STATEMENT 10: EXTERNAL REPORTING STANDARDS AND BUDGET CONCEPTS

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EXTERNAL REPORTING STANDARDS

The Commonwealth *Charter of Budget Honesty Act 1998* requires that the Budget be based on external reporting standards. In accordance with the Charter, 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, including *Australian Accounting Standard No. 31 Financial Reporting by Governments* (AAS31).

The Charter also requires that departures from applicable external reporting standards be identified. Appendix A to Statement 2, Statement 11 and Note 1 in Statement 12 disclose departures from the external reporting standards.

The major fiscal aggregates (including the fiscal and underlying cash balances) are based on the accrual GFS framework. The next section provides an overview of the operation of the GFS framework and a discussion of the GFS financial statements, including the major fiscal aggregates. It also includes a very brief overview of AAS31 and information on reconciling between the two standards.

ACCRUAL GFS FRAMEWORK

The GFS reporting framework is a specialised statistical 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*). Additional information on the Australian accrual GFS framework is available in the ABS publication *Information Paper: Accruals-based Government Finance Statistics, 2000* (Cat. No. 5517.0).

Nature of the GFS framework

The accrual GFS framework is based on an integrated recording of flows and stocks. Flows reflect the creation, transformation, exchange, transfer or extinction of economic value. They involve changes in the volume, composition or value of a unit's assets, liabilities and net worth. Stocks refer to a unit's holdings of assets, liabilities and net worth at a point in time.

Two types of flows are distinguished: transactions and other economic flows.

- **Transactions** represent flows that come about as a result of mutually agreed interactions between units or within a single unit. Despite their compulsory nature, taxes are transactions that are deemed to occur by mutual agreement between the government and the taxpayer.

- **Other economic flows** represent changes to stocks that do not result from a transaction. Other economic flows arise from changes to stocks caused by price movements (revaluations) and volume changes, including interest and exchange rate movements, and phenomena such as discoveries, depletion and destruction.

The GFS conceptual framework is divided into a number of separate statements, each of which is designed to draw out analytical aggregates or balances of particular economic significance. Taken together, these aggregates provide for a thorough understanding of the financial position of the public sector entities. The GFS statements reported in the Budget are the operating statement, balance sheet, cash flow statement and a statement of other economic flows. A discussion of each of these statements follows.

GFS 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** are defined as transactions that increase net worth (effectively inflows) and GFS **expenses** as transactions that decrease net worth (effectively outflows) — general government net worth is the difference between the stock of assets and liabilities and is further defined in the balance sheet section below.

GFS revenues less GFS expenses gives the GFS **net operating balance**. Conceptually, the net operating balance measures government saving plus capital transfers.

The net acquisition of non-financial assets (**net capital investment**) measures the change in the stock of non-financial assets owned by the government 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. Each of these items is briefly expanded upon below.

- Gross fixed capital formation comprises purchases *less* sales of fixed assets (such as buildings) and net acquisitions of fixed assets under finance leases.

- Depreciation measures consumption of fixed assets, such as through physical deterioration or normal obsolescence, as they are used in production.

- Changes in inventories measures investment in new inventory stocks *less* use of current inventories.

- Other transactions in non-financial assets mainly comprise (for the Commonwealth general government sector) changes in the value of work-in-progress and software assets and transactions in non-reproducible, intangible assets (such as telecommunications spectrum).

Fiscal balance

The fiscal balance (or GFS net lending/borrowing) is the net operating balance *minus* net capital investment.

- This formula means that the fiscal balance includes the impact of net expenditure (effectively purchases less sales) on non-financial assets rather than consumption (depreciation) of non-financial assets. The net operating balance includes consumption of non-financial assets, as 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.

The fiscal balance measures the Commonwealth's investment-saving balance. That is, 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 Commonwealth general government sector to the balance on the current account in the balance of payments.

A fiscal balance **surplus** indicates that the Commonwealth is placing financial resources at the disposal of other sectors (that is, the Commonwealth is lending to other sectors). A fiscal balance **deficit** indicates that the Commonwealth is utilising the financial resources of other sectors. Thus, fiscal balance can be viewed as a global indicator of the financial impact of Commonwealth government operations on the rest of the economy.

Balance sheet

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

Assets represent instruments or entities over which ownership rights are enforced by a unit and from which economic benefits may be derived by holding them, or using them, over a period of time. **Liabilities** represent obligations to provide economic value to other institutional units.

Net debt

Net debt is defined as the sum of selected financial liabilities (deposits held; advances received; government securities; loans; and other borrowing) *minus* the sum of selected financial assets (cash and deposits; advances paid; and investments, loans and placements). 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 debt was also measured under the cash framework even though full balance sheets were not reported. The concept of net debt that is reported under accrual-based financial reporting is the same as was reported under cash reporting.

A related concept to net debt is net interest payments. Net interest payments is a cash measure that is defined as interest payments on gross debt less interest received on loans and advances. Net interest payments are affected by the volume of net debt on issue and by interest rates.

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, the formula becomes assets *less* liabilities *less* shares and other contributed capital. Net worth is an economic measure of wealth. It reflects the contribution of the Commonwealth to the wealth of Australia.

The net worth measure provides a more comprehensive picture of a government's overall financial position than the net debt measure. Net worth incorporates a government's non-financial assets such as land and other fixed assets, as well as certain financial assets and liabilities not captured by the net debt measure, most notably accrued employee superannuation liabilities.

For example, a limitation of the net debt measure is that the sale of physical assets decreases net debt, with proceeds from sales increasing financial assets. Net worth recognises that the increase in financial assets has been funded by a decrease in physical assets.

Cash flow statement

The cash flow statement identifies how cash is generated and applied in a single accounting period. 'Cash' means cash on hand (notes and coins held and deposits held at call with a bank or other financial institution) and cash equivalents (highly liquid investments that are readily convertible to cash on hand at the investor's option and overdrafts considered integral to the cash management function).

The cash flow statement reflects a cash basis of recording (rather than an accrual basis) where the information has been 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.

Underlying cash balance

The underlying cash balance (GFS surplus/deficit) is the cash counterpart of the fiscal balance, reflecting the Commonwealth's cash investment-saving balance. The underlying cash balance 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[1]

equals

Underlying cash balance

An underlying cash **surplus** reflects the extent to which cash is available to the Commonwealth to either increase its financial assets or decrease its liabilities (assuming no revaluations and other changes occur). An underlying cash **deficit** is a measure of the extent to which the Commonwealth requires cash, either by running down its financial assets or by drawing on the cash reserves of other sectors.

Headline cash balance

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

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1 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 — acquistions 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.[2] Examples of 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 Contribution Scheme (HECS), and contributions to international organisations that increase the Commonwealth's financial assets.

Statement of other economic flows (reconciliation of net worth)

Changes in GFS net worth are explained by the sum of two types of flows — transactions and other economic flows (both of which were defined earlier). Accordingly, the GFS system includes a fourth financial statement that presents the influences on net worth that are the result of other economic flows (the influence of transactions is reported in the operating statement).[3] The Commonwealth is now publishing this statement of other economic flows for the general government sector, although it is not a specific requirement of the *Accrual Uniform Presentation Framework*.[4]

This statement disaggregates changes in general government sector net worth in each financial year.

The change in net worth from transactions is measured by the GFS net operating balance, as reported in the GFS operating statement.

The remainder of the change in net worth is due to other economic flows (that do not appear in the GFS operating statement as revenues or expenses). As outlined earlier, other economic flows are changes in the value of assets or liabilities due to price movements or volume changes.

The majority of other economic flows for the Commonwealth general government sector arise from price movements in its assets and liabilities. These include:

- valuation changes due to movements in foreign exchange rates;
- increases in the value of assets since purchase leading to a profit on sale;
- changes in the value of investments in commercial entities, including through changes in share prices;

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2 Cash flows from investments in financial assets for policy purposes used to be known as *net advances* under the cash budgeting framework.

3 The ABS publication *Information Paper: Accruals-based Government Finance Statistics, 2000* (Cat. No. 5517.0) calls it the 'Statement of Stocks and Flows' and the IMF's *Government Finance Statistics Manual 2001* calls it the 'Statement of Other Economic Flows'.

4 The *Accrual Uniform Presentation Framework* — an agreement between the Commonwealth, States and Territories — requires all jurisdictions to publish a common core of GFS consistent financial information in their budget documents.

- write-downs in the value of assets, such as through greater allowances for bad and doubtful debts; and

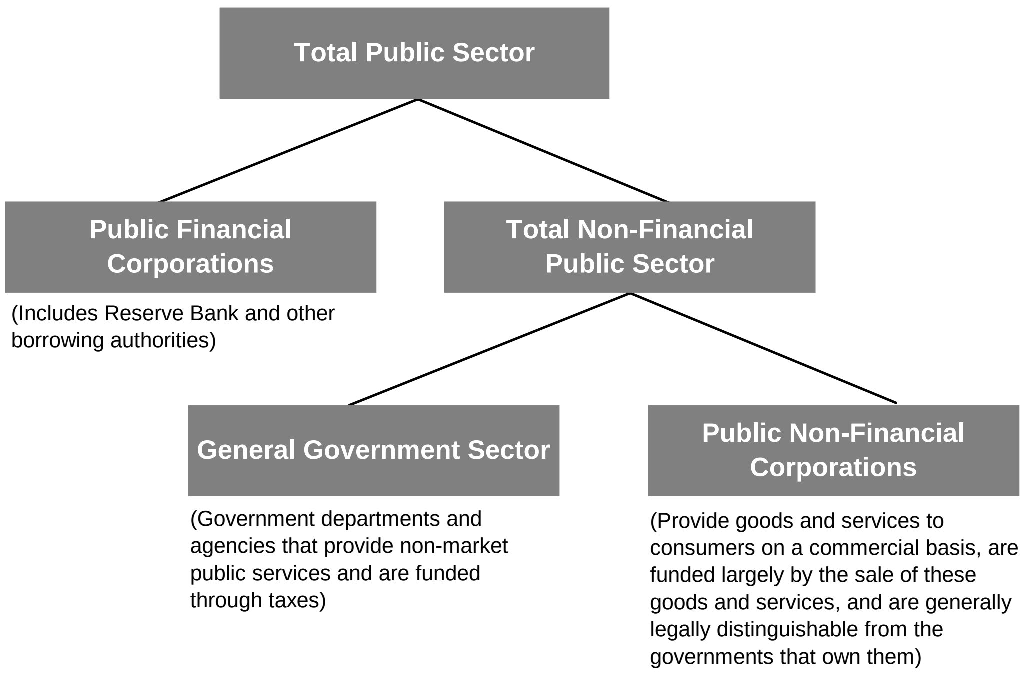
- changes in the valuation of superannuation liabilities due to economic and demographic changes.

The Commonwealth also has a small number of volume changes, including assets recognised for the first time and changes to the assets and liabilities flowing from reclassifications and accounting policy changes.

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



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.

The **public non-financial corporations** (PNFC) **sector** comprises bodies that provide goods and services that are mainly market, non-regulatory and non-financial in nature, financed predominantly through sales to the consumers of these goods and services. In general, PNFCs are legally distinguishable from the governments that own them. A list of major Commonwealth PNFCs is in Box 1.

Box 1: List of major Commonwealth public non-financial corporations at June 2002

Airservices Australia	Albury-Wodonga Development Corporation
Australian Dairy Corporation	Australian Government Solicitor
Australian Hearing Services	Australian Postal Commission
Australian Rail Track Corporation	Australian Submarine Corporation
Bankstown Airport	Camben Airport
Employment National	Hoxton Park Airport
Telstra Corporation Limited	

Together the general government sector and the PNFC sector comprise the **non-financial public sector**.

The GFS coverage of the public sector also includes **public financial corporations** (PFCs). PFCs are public sector bodies that engage in financial intermediation services or auxiliary financial services. They are able to incur financial liabilities on their own account (such as taking deposits, issuing securities or providing insurance services). This sector includes the Reserve Bank of Australia, the Export Finance and Insurance Corporation and Medibank Private. Information on PFCs is not included in the budget papers as PFCs undertake financial intermediation, which is a fundamentally different function from that performed by other public entities. Under the *Uniform Presentation Framework* PFC information is only required to be reported in budget outcome statements.

The **total public sector** comprises all sectors of government — general government, the PNFC sector and the PFC sector.

Australian Accounting Standard No. 31 (AAS31) reporting framework

Australian Accounting Standard No. 31 Financial Reporting by Governments (AAS31) requires governments to prepare accrual-based general purpose financial reports, including in relation to the assets they control and any liabilities incurred, their revenues and expenses, and cash flows. Reporting under this framework is intended to provide a consolidated overview of the financial performance and position of government, including in the area of financing and investing activities.

There are three main general purpose statements that must be prepared in accordance with the AAS31 framework. These are:

- a statement of revenue and expenses, which includes an operating result;
- a balance sheet, which shows net assets; and
- a statement of cash flows, which includes net increase / decrease in cash held.

In addition to these general purpose statements, the standard requires notes to the financial statements to be prepared which report disaggregated information in relation to the financial performance and financial position of the government. The notes should also include other information seen as relevant to users.

While AAS31 provides a general framework for accrual budgeting and financial reporting by governments, compliance with all other applicable accounting standards is required. Exceptions to this rule are explicitly stated in AAS31.

A full set of AAS31 financial statements and accompanying notes prepared for the general government sector can be found in Statement 12.

Reconciliation of GFS and AAS31 aggregates

There is a general consistency of treatment of the elements of financial statements between GFS and accounting standards. 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 AAS31 definitions of the scope of the public sector agree in almost all cases, with AAS31 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 accounting standards; however, where GFS is a framework designed to facilitate macro-economic analysis, AAS31 is designed as a standard 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 AAS31 and GFS standards. Major revaluations include: writedowns 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 AAS31 reporting, valuation changes may affect revenues 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 AAS31 treatments of transactions are outlined in Table 1. Further information on the differences between the two systems is provided in the ABS publication *Information Paper: Accruals-based Government Finance Statistics, 2000* (Cat. No. 5517.0).

Table 1: Selected differences between AAS31 and GFS reporting standards

Issue	AAS31 Treatment	GFS Treatment
Asset writedowns	Treated as part of operating expenses.	Treated as revaluations (other economic flows), except for mutually agreed writedowns, and therefore removed from expenses.
Gains and losses on assets	Treated as part of operating revenues/expenses.	Treated as revaluations (other economic flows) and therefore removed from 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. * Commonwealth does not comply with this latter requirement (see Statement 11).
Interest flows related to swaps and other financial derivatives	Treated as operating revenues and expenses.	Treated as financing transactions 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. Defence weapons platforms do not appear as an asset on the balance sheet and no depreciation is recorded in the operating statement.
Commonwealth general government sector investments in public corporations	Investments in public corporations are valued at historic cost in the balance sheet.	Investments in public corporations are valued at current market value. For publicly listed corporations, the share price is used to calculate market value. For non-listed corporations, the current value of net assets is used.
Public debt net interest	Premiums and discounts on the repurchase of debt are included in public debt net interest expenses at the time of repurchase, regardless of whether the stock is cancelled at that time. Issue premiums and discounts are amortised over the life of the stock.	Repurchase premiums and discounts are treated as economic revaluations at the time the debt is repurchased (provided it is valued at historical cost). The GFS cash flow statement includes repurchase premiums or discounts in the year that the repurchased stock is cancelled or matures.
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 (underlying cash balance).

Table 2 reconciles GFS revenue and expenses with their AAS31 counterparts.

Table 2: Reconciliation of GFS and AAS31 revenue and expenses

	Estimates		Projections		
	2001-02	2002-03	2003-04	2004-05	2005-06
	$m	$m	$m	$m	$m
GFS revenue (Statement 11)	**190,791**	**199,336**	**210,865**	**222,480**	**234,311**
less GST revenue for States and Territories	27,630	29,690	31,310	33,090	34,970
GFS revenue (Statement 2)	**163,161**	**169,646**	**179,555**	**189,390**	**199,341**
plus defence asset revenue recognised first time	8	0	0	0	0
plus foreign exchange gains	646	0	0	0	0
plus other economic revaluations	-357	-400	-400	-400	-311
plus profit on the sale of assets	2,424	11	10,094	9,944	9,873
plus swap interest received	2,518	2,222	1,865	1,630	1,338
AAS31 revenue (Statement 12)	**168,400**	**171,479**	**191,113**	**200,563**	**210,240**
GFS expenses (Statement 11)	**194,206**	**199,612**	**208,728**	**217,819**	**226,845**
less GST grants to States and Territories	27,430	29,380	31,100	32,880	34,760
less GST mutually agreed writedowns	20	40	50	50	50
GFS expenses (Statement 2)	**166,756**	**170,192**	**177,578**	**184,889**	**192,035**
plus revaluations/writedowns from superannuation	652	0	0	0	0
plus net writedown of assets/bad and doubtful debts	4,115	1,171	1,076	1,099	1,092
plus foreign exchange losses	0	98	0	0	0
plus other economic revaluations	-579	-122	-400	-400	-107
plus loss on the sale of assets	8	2	2	0	0
less costs of asset sales	29	15	218	218	218
less other property expenses	0	0	0	0	0
plus swap interest paid	1,845	1,720	1,456	1,269	1,047
plus defence weapons platforms depreciation	1,980	2,161	2,179	2,367	2,029
less defence weapons platforms investment	3,000	3,676	4,404	4,308	4,699
plus AusAid IDA/ADF expenses	342	0	0	679	0
less reversal of interest capitalisation	31	31	31	31	31
AAS31 expenses (Statement 12)	**172,060**	**171,500**	**177,237**	**185,346**	**191,148**

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

AAS31 revenues less expenses calculate the AAS31 net operating result. Similarly, GFS revenues less expenses calculate the GFS net operating balance.

Consequently, the reconciliation between the AAS31 operating result before extraordinary items and the GFS net operating balance relates directly to differences in the definitions of revenues and expenses, as shown in Table 2 above.

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

As discussed previously, 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 AAS31 there is no equivalent measure to the fiscal balance. That is, the AAS31 statement of revenues and expenses stops at the operating result and includes no information on net capital investment. Under the accounting standards framework, the equivalent indicator to the fiscal balance would show whether profits (that is, the net operating result) are sufficient to fund net capital investment.

Table 3: Reconciliation of AAS31 net operating result and fiscal balance

	Estimates		Projections		
	2001-02	2002-03	2003-04	2004-05	2005-06
	$m	$m	$m	$m	$m
AAS31 operating result before extraordinary items (Statement 12)	**-3,661**	**-21**	**13,876**	**15,217**	**19,092**
Net differences from revenue and expense definitions	245	-254	-11,739	-10,557	-11,626
GFS net operating balance (Statement 11)	**-3,415**	**-275**	**2,137**	**4,660**	**7,466**
less purchase of property, plant and equipment and intangibles	5,401	6,310	6,621	6,410	6,716
less assets acquired under finance leases	-83	-50	-3	0	1
less other non-financial assets	-78	-90	-1	4	5
less increase in inventories	-140	-54	-93	-99	-86
plus defence weapons platforms investment	3,000	3,676	4,404	4,308	4,699
plus proceeds from sales of property, plant and equipment and intangibles	860	1,346	864	642	278
plus depreciation and amortisation	3,739	3,949	4,038	4,239	4,027
less weapons depreciation	1,980	2,161	2,179	2,367	2,029
plus reversal of interest capitalisation	31	31	31	31	31
Fiscal balance (GFS net lending) (Statement 11)	**-2,865**	**450**	**2,771**	**5,197**	**7,836**
Impact of GST	-180	-270	-160	-160	-160
Fiscal balance (GFS net lending) (Statement 2)	**-3,045**	**180**	**2,611**	**5,037**	**7,676**

(a) The fiscal balance estimates in Statement 11 are higher than those presented in Statement 2, as explained on page 11-3.