlying cash balance net of Future Fund earnings from 2005-06 onwards because the earnings will be reinvested to meet future superannuation payments and are therefore not available for current spending. However, Future Fund earnings are included in the fiscal balance because superannuation expenses relating to future cash payments are recorded in the fiscal balance estimates.

Expected Future Fund earnings are separately identified in the Australian Government cash flow statement in Table B3, Statement 2 and the historic tables in Statement 13.

Headline cash balance

The headline cash balance is calculated by adding cash flows from investments in financial assets for policy purposes and Future Fund earnings to the underlying cash balance.

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4 The underlying cash balance treats the acquisition and disposal of non-financial assets in the same manner regardless of whether they occur by purchase/sale or finance lease — acquisitions reduce the underlying cash balance and disposals increase the underlying cash balance. However, finance leases do not generate cash flows at the time of acquisition or disposal equivalent to the value of the asset. As such, net acquisitions of assets under finance leases are not shown in the body of the cash flow statement but are reported as a supplementary item for the calculation of the underlying cash balance.

Cash flows from investments in financial assets for policy purposes include equity transactions and net advances.[5] Equity transactions include equity injections into controlled businesses and privatisations of government businesses. Net advances include net loans to the States, net loans to students under the Higher Education Loan Programme (HELP), and contributions to international organisations that increase the Australian Government's financial assets.

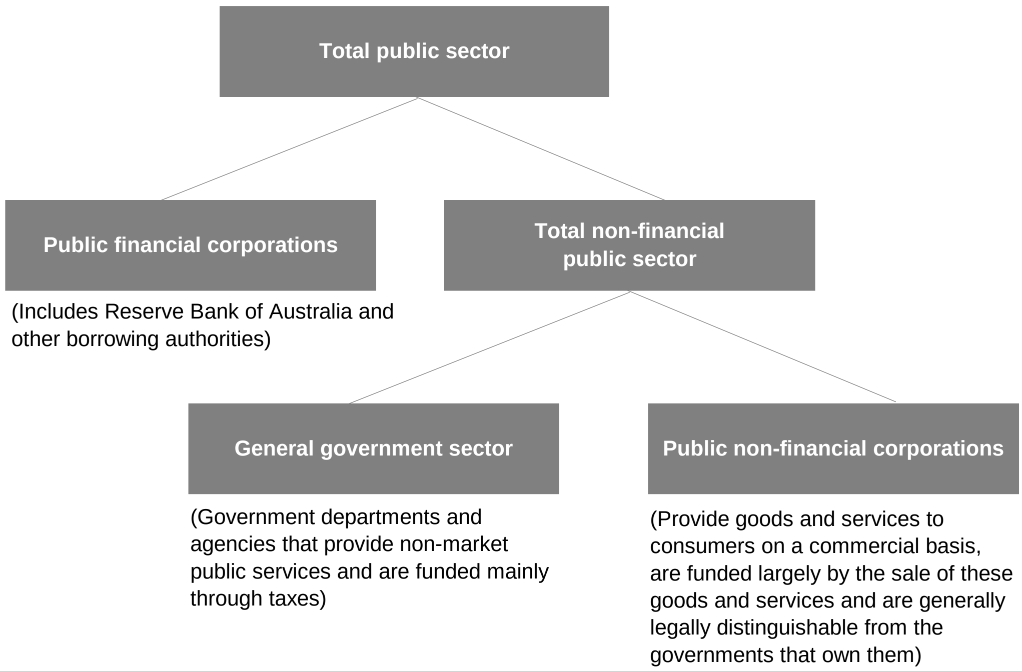
Statement of other economic flows (reconciliation of net worth)

The statement of other economic flows outlines changes in net worth driven by economic flows other than GFS revenues and GFS expenses. GFS revenues, GFS expenses and other economic flows sum to the total change in net worth during a period. The majority of other economic flows for the Australian Government general government sector arise from price movements in its assets and liabilities.

Sectoral classifications

To assist in analysing the public sector, GFS data are presented by institutional sector. GFS distinguishes between the general government sector, the public non-financial corporations sector and the public financial corporations sector, as shown in Figure 1.

Figure 1: Institutional structure of the public sector



5 Cash flows from investments in financial assets for policy purposes were called net advances under the cash budgeting framework.

Budget reporting focuses on the general government sector. The general government sector provides public services that are mainly non-market in nature, and for the collective consumption of the community, or involve the transfer or redistribution of income. These services are largely financed through taxes and other compulsory levies, although user charging and external funding have increased in recent years. This sector comprises all government departments, offices and some other bodies.

In preparing financial statements for the sectors all material transactions and balances between entities within the sectors are eliminated.

AUSTRALIAN ACCOUNTING STANDARD REPORTING FRAMEWORK

The AAS reporting framework, being the AEIFRS and AAS 31, requires the preparation of accrual-based general purpose financial reports, showing government assets, liabilities, income, expenses and cash flows. Reporting under this framework is intended to provide a consolidated overview of the financial performance and financial position of government.

There are four main general purpose statements that must be prepared in accordance with the AAS framework. These are:

- an income statement, which includes an operating result;
- a balance sheet, which shows net assets;
- a statement of changes in equity, which shows movements in equity; and
- a cash flow statement, which includes the net increase/decrease in cash held.

In addition to these general purpose statements, notes to the financial statements are required. These notes include a summary of accounting policies, disaggregated information and other disclosures required by AAS.

A full set of AAS financial statements and accompanying notes prepared for the general government sector can be found in Statement 10.

RECONCILIATION OF GFS AND AAS AGGREGATES

There is a general consistency of treatment of the elements of financial statements between GFS and AAS. Both frameworks are based on the concept of economic events that give rise to stocks and flows. As a result, the definitions of stocks are broadly similar under the two frameworks and relate to the control of economic benefits, while flows are defined with reference to changes in stocks.

The GFS and AAS definitions of the scope of the public sector agree in almost all cases, with AAS 31 recommending the same segmentation of the public sector into general government, public non-financial corporations and public financial corporations sectors.

Transactions are generally treated in a similar manner by GFS and AAS; however, where GFS is a framework designed to facilitate macro-economic analysis, AAS is designed for general purpose financial reporting. The different objectives of the two systems lead to some variation in the treatment of certain items. This differing treatment relates predominantly to the definitions of revenues and expenses under the two frameworks.

In particular, revaluations of assets and liabilities are classified differently under the AAS and GFS standards. Major revaluations include write-downs of bad and doubtful debts (excluding those that are mutually agreed), changes in the valuation of superannuation liabilities, and gains and losses due to changes in foreign exchange rates and interest rates.

Under AAS reporting, valuation changes may affect income or expenses and therefore the operating result. However, under GFS reporting, revaluations are not considered to be transactions (that is, they are considered to be other economic flows) and accordingly do not form part of revenues or expenses. Therefore, most revaluations are not taken into account in the calculation of the GFS net operating balance or fiscal balance. However, revaluations still impact on GFS assets and liabilities, as can be seen in the statement of other economic flows.

Some of the major differences between the GFS and AAS treatments of transactions are outlined in Table 1. Further information on the differences between the two systems is provided in the ABS publication *Australian System of Government Finance Statistics: Concepts, Sources and Methods, 2005* (cat. no. 5514.0).

Table 1: Selected differences between AAS and GFS reporting standards

Issue	AAS treatment	GFS treatment
Asset write-downs	Treated as part of operating expenses.	Treated as revaluations (other economic flows), except for mutually agreed write-downs, and therefore not included in expenses.
Gains and losses on assets	Treated as part of operating income/expenses.	Treated as revaluations (other economic flows) and therefore not included in revenues/expenses.
Provisions for bad and doubtful debts	Treated as part of operating expenses and included in the balance sheet as an offset to assets.	Act of creating provisions is not considered an economic event and is therefore not considered an expense or included in the balance sheet. The Australian Government departs from this latter requirement (see Appendix A to Statement 2).
Interest flows related to swaps and other financial derivatives	Treated as operating income and expenses.	Treated as other economic flows and so not included in revenues and expenses.
Acquisition of defence weapons platforms	Treated as capital expenditure. Defence weapons platforms appear as an asset on the balance sheet. Depreciation expense on assets is recorded in the operating statement.	Treated as an expense at the time of acquisition. Defence weapons platforms do not appear as an asset on the balance sheet and no depreciation is recorded in the operating statement.
Valuation of assets and liabilities	Classes of assets and liabilities are measured using a range of methods. The predominant methods for valuing different asset classes include historic cost and market value.	Individual assets and liabilities are measured at current market value based on current market prices or a suitable proxy where market prices are not available.
Finance leases	Treats finance leases as if an asset were purchased from borrowings. That is, the lease payment is split into an interest component (which is shown as an operating expense) and a principal component. The asset and the liability are recorded on the balance sheet. This convention does not apply to the cash flow statement, which does not record the acquisition of the asset or the liability.	As per the accounting standard, except that the GFS cash flow statement includes the acquisition of the asset as a supplementary item for the calculation of the surplus/deficit and underlying cash balance.

Following the broad strategic direction of the Financial Reporting Council, the Australian Accounting Standards Board has recently finalised a new standard for financial reporting by the general government sector of governments. This standard (AASB 1049) will be applicable from the 2008-09 Budget.

Table 2 reconciles GFS revenue and expenses with their AAS counterparts.

Table 2: Reconciliation of GFS and AAS revenue and expenses

	Estimates		Projections		
	2006-07	2007-08	2008-09	2009-10	2010-11
	$m	$m	$m	$m	$m
GFS revenue (Statement 9)	**276,259**	**289,851**	**306,226**	**322,424**	**337,612**
less GST revenue for states and territories	40,720	43,090	45,500	47,810	50,300
GFS revenue (Statement 2)	**235,539**	**246,761**	**260,726**	**274,614**	**287,312**
plus asset revenue recognised for the first time	478	207	114	126	119
plus foreign exchange gains	0	0	0	0	0
plus other economic revaluations	14,463	1,229	3,024	3,786	4,057
plus proceeds from the sale of assets	0	31	1,267	1	6
plus swap interest revenue	1,813	1,604	1,246	1,001	757
AAS income (Statement 10)	**252,293**	**249,831**	**266,377**	**279,528**	**292,251**
GFS expenses (Statement 9)	**261,405**	**277,650**	**291,909**	**306,332**	**321,759**
less GST grants to states and territories	39,580	41,850	44,200	46,450	48,850
less GST mutually agreed writedowns	200	210	220	230	240
GFS expenses (Statement 2)	**221,625**	**235,590**	**247,489**	**259,652**	**272,669**
plus actuarial revaluations	-197	-1	-1	-1	0
plus net writedown of assets/bad and doubtful debts	2,285	2,501	2,153	2,469	2,578
plus foreign exchange losses	52	0	0	0	0
plus other economic adjustments	0	-32	-3	0	-1
plus value of assets sold	803	0	0	0	0
plus swap interest expense	1,804	1,679	1,315	1,061	819
plus defence weapons platforms depreciation	2,683	2,738	2,740	2,597	2,476
less defence weapons platforms investment	4,471	4,665	5,969	6,643	6,744
plus AusAid IDA/ADF expenses(a)	0	0	0	0	0
AAS expenses (Statement 10)	**224,584**	**237,810**	**247,724**	**259,136**	**271,796**

(a) The treatment of IDA/ADF expenses under AAS has changed to reflect the capitalisation of core contributions, which is now consistent with the treatment under GFS.

Table 3 reconciles the AAS operating result to the GFS net operating balance and the fiscal balance (GFS net lending).

The AAS operating result is equal to AAS income less expenses. Similarly, GFS revenues less expenses equal the GFS net operating balance. Consequently, the reconciliation between the AAS operating result and the GFS net operating balance relates directly to differences in the definitions of revenues and expenses which are shown in Table 2.

The second part of the Table 3 reconciliation shows the adjustment for net capital investment required to derive the fiscal balance from the GFS net operating balance.

As discussed previously, the fiscal balance is calculated as the net operating balance less net capital investment. This is a useful economic indicator as it represents the gap between government saving (less capital transfers) and investment, and so is included at the end of the GFS operating statement. In AAS there is no equivalent measure to the fiscal balance. That is, the AAS income statement stops at the operating result and includes no information on net capital investment.

Table 3: Reconciliation of AAS net operating result and fiscal balance

	Estimates		Projections		
	2006-07	2007-08	2008-09	2009-10	2010-11
	$m	$m	$m	$m	$m
AAS operating result (Statement 10)	**27,708**	**12,021**	**18,653**	**20,392**	**20,455**
Net differences from revenue and expense definitions	-12,855	179	-4,336	-4,300	-4,602
GFS net operating balance (Statement 9)	**14,854**	**12,200**	**14,317**	**16,092**	**15,853**
less purchase of property, plant and equipment and intangibles	8,112	8,350	9,331	9,965	10,281
less assets acquired under finance leases	34	4	502	6	0
less other non-financial assets	126	100	184	152	-187
less increase in inventories	624	111	187	215	411
plus defence weapons platforms investment	4,471	4,665	5,969	6,643	6,744
plus proceeds from sales of property, plant and equipment and intangibles	184	250	220	114	104
plus depreciation and amortisation	4,899	5,216	5,378	5,317	5,193
less weapons depreciation	2,683	2,738	2,740	2,597	2,476
Fiscal balance (GFS net lending) (Statement 9)(a)	**12,828**	**11,029**	**12,940**	**15,231**	**14,914**
Impact of GST	-940	-1,030	-1,080	-1,130	-1,210
Fiscal balance (GFS net lending) (Statement 2)(a)	**11,888**	**9,999**	**11,860**	**14,101**	**13,704**

(a) The fiscal balance estimates in Statement 9 are higher than those presented in Statement 2, as explained in the introduction to Statement 9.