Appendix E: External reporting standards and budget concepts

EXTERNAL REPORTING STANDARDS

The Commonwealth *Charter of Budget Honesty Act 1998* requires that the Mid-Year Economic and Fiscal Outlook (MYEFO) be based on external reporting standards. In accordance with the Charter, the major external standards used in the MYEFO 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. Attachment A to Part III, Appendix B and Note 1 in Appendix C 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 a brief overview of the GFS framework, including the major fiscal aggregates, and the AAS reporting framework. Further information can be found in *Budget Strategy and Outlook 2002-03, Statement 10: External Reporting Standards and Budget Concepts*.

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).

The GFS conceptual framework is divided into a number of separate statements. The GFS statements reported in the MYEFO are the operating statement, balance sheet, cash flow statement and a statement of other economic flows. Each of these statements 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. 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 and GFS expenses as transactions that decrease net worth — 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.

Fiscal balance

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

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.

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 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 does not include superannuation or 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, 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.

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 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

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. 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)

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 Commonwealth general government sector arise from price movements in its assets and liabilities.

Classification and accounting treatment changes

Consistent with ABS advice, the 2002-03 MYEFO reflects classification changes to transactions relating to superannuation arrangements for public non-financial corporations' (PNFC) employees from operating transactions to financing transactions. These changes are further discussed in the ABS publication *Government Financial Estimates, Australia* (Cat. No. 5501.0.55.001), released electronically on Wednesday

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.

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

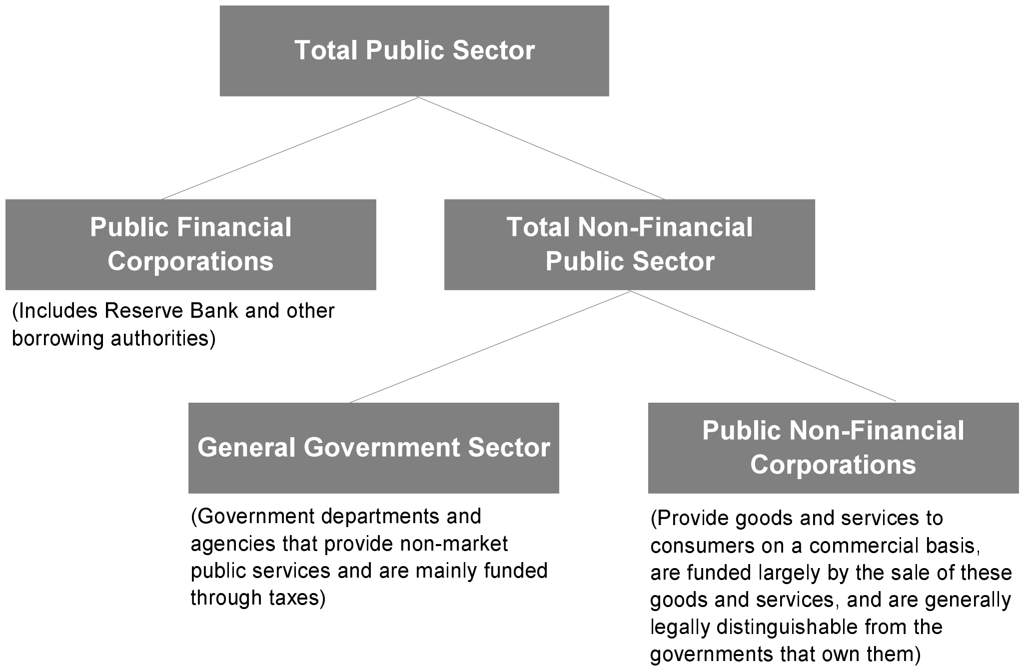
30 October 2002. This reclassification reflects an assessment that these arrangements are not normal operating activities of the general government sector as the superannuants are not general government employees.

This means that Commonwealth payments of the principal amounts of these superannuation payments will now be recorded below the line as financing transactions. However, the interest component of the payments will continue to be recorded as operating transactions, and will continue to directly impact on the underlying cash and fiscal balances.

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 E1.

Figure E1: 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.

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 financial performance, which includes an operating result;
- a statement of financial position, which shows net assets; and
- a statement of cash flows, which includes the 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 Appendix C.

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 E1. 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 E1: 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 Appendix B).
Interest flows related to swaps and other financial derivatives	Treated as operating revenues 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. 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 E2 reconciles GFS revenue and expenses with their AAS31 counterparts.

Table E2: Reconciliation of GFS and AAS31 revenue and expenses

	2002-03	2003-04	2004-05	2005-06
	$m	$m	$m	$m
GFS revenue (Appendix B)	**199,563**	**211,315**	**221,711**	**232,811**
less GST revenue for States and Territories	29,940	31,230	32,920	34,710
GFS revenue (Parts I and III)	**169,623**	**180,085**	**188,791**	**198,101**
plus defence asset revenue recognised first time	415	0	0	0
plus foreign exchange gains	0	0	0	0
plus other economic revaluations	853	20	20	20
plus profit on the sale of assets	21	215	9,530	9,460
plus swap interest received	2,222	1,866	1,630	1,338
AAS31 revenue (Appendix C)	**173,135**	**182,187**	**199,970**	**208,919**
GFS expenses (Appendix B)	**200,336**	**208,247**	**217,920**	**227,231**
less GST Grants to States and Territories	29,630	31,020	32,710	34,500
less GST mutually agreed writedowns	40	50	50	50
GFS expenses (Parts I and III)	**170,666**	**177,177**	**185,160**	**192,681**
plus revalutions/writedowns from superannuation	0	0	0	0
plus net writedown of assets/bad and doubtful debts	1,579	903	893	867
plus foreign exchange losses	445	0	0	0
plus other economic adjustments	323	0	0	0
plus loss on the sale of assets	0	0	0	0
less other expenses	15	10	175	175
plus swap interest paid	1,710	1,437	1,255	1,036
plus defence weapons platforms depreciation	2,056	2,179	2,367	2,029
less defence weapons platforms investment	3,616	4,274	4,150	4,509
plus AusAid IDA/ADF expenses	274	0	575	0
AAS31 expenses (Appendix C)	**173,422**	**177,411**	**185,926**	**191,930**

Table E3 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 E2 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, 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 AAS31 there is no equivalent measure to the fiscal balance. That is, the AAS31 statement of financial performance ends with the operating result and includes no information on net capital investment. Under the accounting standards framework, the equivalent indicator to the fiscal balance would measure the extent to which profits (that is, the net operating result) are sufficient to fund net capital investment.

Table E3: Reconciliation of AAS31 net operating result and fiscal balance

	2002-03 $m	2003-04 $m	2004-05 $m	2005-06 $m
AAS31 operating result before extraordinary items (Appendix C)	**-287**	**4,775**	**14,045**	**16,989**
Net differences from revenue and expense definitions	-486	-1,706	-10,254	-11,410
GFS net operating balance (Appendix B)	**-773**	**3,069**	**3,790**	**5,580**
less purchase of property, plant and equipment and intangibles	6,346	6,646	6,201	6,486
less assets acquired under finance leases	-15	1	7	7
less other non-financial assets	-9	4	4	5
less increase in inventories	-42	-96	-101	-84
plus defence weapons platforms investment	3,616	4,274	4,150	4,509
plus proceeds from sales of property, plant and equipment and intangibles	1,394	888	642	278
plus depreciation and amortisation	3,821	4,040	4,233	4,033
less weapons depreciation	2,056	2,179	2,367	2,029
Fiscal balance (GFS net lending) (Appendix B)(a)	**-278**	**3,537**	**4,336**	**5,957**

(a) The fiscal balance estimates in Appendix B are higher than those presented in Part III, as explained in the introduction to Appendix B.