VICTORIA

Victorian
Auditor-General

Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2006-07

Ordered to be printed

VICTORIAN
GOVERNMENT PRINTER
November 2007

PP No 62, Session 2006-07

ISBN 1 921060 50 6

VAGO

Victorian Auditor-General's Office

Auditing in the Public Interest

The Hon. Robert Smith MLC
President
Legislative Council
Parliament House
Melbourne

The Hon. Jenny Lindell 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, 2006-07.*

Yours faithfully

DDR PEARSON
Auditor-General

21 November 2007

Contents

1 Executive summary

1.1 Introduction

This report sets out the results of the audit of the State of Victoria's Annual Financial Report (AFR) for 2006-07. The AFR is incorporated into the *Financial Report for the State of Victoria, 2006-07* (the Financial Report), and is a key part of the accountability of the Government to Parliament for the management and stewardship of the State's finances.

This report also provides our commentary on the financial outcomes and position achieved by the State and the general government sector[1]. This commentary is in addition to the analysis and discussion provided by the Treasurer and the Minister for Finance, WorkCover and the Transport Accident Commission in chapters 1 to 3 of the Financial Report which are not subject to audit.

RESPONSE provided by Treasurer

The Auditor-General's report is a welcomed endorsement of the Government's commitment to the sound stewardship and management of the State's finances. It confirms that the State's financial condition remains sound and continues to improve. It also acknowledges that the State's Annual Financial Report is a high quality accountability vehicle, providing the Parliament and the Victorian public with a comprehensive account of the State's finances.

1.2 Results of audit

An unqualified audit opinion on the 2006-07 AFR was issued on 27 September 2007. The audited AFR was tabled in Parliament on 10 October 2007, 5 days prior to the deadline required by the *Financial Management Act 1994*.

This result notwithstanding, there remains scope for earlier reporting of the AFR. More timely reporting is, however, highly dependent upon material agencies[2] meeting agreed time frames for the provision of audited data to the Department of Treasury and Finance (DTF).

[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.

[2] A material agency is a public sector agency whose operations have a significant impact on the reporting of the State's finances in terms of Australian accounting standards.

Agencies were to provide audited financial data to DTF by 16 August 2007 to enable preparation of the AFR. Only 2 of the 47 agencies had provided audited financial statements by this deadline. In addition, delays by agencies in submitting audited data was a significant factor in DTF not achieving its target of preparing a complete draft AFR by 24 August 2007. Notwithstanding that some delays in reporting can be attributed to factors outside each agency's control, there are a significant number of agencies which continue to fail to meet agreed reporting time frames. This indicates the need for improved integration of accounting and administrative systems across these agencies.

There is room for improvement in the quality of data submitted by agencies for consolidation into the AFR. A number of corrections were required to the classification of assets and in relation to the completeness of information provided for commitments and contingent assets and liabilities. The poor quality in the agencies' data feeds also contributed to the delays in completion of the first draft of the AFR indicating the need for significantly improved quality assurance processes by agencies.

Over recent years, there has been improvement to the presentation of the AFR, particularly the level and quality of disclosures. Opportunities nevertheless remain to further enhance the presentation and disclosures made in the AFR on:

- financial commitments
- the transfer of resources to central government through capital contributions by public financial and public non-financial corporations
- the State's interests in jointly controlled assets.

Certain other issues in the AFR also need to be addressed. While immaterial in financial terms, the Melbourne Cricket Ground Trust should be included while investments held by the Legal Services Board should be excluded.

This report also provides commentary on impacts of changes in the financial reporting framework on the 2006-07 AFR. The changes discussed are:

- recognition of public-private partnership (PPP) arrangements, including the Australian Accounting Standards Board (AASB) Interpretation 12 *Service Concession Arrangements*
- accounting for financial guarantees under the amended AASB 139 *Financial Guarantees: Recognition and Measurement.*

RESPONSE provided by Treasurer

The Auditor-General's report acknowledges the positive outcomes achieved in 2006-07 by the Government, including:

- *completion and tabling of the AFR well within the statutory timelines and well ahead of the majority of Australian jurisdictions; and*
- *the continuous improvement in AFR presentation, building on an already high quality accountability document.*

RESPONSE provided by Treasurer - continued

It also highlights the ongoing challenge for public sector agencies to improve their timeliness in providing audited financial data for the AFR, and improving on the quality of data submitted.

The Department of Treasury and Finance is committed to working closely with agencies to ensure that they continue to improve the quality and timeliness of their AFR data, and to work toward continuous improvement of AFR presentation – building on the high standard already delivered.

1.3 Financial outcomes achieved by the State in 2006-07

Chapters 1 to 3 of the Financial Report, which are not subject to audit, include detailed explanations and analyses of influences on the State's reported results. This information assists users to make informed assessments about the financial outcomes achieved, and the condition of the State's finances.

This report does not reproduce the analysis and discussion presented in the Financial Report, but provides Parliament and others with independent assurance about the audited financial information relating to the State's finances.

2006-07 financial results

The AFR reports a strong net result for the State and the general government sector for 2006-07. The State achieved a net result of $7 232 million in 2006-07 ($5 876 million, 2005-06), while the general government sector achieved an operating surplus of $4 870 million in the year ($3 922 million, 2005-06).

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

- significant gains due to the increased value of financial assets, reflecting the strong performance of financial and equity markets
- a reduction in the State's unfunded superannuation liabilities
- increased revenue from State taxation and Commonwealth grants resulting from strong Victorian and national economies.

The $7 232 million net result for the State includes $5 985 million resulting from other economic flows. Included in other economic flows is a gain of $3 196 million which is a reduction in the net present value of the amount to be paid in future years for the State's superannuation liability. Additionally, the gain of $2 940 million on financial assets resulting from their fair valuation at 30 June is expected to be realised in future years.

In its assessment of the result in relation to its financial strategy, the Government excludes the impact of other economic flows. The net result from transactions was $1 247 million. The net result from transactions is considered to be the most robust measure of the Government's financial management. In the Financial Report, it is acknowledged that the general government sector's net result from transactions included:

- the impact of $690 million of income additional to that which was expected in the 2006-07 revised estimates which has enabled the Government to bring forward and commit new capital funding
- additional income of $500 million from land transfer duty and income tax equivalent that is not expected to continue at this level in future years.

Financial position and condition of the State

The Financial Report also reports that the State's and the general government sector's financial position improved during 2006-07 and remains sound. We confirm this assessment.

During 2006-07, the State's net assets grew by $9 424 million (12.3 per cent) to $86 148 million, while the general government sector's net asset position increased by $5 961 million to $43 486 million. The growth in net assets has been driven by an increase in the value of property, plant and equipment, and investments. The overall level of State liabilities decreased by $708 million in the year, mainly as a result of reductions in unfunded superannuation liabilities and interest-bearing liabilities.

Notwithstanding the positive assessment of the financial condition of the State in the Financial Report, we draw attention to several external risks to the State's future performance and condition, being:

- 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)
- market volatility impacting on the performance of financial and equity markets, which significantly influence the investment revenues and superannuation expenses[3] of the State
- pressures for wage and salary growth, contributing to increased employment costs.

These factors need ongoing monitoring by the Government.

[3] The financial and equity markets affect the investment returns of superannuation plan assets and, therefore, the movements in unfunded superannuation liabilities.

Key issues impacting on the State's financial result and financial position for 2006-07 include:

- the impact of market conditions on the unfunded superannuation liability
- redemption of the Melbourne CityLink concession notes.

> ***RESPONSE provided by Treasurer***
>
> *The Auditor-General affirms that the State and the General Government Sector financial position remains sound and continues to improve.*
>
> *The report also correctly acknowledges that the year's operating result received an unexpected boost of additional income attributable to the strength of the Victorian and the national economies – with this income not expected to continue into future years. The additional income has enabled the Government to bring forward and commit new capital funding for the benefit of all Victorians.*

1.4 Major factors impacting on financial reporting

The AASB's recent work program for the public sector mainly involves the harmonisation of the Government Finance Statistics (GFS) 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.

This report provides commentary on recent and proposed developments in the financial reporting framework which will impact future financial reporting in the public sector. These are:

- AASB Interpretation 12 *Service Concession Arrangements*
- harmonisation of A-GAAP and GFS, including the issue of AASB 1049 *Whole of Government and General Government Sector Financial Reporting*
- Exposure Draft 156 *Proposals Arising from the Short-term Review of the Requirements* in *AAS 27, AAS 29 and AAS 31*
- Australian accounting standard AASB 7 *Financial Instruments: Disclosures*
- development of a public sector conceptual framework by the International Public Sector Accounting Standards Board
- differential reporting requirements for small and medium-sized entities to reduce their financial reporting burden.

2 Results of audit

At a glance

Background

The *Financial Management Act 1994* requires a Victorian whole-of-government and general government sector Annual Financial Report (AFR) be prepared, audited by the Auditor-General, and tabled in Parliament by 15 October each year. The AFR is contained within the *Financial Report for the State of Victoria, 2006-07* (the Financial Report). The AFR is a key part of 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. To do this it consolidates the financial results of 313 public sector agencies, each of which are also separately audited by the Auditor-General. Of these 313 agencies, 47 are assessed as financially material to the State's AFR in terms of Australian accounting standards.

Key findings

- An unqualified audit opinion was issued on the AFR on 27 September 2007 and tabled in Parliament on 10 October 2007 (in the prior year, an unqualified opinion was provided on 27 September 2006 and tabled on 3 October 2006).
- Most material agencies did not meet the time frames set by DTF for submission of their draft financial statements for audit, or for the certification of their financial statements. This is a recurring issue.
- The AFR can be further improved through additional disclosures on the net present values for all commitments and the nature of major new commitments, and by including disclosure of capital transactions between sectors.

Key recommendation

2.1 That public sector agencies commit to providing resources to improve both their financial statement preparation processes and submission of data feeds to DTF for AFR purposes.

2.1 Introduction

Section 16A of the *Audit Act 1994* requires the Auditor-General to prepare and table a report on the audit of the State's Annual Financial Report (the AFR).

This report presents the results of the audit of the AFR, and provides Parliament and other users with our assessment of the State's finances.

2.2 The financial reporting framework

Responsibility for preparing, tabling and explaining the AFR rests with the Treasurer and the Minister for Finance, WorkCover and the Transport Accident Commission.

The *Financial Management Act 1994* (the FMA) sets the legal framework for the administration of public finances in Victoria. The FMA requires that consolidated financial statements for the State and general government sector be prepared annually, audited by the Auditor-General, and tabled in Parliament.

These financial statements are referred to in the FMA as the "Annual Financial Report" (the AFR). The AFR provides accountability of the Government to Parliament for the management and stewardship of the State's finances. The AFR is incorporated into a narrative report titled *Financial Report for the State of Victoria, 2006-07* (the Financial Report).

The Department of Treasury and Finance (DTF) prepares the AFR in accordance with the requirements of the FMA and Australian accounting standards, particularly Australian accounting standard AAS 31 *Financial Reporting by Governments*.

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 State are, therefore, included in the AFR.

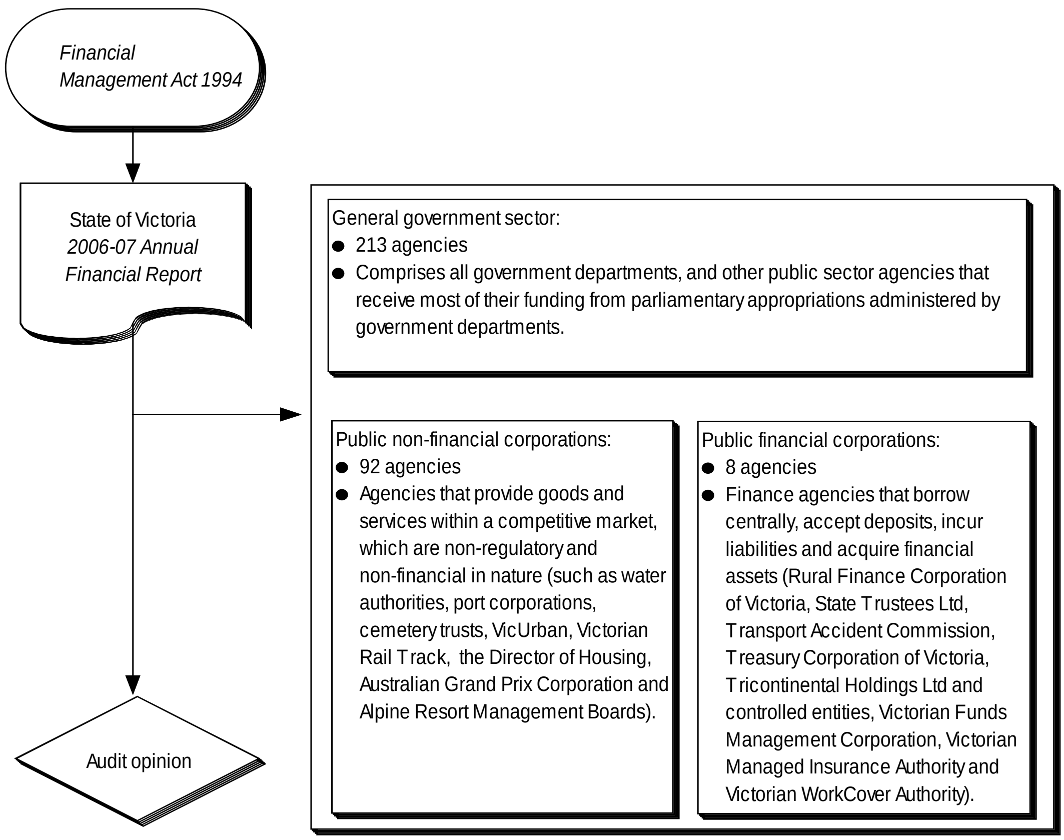
Australian accounting standard AAS 31 *Financial Reporting by Governments* requires disaggregation of the consolidated financial result and balances into 3 sectors of government:

- general government sector[1] (GGS)
- public non-financial corporations
- public financial 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.

Figure 2A
Agencies included in the 2006-07 AFR



2.3 Results of the audit of the AFR

Under the FMA, the Auditor-General is required to audit the AFR, and to issue an audit opinion. The audit opinion is an independent statement which attests to the accuracy and reliability of the AFR.

An unqualified audit opinion on the 2006-07 AFR was issued on 27 September 2007 and included in Chapter 4 of the Financial Report which was tabled in Parliament on 10 October 2007. In the prior year, an unqualified opinion on the AFR was issued on 27 September 2006, and tabled in Parliament on 3 October 2006.

An unqualified opinion indicates that the AFR has been prepared in accordance with the requirements of the FMA and Australian accounting standards.

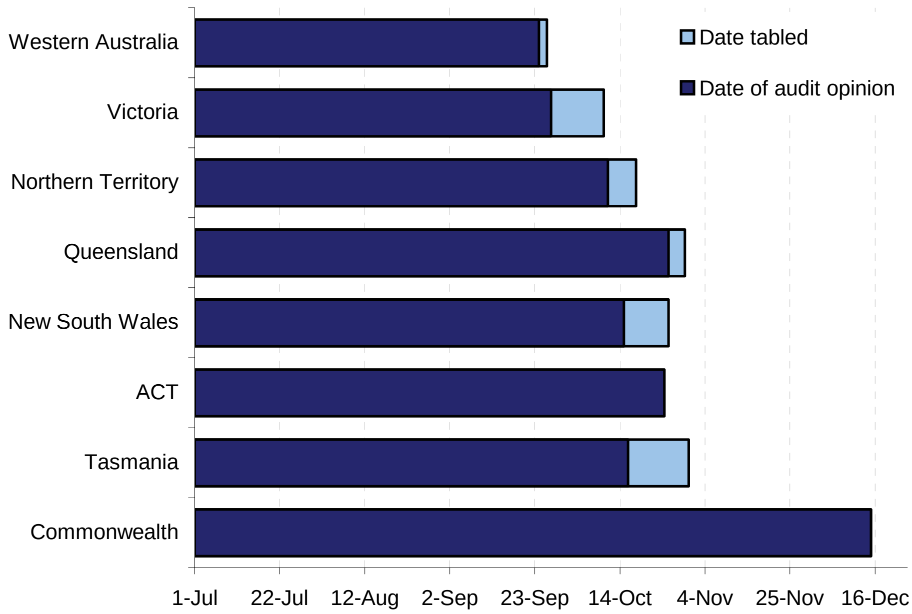
2.4 Timeliness and quality of reporting of the AFR

Under the FMA, a copy of the AFR must be provided for audit on or before 20 September, and tabled in Parliament by 15 October each year.

These timelines were achieved in 2007. A final draft of the AFR was provided to audit on 18 September 2007, and the audited report was tabled in Parliament on 10 October 2007.

This year, we benchmarked the timeliness of the AFR against other Australian jurisdictions. Figure 2B shows the timeliness of the completion of the audited consolidated financial statements and their tabling dates in all Australian jurisdictions for the financial year ended 30 June 2007.

Figure 2B
Timeliness of completion of the audited consolidated financial statements, 2006-07



Note: The date of the audit opinion shown for the Commonwealth is an estimate. Tabling dates for the ACT and the Commonwealth are not known. South Australia had not completed whole-of-government accounts at the time of this report.
Source: Victorian Auditor-General's Office.

The results of our benchmarking show clearly that Victoria reports its consolidated financial statements earlier than all other jurisdictions, except Western Australia.

This result notwithstanding, there remains scope for increased rigour and streamlining of the processes for preparation of the AFR. This can be achieved through a more systematic provision of progressive elements and drafts of the AFR for audit review.

2.4.1 Timeliness and quality of material agency financial statements

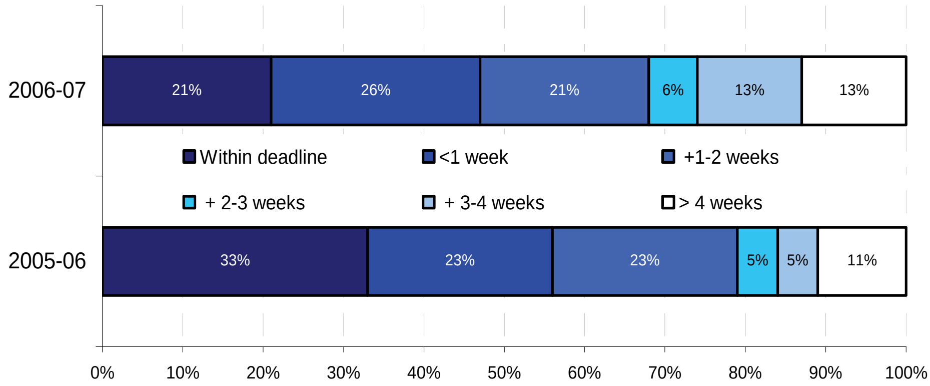
The FMA requires public sector agencies to have their financial statements completed and ready for audit within 8 weeks of balance date each year. The *Audit Act 1994* requires the Auditor-General to express an opinion within 4 weeks after the day on which the financial statements were received for auditing. Consequently, certified and audited statements should be produced within 12 weeks of the end of the financial year.

To enable completion of the AFR, agencies are required to submit audited data feeds to DTF which are used for preparing the consolidated AFR. Data feeds transmitted to DTF should be prepared from agencies' audited accounts and records. Accordingly, those agencies designated as material are required by DTF to prepare financial statements earlier than the legislated time frames so as to enable timely transmission of audited data feeds to DTF for preparation of the AFR. In 2006-07, agencies were required to provide:

- complete draft financial statements for audit by 25 July 2007 (26 July in 2006)
- audited financial data to DTF by 16 August 2007 (17 August in 2006)[2].

Figure 2C shows the timeliness of agencies in achieving DTF's timeline of 25 July 2007 for submitting completed draft financial statements for audit.

Figure 2C
Timeliness of material agency draft financial statements



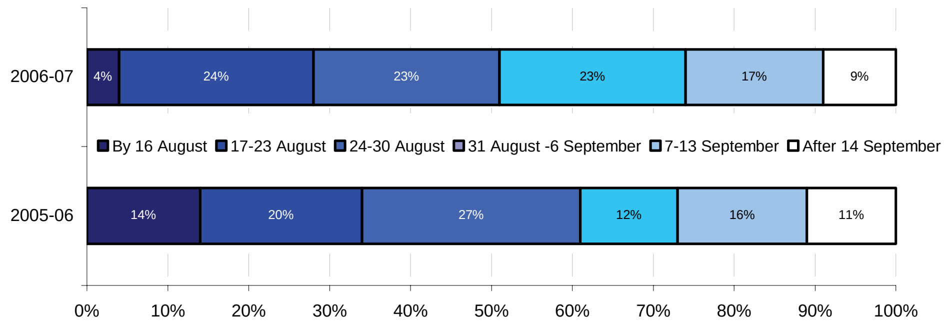
Source: Victorian Auditor-General's Office.

Of the 47 agencies, only 10 (21 per cent) provided complete draft financial statements for audit by the due date, a decline compared with 15 agencies (33 per cent) that met this requirement in 2005-06.

[2] Budget and Financial Management Information Request No. 49a, 26 June 2007.

Figure 2D shows the timeliness of agencies in achieving DTF's timeline for the completion of their audited financial statements.

Figure 2D
Timeliness of completion of audited financial statements, material agencies



Source: Victorian Auditor-General's Office.

Of the 47 agencies, only 2 agencies (4 per cent) had audited financial statements completed by 16 August 2007, compared with 14 per cent (6 agencies) in the previous year. This indicates a majority of material agencies were unable to provide audited data to DTF by 16 August 2007.

The timeliness results shown above are disappointing given that the time frames achieved last year were in more challenging circumstances. Reporting on the 2005-06 period faced significant change to the financial reporting framework in adopting, for the first time, Australian Equivalents to International Financial Reporting Standards requirements which required adjustments to some opening and closing balances, and additional disclosure. By contrast, there were no significant new disclosures, or changed accounting requirements in respect of the 2006-07 reporting period.

For the 2005-06 financial year, the then Premier requested all public sector agencies to table their annual reports by 4 October 2006, due in part to the timing of the impending election. To achieve this externally imposed deadline, there was an imperative to conclude the financial statement reporting process as quickly as possible last year. It is disappointing that in the absence of this imperative, timelines slipped considerably to behind those achieved in respect of the 2004-05 reporting period.

Discussion on the specific factors impacting on the completion of audited financial statements of all government agencies, including material agencies, will be included in our *Report on the Results of Financial Statement Audits of Agencies with 30 June 2007 Balance Dates* which will be tabled later in 2007.

Compared with 2005-06, we also observed deterioration in the quality of data that was extracted from the financial statements of certain agencies and submitted to DTF for the consolidation process. We have detailed below the key areas in which our audit found errors in the AFR data feeds submitted by agencies for 2006-07. These errors were subsequently corrected in the AFR.

Property, plant and equipment

The Financial Reporting Direction (FRD) 103B *Non-Current Physical Assets* was applicable to the 2006-07 financial reporting period for the first time. This reporting direction required non-current physical assets to be classified by the purpose for which the assets are used and specified 5 Government Purpose Classification (GPC) groups. Eight agencies incorrectly classified their non-current assets in their AFR data feeds provided to DTF.

Contingent assets and liabilities

Material omissions and errors were detected in 7 agencies' AFR feeds for both quantifiable and non-quantifiable contingencies. These errors or omissions were a result of agencies incorrectly classifying or entirely excluding data.

Commitments

Our review of commitments identified several omissions, errors and misclassifications in the AFR data feeds submitted by 9 agencies, impacting the accuracy of disclosure of the commitments between capital, operating, private-public partnerships and other commitments. These errors and omissions were a result of agencies incorrectly classifying or entirely excluding data in their data feeds.

Notwithstanding that some delays in reporting can be attributed to factors outside each agency's control, there are a significant number of agencies which continue to fail in meeting agreed reporting time frames. This situation is compounded by the deterioration in the quality of data submitted. This indicates the need for improved integration of accounting and administrative systems within and across these agencies. There is currently a disconnect between the systems, processes and approaches used to prepare the "external" annual financial statements, with those used to produce more frequent "internal" financial reporting against delivery of agencies' programs.

Improvements in the timeliness of providing complete, reliable draft financial statements to audit and, therefore, contributing to the timeliness of provision of data for the purpose of preparing the consolidated AFR will only be achieved and sustained against a background of significant commitment by senior management to achieving rigorous external reporting standards. This commitment extends to management attention to and investment in the resources, systems and processes used by agencies.

Recommendation

2.1 That public sector agencies commit to providing resources to improve both their financial statement preparation processes and submission of data feeds to DTF for AFR purposes.

2.5 Impact of changes in the financial reporting framework

2.5.1 Recognition of public-private partnership arrangements

A public–private partnership (PPP) is a contractual arrangement between at least 2 entities – a public sector grantor and a private sector operator – for the provision of public infrastructure and typically ongoing related services such as transport and water facilities.

In the *Auditor-General's report on the Annual Financial Report of the State of Victoria 2005-06*, it was reported that there was no applicable Australian accounting standard for PPP arrangements and such arrangements had previously been accounted for "off balance sheet". However, our Office agreed on a framework with DTF based on the principles contained in existing Australian accounting standards that considers the economic substance of each arrangement. We assessed a number of PPP arrangements last year and found that a number of these arrangements were "in substance" financing arrangements. Accordingly, we recommended that they be reported on the State's consolidated balance sheet as at 30 June 2006 and this was accepted by DTF, pending a review of the overall treatment of service concessions at a later date.

In February 2007, the Australian Accounting Standards Board (AASB) released Interpretation 12 *Service Concession Arrangements*, which addresses the private sector operator's accounting for service concession arrangements, which are a subset of PPP arrangements.

To establish how a service concession arrangement should be brought to account by the private sector operator, Interpretation 12 considers whether the grantor:

- controls or regulates what services the private sector operator must provide, including to whom they are provided and at what price
- controls, through ownership or beneficial entitlement or otherwise, significant residual interest in the infrastructure at the end of the service arrangement.

To the extent that there is control by the grantor, the private sector operator does not recognise any physical asset constructed by it under the arrangement. However, Interpretation 12 does not deal with how the public sector grantor of the service concession should account for the arrangement.

Shortly after release of Interpretation 12, the AASB formed an Interpretation Advisory Panel to develop recommendations on the accounting of service concession arrangements by public sector grantors. This panel has yet to make any recommendations to the AASB. Accordingly, aside from the framework agreed between audit and DTF, there remains no authoritative standard for the accounting of service concession arrangements by public sector grantors.

Regardless of how a PPP arrangement is classified, each government agency is required to disclose details of the PPP in the notes to the financial report in accordance with AASB Interpretation 129 *Service Concession Arrangements: Disclosures*.

Given the above, there was no substantive change required to be adopted in accounting for PPPs. The only new PPP to be recognised this year under the existing accounting framework relates to the Southern Cross Station redevelopment, brought to account at 30 June 2007. This development is discussed in section 3.3.4 of this report.

We will continue to monitor developments in this area and update our position paper when the AASB issues further guidance on the accounting treatment from the grantor's (public sector's) perspective.

2.5.2 Financial guarantees

Changes were made to Australian accounting standard AASB 139 *Financial Instruments: Recognition and Measurement* in September 2005, detailed in amendment standard AASB 2005-9. The amended accounting standard is applicable to reporting periods commencing on or after 1 January 2006, and was, therefore, applicable to agencies consolidated in the State's AFR for the first time in the 2006-07 reporting period.

A significant change in AASB 139 impacting on the 2006-07 reporting period was a change in the accounting treatment of some financial guarantee contracts. In previous years, financial guarantees were disclosed as contingent liabilities by the guarantor in accordance with accounting standard AASB 137 *Provisions, Contingent Liabilities and Contingent Assets.* As at 30 June 2006, guarantees, indemnities and warranties of $797.3 million were disclosed as contingent liabilities for the State of Victoria. Under the amendments to AASB 139, some financial guarantee contracts are now required to be recognised as liabilities on the guarantor's balance sheet as required by AASB 139. Recognition of these liabilities is dependent upon the probability of default by the party guaranteed and the materiality of the likely loss to the State resulting from the default.

Most of the State’s financial guarantees are held by DTF, being guarantees provided to other State government agencies. DTF conducted a review of the guarantees it holds to determine the impact of the change to AASB 139. It was found that DTF hold 2 kinds of financial guarantee contracts:

- automatic guarantees, arising under the *Borrowing and Investment Powers Act 1987*, which are considered to be statutory guarantees. Statutory guarantee liabilities are not required to be recognised on the balance sheet in accordance with AASB 139
- discretionary guarantees, which the Treasurer has power to grant with specific terms and conditions. Discretionary guarantees should be recognised on the balance sheet as required by AASB 139.

One discretionary guarantee provided to the Melbourne Cricket Club in relation to liabilities incurred to fund the redevelopment of its grounds for the 2006 Commonwealth Games was identified. However, this was considered to have a negligible risk of default and, as a result, no liability was recognised in DTF’s and the AFR balance sheets. Consistent with Australian accounting standards, DTF has disclosed all the State’s guarantees as contingent liabilities valued at $743.8 million at 30 June 2007.

2.6 Quality of disclosures in the AFR

Over recent years there has been improvement in the presentation of the AFR, particularly the level and quality of disclosures.

2.6.1 Progress of prior year issues

Insurance claims expense

In our 2005-06 report on the Annual Financial Report of Victoria, we noted that insurance claims expenses made up a major component ($2.3 billion or 7 per cent) of State expenditure, and we recommended that this item be separately disclosed in the notes to the AFR. In 2006-07, DTF disclosed insurance claims expenses of $2.6 billion as a separate line item in Note 14 to the AFR.

Financial commitments

In 2005-06, although not required under current accounting standards, we recommended improvements be made to the disclosure of the State's outstanding financial commitments, including disclosure of the:

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

In 2006-07, DTF improved the disclosure of commitments in Note 33 to the AFR by reporting the net present value for all PPP commitments. The disclosure in the AFR can be further enhanced in future years through disclosure of net present values for all major commitments and disclosure of the nature of major new commitments.

Disaggregated note disclosures – Capital transactions

Note 2 to the AFR presents disaggregated information about the financial performance and financial position of each of the 3 sectors of the State: the general government sector; public non-financial corporations sector; and public financial corporations sector[3]. Consistent with the reporting requirements of Australian accounting standard AAS 31 *Financial Reporting by Governments,* capital transactions are excluded from the disaggregated operating statement and balance sheet of each of these sectors[4]. This means that only the net effect of capital contributions to other sectors is disclosed for the GGS in the cash flow statement in the AFR, and users are unable to identify significant capital transactions between sectors.

In adopting AASB 1049 *Whole of Government and General Government Sector Financial Reporting*, improved disclosure of significant capital transactions and their impact on the relevant sectors through additional/supplementary disclosure in the notes to the AFR could be made.

2.6.2 Issues identified in this year's audit

DTF provided its pro forma draft financial statements 3 weeks earlier than the prior year. This enabled early resolution of most disclosure issues. However, there remain further opportunities to improve the quality of the presentation of the AFR.

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[3] 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.

[4] 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.

Opportunities exist to address the following issues which while immaterial in financial terms, will improve the accuracy of the State's Financial Report:

- inclusion of the Melbourne Cricket Ground (MCG) Trust as a controlled entity of Government. The MCG Trust should have been consolidated into the AFR as the State has control over the Trust's financial and operating policies and it is therefore considered a controlled agency of the State. At 30 June 2007, the Trust held assets of approximately $43 million, of which $31 million represented its land value.
- Investments held by the Legal Services Board were incorrectly consolidated into the AFR. The Legal Services Board's investments relate to trust funds held on behalf of external parties on a fiduciary and custodial basis. These funds are not controlled by the Victorian Government, therefore should not have been consolidated into the AFR balance sheet. Instead, the funds should have been disclosed in Note 35 to the AFR (Funds under management), similar to the disclosure of funds held by the Residential Tenancies Bond Authority and Senior Master of the Supreme Court.
- AASB 131 *Interests in Joint Ventures* requires certain disclosures to be made in an agency's financial report for interests in jointly controlled assets. The 2006-07 AFR does not fully disclose the State's interests in jointly controlled assets, such as the Royal Melbourne Showgrounds. In future years, DTF should ensure that the disclosure requirements in AASB 131 are met.

3 Financial outcomes achieved by the State in 2006-07

At a glance

Background

The Financial Report of the State provides information on financial performance for the year and on the financial position at the end of the year.

Analysis of this information using appropriate financial ratios provides one set of measures of financial sustainability.

This section of the report discusses trends in selected financial ratios, and also examines exposures to factors outside the control of the State that could impact on financial performance and position.

Key finding

- Overall, the financial performance and position of the State has improved. The net result of $7 232 million largely reflects the continued strength and performance of both the Victorian and Australian economies. Investment gains, asset acquisitions and the revaluation of assets have improved the net asset position by $9 424 million to $86 148 million.

3.1 Introduction

The *Financial Report of the State of Victoria, 2006-07* (the Financial Report), which includes the State's Annual Financial Report (AFR), also contains analysis and discussion of the AFR. This accompanying narrative is presented in chapters 1 to 3 of the Financial Report, which is not subject to audit[1]. The Department of Treasury and Finance is responsible for ensuring that this analysis and discussion is comprehensive, meaningful and consistent with the audited AFR.

In this part of the report we provide our independent assessment of the State's finances. Where considered appropriate, we have amplified or augmented analyses and assessments provided in the Financial Report to assist users to better understand the reported results and outcomes.

Our analysis considers the financial performance of the State for 2006-07 and its financial position at the end of the year. We also comment on trends over the 3 year period commencing 2004-05. Our analysis is based on AIFRS, adopted in 2005-06 which includes 2004-05 restated comparatives. The analysis does not therefore include previous years figures which were derived under the AGAAP reporting framework.

3.2 Financial performance

The net result is the State's "bottom line". It is a key measure of financial performance and sustainability.

In the AFR, the consolidated net result for the State is dissected in 2 ways:

- it is segmented to show a separate result for the general government sector[2] (GGS)
- it is sub-totalled to first produce a "net result from transactions", to which is added "other economic flows"[3], to arrive at the overall net result and the segmented result.

The sub-total "net result from transactions" is the key measure of short-term financial performance, consistent with previous years. In this regard, the stated objective is to maintain an operating surplus for the net result from transactions of at least $100 million for the GGS.

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

[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.

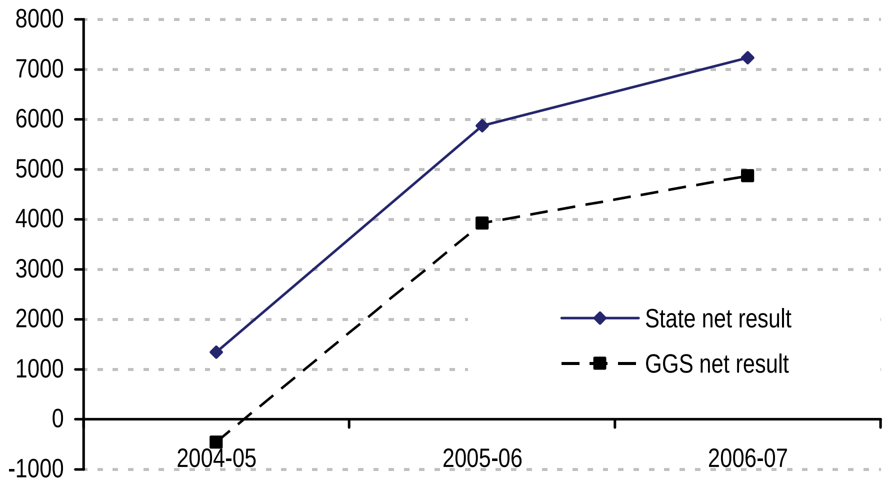
[3] "Other economic flows" generally include revaluations of (gains/losses on) assets and liabilities arising from price changes (refer note 1(E) to the AFR).

The operating statement for 2006-07 shows that the consolidated “net result from transactions” for the State was $1 247 million ($551 million in 2005-06). The sector result for the GGS was a $1 365 million surplus ($825 million in 2005-06). Accordingly, the Government achieved its short-term financial performance target in 2006-07.

Our analysis of the financial performance of the State takes account of the overall net results, for the GGS and for the whole-of-government, rather than just the results from transactions. This analysis provides a comprehensive view of all of the factors that contribute to the result irrespective of whether they are classified as transactions or other economic flows. Other economic flows are outside the direct control of government.

Figure 3A shows the net results for the State and the GGS for the last three financial years.

Figure 3A
Net results – State of Victoria and general government sector ($million)



Source: Annual Financial Reports for the respective reporting periods.

This year, the State achieved a net result of $7 232 million ($5 876 million, 2005-06) while the GGS achieved a net result of $4 870 million for the year ($3 922 million, 2005-06). This represents a 23 and 24 per cent increase over the prior year, respectively. The 3-year trend for both results is positive, but the rate of growth of the surplus slowed in 2006-07.

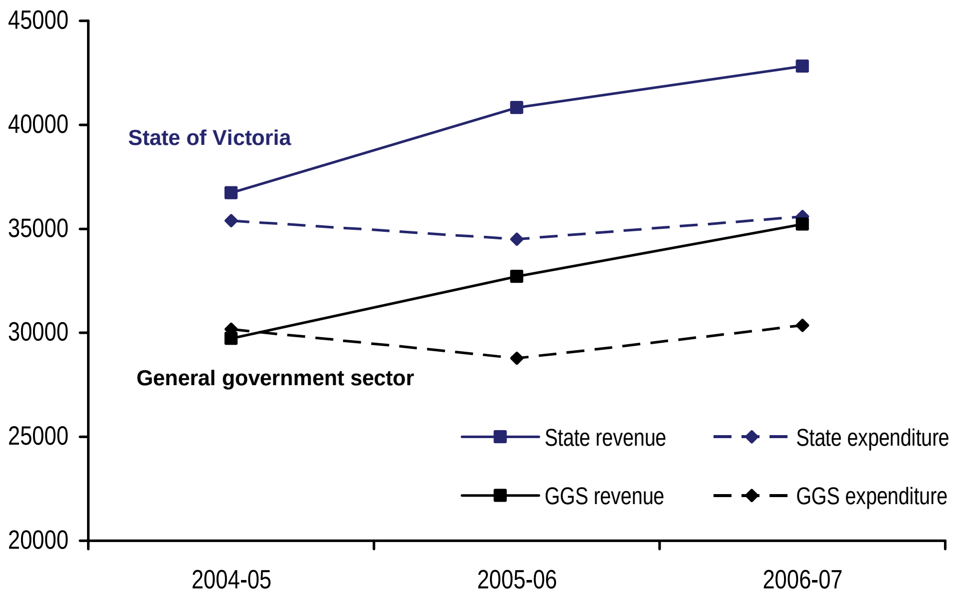
The $7 232 million net result includes $5 985 million resulting from other economic flows. Included in other economic flows is a gain of $3 196 million which is a reduction in the net present value amount to be paid in future years for the State’s superannuation liability. Additionally, the gain of $2 940 million on financial assets resulting from their fair valuation at 30 June is expected to be realised in future years.

In its assessment of its financial strategy, the Government excludes the results of other economic flows; the net result from transactions was $1 247 million. The net result from transactions is considered to be the most robust measure of the Government's financial management. In the Financial Report, it is acknowledged that the general government sector's net result from transactions included:

- the impact of $690 million of income generated by the ongoing solid performance of the Victorian and national economies, additional to that which was expected in the 2006-07 revised estimates which has enabled the Government to bring forward and commit new capital funding
- additional income of $500 million from land transfer duty and income tax equivalent that is not expected to continue at this level in future years.

Figure 3B further presents the income and expenditure trends for the State and the general government sector over the past 3 years.

Figure 3B
State income and expenditure ($million)



Source: Annual Financial Reports for the respective reporting periods.

Since 2004-05, the annual average rate of State income growth of 6.7 per cent has exceeded the annual average rate of State expenditure growth of 1.6 per cent.

As explained in the Financial Report, the major factors contributing to the increased State income in 2006-07, compared with 2005-06, included:

- an increase of $803 million in State taxation revenues. This increase is largely due to increased payroll tax revenues ($177 million), land tax revenues ($199 million) and land transfer duty revenues ($290 million). As with the prior year, increased taxation revenues reflects ongoing favourable employment and property market conditions
- an increase of $463 million in general purpose operating grants to the State. This reflects a $650 million increase in GST Commonwealth grants which was offset by a decrease of $187 million in national competition policy payments, following their abolition in 2005-06. The net increase reflects a further strengthening of the Victorian and national economies during 2006-07, contributing to an increased Commonwealth GST revenue pool
- an increase in other specific purpose grants (including hospital funding, grants to government and non-government schools, and funding for drought relief) totalling $488 million, primarily attributable to indexation in existing funding agreements
- an increased net gain on financial assets at fair value of $1 046 million. This increased gain reflects increasing values of investments due to the continued strong performance of financial and equity markets
- an increase in the gain on the unfunded superannuation liability of $761 million due to the increase in the government bond rate used to calculate the present value of the liability and, returns on the superannuation plans assets.

The increase in income for the year was partly offset by the following:

- increased “expenses from transactions” of $1 868 million (5 per cent). This increase was largely attributable to the rising costs of employee benefits (increase of 6 per cent), mainly caused both by an increase in total employee numbers due to additional service delivery and enterprise bargaining agreement pay adjustments. There was also growth in the cost of supplies and services impacted by the drought, the prolonged bushfire season, and the implementation of health and education policy commitments
- a loss of $792 million on the State Electricity Commission of Victoria (SECV) onerous contract provision. The increase in this liability was offset by $954 million gain on financial instruments used by the SECV to minimise the financial impact of the onerous contract provision. The overall result was a gain of $162 million.

3.3 Financial position and condition

3.3.1 Financial position of the State

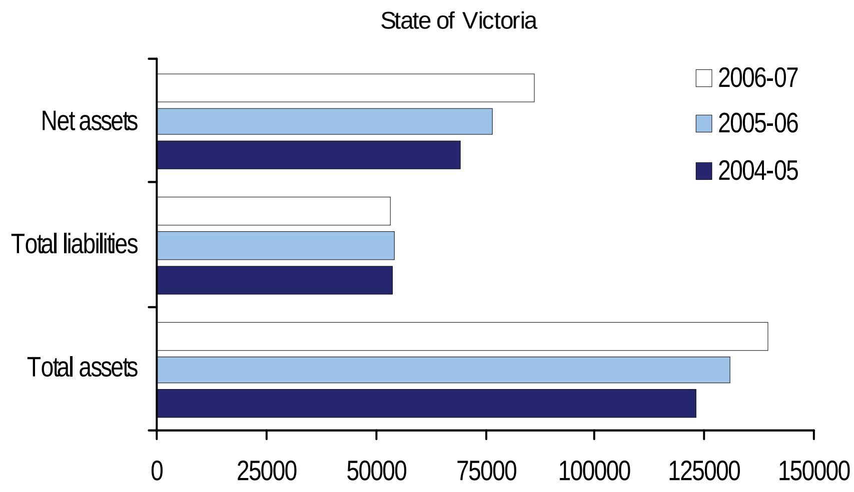
The consolidated balance sheet in the AFR contains information about the value and composition of the State’s assets and liabilities. The notes to the AFR contain further information about financial commitments, and contingent assets and liabilities, which are not reflected in the consolidated balance sheet.

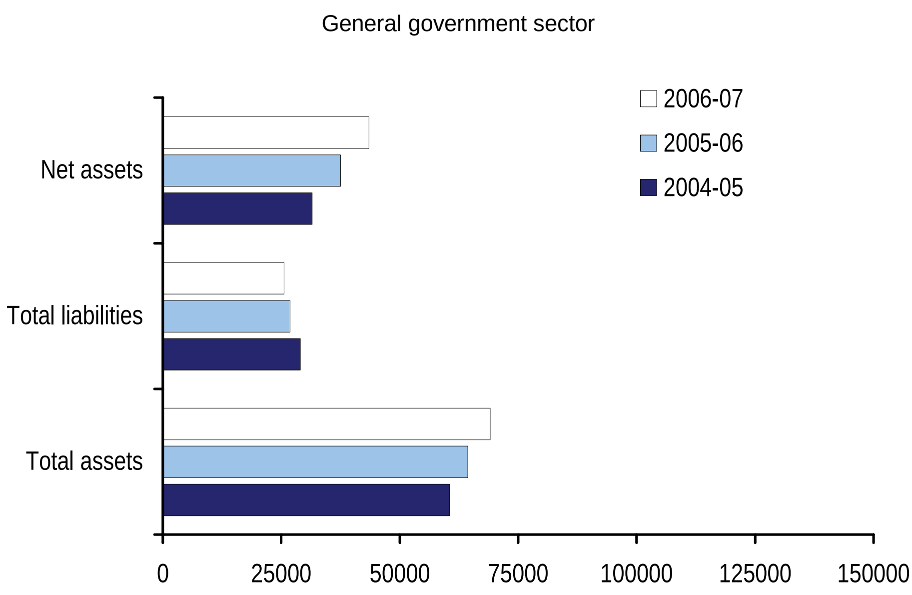
As disclosed in the AFR, the financial position of the State (and of the general government sector) improved during 2006-07, and remains sound.

During 2006-07, the State's net asset position (assets less liabilities) grew by $9 424 million (or 12.3 per cent) to $86 148 million, while the general government sector's net asset position improved by $5 961 million to $43 486 million.

Figure 3C shows movements in the value of the state and general government sector assets and liabilities over the past 3 years.

Figure 3C
State of Victoria and general government sector, assets and liabilities ($million)





Source: Annual Financial Reports for the respective years.

Assets

As explained in the Financial Report, the value of the State's assets increased by $8 716 million (or 6.7 per cent) in 2006-07, mainly due to increases in:

- property, plant and equipment ($4 936 million) relating to new asset additions and asset revaluation increments
- other financial assets ($2 435 million) mainly attributable to continuing gains in market value due to strong financial markets.

Property, plant and equipment

The State held property, plant and equipment at 30 June 2007 valued at $99 678 million, an increase of $4 936 million (or 5.2 per cent) from the prior year. This increase is predominantly due to $6 011 million of asset additions and revaluation increments of $2 120 million, offset by depreciation and impairment charges ($2 180 million), disposals ($490 million), assets reclassifications ($313 million) and decrease in leased motor vehicles ($212 million).

Asset acquisitions

Major asset additions for 2006-07 were recognised by the following agencies:

- $832 million of road infrastructure asset additions by the Roads Corporation, mostly being capital works in progress for various road improvement projects
- $625 million of increase in buildings for hospitals due to capitalisation of buildings works in progress (i.e. Alfred Centre, Royal Children's Hospital and Royal Women's Hospital Redevelopment)
- $583 million of additions (including $280 million capital works in progress) by the Department of Education, which mainly relate to capital works in the State's public schools
- $567 million of additions by Victorian Rail Track for the renewal of rail infrastructure
- $389 million of additions by the Department of Human Services, which includes $102 million for new residential properties acquired by the Director of Housing
- $359 million of additions by Southern Cross Station Authority in relation to the building completed on 31 July 2006
- more than $680 million of additions by the State's 6 material water authorities mainly for the improvement of water infrastructure assets
- $161 million of material additions to metropolitan and regional hospitals in relation to acquisitions of general medical equipment and computer communication infrastructure
- an $87 million increase in additions with the Office of Chief Commissioner of Police due to the capitalisation of various new police stations.

Asset revaluations

Major revaluation movements included:

- the Department of Sustainability and Environment recorded a $1 094 million increment relating to its land holdings (including Crown land) and national parks

- Southern Cross Station Authority recorded a $293 million increment relating to its land and buildings
- Arts agencies recorded a $130 million increment relating to buildings
- a Department of Justice revaluation increment of $105 million relating to land and buildings at the Melbourne Magistrate's Court Men's Prison and Beechworth Prison
- Melbourne Olympic Park Trust recorded a $98 million increment relating to buildings
- The Trustees of The Necropolis Springvale cemetery recorded a decrement of $83 million on revaluation of land, resulting from a prior period accounting error and also the revision of the estimate obtained in its 2003 land valuation.

Liabilities

The State's liabilities decreased by $708 million (or 1.3 per cent) in 2006-07. The decrease reflects:

- a significant reduction in the present value of the State's unfunded superannuation liability of $2 781 million from $12 934 million at 30 June 2006 to $10 153 million at 30 June 2007. The reduction arose because of changes in the government bond rate used to discount the liability to its present value and strong investment market returns on superannuation plan assets
- a decrease in interest-bearing liabilities of $303 million reflecting an overall decrease in domestic borrowings, but offset by increased finance leases primarily relating to the recognition of the finance lease associated with the Southern Cross Station and foreign currency borrowings held by the Treasury Corporation of Victoria (TCV).

The overall decrease was also partly offset by increases in other liabilities, including:

- "other" provisions which increased by $1 152 million. Of this increase, $792 million arose from the onerous contract[4] provisions recognised by the State Electricity Commission of Victoria (SECV) for the supply of electricity to Victoria's aluminium smelters at Portland and Point Henry[5]
- an increase of $358 million in unearned income, primarily resulting from the receipt of moneys from Transurban for the encashment of the Melbourne CityLink concession notes; and a $247 million increase in derivative financial instruments (comprising an increase in foreign exchange swaps of $322 million held by TCV and offset by a decrease of $82 million of SECV derivatives).

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[4] An onerous contract is defined in AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* to be "a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it".

[5] The increase in this liability was offset by $954 million gain on financial instruments used by the SECV to minimise the financial impact of the onerous contract provision. The overall result was a gain of $162 million.

General government sector

The value of GGS assets increased by $4 695 million (or 7.3 per cent), of which $3 446 million represented higher property, plant and equipment holdings, and valuation increments.

GGS liabilities decreased by $1 266 million (or 4.7 per cent), mainly represented by a reduction in unfunded superannuation liabilities of $2 759 million to $10 138 million at 30 June 2007. These decreases were partly offset by increases in other liability items, including interest-bearing liabilities ($1 014 million) and other liabilities ($334 million).

3.3.2 Financial condition of the State

Strong financial markets and economic growth had a significant impact on the State's operating statement and balance sheet in 2006-07, resulting in an improvement in the State's financial condition.

Our assessment of the financial condition of the State uses 2 financial ratios:

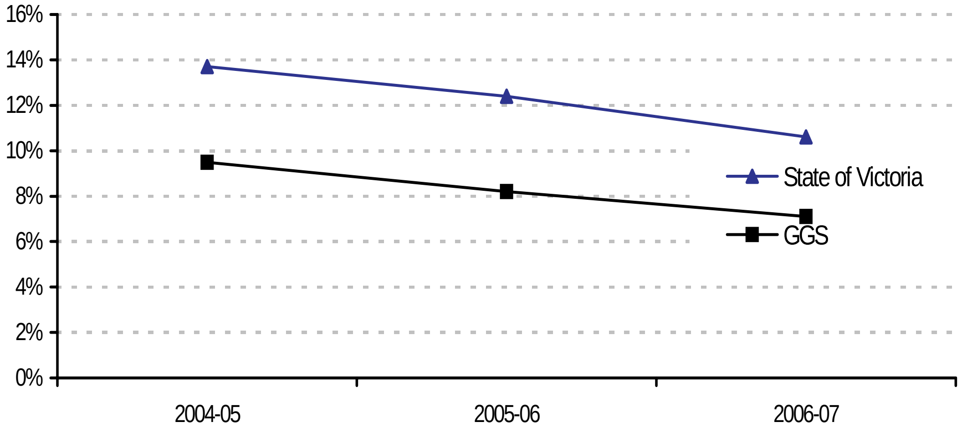
- debt sustainability – interest-bearing liabilities and unfunded superannuation liabilities to gross state product (GSP)
- gearing – interest-bearing liabilities to total assets.

Debt sustainability

The level of debt sustainability is a key measure of the State's ability to support and finance its debt. A lower ratio indicates that the State is better able to service its debt obligations.

In recent years, the ratio has reduced, as shown in Figure 3D. This indicates progressive improvement in the sustainability of the State's relative debt.

Figure 3D
Debt sustainability
(interest-bearing liabilities and unfunded superannuation liabilities to GSP)
(per cent)



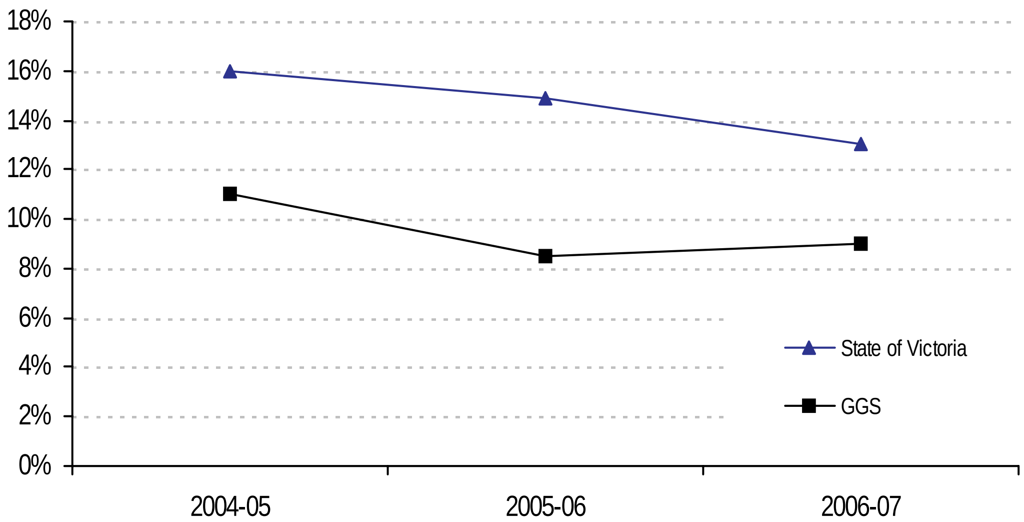
Source: Victorian Auditor-General's Office.

Gearing

Gearing is a key measure of the extent of the State's reliance on debt to fund asset acquisition and growth. A lower ratio indicates a lower exposure to rising finance costs associated with increased interest rates.

In recent years, the level of gearing for the State has declined as shown in Figure 3E. The State's debt levels have continued to reduce relative to the State's asset base and State economic activity levels. However, the general government sector's gearing ratio increased slightly in 2006-07, primarily due to financing arrangements associated with increased infrastructure expenditure.

Figure 3E
Gearing
(interest-bearing liabilities to total assets)
(per cent)



Source: Victorian Auditor-General's Office.

Trends in the above financial ratios confirm an improved financial condition for the State.

3.3.3 Risks to financial performance and condition

While the Victorian Government has benefited from a strong economy in 2006-07, there are a number of external factors which need to be continuously monitored by the Government. For example, in 2006-07, market conditions contributed to the State's:

- $3 196 million gain on its unfunded superannuation liability balance
- $2 940 million gain upon revaluation of its other financial assets (investments).

These gains were partly offset by a $792 million increase in its onerous provisions liability held by SECV[6].

External factors that could impact the State's future financial performance and condition 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)
- market volatility impacting the performance of financial and equity markets, which significantly influence the investment revenues and superannuation expenses[7] of the State
- pressures for wage and salary growth, contributing to increased employment costs.

The extent of the impact of financial and equity markets on the State's financial position and performance is demonstrated in the following analysis of 3 key account balances.

The State's unfunded superannuation liability

At 30 June 2007, the State's unfunded superannuation liability was $10 153 million, $2 781 million less than the previous year. Economic conditions were a major factor in the reduction of the State's liability. This balance was affected by financial and equity market conditions during 2006-07, namely:

- the discount rate used to measure the present value of the defined benefits obligations in 2006-07 was increased due to higher interest rates
- higher than expected yields from superannuation fund investments, with a full year return of 17.71 per cent in 2006-07, led to a decrease in the net liability.

The movement in the value of this liability is mainly reflected in the State's consolidated operating statement as "other economic flows – Actuarial gains on defined superannuation plans".

Financial assets at fair value

As at 30 June 2007, the State's other financial assets (comprising mainly shares, debt securities and derivative financial instruments) were valued at $29 230 million. Under the requirements of Australian accounting standards, a majority of financial assets must be shown at fair value[8].

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[6] The increase in this liability was offset by $954 million gain on financial instruments used by the SECV to minimise the financial impact of the onerous contract provision. The overall result was a gain of $162 million.

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

[8] Fair value is defined in AASB 132 *Financial Instruments: Presentation* as "the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's-length transaction.

As financial assets are sensitive to movements in the financial markets, substantial increases in the value of equities, combined with a higher government bond rate at 30 June 2007, resulted in significant unrealised gains on revaluation of financial assets of around $2 940 million.

Aluminium smelter electricity supply arrangements

As at 30 June 2007, the "Provision for onerous contracts – aluminium smelters" increased by $792 million on the previous year, resulting in the recognition of a loss in the operating statement. However, when the offsetting revaluation of financial instruments are taken into account, the overall impact was a net gain to the State of $162 million.

The provision represents obligations under low flexible tariff electricity arrangements entered into by the State in 1984 to attract investments in the Point Henry and Portland aluminium smelters. The tariff arrangements require the Government, through the SECV, to subsidise the lower electricity prices charged to the smelters. The SECV is responsible for the future liabilities arising from the tariff arrangements until the smelter contracts expire in 2014 (Point Henry) and 2016 (Portland).

The value of the SECV's obligations are assessed at the end of each financial year, taking 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. During 2006-07, electricity prices, which are a significant driver of the onerous contract balance, increased substantially by 313 per cent[9], resulting in a considerable increase in the State's liability for the aluminium smelter contracts and a loss to the State of $792 million as disclosed in the State's consolidated operating statement (as part of "other economic flows").

Included as part of the long-term onerous contracts are derivative financial instruments, which under Australian equivalents to International Financial Reporting Standards (A-IFRS), must be reported separately as financial assets and financial liabilities. The net asset value of these derivatives at 30 June 2007 was $1 336 million. Further, the SECV uses financial instruments to implement strategies which achieve a level of certainty for electricity costs. At 30 June 2007, these financial instruments were represented on the State's balance sheet by receivables of $25 million and payables of $99 million.

9 Electricity price drivers include the demand for energy and the cost of generating energy. Demand for electricity is impacted by a number of factors, including economic growth and the weather. In line with growth in the Victorian economy, the demand for and price of electricity increased in 2006-07. In addition, record high and low temperatures during 2006-07 increased demand for electricity due to the greater use of air conditioners in summer and heaters in winter. Another factor affecting the price of electricity is the drought and its impact on the cost of generating electricity. Power stations use high levels of water in the process of generating electricity and with water restrictions in force in Victoria, power stations have been forced to buy some water from other sources to maintain their capacity. This then increases the cost of generating electricity. Average electricity price increased from $35.77 per MWh in June 06 to $147.69 per MWh in June 07.

The SECV uses financial instruments in the course of its risk management activities to minimise the financial impact of the onerous contract provision. If we deduct the financial instruments held by SECV from the onerous contract provision, the net exposure to the State from the aluminium smelter electricity supply onerous contracts as at 30 June 2007 was $263 million. This is $162 million less than the exposure in 2005-06.

3.3.4 Assessment of significant events and other issues of interest

The State's and general government sector's operating result and financial position were impacted by a number of events which occurred during the year. 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.

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

In October 1995, the Government contracted CityLink Melbourne Limited (CML), a private sector consortium within the Transurban Group, to finance, construct and operate the Melbourne CityLink road network.

CML and the State entered into a concession deed requiring CML 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 2006, the State recognised $220 million as a non-current receivable, representing the present value of the concession notes issued to that date.

In the *Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2005-06*, we reported that in May 2006, the State and the Transurban Group 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 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.

On 25 July 2006, the Government and CML entered into the M1 Corridor Deed of Assignment, formalising the terms of the letter of intent. The financial transactions resulting from this assignment have been disclosed in the State's AFR at the present value of the estimated future payments to be made by CML in respect of the concession notes.

The estimated future payments are calculated based on a financial model of CML's future profitability levels and cash flows. The payments are then discounted using an interest rate implied in the estimated concession note redemption profile included in the M1 Corridor Deed of Assignment. The present value of the future payments has been calculated using a discount interest rate equivalent to the 3 year Commonwealth Government bond rate.

The financial transactions resulting from this assignment have been disclosed in the State's AFR as a present value receivable of $573 million and other liabilities of $317 million which represents future revenue for the State, which has not yet been earned. The difference between the CityLink receivable and the CityLink liability is revenue from the CityLink concession notes that has already been brought to account during 2006-07 and prior periods.

In addition, further revenue of $45.7 million was recognised in the State's operating statement relating to concession notes at 30 June 2007. This included $24 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 $21.7 million.

The financial effects of these events have been adequately disclosed in the AFR. We are currently examining the financial implications of the redemption of CityLink concession notes for the State. A report to Parliament will be made at a later date.

Buy back of the regional rail network from Pacific National Pty Ltd

Victoria's intrastate regional passenger and freight network consists of approximately 3 900 route kilometres. This includes broad and standard gauge track, sidings, marshalling yards and terminals. The network carries approximately 4 070 million gross tonne kilometres per annum: made up of passengers (23 per cent), grain (37 per cent) and other freight (40 per cent).

In July 1997, V/Line Freight Corporation (V/Line), the access provider for the rail network, and Victorian Rail Track Corporation (VicTrack), the owner of the rail infrastructure, were formed into government corporations and separated from the Public Transport Corporation. In February 1999, Freight Victoria Ltd (owned by Rail America) paid the Government $72.9 million to acquire V/Line's business and $89.2 million for a 15-year infrastructure lease (with options for 2 further 15-year lease term extensions) to effectively take possession of the regional rail network and operate and maintain it. In August 2004, Pacific National Pty Ltd acquired Freight Victoria's business, including its plant and equipment and infrastructure lease.

In November 2006, the Government announced that, due to inadequate expenditure on track maintenance, the regional rail network had become rundown and that it would buy back the network to ensure that it was properly maintained in the future. In addition, the buy back would give the Government better access to the regional rail network to carry out major rail projects. In April 2007, the Government announced that it had agreed with Pacific National to buy back the intrastate regional rail network for $133.8 million.

VicTrack, V/Line and the Director of Public Transport entered into an Asset Sale and Surrender Agreement with Pacific National. The overall effect of the agreement was that Pacific National agreed to surrender its leases over the rail infrastructure and transfer its assets to VicTrack for a total consideration of $121.3 million, comprising a cash consideration of $99.2 million and assets previously contributed to Pacific National of $22.1 million. The sale was completed on 4 May 2007.

The specific obligations of the agreement require Pacific National to give up all of its rights to, and interest in, the infrastructure lease and plant and equipment, and transfer its plant and equipment to VicTrack. VicTrack is responsible for paying Pacific National for the surrender of the leases and the sale of the assets. V/Line is required to offer employment to former employees of Pacific National. In addition, the Director of Public Transport must arrange for spending $25 million on network maintenance in the period ending 1 November 2007.

When Freight Victoria entered into the infrastructure lease in 1999, it paid all of the lease payments up-front, thus the State recorded a liability for lease income that had not yet been earned. At 30 June 2007, $82.8 million of the liability for prepaid/unearned income for the infrastructure lease had not been brought to account. As part of the buy back this liability was forgiven. The impact on the State’s accounts is that the State’s operating revenue increased by the amount of the forgiven liability. However, this is offset by an operating grant of $82.8 million towards payment for the purchased assets resulting in no impact on the State’s operating statement.

The State will take on liabilities of Pacific National totalling $11.8 million which comprises employee entitlements.

The net assets from the buy back were brought to account in the balance sheet of the State (by VicTrack) at a value of $96 million, increasing the value of the State’s assets by this amount, and resulting in recognition of $10.9 million of goodwill. The regional rail operations were transferred to V/Line at no cost resulting in the write-off of the $10.9 million goodwill and reduction of the State’s operating result by this amount.

Southern Cross Station redevelopment

The redevelopment of Southern Cross Station (formerly Spencer Street Station) was undertaken by the State Government under the *Partnerships Victoria* public-private partnership (PPP) framework. Our previous reports to Parliament have commented on the costs and progress of the project, including claims lodged by the developer to recoup construction cost overruns[10].

In July 2002, the Southern Cross Station Authority entered into a Services and Development Agreement (SDA) with Civic Nexus Pty Ltd (the concessionaire). Under this agreement, the concessionaire was assigned responsibility to design and construct the redeveloped station and, upon completion, manage the operations of the station for a 30-year period.

Under the terms of the SDA, the State agreed to pay the concessionaire quarterly core service payments over the 30-year concession period, commencing upon completion and commissioning of the redeveloped station interchange facility. The core service payments are potentially subject to abatement if the concessionaire does not meet the service standards in the SDA. The core service payments comprise:

- a capital cost component to enable the concessionaire to repay development costs of the station
- operating cost and insurance cost components to enable the concessionaire to meet on going operating costs of the station.

In August 2002, the concessionaire engaged Leighton Contractors Pty Ltd (the developer) to complete the design and construction of the station. The redevelopment was scheduled to be completed by 27 April 2005, at which time the authority would handover management of the station's operations to the concessionaire.

Construction commenced in October 2002. The developer encountered unexpected delays and significant cost overruns, and it became apparent to the authority that the construction milestones would not be met. By late-2004, the developer had publicly announced a forecast loss on the redevelopment project of more than $110 million, and was beginning to make some significant claims primarily against the State and to a lesser extent against the concessionaire.

The State entered into negotiations with the concessionaire and developer, and the claims were settled on 31 July 2006, the same day the redevelopment was practically completed (15 months later than the original scheduled completion date). Upon completion of the construction, the authority recognised the value of the asset and the associated finance lease liability in its books.

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[10] *Report of the Auditor-General on the Finances of the State of Victoria – Part 7: 2001-02, 2003-04, 2004-05.*

As at 30 June 2007, the authority recognised:

- $534.3 million of buildings at valuation. This represented $359.2 million cost of construction, plus a revaluation increment of $184.6 million at year-end, less depreciation expense for the year[11]
- a $108 million increase in the value of land.

The authority also recognised the associated finance lease liability of $360.2 million at 30 June 2007, representing the net present value of the future quarterly payments that will be paid to the concessionaire for construction of the new building and $505 million (indexed nominal value) of operating lease commitments (being the operating and insurance cost components of core service payments payable to the concessionaire over the 30-year contract).

The above asset and liability balances have been recognised in the State's AFR in 2006-07, reflecting a net increase in assets of $174.1 million.

The redevelopment and ongoing management of Southern Cross Station, including the outcomes of the July 2006 global settlement agreement, will be the subject of a detailed report to Parliament expected to be tabled in November 2007.

[11] In accordance with FRD 103B, the buildings were revalued on the basis of fair value by the Valuer-General.

4 Major factors impacting financial reporting

At a glance

Background

The Australian Accounting Standards Board's (AASB's) recent work program for the public sector mainly involves the harmonisation of the Government Finance Statistics (GFS) 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.

Key findings

- The AASB approved a standard that integrates A-GAAP/GFS harmonisation requirements for both general government sectors and whole-of-governments. The standard will become applicable for annual reporting periods commencing on or after 1 July 2008.
- AASB 7 *Financial Instruments: Disclosures,* applicable to annual reporting periods commencing on or after 1 January 2007, may require agencies to implement new systems and processes in order to record data and ensure that there are effective internal controls over these systems and processes.

Key recommendation

4.1 That the additional disclosure obligations imposed by AASB 7 *Financial Instruments: Disclosures* operative for the 2007-08 financial year, are addressed by agencies as a priority well in advance of year-end.

4.1 Introduction

There have been substantial changes in accounting standards and financial reporting requirements for public sector agencies over recent years resulting from the implementation of Australian Equivalents to International Financial Reporting Standards (AIFRSs). Following from these changes, the International Accounting Standards Board (IASB) decided that no new accounting standards or major amendments to existing standards would be required to be applied until after 1 January 2009. The AASB has subsequently concentrated its focus on addressing several issues specific to public sector agencies.

The AASB's work program for the public sector mainly involves the harmonisation of the Government Finance Statistics (GFS) [1] 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.

4.2 Harmonisation of A-GAAP and GFS financial reporting requirements

The audited whole-of-government financial reports of Australian jurisdictions are currently prepared in accordance with Australian accounting standards based on A-GAAP. The GFS framework is used for the preparation of other financial reports, such as reporting on the general government sectors. The Victorian Government applies all relevant Australian accounting standards to prepare accrual-based, whole-of-government, general purpose financial statements which are audited, and uses GFS to prepare statements for the Uniform Presentation Framework (UPF). The UPF is used by all Australian jurisdictions to present financial information about each of the sectors of government in a consistent format. Under A-GAAP, reports are prepared from an accounting viewpoint, whereas under GFS, they are presented from an economic impact perspective. Accordingly, reports based on the different frameworks can give different perspectives of the financial position and performance of a jurisdiction.

[1] GFS is the reporting framework established by the International Monetary Fund to allow economic analysis of the public sector. In Australia, the *Australian Bureau of Statistics GFS Manual* is used.

In 2002, the Financial Reporting Council (FRC) issued the AASB with a strategic direction to harmonise the A-GAAP and GFS reporting frameworks as a matter of urgency. The objective of the harmonisation project was to develop an Australian accounting standard prescribing governments to produce single financial reports combining the current A-GAAP and GFS requirements into one report which can be audited. This would, thereby, enable comparisons between jurisdictions and between government outcomes and their relevant budget statements, and would reduce the confusion that can result from the publication of 2 different sets of financial statements. To achieve this direction, the AASB addressed the issues in 2 phases: initially addressing financial reporting by general government sector, and then secondly, addressing whole-of-government reporting.

The AASB recently considered and approved a standard that integrates GAAP/GFS harmonisation requirements for both GGSs and whole-of-governments, combining the requirements currently in AASB 1049 *Financial Reporting of General Government Sectors by Government*, the proposals in ED 155 *Financial Reporting by Whole of Governments* and its supplement and matters raised by respondents to ED 155. The AASB agreed that a single standard is preferable to 2 separate standards. The standard will become applicable for annual reporting periods commencing on or after 1 July 2008.

The main elements of the standard are:

- government must prepare a general purpose whole-of-government financial report that consolidates controlled agencies on a line-by-line basis
- where Australian accounting standards allow for optional treatments, only those treatments aligned with the *Australian Bureau of Statistics GFS manual* shall be applied
- information required by current accounting standards and the *GFS manual* will be required to be reported on the face of financial statements, such as:
  - the operating result and the “comprehensive result” will be reported on the face of the operating result, and income and expenses will be classified between transactions and other economic flows according to GFS principles
  - investing cash flows for policy purposes must be separately disclosed from investing cash flows for liquidity management purposes on the face of the cash flow statement
  - if key fiscal aggregates disclosed on the face of the statements are not consistent with the aggregates measured under the *GFS manual*, a reconciliation must be provided in the notes with an explanation of the differences
- additional specified disclosures and explanatory notes will be required
- disclosure of descriptions of the government's broad functions and the assets and expenses that can be reliably attributed to those functions
- disclosure of sector information and descriptions of each sector consistent with the GFS manual
- where published, whole-of-government budgeted information to be disclosed with explanations of major variances between budget and actual amounts.

4.3 Review of public sector accounting standards

In recent years, the AASB has adopted a policy of issuing "transaction-neutral topic-based" accounting standards with the objective of having one set of accounting standards for all agencies across all sectors, with some variation as to the application or requirements within these standards for not-for-profit agencies.

In addition to the current suite of A-IFRSs, Australian accounting 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. Each of these standards includes requirements addressing a number of different accounting and financial reporting matters. The 3 AAS standards contain “override provisions”, where if there is a conflict between the requirements of one of these standards and another Australian accounting standard, the requirements in AAS 27, 29 or 31 would prevail.

In line with its policy of developing one set of common accounting standards, the AASB decided to conduct a review of the 3 public sector standards AAS 27, 29 and 31, with the objectives of:

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

The AASB's short-term objective is to relocate the requirements from AAS 27, 29 and 31 into existing or new transaction-neutral topic-based standards. Once this is complete, the AASB will continue with its longer-term objective of improving each topic-based standard as determined necessary. The AASB has developed a policy paper which outlines the principles, actions and the timetable for its review of these standards, and has continually updated this paper throughout the review process.

As a result of the AASB's short-term review, exposure draft ED 156 *Proposals Arising from the Short-Term Review of the Requirements in AAS 27, AAS 29, and AAS 31* was released for comment in June 2007.

The key changes that would result from the AASB's proposals contained within ED 156 are:

- amendments to some existing AASB accounting standards to incorporate requirements of the 3 AASs into AASB 3 *Business Combinations*, AASB 116 *Property, Plant and Equipment,* AASB 127 *Consolidated and Separate Financial* Statements, AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* and AASB 1004 *Contributions*

- creation of new topic-based AASB accounting standards to prescribe accounting treatment for issues that are currently only addressed by the 3 AAS standards. This will include standards for administered items, disaggregated disclosures and transitional requirements for local governments, government departments and government relating to land under roads
- some requirements/guidance contained within the 3 AAS standards will no longer be addressed in any standards due to either not being mandated or not providing relevant information for users. This includes requirements relating to:
  - budget reporting (paragraph 26 of AAS 27)
  - cash flows from government-controlled financial institutions (paragraphs 15.11 and 15.11.1 of AAS 31)
  - frequency, availability and timeliness of general purpose financial reports (paragraphs 100-103 of AAS 27, 13.1–13.1.2 of AAS 29, and 18.1 of AAS 31)
  - performance indicators (paragraphs 98-99 of AAS 27, 12.10-12.10.1 of AAS 29, and section 16 of AAS 31)
- consequential amendments to standards to remove references to the 3 AAS standards.

The exposure draft was closed for comment early in September 2007, and the AASB plans for the new and amended standards to take effect for annual reporting periods beginning on or after 1 July 2008.

4.4 Other major developments

Summarised below are the other major developments in the financial reporting framework that may impact on future reporting periods.

4.4.1 Financial instrument disclosures

Australian accounting standard AASB 7 *Financial Instruments: Disclosures* is applicable to annual reporting periods beginning on or after 1 January 2007. The new standard supersedes the disclosure requirements currently located in accounting standards AASB 130 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* and AASB 132 *Financial Instruments: Presentation*. AASB 7 requires agencies to make up to 70 additional disclosures relating to financial instruments, the extent of disclosures required by each agency depending on the extent an agency uses financial instruments and the level of risks it is exposed to.

The main requirements prescribed by AASB 7 are that agencies must:

- disclose the significance/impact of financial instruments on their financial position and performance
- disclose both qualitative and quantitative information about their exposure to risks arising from the financial instruments, including minimum disclosures for:
  - credit risk - including maximum exposure and age analysis
  - liquidity risk - maturity analysis for financial liabilities

    - market risk - including a sensitivity analysis for each type of market risk and how profit/loss and equity would have been affected by reasonably possible changes in the relevant risk variable
- describe management's objectives, policies and processes for managing these risks
- quantify the extent of risk that the agency is exposed to, based on information used by management to measure and manage risk.

The most significant implication of AASB 7 for individual agencies is that they may need to implement new systems and processes in order to record data and ensure that there are effective internal controls over these systems and processes.

Initial implementation of this standard will require:

- agencies to begin the process of collecting disclosure information required for the comparative year
- agencies to assess the appropriateness of their current reporting systems with reference to the required disclosure information. Agencies should consider whether there is a need for enhanced or replacement reporting systems and processes to accurately and efficiently record the data required for some of the more complex AASB 7 disclosures
- key management to develop a communications plan that clearly articulates their strategy for holding financial instruments and how the associated risks for these financial instruments are managed and mitigated.

Timely attention to these new requirements is necessary to avoid delays in the provision of complete financial statements draft by the deadlines set by DTF in 2007-08. Delays for individual agencies could in turn delay the AFR consolidation process.

Recommendation

4.1 That the additional disclosure obligations imposed by AASB 7 *Financial Instruments: Disclosures* operative for the 2007-08 financial year, are addressed by agencies as a priority well in advance of year-end.

4.4.2 Development of public sector conceptual framework

In July 2006, the International Public Sector Accounting Standards Board (IPSASB) and a number of national standard-setting bodies decided to commence a collaborative project to develop a public sector conceptual framework. The current IASB conceptual framework in place does not address the needs of public sector agencies adequately. The objective of the project is to develop a Public Sector Conceptual Framework which is applicable to the preparation and presentation of general purpose financial reports of public sector agencies.

It is intended for the Public Sector Conceptual Framework to have similar authority to the IASB Conceptual Framework. The project brief was issued in December 2006 and it is planned for the final framework document to be issued in 2012.

4.4.3 Proposed differential reporting by small and medium-sized agencies

The International Accounting Standards Board (IASB) released an exposure draft for a proposed standard containing differential reporting requirements for small and medium-sized entities (SMEs) in February 2007. The aim of the proposed standard is to reduce the reporting burden for SMEs.

The IASB defines an SME to be an agency that publishes general purpose financial statements for external users, and does not have public accountability. Under this definition, all Australian public sector agencies and most not-for-profit agencies would not meet the definition of SMEs because of their public accountability.

As a result, the AASB issued an Invitation to Comment (ITC 12) in May 2007 requesting feedback from Australian stakeholders on a proposed revised differential reporting regime for Australia. Under the proposed regime, the following agencies would be able to prepare general purpose financial reports under the SME accounting standard:

- for-profit agencies that are not considered publicly accountable under the IASB definition or are important from a public interest perspective, based on nominated size thresholds
- not-for-profit agencies that fall below nominated size thresholds
- public sector agencies that fall below nominated size thresholds.

In addition, the AASB has proposed that all financial reports on a public register or made available to the public would be regarded as general purpose financial reports, rather than focusing on whether an agency meets the definition of a reporting agency.

The potential implications for most SMEs would be simpler measurement rules and significantly reduced disclosure requirements. However, some agencies will have more onerous reporting obligations than they are currently subject to.

The AASB's proposed size criteria for determining whether an agency can apply the SME accounting standard is if an agency's consolidated revenue is less than $25 million and its consolidated assets are less than $12.5 million.

The AASB's Invitation to Comment closed for comment on 1 September 2007 to enable the AASB time to formulate a response to the IASB's exposure draft by the closing date of 1 October 2007.

The implications of the proposed SME accounting standard from a whole-of-government perspective has added complexities in consolidating SME and non-SME agencies together that use different accounting policies, measurement bases and provide different levels of disclosures.

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New Ticketing System Tender (2007-08:4)	October 2007
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