

STATEMENT 8: FINANCIAL REPORTING STANDARDS AND BUDGET CONCEPTS

This statement describes the financial accounting frameworks relevant to the Commonwealth.

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STATEMENT 8: FINANCIAL REPORTING STANDARDS AND BUDGET CONCEPTS

The Commonwealth *Charter of Budget Honesty Act 1998* stipulates 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, including *Australian Accounting Standard No. 31 Financial Reporting by Governments* (AAS31). 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 and Note 1 in Statement 10.

ACCRUAL GFS FRAMEWORK

The GFS reporting framework is a specialised accounting 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

GFS financial statements are contained in Statements 2 and 9.

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.

The framework distinguishes between two types of flows: transactions and other economic flows.

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

¹ 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).

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- **Other economic flows** represent changes to stocks that do not result from a transaction. Other economic flows arise from 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 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.

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 Commonwealth's stock of non-financial assets due to transactions. As such, it measures the net effect of purchases, sales and consumption (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.

- 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 comprise mainly (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 less net capital investment. Thus fiscal balance includes the impact of net expenditure (effectively purchases less sales) on non-financial assets rather than consumption (depreciation) of non-financial assets.²

The fiscal balance measures the Commonwealth'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 Commonwealth general government sector to the balance on the current account in the balance of payments.

A fiscal balance surplus indicates the Commonwealth is lending to other sectors. A fiscal balance deficit indicates the Commonwealth is using 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 their owners from 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 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 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.

² 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.

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Net interest payments is a concept related to net debt. Net interest payments is a cash measure defined as interest payments on gross debt less interest received. 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. Abstracting from the effect of revaluations (recorded in the statement of other economic flows), changes in general government sector net worth reflect the net operating balance. 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 Commonwealth's contribution to the wealth of Australia.

The net worth measure is a more comprehensive indicator of a government's overall financial position than net debt as it 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 this increase in financial assets is funded by a decrease in physical assets. Net worth itself, however, also has limitations. It can be volatile, and changes can reflect circumstances beyond the direct control of the Government.

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 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 identified specifically 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
<i>plus</i>
Net cash flows from investments in non-financial assets
<i>less</i>
Net acquisitions of assets acquired under finance leases and similar arrangements ³
<i>equals</i>
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 measures the extent to which the Commonwealth requires cash, either by running down its financial assets or drawing on other sectors' cash reserves.

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.⁴ 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.

3 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.

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

Statement of other economic flows (reconciliation of net worth)

The sum of two types of flows — transactions and other economic flows (both defined earlier) — account for changes in GFS net worth. Accordingly, the GFS system includes a fourth financial statement that presents changes in net worth in an accounting period due to other economic flows (the effect of transactions is reported in the operating statement).⁵

Other economic flows are changes in the value of assets or liabilities due to price movements or volume changes. Most other economic flows for the Commonwealth general government sector arise from price movements in its assets and liabilities, including:

- changes in the value of investments in commercial entities, including through changes in share prices;
- writedowns in asset values, such as through greater allowances for bad and doubtful debts;
- changes in the valuation of superannuation and employee compensation liabilities due to economic and demographic changes; and
- valuation changes due to movements in foreign exchange rates and interest rates.

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

Classification and accounting treatment changes

The ABS GFS framework requires that flows and stocks are valued at current market prices (or where these are not observable, a suitable proxy indicator). As discussed in Box 1 of Statement 2, the 2003-04 Budget adopts the market valuation of net debt with new debt valuation systems being introduced by the Australian Office of Financial Management. Previous budgets foreshadowed that the Commonwealth would align reporting with the ABS GFS treatment of debt as the accruals framework is bedded down.

The revised valuation methodology has been applied from the 1999-2000 fiscal year, when accrual accounting was introduced and the ABS accrual GFS framework was adopted. This creates a disconformity in the net debt series as outcomes prior to 1999-2000 are based on historic cost, consistent with the applicable budgeting framework of the time.

⁵ 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'.

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Under market valuation, movements in the market prices of debt instruments are reflected in their balance sheet valuations. Revaluations due to changes in market prices are recorded in the statement of other economic flows (reconciliation of net worth) and do not impact on the underlying cash or fiscal balances.

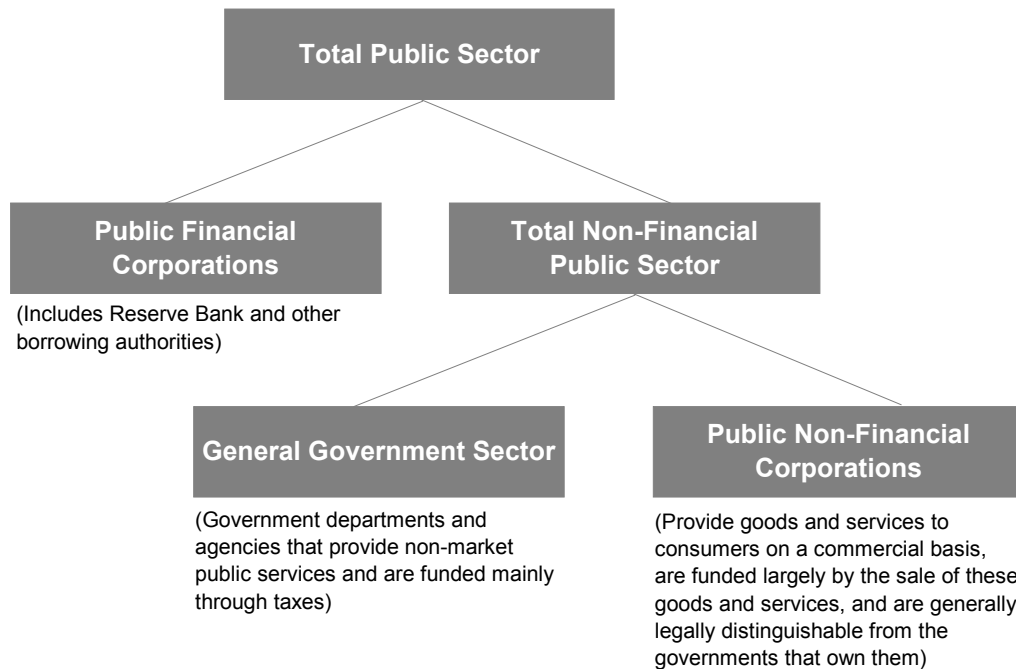
In addition, the 2003-04 Budget adopts the ABS GFS treatment of debt transactions relating to issue and repurchase premia and discounts. Under ABS GFS, issue premia and discounts are recorded as financing transactions and do not impact on the underlying cash or fiscal balances. Previously issue premia were treated as interest savings thereby improving the underlying cash balance when debt was issued. Offsetting this, repayments of issue premia over the life of the bond were recorded as interest payments reducing the underlying cash balance.

Similarly, under the ABS GFS framework, repurchase premia and discounts do not impact on the underlying cash or fiscal balances. Amounts relating to the movement in the price of debt between when the bond is issued and repurchased are attributable to market revaluations, which are recorded in the statement of other economic flows over the life of the bond. Amounts paid to repurchase a bond are recorded as financing transactions in full at the time of repurchase. Under the previous budget treatment repurchase premia and discounts were recorded as interest payments impacting on the underlying cash balance.

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 sector comprises bodies that provide goods and services that are mainly market, non-regulatory and non-financial in nature, and are financed predominantly through sales to the consumers of these goods and services. In general, public non-financial corporations are legally distinguishable from the governments that own them. Commonwealth public non-financial corporations include Telstra, Australia Post, the Australian Dairy Corporation and the Australian Government Solicitor.

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

The GFS coverage of the public sector also includes public financial corporations. Public financial corporations are public sector bodies that engage in financial intermediation services or auxiliary financial services and 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 public financial corporations is not included in the budget papers as public financial corporations undertake financial intermediation, which is a fundamentally different function from that performed by other public entities. Under the Uniform Presentation Framework public financial corporations information is only required to be reported in budget outcome statements.

The total public sector comprises all sectors of government – general government, the public non-financial corporations sector and the public financial corporations sector.

AUSTRALIAN ACCOUNTING STANDARD NO. 31 (AAS31) REPORTING FRAMEWORK

Australian Accounting Standard No. 31 Financial Reporting by Governments 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, position and cash flows 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 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 are contained in Statement 10.

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 generally 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 9).
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.
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 (underlying cash balance).

Following the broad strategic direction of the Financial Reporting Council, the Australian Accounting Standards Board is currently pursuing harmonisation of GFS and Australian accounting standards. A converged financial reporting framework will reduce confusion associated with the publication of two sets of financial statements and increase the accessibility of government budget and outcome reports.

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

Table 2: Reconciliation of GFS and AAS31 revenue and expenses

	Estimates		Projections		
	2002-03 \$m	2003-04 \$m	2004-05 \$m	2005-06 \$m	2006-07 \$m
GFS revenue (Statement 9)	203,030	210,375	218,806	229,924	242,405
<i>less</i> GST revenue for States and Territories	31,230	32,050	33,815	35,680	37,690
GFS revenue (Statement 2)	171,800	178,325	184,991	194,244	204,715
<i>plus</i> asset revenue recognised first time	821	281	1	1	1
<i>plus</i> foreign exchange gains	753	0	0	0	0
<i>plus</i> other economic revaluations	1,324	20	20	20	20
<i>plus</i> proceeds from the sale of assets	1,278	1,182	926	11,707	11,725
<i>plus</i> swap interest revenue	2,198	1,858	1,506	1,208	956
AAS31 revenue (Statement 10)	178,175	181,666	187,445	207,181	217,418
GFS expenses (Statement 9)	201,234	209,761	220,001	229,506	239,671
<i>less</i> GST grants to States and Territories	30,670	31,700	33,450	35,300	37,280
<i>less</i> GST mutually agreed writedowns	30	30	30	30	40
GFS expenses (Statement 2)	170,534	178,031	186,521	194,176	202,351
<i>plus</i> actuarial revaluations	4,967	0	0	0	0
<i>plus</i> net writedown of assets/bad and doubtful debts	2,104	1,445	1,147	1,168	1,145
<i>plus</i> foreign exchange losses	0	122	28	10	0
<i>plus</i> other economic adjustments	52	0	8	0	0
<i>plus</i> value of assets sold	1,224	901	787	2,057	2,076
<i>plus</i> swap interest expense	1,644	1,354	1,107	898	703
<i>plus</i> defence weapons platforms depreciation	2,056	2,179	2,367	2,029	2,098
<i>less</i> defence weapons platforms investment	3,212	3,470	3,310	3,683	4,131
<i>plus</i> AusAid IDA/ADF expenses	274	0	620	0	0
AAS31 expenses (Statement 10)	179,643	180,561	189,274	196,657	204,241

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

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

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measure the extent to which 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		
	2002-03 \$m	2003-04 \$m	2004-05 \$m	2005-06 \$m	2006-07 \$m
AAS31 operating result before extraordinary items (Statement 10)	-1,468	1,105	-1,829	10,524	13,177
Net differences from revenue and expense definitions	3,265	-491	635	-10,106	-10,442
GFS net operating balance (Statement 9)	1,796	614	-1,194	418	2,734
less purchase of property, plant and equipment and intangibles	5,837	6,008	5,685	5,913	6,182
less assets acquired under finance leases	-4	1	8	7	8
less other non-financial assets	98	72	52	45	-18
less increase in inventories	104	-46	-78	-64	52
plus defence weapons platforms investment	3,212	3,470	3,310	3,683	4,131
plus proceeds from sales of property, plant and equipment and intangibles	1,278	1,073	835	427	445
plus depreciation and amortisation	3,836	4,087	4,270	4,077	4,195
less weapons depreciation	2,056	2,179	2,367	2,029	2,098
Fiscal balance (GFS net lending) (Statement 9)(a)	2,031	1,031	-813	674	3,182
Impact of GST	-530	-320	-335	-350	-370
Fiscal balance (GFS net lending) (Statement 2)(a)	1,501	711	-1,148	324	2,812

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