

# APPENDIX A: FINANCIAL REPORTING STANDARDS AND BUDGET CONCEPTS

## EXTERNAL REPORTING STANDARDS

The *Charter of Budget Honesty Act 1998* requires that the Final Budget Outcome be based on external reporting standards. Accordingly, the major external standards used in the Final Budget Outcome are the Australian Bureau of Statistics (ABS) accrual Government Finance Statistics (GFS) framework and Australian Accounting Standards (AAS), including 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 Attachment A to Part 1 and Note 1 in Part 3.

The next section provides a brief overview of the GFS and AAS reporting frameworks. Further information can be found in Budget Paper No. 1 *Budget Strategy and Outlook 2004-05, Statement 8: Financial Reporting Standards and Budget Concepts*.

## ACCRUAL GFS FRAMEWORK

The GFS reporting framework is a specialised 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*).<sup>1</sup>

The GFS framework comprises 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 Final Budget Outcome 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).

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<sup>1</sup> Additional information on the Australian accrual GFS framework is available in the ABS publication *Australian System of Government Finance Statistics: Concepts, Sources and Methods, 2003* (Cat. No. 5514.0.55.001).

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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 decrease net worth (assets minus liabilities) are reported as revenues and expenses respectively in the operating statement.<sup>2</sup>

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. 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 effected periods and can be reliably assigned to the relevant period(s).

### **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

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<sup>2</sup> 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.<sup>3</sup>

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 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, 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 identified specifically because cash management is considered an integral function of accrual budgeting.

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<sup>3</sup> 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.

### **Underlying cash balance**

The underlying cash balance (GFS surplus/deficit) is the cash counterpart of the fiscal balance, reflecting the Australian Government'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 <sup>4</sup>
<i>equals</i>
Underlying cash balance

### **Headline cash balance**

The headline cash balance is calculated by adding net 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.<sup>5</sup> 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 Australian Government's financial assets.

### **Statement of other economic flows (reconciliation of net worth)**

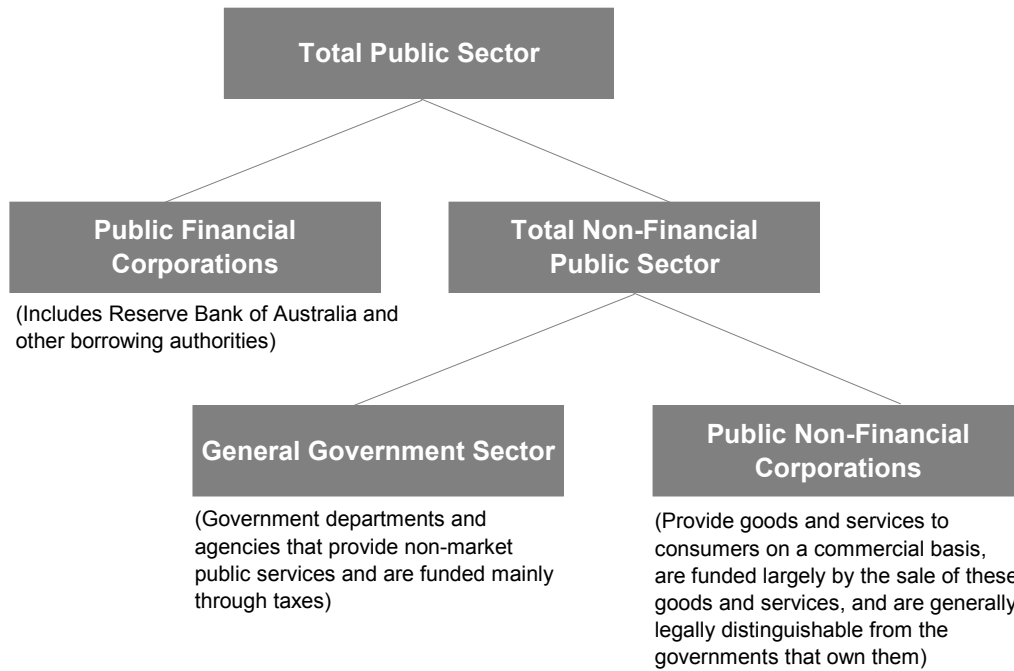
The statement of other economic flows outlines changes in net worth driven by economic flows other than GFS revenues and GFS expenses. GFS revenues, GFS expenses and other economic flows sum to the total change in net worth during a period. The majority of other economic flows for the Australian Government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

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

## 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 A1.

**Figure A1: 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.

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

## AUSTRALIAN ACCOUNTING STANDARDS REPORTING FRAMEWORK, INCLUDING AAS 31

AAS 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.

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Reporting under this standard 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 AAS 31. 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 AAS 31 provides a general framework for financial reporting by governments, compliance with all other applicable accounting standards is required. Exceptions to this rule are explicitly stated in AAS 31.

A full set of AAS financial statements and accompanying notes prepared for the general government sector can be found in Part 3. These statements are derived from audited financial statements with the exception of the Department of Defence and the Department of Family and Community Services, for which audit opinions are pending. Nevertheless, the financial tables in this report include the financial results for these two departments as at the time of publication. Final 2003-04 audit opinions for these two departments will be included in their respective annual reports and in the Australian Government *Consolidated Financial Statements for the year ended 30 June 2004* which will be released at a later time.

## **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.

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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, 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 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 AAS 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 AAS treatments of transactions are outlined in Table A1. 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, 2003* (Cat. No. 5514.0.55.001).

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**Table A1: Selected differences between AAS and GFS reporting standards**

Issue	AAS 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.  The Australian Government departs from this latter requirement (see Attachment A to Part 1).
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 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 (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 AAS. A converged financial reporting framework will reduce confusion associated with the publication of two sets of financial statements and improve the readability of government budget and outcome reports.

Table A2 reconciles GFS revenue and expenses with their AAS counterparts.

**Table A2: Reconciliation of GFS and AAS revenue and expenses**

	2003-04 Outcome \$m
<b>GFS revenue (Part 2)</b>	<b>221,679</b>
<i>less</i> GST revenue for States and Territories	34,121
<b>GFS revenue (Part 1)</b>	<b>187,559</b>
<i>plus</i> asset revenue recognised for the first time	797
<i>plus</i> foreign exchange gains	599
<i>plus</i> other economic revaluations	360
<i>plus</i> proceeds from the sale of assets	1,497
<i>plus</i> swap interest revenue	1,912
<b>AAS revenue (Part 3)</b>	<b>192,723</b>
<b>GFS expenses (Part 2)</b>	<b>214,503</b>
<i>less</i> GST grants to States and Territories	33,195
<i>less</i> GST interest on overpayments	12
<i>less</i> GST mutually agreed writedowns	59
<b>GFS expenses (Part 1)</b>	<b>181,238</b>
<i>plus</i> actuarial revaluations	-840
<i>plus</i> net writedown of assets/bad and doubtful debts	4,828
<i>plus</i> foreign exchange losses	0
<i>plus</i> other economic adjustments	1,772
<i>plus</i> value of assets sold	954
<i>plus</i> swap interest expense	1,572
<i>plus</i> defence weapons platforms depreciation	2,104
<i>less</i> defence weapons platforms investment	2,040
<i>plus</i> AusAID IDA/ADF expenses	0
<b>AAS expenses (Part 3)</b>	<b>189,587</b>

Table A3 reconciles the accounting operating result to the GFS net operating balance and the fiscal balance (GFS net lending).

The AAS net operating result is equal to AAS revenues less expenses. Similarly, GFS revenues less expenses equal the GFS net operating balance. Consequently, the reconciliation between the AAS 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 A2.

The second part of the Table A3 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 AAS there is no equivalent measure to

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the fiscal balance. That is, the AAS statement of financial performance stops at the operating result and includes no information on net capital investment.

**Table A3: Reconciliation of AAS net operating result and fiscal balance**

	2003-04 Outcome \$m
<b>AAS operating result before extraordinary items (Part 3)</b>	<b>3,136</b>
Net differences from revenue and expense definitions	4,039
<b>GFS net operating balance (Part 2)</b>	<b>7,176</b>
<i>less</i> purchase of property, plant and equipment and intangibles	4,450
<i>less</i> assets acquired under finance leases	5
<i>less</i> other non-financial assets	4
<i>less</i> increase in inventories	780
<i>plus</i> defence weapons platforms investment	2,040
<i>plus</i> proceeds from sales of property, plant and equipment and intangibles	832
<i>plus</i> depreciation and amortisation	3,747
<i>less</i> weapons depreciation	2,104
<b>Fiscal balance (GFS net lending) (Part 2)(a)</b>	<b>6,452</b>
<i>Impact of GST</i>	-855
<b>Fiscal balance (GFS net lending) (Part 1)(a)</b>	<b>5,597</b>

(a) The fiscal balance in Part 2 is higher than the fiscal balance presented in Part 1, as explained in the following section.

## **ACCOUNTING FOR GST AND BUDGET ASSISTANCE TO STATES AND TERRITORIES (THE STATES)**

Under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (the IGA), all goods and services tax (GST) receipts are appropriated to the states and territories and thus are not available for expenditure by the Australian Government. As such, the GST is a State tax, with the Australian Taxation Office acting as the States' agent in the collection of the tax. Consequently, collections of GST from taxpayers and payments of the GST to the States are not recorded as revenues and expenses of the Australian Government in Part 1.

Under the IGA, the Australian Government has guaranteed that the budgetary position of each individual state and territory will be no worse off than it would have been had the GST reforms not been implemented. Grants to the States to meet this guarantee are titled 'general budget assistance to the States' (GBA) and are recorded as expenses of the Australian Government.<sup>6</sup> GBA comprises Budget Balancing Assistance (BBA) grants paid in accordance with the provisions of the IGA and any adjustments to account for actual GST cash collections. For States no longer receiving BBA grants, GBA relates to the difference between actual GST cash receipts and the Commissioner of Taxation's mid-June determination of cash GST receipts.

In Part 2, the accounts are presented including GST as Australian Government revenue. In addition to GBA, the Part 2 fiscal balance is adjusted for the accrual GST revenue less actual cash GST receipts, which are payable to the states and territories. This results in the Part 2 fiscal balance being \$855 million greater than the fiscal balance reported in Part 1 and elsewhere in the Final Budget Outcome. A reconciliation of GFS revenue and GFS expenses in Part 1 and Part 2 is presented in Table A2.

The different accounting approaches also flow through to differences in GFS net worth, resulting in GFS net worth in Part 2 being \$1.6 billion greater than GFS net worth reported in Part 1 and elsewhere. This difference results from the inclusion of GST receivables and payables in the GFS balance sheet in Part 2.

However, the net impact on cash flows is the same regardless of the accounting approach. Therefore the underlying cash balance is the same whether it is calculated on the basis that the GST is a State tax or an Australian Government tax.

Further information on accounting for GST and budget assistance to the states and territories can be found on page 10 of the *Final Budget Outcome 2000-01*.

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6 The term 'general budget assistance to the States' explains aggregate changes in Australian Government expenses under a States' agent accounting arrangement and does not appear in the IGA, which governs the actual payments from the Australian Government to the States.