

VICTORIA

Auditor General

Victoria

**Auditor-General's
Report on the
Annual Financial Report
of the State of Victoria,
2005-06**

September 2006

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AUDITOR GENERAL
VICTORIA

The Hon. Monica Gould MP
President
Legislative Council
Parliament House
Melbourne

The Hon. Judy Maddigan MP
Speaker
Legislative Assembly
Parliament House
Melbourne

Dear Presiding Officers

Under the provisions of section 16AB of the *Audit Act 1994*, I transmit the *Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2005-06*.

Yours faithfully

Edward M. Hay
Acting Auditor-General

29 September 2006

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1. Executive summary



1.1 Introduction

This report sets out the results of the audit of the *Financial Report for the State of Victoria* (the AFR) for the year ended 30 June 2006. It also provides parliament and other users of the AFR with our assessment of the explanations provided by the Treasurer of Victoria and the Minister for Finance of the financial outcomes achieved by the state and the general government sector¹, in chapters 1 to 3 of the AFR which are not subject to audit.

The report also includes the results of the audit of the special purpose *Report on the Financial Contribution by the Victorian Government to the Melbourne 2006 Commonwealth Games*, which was prepared by the Department for Victorian Communities to facilitate transparency and accountability about the aggregate financial outcomes of the games.

1.2 Results of audit

An unqualified audit opinion on the 2005-06 AFR was issued on 27 September 2006.

Both this Office and the Department of Treasury and Finance (DTF) have worked over several years to improve the presentation of the AFR, including the level and quality of disclosures, and the timeliness of its completion and tabling in parliament. These efforts have contributed to improved financial transparency and timeliness of reporting in relation to this financial report.

The AFR provides the accountability to parliament of the government's stewardship of the state's finances. Opportunities remain to further enhance the AFR, through the presentation of improved information about:

- the costs of public sector insurance schemes (such as the workers' compensation and transport accident schemes), which represent a major component of state expenditure
- any major new financial arrangements in the year, which significantly affect the level of future state expenditures

¹ The general government sector (also referred to as the budget sector) comprises all government departments and other public sector agencies that receive most of their funding from parliamentary appropriations administered by government departments.

- the transfer of resources through capital contributions (including the creation, payment and return of contributed capital, and dividend payments) by public financial and public non-financial corporations to central government (the general government sector) – within (or referenced to) the disaggregated information presented in the AFR.

Delays by the state's major agencies in completing their audited financial reports (and submitting the related data to DTF for AFR preparation purposes) continue to impede achievement of planned AFR completion and tabling dates. In 2005-06, 14 per cent of the major agencies completed their audited financial statements by the agreed date of 17 August 2006. Consequently, DTF was not able to meet its target of preparing a complete draft AFR by 25 August 2006. DTF provided us with a complete draft on 9 September 2006.

The state's major agencies need to review their financial reporting processes and identify opportunities to improve the timeliness of their reporting. Key areas where opportunities exist include improved planning and monitoring of year-end reporting; the introduction of financial account "close-offs" at interim reporting dates; and the earlier identification, discussion and resolution of complex/contentious accounting issues.

A number of recent accounting developments will have major impacts on future financial reporting in the public sector. These flow from work currently underway by the Australian Accounting Standards Board (AASB) to:

- harmonise the reporting requirements of the Australian Generally Accepted Accounting Principles (A-GAAP) and the Government Finance Statistics (GFS) frameworks². In September 2006, the AASB issued a new accounting standard dealing with the governments' reporting of general government sector operations, applicable for accounting periods beginning from 1 July 2008
- review several current public sector-specific accounting standards with the view to their integration with other "sector neutral" standards and/or the creation of new public sector topic specific standards.

We will continue to monitor the development of accounting standards to further enhance the overall quality of financial reporting of the state.

² Under A-GAAP, transactions are reported from an accounting viewpoint, whereas under GFS, transactions are reported from an economic impact perspective.

1.3 Financial outcomes achieved by the state in 2005-06

Improvements in the presentation of audited AFRs over recent years have been complemented with improved analysis and discussion of the reported financial outcomes, as presented in chapters 1 to 3 of the AFR which are not subject to audit. Improvements in the latter have included more comprehensive explanations and analyses of influences on the reported results, and the presentation of selected indicators of financial condition covering several years. While scope remains for further enhancement, the information now presented (in both the audited and unaudited parts of the AFR) assists users make informed assessments about the financial outcomes achieved, and the financial condition of the state's finances.

For this reason, this report does not reproduce the analysis and discussion presented in the AFR, but provides parliament and other users of the AFR with independent assurance about the audited financial information relating to the state's finances.

2005-06 operating results

The AFR reports a strong net result for the state and the general government sector for 2005-06. The state achieved an operating surplus of \$5 876 million in 2005-06 (\$1 346 million, 2004-05) while the general government sector achieved an operating surplus of \$3 922 million in the year (\$457 million deficit, 2004-05).

The major factors contributing to these positive results for the year were:

- a reduction in the state's unfunded superannuation liabilities. This was mainly due to the achievement of higher than expected investment yields and the use of a higher discount rate (due to a movement in interest rates in the year) than previously used to value these liabilities
- increased Commonwealth grants to the state
- higher investment yields
- increased state taxation revenues, particularly payroll tax and land transfer duty.

The AFR indicates that the financial outcomes achieved by the state are consistent with Victorian economic trends. Our analysis confirms this assessment. Over the 5-year period to 30 June 2006, the rate of growth in state expenditures has been below that of the rate of growth of the Victorian economy. This indicates that the current level of government activity remains "affordable" and sustainable.

The financial outcomes achieved by the general government sector are also consistent with the government's financial performance target of achieving a "net result from transactions" of at least \$100 million, but the "underlying" expenditure trends for the sector indicate a growth rate consistent with the rate of revenue growth, but exceeding the rate of state economic growth, indicating a need for government monitoring over future years.

Financial position and condition of the state

The AFR also reports that the state's and the general government sector's financial position improved during 2005-06 and remains sound. We confirm this assessment.

During 2005-06, the state's net assets grew by \$7 246 million to \$76 724 million, while the general government sector's net asset position improved by \$6 017 million to \$37 525 million. This improvement has been driven by an increase in the value of assets - mainly property, plant and equipment (due to a combination of new acquisitions and asset revaluations), and investments (mainly due to market value movements in the year). The overall level of state liabilities increased by \$462 million in the year, with increases in borrowings and insurance claim liabilities being largely offset by reduced unfunded superannuation liabilities.

In previous years, we assessed the state's "financial condition" against several measures of sustainability, flexibility and vulnerability, and concluded that it was sound. Our review of the financial results and outcomes achieved by the government for 2005-06 confirmed that assessment for the current year.

Notwithstanding the above positive assessments, our past reports to parliament on the state's finances have drawn attention to several external factors which need continuous monitoring by government, given the major risks they pose and impacts they can have on the state's financial performance and condition. These include:

- the performance of the national economy, and the policy directions and decisions of the Commonwealth Government, both of which significantly influence the level of Commonwealth grants to the state
- the performance of the state economy and property markets, which significantly influence the level of state own-sourced revenues (mainly taxation revenues)

- the performance of financial and equity markets, which significantly influence the investment revenues and superannuation expenses³ of the state
- pressure for wage and salary growth, contributing to increased employment costs.

These external factors continue to need ongoing monitoring by the government, given the impacts they can have on the state's finances.

1.4 Melbourne 2006 Commonwealth Games - Special purpose financial statements

The Commonwealth Games were a significant source of revenue and expenditure to the state during the year.

Operating revenues generated by the games from actual and planned asset sales are expected to be \$53 million above the original target of \$400 million. However, much of this extra revenue relates to expected proceeds from the sale of Commonwealth Games Athletes' Village housing and apartments. As such, the final revenue achieved will depend on the timing and amount of actual sales.

Total expenditure on the games was \$1 144 million, which is consistent with the government's target announced in 2003. The net cost of the games to the state was also \$5.8 million below the original budget.

The Office of Commonwealth Games Coordination (part of the Department for Victorian Communities) prepared a whole-of-games' special purpose financial report that set out the state's financial contribution. This report was audited by the Victorian Auditor-General's Office and an unqualified audit opinion was issued on 13 September 2006.

³ The financial and equity markets affect the investment returns of superannuation funds and, therefore, the movements in unfunded superannuation liabilities.



2. Results of audit



2.1 The reporting framework

The *Financial Management Act 1994* sets out the legislative framework for the administration of public finances in Victoria. The Act requires that an Annual Financial Report (AFR) be prepared, audited by the Auditor-General, and tabled in parliament. The AFR provides the accountability of the government to parliament for the management and stewardship of the state's finances.

The Department of Treasury and Finance (DTF) prepares the AFR according to the requirements of the Act and Australian accounting standards, particularly Australian Accounting Standard AAS 31 *Financial Reporting by Governments*. In addition to the requirements of Australian accounting standards, the Act provides that the AFR must present fairly the financial transactions and position of the Victorian general government sector¹ and the financial transactions of the Public Account², comprising the Consolidated Fund and the Trust Fund.

The accounting standards require the AFR to be a consolidated general purpose financial report of the Victorian Government. Government departments, state-owned enterprises and other agencies controlled by the government are, therefore, included in the AFR.

The AFR provides a disaggregation of the consolidated result and balances into 3 sectors:

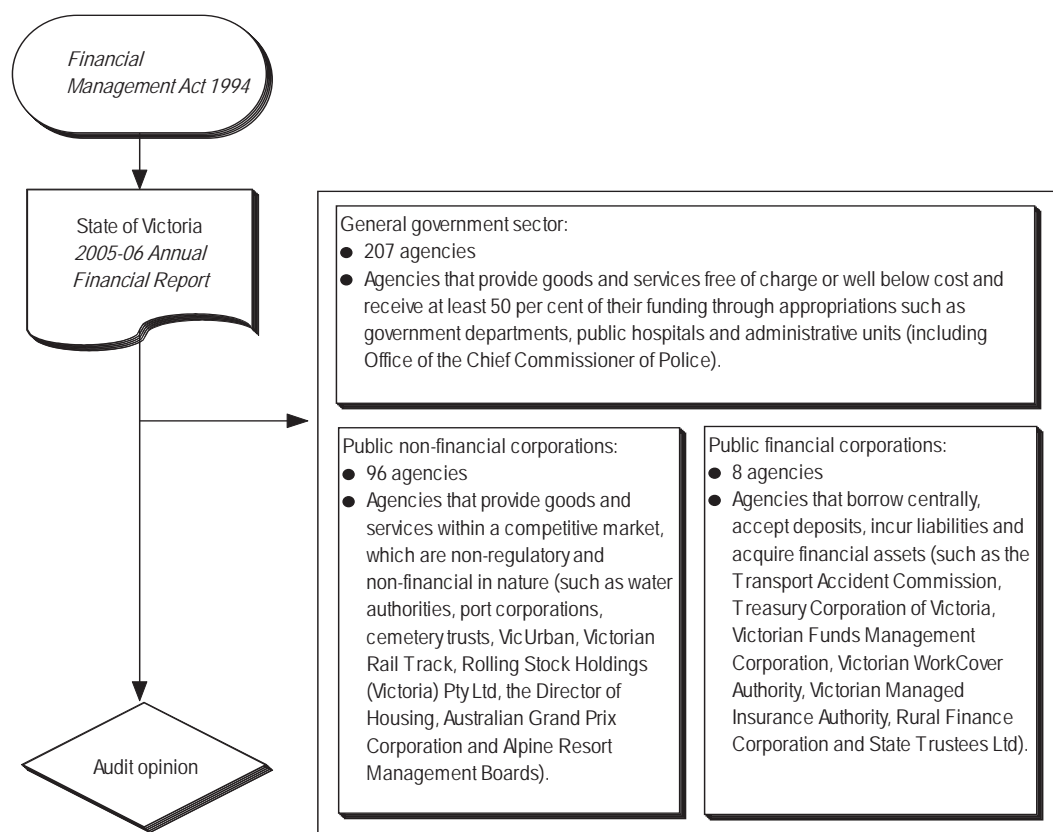
- general government sector
- public non-financial corporations
- public corporations.

Figure 2A outlines the composition of these sectors and the number of agencies in each sector.

¹ The general government sector comprises all government departments and other public sector agencies that receive most of their funding from parliamentary appropriations administered by government departments.

² The Public Account represents the government's central bank account, through which all revenues and expenditures of government departments are transacted.

FIGURE 2A: AGENCIES INCLUDED IN THE 2005-06 ANNUAL FINANCIAL REPORT



Under the *Financial Management Act 1994*, the Auditor-General is required to audit the AFR, and to issue an audit opinion. The audit opinion is published with the AFR and tabled in parliament.

Under the *Audit Act 1994*, the Auditor-General is also required to prepare and table a report on the AFR. Responsibility for presenting and explaining the AFR rests with the government. The primary purpose of this report is to present the results of the audit of the AFR, and provide parliament and other users of the AFR with our assessment of the state's finances.

2.2 Unqualified audit opinion issued

An unqualified audit opinion on the 2005-06 *Financial Report for the State of Victoria* was issued on 27 September 2006. The audit opinion is presented in chapter 4 of the 2005-06 AFR.

2.2.1 Removal of prior year “emphasis of matter” comment

An unqualified audit opinion was also issued on the 2004-05 AFR. However, that opinion included an “emphasis of matter” which drew attention to an inconsistency between the commentaries and explanations contained in chapters 1 to 3 of the AFR (which are not subject to audit), and the audited financial report included in the AFR.

For 2004-05, the AFR was prepared in accordance with the then existing Australian accounting standards and Australian Generally Accepted Accounting Principles (A-GAAP). For 2005-06 onwards, the accounting standards used in preparing financial reports were replaced by Australian equivalents to International Financial Reporting Standards (A-IFRS). Early adoption of the new A-IFRS standards was not permitted in 2004-05, but preparers of financial reports were required to disclose what the financial result would have been had they been adopted.

In 2004-05, the commentaries and explanations in the unaudited sections of the AFR, in relation to the net result, were presented in a format that was not consistent with the basis on which the AFR was presented, namely, the A-GAAP format. References were made to “A-IFRS net result from transactions”, “net result from other economic flows” and the associated tables on financial performance were presented in a format that the government intended to adopt in 2005-06. The audited AFR did not reflect these results and, accordingly, they were not subject to audit.

It was considered that the commentaries and explanations had the potential to confuse users of the AFR and conflicted with the audited net result presented under the then existing A-GAAP framework.

For 2005-06, the “emphasis of matter” comment has been removed from the audit report. The AFR is presented in compliance with A-IFRS and, therefore, the commentary in chapters 1 to 3 of the AFR is now consistent with the audited parts of the AFR.

2.3 Significant matters arising from the audit

2.3.1 Preparation of the AFR

DTF prepares the AFR by electronically collating financial and non-financial data from more than 310 public sector agencies. The timely preparation of the AFR depends on agencies submitting their data to DTF within specified time frames.

DTF also requires the state's larger agencies (known as the "material entities") to have their financial statements completed and audited earlier than the 12-week time frame required by the *Financial Management Act 1994*³. In 2005-06, 44 agencies were designated as "material entities". These agencies control and account for the majority of the state's revenues, expenditures, assets and liabilities. The reporting time frames set by DTF for these agencies were:

- draft financial statements to be completed and provided for audit by 26 July 2006
- audited financial statements to be completed by 17 August 2006.

Timeliness of "material entity" financial statement completion

"Material entities" experienced delays in 2005-06 in submitting their draft financial statements for audit. Of the 44 "material entities", only 15 (34 per cent) provided complete draft financial statements to us by 26 July 2006. Twenty-one "material entities" (48 per cent) submitted their draft financial statements more than one week after the due date. These delays impacted on our ability to complete the audit of the year-end balances and other disclosures for "material agencies" within the required AFR completion time frame of 17 August 2006.

A major cause of delay was the requirement for the first time to fully implement the new Australian accounting standards (A-IFRS), including restating the 2004-05 (comparative) balances and developing additional disclosure requirements associated with the new standards. The combination of additional reporting complexities introduced by the new standards and, in some cases, inadequate planning and preparation by agencies for their implementation, were the key contributors to the delay. Further comment on the implementation of A-IFRS is provided later in this part of the report.

Delay in the completion of draft financial statements by agencies and the need to resolve various issues identified as part of the audit process (including a number of contentious accounting treatments, and disclosure and presentation issues), resulted in delays in the completion of "material entity" audits and the submission of AFR data by agencies to DTF.

Figure 2B shows the timeliness of "material entities" in achieving DTF's timeline of 17 August 2006 for the completion of its audited financial statements.

³ The Act requires the audited financial statements of agencies with 30 June balance dates to be completed by 22 September each year.

FIGURE 2B: TIMELINESS OF COMPLETION OF AUDITED FINANCIAL STATEMENTS, MATERIAL ENTITIES

Audited financial statements finalised	2005-06		2004-05	
	Number of agencies	Per cent (cumulative)	Number of agencies	Per cent (cumulative)
By 17 August	6	14	7	15
18-24 August (overdue < 1 week)	9	34	14	44
25-31 August (overdue 1-2 weeks)	12	61	8	60
1-7 September (overdue 2-3 weeks)	5	73	7	75
8-14 September (overdue 3-4 weeks)	7	89	2	79
15 September + (overdue > 4 weeks)	5	100	10	100
Total	44	-	48	-

Source: Victorian Auditor-General's Office.

Figure 2B shows that a similar percentage of agencies achieved the 17 August 2006 deadline in 2005-06, as compared with the previous year.

However, the failure each year by a large number of the "material entities" to meet the established reporting time frame points to the need for action by these entities to identify opportunities and strategies to improve the timeliness of their reporting. Key areas where improvements could be made include:

- introduction of earlier/interim financial account "close-offs" (e.g. 31 May), which would include the completion of major account balances (such as asset revaluations, calculation of employee liability provisions, and actuarially determined liabilities). Better practice indicates that early "close-offs" can achieve significant time and resource savings at year-end
- improved planning and monitoring of the year-end reporting processes, including the scheduling of critical audit committee and board meetings at earlier times to allow the clearance and sign-off of the financial statements
- earlier discussions with my staff on complex and contentious accounting issues, resulting in the more timely resolution of such issues.

We will continue to work closely with agencies to further reduce the time they take to report.

Timeliness and quality of the AFR consolidation process

Delays in agencies' submission of the AFR data to DTF, meant that DTF was not able to meet its milestone of preparing a complete draft AFR by 25 August 2006. DTF provided us with a "substantially" complete draft on 6 September 2006 and a complete draft on 9 September 2006, around 2 weeks past the planned date of completion.

Our examination of DTF's processes to prepare the AFR, including consolidating agency information, concluded that they were satisfactory. DTF established clear responsibilities, and adequate resourcing and quality assurance processes, to help ensure that the AFR preparation process was well managed.

2.3.2 Implementation of A-IFRS

New accounting standards were implemented in Australia for all reporting entities, for reporting periods beginning on or after 1 January 2005, to harmonise the Australian reporting framework with international financial reporting standards. These new standards are referred to as Australian equivalents to International Financial Reporting Standards, or A-IFRS.

In 2005-06, the AFR was prepared (for the first time) in compliance with A-IFRS, on a "not-for-profit" basis. One of the key matters that DTF was required to consider in preparing the AFR was how to consolidate the financial balances of agencies deemed to be "for-profit" in the AFR. These agencies can apply different accounting policies from those applied by "not-for-profit" entities.

The government designated 16 agencies as "for-profit entities" and DTF reviewed the possible adjustments that may be required to their financial balances, so that they could be made consistent with the "not-for-profit" accounting policies adopted for the preparation of the AFR. The key areas of difference were:

- *Assets received free of charge.* AFR accounting policy requires these assets to be measured at fair value and recognised as revenue in the year of receipt, whereas "for-profit" entity accounting policy is to measure these at cost.

- *Impairment of assets.* AFR accounting policy requires agencies to annually review certain asset classes for indicators of impairment and, where these exist, assess the reasonableness of the assets' carrying value compared with their "value in use". The "value in use" of cash-generating assets and assets of "for-profit" entities is estimated using a "present value of future cash flows" methodology, whereas the "value in use" of assets in "not-for-profit" entities that are not cash-generating may be estimated based on the replacement cost of an asset in similar condition.
- *Revaluation of property, plant and equipment.* AFR accounting policy requires asset revaluation increases and decreases relating to individual assets to be offset against one another within the relevant class of assets, whereas "for-profit" entity accounting policy does not permit the offsetting of revaluation adjustment for individual assets within asset classes.

We confirmed DTF's assessment that the differences arising from consolidating "for profit" agency financial information in the "not-for-profit" AFR did not result in a material misstatement of the AFR reported net results, or the asset and liability balances.

In preparing the 2005-06 AFR, the 2004-05 comparative balances have also been restated from the previous A-GAAP-based balances to comply with A-IFRS. The exception was the presentation of balances related to financial instruments and insurance products, which have not been restated. In these cases, the government adopted the exemption available under AASB 1 *First time adoption of A-IFRS* from having to apply the relevant new standards to the comparative period.

While the impact of the new accounting standards varied depending on individual agencies' business and scope of financial operations, the major changes for the public sector, and the AFR, related to:

- valuation of unfunded superannuation liabilities
- valuation and recognition of insurance liabilities
- valuation and recognition of financial instruments
- valuation and impairment of non-current assets
- valuation and classification of employee benefit liabilities
- recognition and measurement of certain arrangements previously designated as operating leases, as finance leased assets and liabilities.

Overall, public sector agencies were well prepared for the implementation of A-IFRS. However, as previously mentioned, most agencies underestimated the amount of time needed to tailor their financial statements to the requirements of A-IFRS, which adversely impacted on their ability to meet key AFR milestones.

Our review of the AFR disclosures relating to the implementation and first time full adoption of A-IFRS concluded that they were satisfactory and consistent with professional requirements.

2.3.3 Quality of disclosures in the AFR

Over several years, both DTF and the Victorian Auditor-General's Office have worked to improve the presentation of, and the level of disclosure in the AFR, and the timeliness of its completion and tabling in parliament. There are still opportunities to improve the quality of its presentation. A number of these are outlined below.

Insurance claims expense

Insurance claims expenses are a major component of state expenditure and are not separately identified in the AFR. Given their significance (around \$2.3 billion or 7 per cent of total state expenses in 2005-06) and their impact on the state's reported results, consideration should be given to insurance claims expenses being separately disclosed in the notes to the AFR.

Financial commitments

Note 34 to the AFR presents the state's outstanding financial commitments for contracted operating and capital activities to be delivered over future years. These commitments are not recognised as liabilities in the balance sheet because the contracted services had yet to be delivered to the state as at 30 June of the respective reporting period. The commitments arise from a range of contracted arrangements, including accommodation rental leases, and complex service and infrastructure delivery arrangements (including public-private partnerships) and are shown in note 34 at their nominal value. At 30 June 2006, these outstanding financial commitments totalled \$15.8 billion (30 June 2005, \$14.8 billion).

The disclosure of these significant commitments of the state, and their financial impact on future state finances, would be enhanced through improved information on:

- the nature of any major new commitments entered into in the year, including the key rights and obligations of the state
- their present value, so that users can more readily assess their relativity with balance sheet values (which are generally presented on a present value basis).

Disaggregated note disclosures - Capital transactions

Note 2 to the AFR presents disaggregated information about the financial performance (revenues and expenses) and financial position (assets and liabilities) of each of the 3 sectors of the state: the general government sector; public non-financial corporations sector; and public financial corporations sector⁴. Consistent with the reporting requirements of Australian Accounting Standard AAS 31 *Financial Reporting by Governments*, capital transactions (such as the payment and redemption of contributed capital between sectors) are excluded from the disaggregated operating statement and balance sheet of each of these sectors⁵.

The net effect of these transactions on the general government sector is, however, disclosed in the consolidated cash flow statement as part of “cash flows from investing activities”. For 2005-06, that statement shows that the general government sector made a “net contribution to other sectors of government” of \$51 million. This was, however, net of a \$600 million return of capital by the Transport Accident Commission. The net contribution to other sectors for 2004-05 was \$513 million.

As these types of transactions involve the transfer of substantial resources between sectors, it is considered that information about their impact on the financial position of the relevant sectors would be enhanced by providing additional/supplementary disclosures in notes of the AFR.

We will continue to work closely with DTF to further enhance the quality of the AFR disclosures for future years.

⁴ AAS 31 requires disaggregated information to be presented in the general purpose financial reports of governments to assist the users of these reports assess the effects of the different activities within the jurisdictions on the financial performance and financial position of the jurisdiction.

⁵ The disaggregated information for the public non-financial corporations, and public financial corporations sectors also does not include information about the dividends and income tax equivalents paid to the general government sector.

2.4 Major developments impacting on future public sector reporting

During 2005-06, the Australian Accounting Standards Board (AASB) focused its efforts on progressing the development of financial reporting standards for the public sector.

The AASB's work program for the public sector mainly involves the harmonisation of the Government Finance Statistics (GFS)⁶ and the Australian Generally Accepted Accounting Principles (A-GAAP) reporting frameworks, and the review of the public sector specific accounting standards. The outcomes of this work are likely to have significant impacts on future financial reporting in the public sector.

Harmonisation of A-GAAP and GFS financial reporting requirements

The audited whole-of-government financial reports of Australian jurisdictions are currently prepared on the basis of the principles set out in the A-GAAP framework. The GFS framework is used for the preparation of other financial reports, such as reporting on the general government sectors etc.⁷. Under A-GAAP, transactions are reported from an accounting viewpoint, whereas under GFS, transactions are reported from an economic impact perspective. Accordingly, reports based on the different frameworks can give different perspectives of the financial position and performance of a state.

The main objectives of the harmonisation of the A-GAAP and GFS reporting frameworks are to achieve comparability between jurisdictions and to reduce the confusion that can result from the publication of 2 sets of financial statements.

⁶ GFS is the reporting framework established by the International Monetary Fund to allow economic analysis of the public sector. To date, it is mainly used by central government agencies to report at a whole-of-government or general government sector levels.

⁷ The Victorian Government uses Australian accounting standards to prepare accrual-based, whole-of-government, general purpose financial statements, and uses GFS to prepare statements for the Uniform Presentation Framework which is used by all Australian jurisdictions to present financial information in a consistent format, about each of the sectors of government.

The AASB issued Australian accounting standard AASB 1049 *Financial Reporting of General Government Sectors by Governments* in September 2006, for application to annual reporting periods beginning on or after 1 July 2008. The standard requires:

- governments to prepare a general government sector financial report and a whole-of-government financial report, with the general government sector report not being available prior to the whole-of-government report
- the general government sector financial report to adopt A-GAAP definition, recognition and measurement principles, with any A-GAAP options limited to the extent that they are consistent with GFS requirements
- amounts to be presented in the operating statement of the general government sector financial report in a manner that reflects GFS definitions of “transactions” and “other economic flows” (further comment on these definitions is provided in part 3 of this report)
- the general government sector financial report to disclose any major convergence differences between A-GAAP and GFS key fiscal aggregates
- the general government sector financial report to include budgetary information for the sector and explanations of major variances between the original budgets and actual amounts.

The implications of implementing this standard for general government sector reporting from 2008-09 include the adoption of some changed accounting treatments (such as accounting for the ownership interest in agencies outside the general government sector) and additional disclosures, as indicated above.

Review of public sector accounting standards

Individual A-IFRS standards specify the extent to which they are applicable to public sector agencies. Some A-IFRS standards specifically exclude public sector agencies from their application, while others provide additional requirements, or limit the availability of accounting treatment or disclosure options available in the relevant A-IFRS.

In addition to the new standards, AAS 27 *Financial Reporting by Local Governments*, AAS 29 *Financial Reporting by Government Departments* and AAS 31 *Financial Reporting by Governments* continue to be applicable to the public sector.

The AASB is reviewing AAS 27, AAS 29 and AAS 31 to:

- assess the extent to which the requirements for local governments, departments and governments should differ from requirements already contained in other Australian accounting standards
- remove differences from existing Australian accounting standards to improve the overall quality of financial reporting.

In July 2005, the AASB indicated that it would either amend other relevant Australian accounting standards to include any necessary additional requirements relevant to the public sector, or (if deemed necessary) create specific topic-based standards to address matters that are pertinent to the public sector.

The AASB has developed a policy paper which outlines the principles, actions and the timetable for its review of these standards. At the time of preparing this report, the AASB had not issued an exposure draft reflecting its proposals.

These developments may have significant implications for the public sector as there are particular financial reporting issues faced by “not-for-profit” public sector agencies, which are not addressed by the current A-IFRS standards.

We will continue to monitor the development of accounting standards to further enhance the overall quality of financial reporting of the state.



3. Financial outcomes achieved by the state in 2005-06



3.1 Introduction

Financial reports present the financial performance and position of an entity, generally for the current and previous financial periods. The information contained therein may need to be analysed, explained and interpreted for users to better understand its meaning. For this reason, management analysis and discussion generally accompany financial reports.

Management analysis and discussion can help users better understand the key influences on the reported operating results and position. It also helps establish a meaningful context for the reported results, by explaining the extent to which established financial and other objectives/measures are achieved; presenting long-term trends; and benchmarking the financial outcomes against relevant external measures (such as rates of inflation, economic growth etc.).

Accordingly, while the audited financial report presents the state's and the general government sector's financial performance for 2005-06, and their financial position at 30 June 2006, the accompanying analysis and discussion presented in chapters 1 to 3 of the Annual Financial Report (AFR) (which are not subject to audit¹) forms an integral part of the AFR. The government is responsible for ensuring that this analysis and discussion is comprehensive, meaningful and consistent with the audited financial information.

While the 2004-05 audit opinion on the AFR included an "emphasis of matter", drawing attention to an inconsistency between the basis used to present some information in chapters 2 and 3 of the AFR, and the basis used for the presentation of the audited AFR, this inconsistency does not exist in 2005-06 and improvements have been made in recent years to both the extent and quality of disclosures, analysis and discussion included in the AFR. Improvements have included more comprehensive explanations and analyses of influences on the reported results, and the presentation of selected indicators of financial condition covering several years.

While scope remains for further improvement, the quality of information now presented (in the audited and unaudited parts of the AFR) assists users make informed assessments about the financial outcomes achieved and the financial condition of the state's finances.

¹ While we are not required to audit management analysis and discussion, Australian auditing standards require us to ensure that the information contained therein is generally consistent with the audited financial report.

As a result, this report does not reproduce the analysis and discussion presented in the AFR. Its objective is to provide parliament and other users of the AFR with our assessment of the state's finances. Where considered appropriate, we have amplified or augmented analyses and assessments provided in the AFR with the aim to assist users better understand the reported results and outcomes.

3.2 Operating results

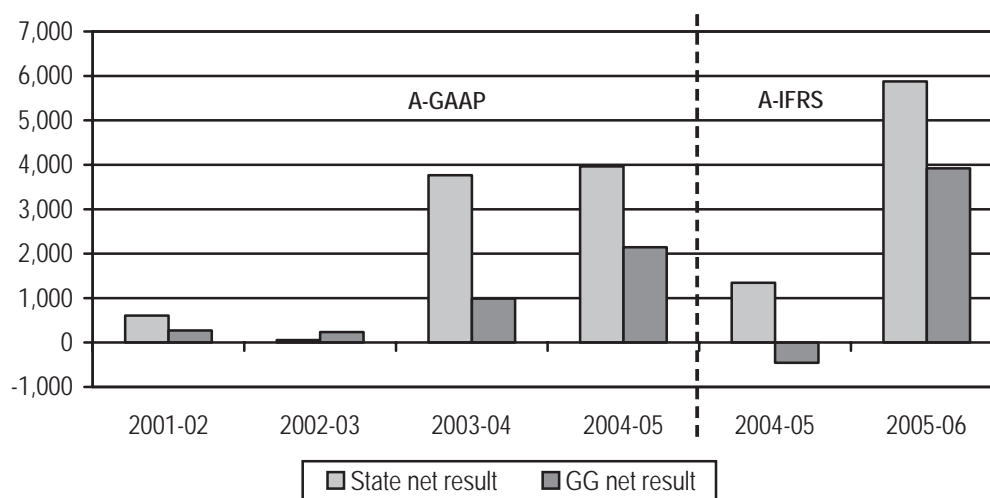
The net result presented in the consolidated operating statement of the AFR indicates whether the government spends more or less than the revenue it receives: that is, whether the government is "living within its means". The net result (generally referred to as the operating surplus or deficit) is presented for the State of Victoria (the whole-of-government) and for the general government sector² (the central government sector only). In addition, each of these reported results is sub-totalled into 2 components, namely, the "net result from transactions" and "total other economic flows"³. Our analysis below focuses on the overall net results of the state and the general government sector.

The AFR reports a strong net result achieved by the state and the general government sector for 2005-06. The state achieved an operating surplus of \$5 876 million in 2005-06 (\$1 346 million, 2004-05) while the general government sector achieved an operating surplus of \$3 922 million in the year (\$457 million deficit, 2004-05).

Figure 3A shows the operating results for the state and the general government sector for 2001-02 to 2005-06.

² The general government sector comprises all government departments and other public sector agencies that receive most of their funding from parliamentary appropriations administered by government departments.

³ As explained in note 1(E) to the AFR, the GFS reporting framework has been used to classify consolidated operating statement items between "transactions" and "other economic flows". Under this framework, "transactions" generally represent "changes in stocks that come about from mutually agreed interactions" between entities, and flows within an entity (for example, depreciation) where the owner of the asset is simultaneously acting as the owner and consumer of the asset. "Other economic flows", on the other hand, generally include revaluations of (gains/losses on) assets and liabilities arising from price changes.

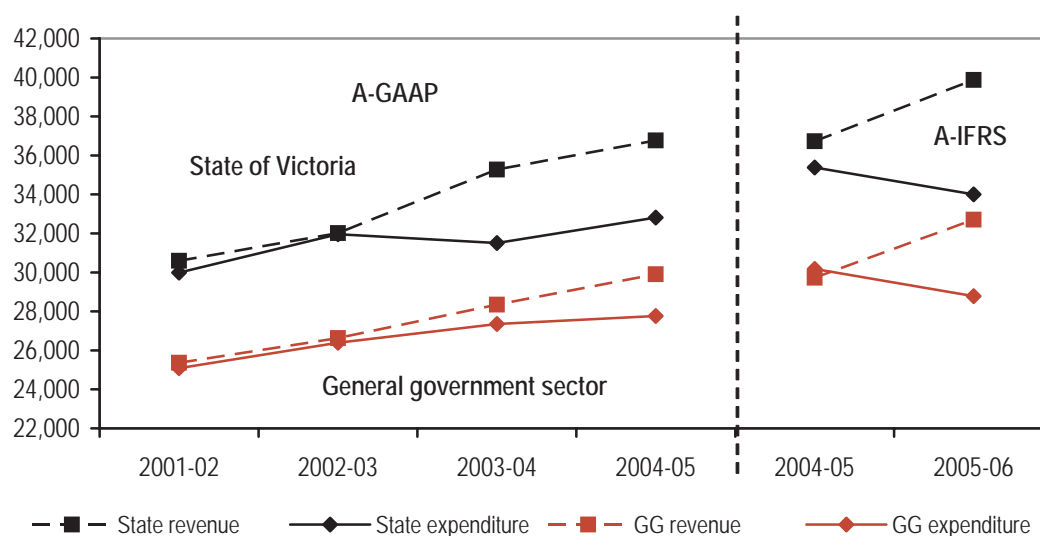
FIGURE 3A: OPERATING RESULTS - STATE OF VICTORIA AND GENERAL GOVERNMENT SECTOR (\$MILLION)

Source: Annual Financial Reports for the respective reporting periods.

The operating results for 2004-05 and 2005-06 (as reported in the 2005-06 AFR) are determined based on Australian equivalents to International Financial Reporting Standards (A-IFRS). The operating results for previous years are determined based on the then existing Australian Generally Accepted Accounting Principles (A-GAAP) reporting framework. For 2004-05 (the first year of transition to A-IFRS), the operating results are presented in Figure 3A on both the A-GAAP and A-IFRS basis of reporting. The major difference between the 2 accounting results relates to a change in the basis used to value the state's unfunded superannuation liabilities, the effect of which was to increase the reported value of the superannuation expense for 2004-05 (under A-IFRS) by around \$2.6 billion. As a result, the operating result for the general government sector was a deficit of \$457 million.

Figure 3B further presents the revenue and expenditure trends for the state and the general government sector over the past 5 years. It indicates that the rate of state revenue growth from 2001-02 to 2004-05 (annual average of 5.7 per cent) has exceeded the rate of expenditure growth (annual average of 3.7 per cent). The growth rates for the state for 2005-06 (based on A-IFRS) were 8.6 per cent for revenue and negative growth of 3.9 per cent for expenditure.

FIGURE 3B: STATE REVENUE AND EXPENDITURE (\$MILLION)



Note: The 2004-05 and 2005-06 balances are determined based on A-IFRS, while the balances for previous years are determined based on the then existing A-GAAP reporting frameworks.

Source: Victorian Auditor-General's Office.

Over the 5-year period, the major contributors to revenue growth have been the strong performance of the state and Australian economy, including the domestic and international equity markets, and the property market, and increased Commonwealth grants. Major influences on expenditure levels have been wages growth, partly offset by the positive impact on superannuation expenses of strong equity markets (which have contributed to the reporting of “gains” in the operating statement arising from a reduction in unfunded liabilities resulting from higher investment earnings and investment values).

As explained in the AFR, the major factors contributing to the improved operating results in 2005-06, compared with 2004-05, included:

- a reduction in the state’s unfunded superannuation liabilities in 2005-06 (mainly due to higher than expected investment yields achieved in 2005-06, but also due to a change in the discount rate used to measure the liability resulting from a change in prevailing interest rates). This resulted in a \$2.4 billion gain in the operating statement - compared with a loss of \$1.5 billion in the previous year
- an increase of \$1.1 billion in Commonwealth grants to the state, including higher GST general purpose grants of \$600 million - reflecting the strength of the Victorian and national economies during 2005-06

- an increased “gain” of \$566 million, reflecting the higher value of financial assets (investments) resulting from the continued strong performance of financial and equity markets
- an increase of \$470 million in state taxation revenues, driven by favourable employment and property market conditions in the year – resulting in higher revenues from payroll tax (\$252 million) and stamp duties from conveyancing (\$334 million), partly offset by reduced revenues associated with the abolition of debits tax from 1 July 2005 (\$244 million).

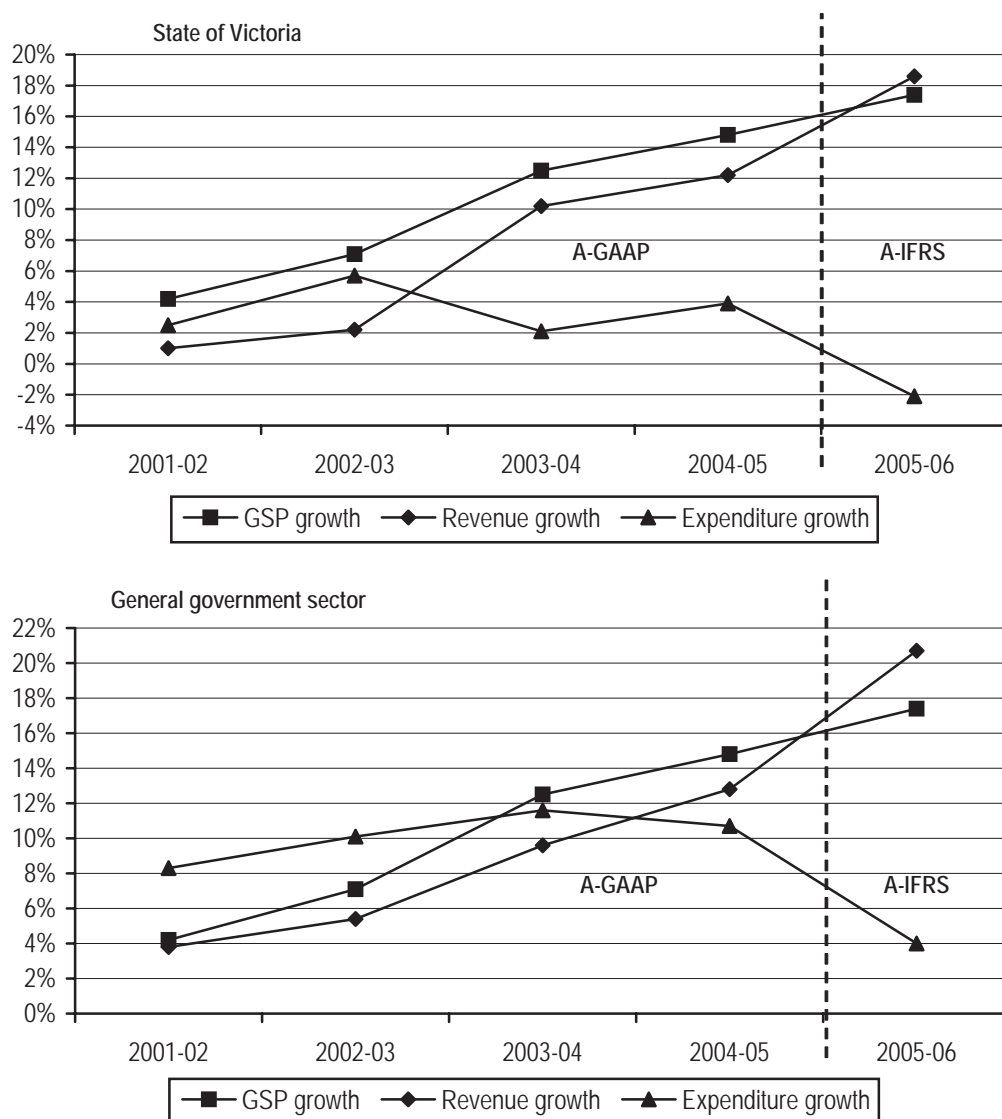
The increased revenues in the year were partly offset by increased “expenses from transactions” of \$2 545 million in the year, largely associated with employee benefits and the purchase of supplies and services within the education, human services and justice portfolios, and expenses associated with the hosting of the 2006 Commonwealth Games.

In the AFR, the government has assessed that the financial outcomes achieved by the state and the general government sector are consistent with Victorian economic trends. Our analysis confirms this assessment, as shown in Figure 3C.

Figure 3C compares, for both the state and the general government sector, the growth in revenues and expenditures (adjusted for the effects of inflation), with the growth in the state economy⁴ (also adjusted for the effects of inflation) over the past 5 years.

⁴ The gross state product (GSP) measures the level of activity within the state economy during a given period.

FIGURE 3C: STATE OF VICTORIA AND GENERAL GOVERNMENT SECTOR, REVENUE AND EXPENDITURE GROWTH COMPARED WITH GSP GROWTH (PER CENT)⁵



Note: The growth rates in revenue and expenditure for 2001-02 to 2004-05 are based on A-GAAP, while the growth rates for 2005-06 are based on A-IFRS.

Source: Victorian Auditor-General’s Office.

Figure 3C shows that over the 4 years to 2004-05, the rate of growth in state revenues has been below that of the Victorian economy. In 2005-06, state revenues grew at a faster rate (6.5 per cent, adjusted for the effects of inflation) than the Victorian economy (2.5 per cent, adjusted for the effects of inflation). As previously mentioned, the major contributors to increased 2005-06 revenues were state taxation, GST grants and investments.

⁵ The growth rates exclude the effects of price changes as reflected in the “gross state product (GSP) deflator”, which is determined using GSP data published by the Australian Bureau of Statistics (ABS) - using 2001-02 as the base year. GSP data for financial years up to 2004-05 is sourced from the ABS, while the estimated GSP for 2005-06 is sourced from the Department of Treasury and Finance.

Over the 5-year period to 2005-06, the rate of growth in state expenditures has been well below that of the Victorian economy, with “negative growth” reported in 2005-06. This has been mainly due to the previously mentioned reduction in the value of the state’s unfunded superannuation liabilities in 2005-06, which resulted in a \$2.4 billion gain in the operating statement - compared with a reported loss of \$1.5 billion in the previous year.

Excluding the changes in superannuation liabilities (which are treated as a reduction/increase in the superannuation expenses), over the past 5 years the “underlying” rate of growth in state expenditures has been generally consistent with the rate economic growth. However, over the same period, the “underlying” rate of growth in general government sector expenses is consistent with revenue growth and has exceeded state economic growth by 4.2 per cent, indicating a need for monitoring by the government of expenditure levels over future years.

Further to the above, our past reports to parliament on the state’s finances have drawn attention to several external factors which need to be continuously monitored by government. These external factors pose some risk and could have major impacts on the state’s financial performance and condition. They include:

- the performance of the national economy, and the policy directions and decisions of the Commonwealth Government, which significantly influence the level of Commonwealth grants to the state
- the performance of the state economy and property markets, which significantly influence state-sourced revenues (mainly taxation revenues)
- the performance of financial and equity markets, which significantly influence the investment revenues and superannuation expenses⁶ of the state
- pressures for wage and salary growth, contributing to increased employment costs.

3.2.2 Assessment of significant events

In the course of our audit of the AFR, we assessed several significant developments to determine their appropriate accounting treatment, and impact on the reported operating result and financial position. In each case, we agreed with the accounting treatments and disclosures included in the AFR. These developments are outlined below.

⁶ The financial and equity markets affect the investment returns of superannuation funds and, therefore, the movements in unfunded superannuation liabilities.

Redemption of Melbourne CityLink concession notes and financing of the Westgate/Monash Freeways project

Our previous reports to parliament provided a detailed analysis of the complex arrangements established by government and CityLink Melbourne Limited (CML), a private sector consortium, for the financing, construction and operation of the Melbourne CityLink road network.

The main contractual document for the arrangements was a concession deed entered into in October 1995. Under the deed, CML is required to pay concession fees to the state. CML does this by issuing concession notes each year (which are non-interest-bearing promissory notes). These are payable at the end of the 35-year concession deed period (at which time ownership of CityLink will revert to the state at no cost), or earlier (if specified profit levels and cash flows are achieved). At 30 June 2005, the state recognised \$167 million as a non-current receivable on account of the concession notes issued to that date.

In May 2006, the state and the Transurban Group (which includes CML) signed a "letter of intent" outlining an intention to assign to Transurban all concession notes held by, and due to be issued to, the state. In return, Transurban agreed to a payment stream to the state totalling \$614 million over 4 years. This payment stream is intended to be used by the state to jointly fund (together with Transurban) upgrades and improvements to sections of the Westgate – CityLink – Monash Freeways. Transurban will fund the CityLink works, while the state will fund the non-CityLink works.

While the state and Transurban intended to formalise the above arrangements during 2005-06, the contracts were not signed until 25 July 2006. As the signing of the contracts occurred after 30 June 2006, it was determined that the May 2006 "letter of intent" was a "non-adjusting event" in accordance with Australian accounting standard AASB 110 *Events after the Balance Sheet Date*. Accordingly, revenue and a receivable relating to the unissued concession notes was not required to be disclosed in the AFR consolidated operating statement and the consolidated balance sheet. An appropriate note to the AFR (note 37) was included to draw attention to this significant event.

The impact of the contracts signed on 25 July 2006 (post-balance date) and the results of a High Court decision on 20 July 2006 (also post-balance date) about the tax deductibility of concession notes, on the value of issued concession notes (which is shown as a non-current receivable in the state's consolidated balance sheet at 30 June 2006) was also considered. An adjustment was made to the value of these concession notes at 30 June 2006 to reflect the impact of these 2 events, because they clarified the value of issued concession notes at 30 June 2006. The net effect of this adjustment was to increase the state's net result for 2005-06 by \$12.5 million, and the value of non-current assets (receivables) by the same amount.

Apart from the above events, further revenue of \$40.4 million was recognised in the state's operating statement relating to concession notes, including \$25.4 million relating to the present value of additional concession notes issued during the year, and a revaluation adjustment to the present value of the receivables at 30 June 2006 of \$14.9 million. At 30 June 2006, the reported present value of issued concession notes was \$220 million.

The financial effects of these events have been adequately disclosed in the AFR.

Capital repatriation from the Transport Accident Commission

In May 2006, the Minister for WorkCover issued a direction to the Transport Accident Commission (TAC), for TAC to convert \$600 million of its accumulated funds into contributed capital. At the same time, the Treasurer issued a further direction for TAC to repay the \$600 million contributed capital to the state.

The net effect of these directions was that the state repatriated \$600 million of TAC's accumulated funds by redesignating it as contributed capital (owner's equity interest) and then having it paid to the Consolidated Fund.

While this transaction has no effect on the operating result of the state (because it is not external to government), we assessed whether it gave rise to "revenue" for the general government sector in accordance with the requirements of Australian accounting standard AAS 31 *Financial Reporting by Governments*. The transaction is eliminated from (and, therefore, has no impact on) the general government sector operating result, as it is in the nature of a capital/investing (rather than an operating) transaction. Accordingly, it is shown in the cash flow statement as part of investing activities - "net contributions to other sectors of government".

Disclosure of its financial impact is provided in note 1 to the AFR (which includes the accounting policy applicable to this and similar capital transactions) and note 2 to the AFR (which presents disaggregated information for each of the 3 sectors of the state of Victoria).

Revaluation gains relating to the aluminium smelter electricity supply arrangements

In 1984, the state government offered a low flexible electricity tariff for the Point Henry and Portland aluminium smelters in order to attract the smelter investments. The tariff arrangements required the government, through the State Electricity Commission of Victoria (SECV), to subsidise the lower prices charged to the smelters.

The SECV's obligations and rights under the flexible electricity arrangements are assessed at the end of each financial year. The assessment takes into account changes in the electricity market and predicted future changes in aluminium and electricity prices, foreign exchange rates, discount rates and the consumer price index. The estimated future liability from the arrangements until the smelter contracts expire in 2014 and 2016, respectively, was estimated to be \$1 027 million at 30 June 2005 on a net present value (A-IFRS) basis. The estimate was re-assessed at 1 July 2005, in accordance with the new A-IFRS requirements, and increased by \$81 million to \$1 108 million.

An increase in aluminum prices during 2005-06 significantly reduced the SECV's forecast annual trading losses. Consequently, the estimated future liability from this arrangement (which is disclosed as part of "other provisions" in the state's consolidated balance sheet) was reduced from \$1 108 million at 1 July 2005 to \$723 million at 30 June 2006 (on a net present value basis). This favourable reduction in the liability resulted in a gain of \$385 million recorded in the state's consolidated operating statement (as part of "other economic flows").

As part of the transition to A-IFRS, “embedded derivatives”⁷ within long-term onerous contracts must be separately recognised as financial assets and financial liabilities in the balance sheet. The net asset value of these embedded derivatives at 30 June 2006 was \$316 million. Further, the SECV uses financial instruments to implement strategies which achieve a level of certainty for electricity costs. At 30 June 2006, these financial instruments were represented on the state’s balance sheet by receivables of \$11 million and payables of \$28 million.

Overall, the state’s net exposure from the aluminium smelter electricity supply onerous contracts at 30 June 2006 was \$424 million.

Revaluation gains relating to the state’s unfunded superannuation liability

At 30 June 2006, the state’s unfunded superannuation liability totalled \$12 934 million, which was \$2 411 million less than the previous year (based on A-IFRS). This improvement mainly reflected the impact of:

- using a higher discount rate in 2005-06 (due to increased interest rates) to measure the present value of the defined benefit obligations, resulting in a \$2 355 million revaluation gain
- higher than expected yields from superannuation fund investments, resulting in a further \$1 495 million revaluation gain
- a reduction in tax liabilities of \$312 million.

The positive impact of these factors on the unfunded liability was partly offset by the effect of several changes to actuarial assumptions, including members and pensioners now being assumed to live longer, and members now being assumed to work longer before retiring - leading to a \$1 740 million increase in the unfunded liability.

The movement in the value of this liability is reflected in the state’s consolidated operating statement as part of “other economic flows – actuarial gains of defined superannuation plans”.

We examined the actuaries’ valuation of the unfunded superannuation liability, and the movements thereto. We were satisfied that the AFR disclosures are consistent with the relevant Australian accounting standards.

⁷ Australian Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* defines an embedded derivative as a component of a hybrid (combined) instrument that also includes a non-derivative host contract – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable.

Impact of the Melbourne 2006 Commonwealth Games

The staging of the 2006 Commonwealth Games in Melbourne during March 2006 represented one of the largest international sporting events held in the state, and the games generated substantial additional revenues and expenditures for the state.

The Department for Victorian Communities prepared a “whole-of-games” special purpose financial report⁸ to inform the parliament of the financial impacts and outcomes of the games for the state.

Part 4 of this report outlines the results of our audit of the “whole-of-games” special purpose financial report together with our independent assessment of the reported financial results and outcomes.

3.2.3 Other measures of performance used by government

One of the government’s key short-term financial objectives is to maintain an operating surplus of at least \$100 million. In the 2005-06 state budget, the government determined that the “net result from transactions” was appropriate to use as the measure of its performance against this objective. This measure derives the same result as the “GFS net operating balance”, and, therefore, provides some comparability between financial reporting under the A-GAAP and GFS reporting frameworks.

The “net result from transactions” is one of 2 components of the comprehensive “net result” presented in the state’s consolidated operating statement. It is determined using the concepts and definitions set out in the GFS reporting framework, but does not include all income and expenses forming part of the comprehensive “net result” determined in accordance with Australian accounting standards. In the main, the “net result from transactions” does not include asset and liability revaluation gains and losses which meet the definition of revenues and expenses under Australian accounting standards.

The consolidated operating statement shows that the state has achieved a positive “net result from transactions” of \$1 056 million, while the equivalent result for the general government sector was \$825 million. Accordingly, the government has achieved its short-term financial performance target.

⁸ Special purpose financial reports are prepared to meet specific purposes and needs. They are not required to be prepared in accordance with the Australian accounting standards which are applicable for general purpose financial reports. The basis of their preparation is generally disclosed in the notes that accompany them.

In addition to using the overall “net result” and “net result from transactions” as key measures of financial performance, in chapters 1 to 3 of the AFR (which present the government’s analysis and discussion of the AFR), the government identifies 3 other measures of its financial performance. These are:

- GFS net operating balance
- GFS net lending/(borrowing)
- GFS cash surplus/(deficit).

The following is a brief summary of the 3 measures.

- *GFS net operating balance.* This measure is the same as the “net result from transactions”, as it excludes the effects of revaluation gains/losses arising from changes in the market prices. It is the conceptual basis of most state budgets, and allows for comparability across states.
- *GFS net lending/(borrowing).* The GFS net lending/borrowing result is equal to the GFS net operating balance less net acquisitions of non-financial assets. The GFS net lending result reflects the size of the infrastructure program, as it accounts for capital spending.
- *GFS cash surplus/(deficit).* The GFS cash surplus/(deficit) is equal to net cash flows from operating activities (A-GAAP) less net cash investment in non-financial assets.

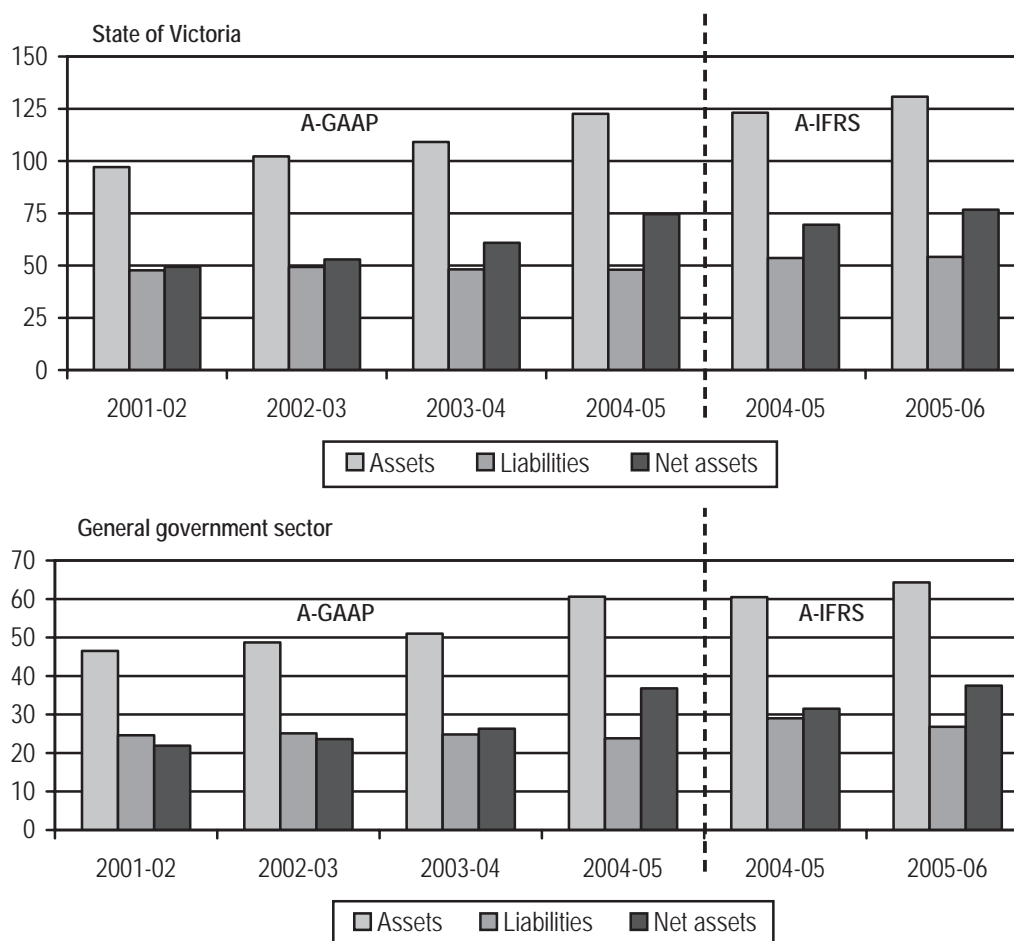
Of these measures, only the “net result” and “net result from transactions”, are reported in the audited financial statements. The other measures used in chapters 1 to 3 of the AFR, are GFS-based and are not subject to audit.

3.3 Financial position and condition of the state

The consolidated balance sheet in the AFR contains information about the value and composition of the state’s assets and liabilities at 30 June 2006. The notes accompanying the AFR contain further information about financial commitments, and contingent assets and liabilities, which are not reflected in the consolidated balance sheet.

As reported by the AFR, the state’s and the general government sector’s financial position improved during 2005-06 and remains sound.

During 2005-06, the state’s net assets grew by \$7 246 million to \$76 724 million, while the general government sector’s net asset position improved by \$6 017 million to \$37 525 million. Figure 3D shows movements in the value of state and general government sector assets and liabilities over the past 5 years.

FIGURE 3D: STATE OF VICTORIA AND GENERAL GOVERNMENT SECTOR, ASSETS AND LIABILITIES (\$BILLION)

Note: The 2004-05 and 2005-06 balances are determined based on A-IFRS, while the balances for 2004-05 are also presented under the A-GAAP reporting framework. The balances for 2001-02 to 2003-04 are presented based on A-GAAP.

Source: Annual Financial Reports for the respective years.

As explained in the AFR, the value of state assets increased by \$7 708 million in 2005-06, mainly including:

- property, plant and equipment (\$4 584 million) – mainly due to combination of new acquisitions (\$4 126 million) and asset revaluations (\$1 922 million), offset by depreciation charges (\$1 929 million)
- other financial assets (\$2 187 million) – mainly due to market value movements in the year.

The overall value of state liabilities increased by \$462 million in 2005-06. This increase was mainly due to higher insurance claims liabilities (\$1 413 million⁹), interest-bearing liabilities (\$911 million) and outstanding employee benefits (\$240 million), offset by the previously explained decrease in the state's unfunded superannuation liability of \$2 411 million.

⁹ The increase in the value of outstanding insurance claims liabilities for 2005-06, includes an adjustment of \$805 million associated with the implementation of A-IFRS as at 1 July 2005.

The value of general government sector assets increased by \$3 841 million, of which \$3 208 million represented higher property, plant and equipment holdings and value adjustments. General government sector liabilities decreased by \$2 177 million, mainly represented by the reduction in unfunded superannuation liabilities.

3.3.2 Financial condition of the state

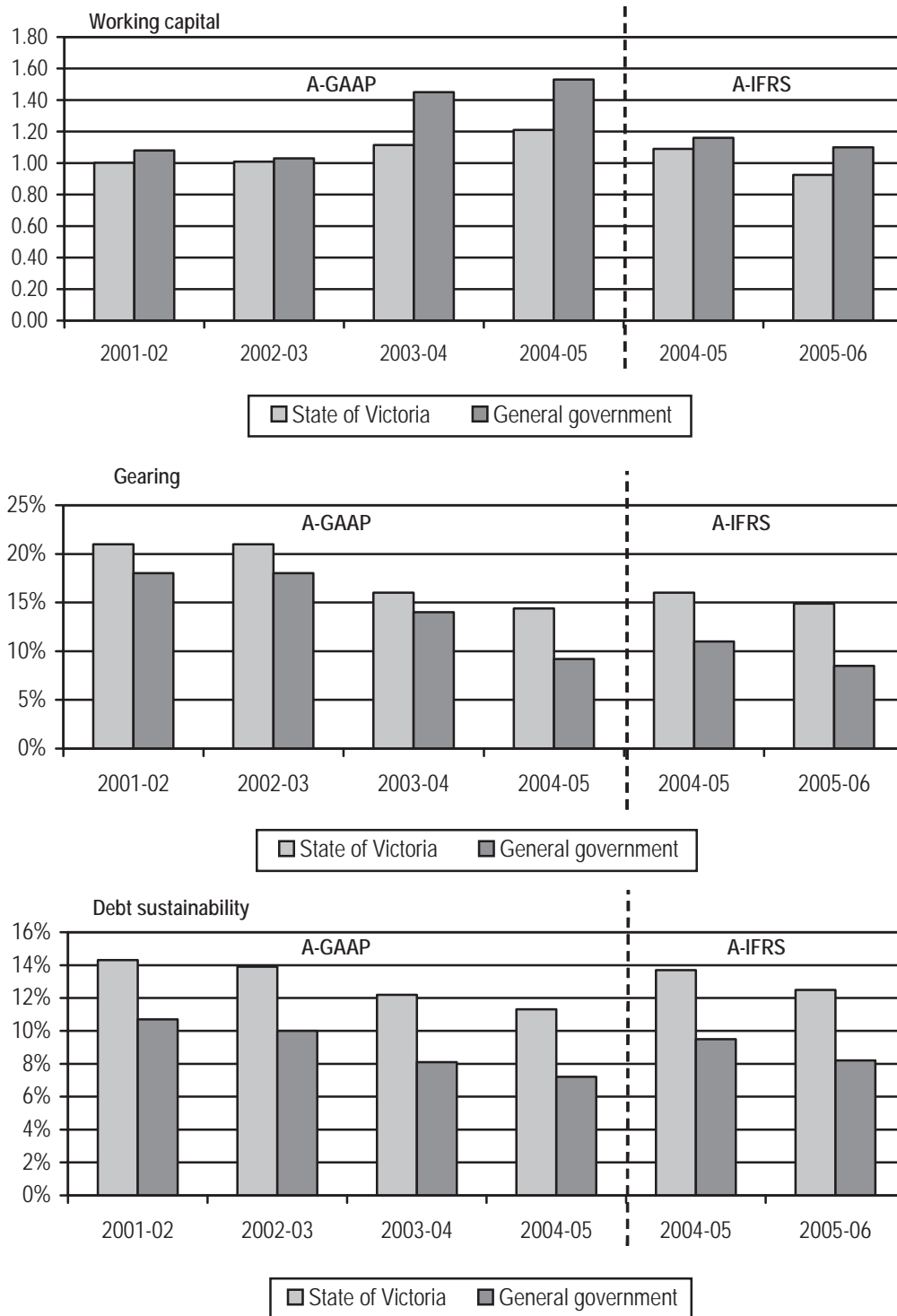
In previous years, we considered the state's financial condition against measures of sustainability, flexibility and vulnerability, and concluded that the state's "financial condition" was sound. Some of these measures are included in the AFR.

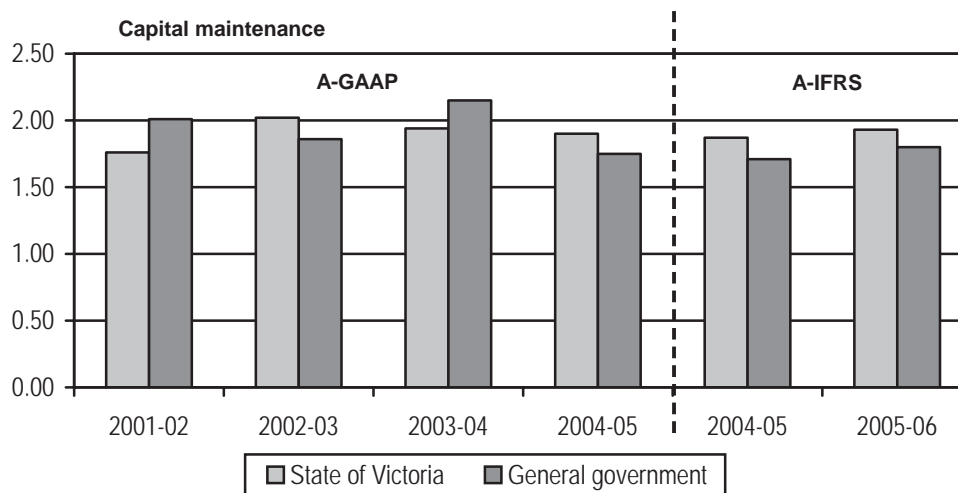
When making our assessment of the financial results and outcomes in 2005-06, we considered the following further indicators of financial condition, most of which are also presented in the AFR analysis and discussion:

- *Working capital.* This is the ratio of current assets to current liabilities and measures trends in the ability of the state to meet its short-term financial obligations. A ratio of at least 1:1 is generally considered appropriate.
- *Gearing.* This is the ratio of interest-bearing liabilities to total assets and measures the reliance on debt to fund asset acquisition and growth. The lower the ratio the less exposure to rising financing costs (increasing interest rates).
- *Debt sustainability.* This is the ratio of interest-bearing liabilities and unfunded superannuation liabilities to GSP, and measures the rate of "debt" growth/reduction relative to changes in state economic activity levels. The lower the ratio, the better able the state is to absorb any need to increase debt levels in the future.
- *Capital maintenance.* This is the ratio of asset acquisition expenditure to depreciation and amortisation expenditure, and measures the extent to which asset consumption is being replaced by asset investment. Ratios in excess of 1:1 are required over the long-term.

Figure 3E shows the results of our analysis.

FIGURE 3E: FINANCIAL CONDITION INDICATORS





Note: The indicators in Figure 3E are presented either as ratios or percentages (refer to the previous description of each of the indicators). The 2004-05 and 2005-06 figures are determined based on A-IFRS, while the figures for 2004-05 are also presented under the A-GAAP reporting framework. The figures for 2001-02 to 2003-04 are presented based on A-GAAP.

Source: Annual Financial Reports for the respective years.

Overall, Figure 3E shows that, over the past 5 years:

- the general government sector reported a positive working capital position. The state reported a consolidated positive position for the 4 years to 2004-05, but recorded a small working capital shortfall in 2005-06 (that is, the ratio fell below 1:1). This indicates that some agencies may have increased pressures on existing cash flows to meet financial obligations that fall due in 2006-07 (without liquidating their non-current financial assets)
- debt levels have reduced relative to the state's asset base and state economic activity levels
- the rate of asset investment has exceeded the rate of asset consumption.

Overall, these measures show a positive trend and an improving financial condition of the state and the general government sector, consistent with the assessments provided in the AFR.

3.3.3 Assessment of significant events

The state's and general government sector's financial position, including the assets and liabilities set out in the consolidated balance sheet in the AFR, was impacted by a number of events which we examined during the year. In each case, we agreed with the accounting treatment and disclosures included in the AFR. These events are outlined below.

Recognition of the state's interest (investment) in the Murray-Darling Basin Commission

As part of the Murray-Darling Basin Agreement 1992, the State of Victoria (along with 4 other jurisdictions) is required to contribute funds towards the activities of the Murray-Darling Basin Commission (MDBC). The agreement sets out the designated responsibilities for providing infrastructure maintenance by each of the participating states. The state (along with the 4 other jurisdictions) participates in the MDBC through its 20 per cent share of the voting rights in the MDBC.

In prior years, the state had not recognised its investment in the MDBC because the level of its "ownership interest" in the MDBC was not determined and the major physical assets of the MDBC had not been recognised in the MDBC financial statements. Our previous reports to parliament on the state's finances¹⁰ identified that this issue needed to be investigated and resolved so that the state's investment in the MDBC could be recognised in the AFR.

In 2005-06, our Office requested the MDBC to advise us of Victoria's ownership interest for the purpose of financial reporting of that interest. The MDBC confirmed that Victoria's ownership interest is 26.67 per cent, based on the assets contributed and the maintenance funding provided to the MDBC¹¹. In addition, the MDBC advised that it had reviewed and confirmed the ownership interests in 2003.

As a result of this advice, in 2005-06 the state recognised its investment in the MDBC as an "opening adjustment" at 1 July 2004, and included this investment as part of its reported assets at 30 June 2005 (\$364 million) and 30 June 2006 (\$588 million). The increase in the value of the investment mainly results from a revaluation of the MDBC's assets during 2005-06.

Under Australian accounting standard AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, the adjustment represents a prior period error and is disclosed in note 33 to the AFR. The adjustment is considered a prior period error because the ownership interest and the value of the MDBC's assets were both available and could be reliably measured by the Department of Treasury and Finance (DTF) in preparing previous AFRs.

¹⁰ Victorian Auditor-General's Office 2005, *Auditor-General's Report on the Finances of the State of Victoria, 2004-05*, Victorian Government Printer, Melbourne.

¹¹ The Commonwealth Government (20 per cent), and the states of New South Wales (26.67 per cent) and South Australia (26.67 per cent) are the other owners.

Recognition of public private partnership (PPP) arrangements

As part of determining the implications of transition to A-IFRS during 2005-06, the Office agreed with DTF to review the accounting treatment for previously established public private partnership (PPP) arrangements¹² that had been accounted for “off balance sheet”. The objective of our review was to establish a robust framework to be applied to the assessment of all PPP arrangements within the Victorian public sector against the requirements of the Australian accounting standards. Although there is no applicable Australian accounting standard for PPPs, the accounting framework requires the reporting of all arrangements based on the economic substance of the arrangement, rather than their legal form.

We assessed the selected arrangements to be financing in nature and, therefore, recommended that they be reported on the state’s consolidated balance sheet. The government agreed to recognise the selected PPP arrangements “on balance sheet” in the 2005-06 AFR, after considering the results of our review.

The following PPP arrangements were recognised as finance leases at 1 July 2004, with the corresponding asset and liability balances reflected in the state’s consolidated balance sheet at 30 June 2006:

- water infrastructure (\$144 million liability)
- correctional services facilities (\$106 million liability)
- County Court facilities (\$133 million liability)
- metropolitan train services (\$265 million liability).

The major impacts on the AFR of recognising these PPP arrangements “on balance sheet” at 30 June 2006 were:

- leased infrastructure assets increased by \$605 million
- finance lease liabilities increased by \$648 million.

In addition, the construction of facilities and assets under 3 other PPP arrangements was completed during 2005-06, which resulted in the further recognition of \$366 million finance lease liabilities in the AFR. These were:

- metropolitan mobile radio network (\$82 million)
- emergency alerting system (\$76 million)
- correctional services facilities (\$208 million).

We expect the level of PPP assets and liabilities to further increase over future years, when a number of other major PPP projects, such as the Southern Cross Station and the Melbourne Convention Centre, are completed.

¹² PPP arrangements generally involve the provision of public infrastructure under contractual agreements between at least 2 entities – a public sector provider and a public sector recipient.

3.3.4 Key measures of financial performance and condition used by government

A key financial objective of the government is to maintain the state's net financial liabilities at prudent levels in order to achieve and maintain a triple-A credit rating for Victoria.

In its analysis and discussion, in chapters 1 to 3 of the AFR, the government uses 2 key measures of financial condition, being "net debt" and "net financial liabilities", and trends thereon. The international credit rating agencies use these measures, together with other measures of financial performance, when assessing the state's credit rating. Both of these measures are derived from the GFS reporting framework, and are not individually disclosed in the audited AFR.

The following briefly describes the 2 measures:

- *Net debt*. This measure is used to assess general government sector indebtedness. It is determined by deducting "liquid financial assets" from "gross debt". Liquid assets are deducted because they are readily available to redeem debt.
- *Net financial liabilities*. This measure is the sum of "net debt" plus unfunded superannuation liabilities.

The government has not set quantitative targets for these measures, instead in its analysis and discussion shows trends over time. We have not audited these disclosures.



4. Melbourne 2006 Commonwealth Games - Special purpose financial statements



4.1 Introduction

The government prepared a special purpose financial report of the *Financial Contribution by the State of Victoria to the Commonwealth Games* for the period from July 1999 to 31 August 2006.

The special purpose financial report is an accounting of the 2006 Commonwealth Games event, and is in addition to the general purpose financial statements produced by each government agency. While the special purpose report has been prepared on an accrual basis, consistent with generally accepted accounting practices, both its format and the accounting policies adopted in its preparation are determined by the preparer of the report – the Office of Commonwealth Games Coordination in the Department for Victorian Communities. Special purpose financial reports are not required to be prepared in accordance with Australian accounting standards. The basis of their preparation is disclosed in the notes accompanying them.

The special purpose financial report was audited and an unqualified audit opinion was issued.

4.2 Structure of the special purpose report

The special purpose financial report presents a “consolidated” view of the financial resources used to deliver the games and incorporates the resources used by all public sector agencies involved in the games.

The state’s financial contribution in the special purpose report is also reflected, in terms of its constituent parts, in the individual audited financial statements of each public sector agency involved in the delivery of the games. However, apart from the Melbourne 2006 Commonwealth Games Corporation, the financial contribution by the state is not separately disclosed within each agency’s own financial statements.

It is, therefore, not possible for a user to extract data from each agency’s financial report to arrive at the consolidated view presented in the special purpose financial report. As a result, the special purpose financial report is the key financial accountability document relating to the total cost of the games to the state.

The government's special purpose financial report needs to be clearly distinguished from the annual statutory financial statements produced by the Melbourne 2006 Commonwealth Games Corporation. While the corporation was the organising committee for the event, its financial statements do not include all games' expenditures or revenues. The corporation (formerly Melbourne 2006 Commonwealth Games Pty Ltd) also produced a special purpose report on its own activities, which represent an aggregation of the total income it raised and the expenditure it incurred during its existence. This report and the annual financial statements of the corporation were also audited and unqualified audit opinions issued. The state's special purpose financial report also incorporates the activities of the corporation.

The state's special purpose financial report comprised 2 primary statements: a *Statement of Net Outlays by the Victorian Government* and a *Statement of Net Operating Resources Contributed by the Victorian Government*.

The statement of net outlays measures how much extra the state had to appropriate and spend on the games over and above its normal annual operating costs. It also measures the amount of new "capital" spending required on games facilities and infrastructure over and above that already announced. This "additional" expenditure is offset by actual operating revenues received and both actual and anticipated "capital" revenues from the disposal of assets; to arrive at an overall net "cost" of the games.

The statement of net operating resources was prepared as though it were an operating statement under Australian accounting standards. This statement differs from the outlays statement in 3 material respects:

- it includes financial resources related to the staging of the games that were funded by agencies from within their existing annual budget allocations
- it excludes "capital" outlays and replaces these with a notional venue hire charge, as a large proportion of the amounts spent on assets remain reflected in their value after the games
- it includes in-kind contributions from other levels of government.

The net operating statement affords users an opportunity to better understand the full resources consumed in delivering the games. To this end it also discloses the material resources provided free of charge to the state from other levels of government. However, the accounting standards provide that the value of such resources also be shown as an offsetting revenue item – as such there is no net effect on the state's bottom line.

4.3 What did the games “cost”?

4.3.1 What was the planned cost

In March 2003, the Premier announced that the “net cost” of the games to the state would be capped at \$697 million. Total operating and capital “costs” were expected to be \$1 142 million and operating revenues were expected to be around \$400 million.

The following table summarises the key original and revised budget targets, and sets out the final costs as disclosed in the special purpose financial report.

FIGURE 4A: SUMMARY OF BUDGET AND ACTUAL GAMES COSTS (\$MILLION)

Component	Original budget	Revised budget	Cost (Outlays)
Net operating cost	474	546.4	468.6
Facilities and infrastructure (a)	223	223.7	222.6
Net total outlays	697	770.1	691.2
Total outlays	1 142	1 218.6	1 144.4

(a) The original budget included an amount of \$18.5 million for the MCG athletics track. Actual expenditure on the track is shown under operating outlays, as it was destroyed. Without this amount, the original budget for facilities and infrastructure would be \$204.5 million.

The actual costs and revenues are discussed below.

4.3.2 What were the outflows?

“Outlays” basis

As reported by the government, total additional outlays on the games were \$1 144.4 million, comprising:

- \$831.9 million on operations
- \$89.9 million on security¹
- \$222.6 million on facilities and infrastructure.

The total outlays figure compares favourably overall with both the original budget estimate of \$1 142 million announced in 2003, and with the approved revised budget of \$1 219 million.

¹ Actual outlays by the state on security were \$44 million more than the original budget of \$46 million but \$29 million below the approved revised budget.

Total “capital” costs (excluding the MCG athletics track) exceeded their original combined budgets by net \$18.1 million, but were \$1.1 million below the revised budget. The outdoor pool at the Melbourne Sports and Aquatic Centre (\$15.6 million) and the William Barak pedestrian bridge (\$4.9 million) contributed almost entirely to the upward revision of the original budget, necessitating use of \$20 million of the overall games’ contingency of \$60 million.

“Resources” basis

When the “operating” cost of the games (excluding capital expenditure) is measured by considering the outflow of all resources applied to their delivery, the figure arrived at is \$1 100 million, comprising:

- \$905.2² million for operations
- \$194.8 million for security.

The key differences between the \$1 100 million resource contribution and the combined operating and security outlays of \$921.8 million reported in the outlays statement arise from:

- resources provided from state agencies’ own budgets (\$41.3 million)
- resources provided free of charge by the Commonwealth (\$103.3 million)
- resources provided free of charge by local governments in Victoria (\$16.4 million)
- use of market value for the games village land rather than its book value (\$16.6 million).

4.3.3 What were the inflows?

“Outlays” basis

The total actual and anticipated revenue from the games is estimated by the government to be \$453.2 million, comprising:

- operating revenue (\$246.1 million)
- non-operating interest revenue (\$10.2 million)
- grants from other governments (\$115.9 million)
- proceeds from sale of games village land (\$81.0 million).

² The difference of \$81 million between this figure and the figure of \$824.2 million reported in the financial statements, arises from the netting of expected Village revenue in accordance with the requirements of the A-IFRS accounting standards.

Operating revenues comprise ticket sales, sponsorship, broadcast rights and commissions on sale of merchandise and catering. The original operating revenue target was \$240.8 million. The target was exceeded largely due to higher than expected ticket sales (\$21.8 million above the original target) offset by lower than expected sponsorship revenues (\$14.5 million below the original target).

Interest revenue earned by the corporation was \$9.8 million above the initial budget. This variation arose because the corporation received significant funding from the state in advance of need in both 2004 and 2005, and was, therefore, able to invest surplus funds.

Grant revenue from the Commonwealth was \$12.9 million above the original budget – the Commonwealth contributed extra direct funding to cover an expansion in the scope of the opening ceremony. The City of Melbourne also contributed \$3 million in direct funding to the river festival, which was unbudgeted.

As indicated above, the statement of net outlays includes the current best estimate of the present value of proceeds from the sale of land and housing in the games village development of \$81 million. This figure comprises expected revenues from the sale of:

- houses (\$28.2 million)
- apartments (\$34.0 million)
- heritage precinct apartments and townhouses (\$13.6 million)
- demountables (\$3.7 million)
- other (land payments, aged care precinct) (\$1.5 million).

At 31 August 2006, of the \$81 million included in the net outlays statement, actual revenue received was \$4.6 million. The remainder will be received following the construction and sale of the remaining apartments, from the sale of the remaining houses and from reimbursements associated with the heritage precinct. At the date of preparing this report, we were advised that:

- 155 of the planned 168 houses have been constructed, and 102 had been sold, but not all settled, at 31 August 2006
- while 105 apartments were required for the games, the revenue estimate of \$34 million is based on a total of 650 apartments. It is understood that the developer has yet to finalise planning, pricing and timing for the building of the additional apartments. The final likely revenue achieved will, therefore, not be certain until these matters are resolved
- as disclosed in the notes to the special purpose report, the state is currently negotiating with the developer in relation to the amount of the heritage precinct reimbursement

- all of the 115 demountables had been sold at 31 August 2006 for \$3.7 million.

The final net cost of the games will depend on the amount and timing of the actual revenues received in relation to the games village. At the time of preparing this report, there remains some uncertainty about the final amount of revenue from the sale of the apartments and the reimbursements for the heritage precinct. The forecast revenues used in the special purpose financial report were based on sales experience to date and on the state of the property market at the time of the report.

“Resources” basis

Total revenue inflows, when measured on the basis of the fair value of all resources received in relation to the games, were \$577.3 million. The difference between the reported “outlays” revenue of \$453.2 million and this higher amount is explained largely by:

- including revenue for “in-kind” resources provided by other levels of government (\$119.7 million) and “in kind” resources provided by games venues (\$8.2 million)
- excluding revenue from sponsorships by government agencies (\$3.3 million).

4.3.4 What was the net cost?

The total net outlays contributed by the government were \$691.2 million. This compares favourably to the original budget “cap” of \$697 million and the approved revised budget of \$770.1 million.

On the “outlays” basis of reporting the net operating outlays by the state, including security, were \$468.6 million. On the “resources” basis, the net operating resources contributed by the state were \$522.7 million.

As discussed previously, resources provided free of charge to the state have no net impact on the operating result. Consequently, the key differences between the 2 reported net operating results are the resources contributed by state agencies included in their existing budgets (\$41.3 million), and the different basis of measurement of the value of the land contributed by the state to the games village (\$16.6 million).

The value of the land contribution used in the resources statement was \$28.4 million, which was its estimated market value just prior to the agreement with the developer. As this represents the fair value of the land assets given up by the state, it was considered appropriate to use this value in the resources statement.

In the outlays statement, the fair value of the land was impaired to its recoverable amount of \$11.8 million. This impairment of \$16.6 million was required because the fair value of the assets given up by the state was greater than the fair value of the future revenue streams expected to be received by the state. This was considered to be an appropriate value to use in this statement as it reflected the carrying value of the land asset in the state's accounts.

4.3.5 Other measures of cost and benefit

The net financial cost of the games can also be assessed against the legacy derived from infrastructure expenditure on sporting facilities and social housing; and also against the economic, environmental and social impact of the event.

It is understood that the government is preparing an updated economic impact study, together with an environmental report card as part of a "triple bottom line report". These reports are expected to be released in October 2006.

Auditor-General's reports

2006

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