Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2007-08

Victorian Auditor-General's Report November 2008 2008-09:11

VICTORIA

Victorian
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Ordered to be printed

VICTORIAN
GOVERNMENT PRINTER
November 2008

PP No 150, Session 2006-08

ISBN 1 921060 89 1

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, 2007–08.*

Yours faithfully

D D R PEARSON
Auditor-General

13 November 2008

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1 Executive summary

1.1 Introduction

The Annual Financial Report (AFR) is incorporated into the *Financial Report for the State of Victoria 2007–08* (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 by the Treasurer and the Minister for Finance, WorkCover and the Transport Accident Commission. Chapters 1 to 3 of the Financial Report, which are not subject to audit, provide analysis and discussion.

The Auditor-General is required under Section 9A of the *Audit Act 1994*, to express an opinion on the AFR of the State of Victoria and by Section 16A to report to Parliament on the audit of the AFR.

This report:

- sets out the results of the audit of the AFR
- discusses the financial performance and the financial position of the state and highlights some challenges to the state's long term ability to sustain operations and respond to changing community requirements
- outlines changes to the financial reporting framework implemented in 2007–08 and required to be implemented in future years.

The total cost of preparing and printing this report was $170 000.

1.2 Results of audit

An unqualified audit opinion on the 2007–08 AFR was issued on 24 September 2008, the earliest timeframe achieved since the inception of the AFR. The audited AFR was tabled in Parliament on 14 October 2008.

While an unqualified audit opinion was provided, audit noted the opportunity for entities and the Department of Treasury and Finance (DTF) to improve the quality of data submitted by entities for consolidation into the AFR. Twenty-eight (60 per cent) material entities did not undertake appropriate quality assurance processes to ensure that data submitted to DTF agreed with their audited financial statements. In addition, DTF's quality assurance processes did not detect material variances between financial instrument note disclosures and financial instrument balances reported in the draft balance sheet. These variances were addressed during the audit process.

1.3 The state's financial result

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

1.3.1 2007–08 financial performance

The AFR reports a negative net result for the state and the general government sector (GGS) for 2007–08. The state achieved a negative net result (including transactions and economic flows) of $3 107 million in 2007–08 (surplus of $7 668 million, 2006–07), while the GGS achieved a negative net result (including transactions and economic flows) of $1 876 million in the year (surplus of $5 307 million, 2006–07).

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

- $1 452 million in losses, comprising realised losses of $379 million and unrealised losses of $1 073 million, due to the decreased value of financial instruments, reflecting the weaker performance of financial and equity markets
- an increase of $3 044 million in the state's superannuation liability due to the decreased value of superannuation plan assets, also reflecting the weaker performance of financial and equity markets.

In its assessment of its financial performance the government excludes the results of the economic flows and considers the net result from transactions to be the most robust measure of the government's financial management as this can be directly attributed to government policy. The net result from transactions for the state was a surplus of $1 452 million in 2007–08 ($1 217 million, 2006–07), while the GGS net result from transactions was a surplus of $1 482 million in 2007–08 ($1 335 million, 2006–07). This reflects a strong operating performance for the year.

1.3.2 Financial position of the state

During 2007–08, the state's net assets grew by $5 323 million to $91 650 million, while the GGS's net asset position increased by $1 903 million to $45 569 million. The growth in assets has been largely driven by an increase in the value of property, plant and equipment from asset acquisitions ($5 631 million) and revaluations ($8 425 million). The overall level of state liabilities increased by $4 978 million in the year, mainly as a result of increases in superannuation liabilities ($3 044 million) and interest bearing liabilities ($1 783 million).

The state's recent past and current surpluses from transactions indicate continued sustainability.

Both the state and the GGS net results from transactions are again in surplus, but there exists a current underlying tension that the slow-down in economic conditions now forecast may place income estimates at risk. This would inevitably put pressure on the result from transactions. For example, the recent growth in wages brought about by increases in service delivery and related public sector employees and wage bargaining outcomes will be difficult to reverse in the short to medium term, particularly as demand for services has a direct correlation with population growth.

When looking at the 'bottom line' by taking into account other economic flows, the significant deficit in the 2007–08 net result clearly demonstrates the state's exposure to financial markets and economic conditions outside its control. These factors can put at risk longer-term financial sustainability and will need to continue to be monitored closely, to ensure that current income and expenditure policy settings remain sustainable.

In Chapter 3 we draw attention to three significant elements affecting the state's financial condition that the state needs to continue to manage for continued sustainability:

- employee costs
- infrastructure renewal
- state liabilities.

1.4 Financial reporting framework and issues in financial reporting

During 2007–08, entities were required to comply with the following changes to the financial reporting framework which were applicable for the first time:

- AASB 7 *Financial Instruments: Disclosures*
- Financial Reporting Direction (FRD) 103C *Non-Current Physical Assets.*

Commentary on the state's implementation of these new reporting requirements and their impacts on the state's financial performance and position is provided in Chapter 4.

The AFR for 2007–08 will be the last prior to the adoption of AASB *1049 Whole of Government and General Government Sector Financial Reporting*. Accordingly, the preparation of the 2008–09 AFR will require compliance, in certain instances with the Australian Bureau of Statistics Government Finance Statistics (ABS GFS) manual, where it does not conflict with A–GAAP. Commentary on the state's preparedness to apply the AASB 1049 standard and implications arising from its adoption is provided in Chapter 4.

Commentary is also provided on the impacts of other changes on the financial reporting framework for future years AFR in Chapter 4.

1.5 Recommendations

- DTF should in consultation with material entities establish an agreed timetable by March each year and improve their quality assurance processes over data provided by entities **(Recommendation 2.1)**.
- Material entities should allocate sufficient resources to achieve the AFR timetable and develop adequate contingency plans to address possible complications to their processes in providing data for the AFR. **(Recommendation 2.2)**.
- DTF should act to amend FRD 103C *Non-Current Physical Assets* to incorporate the measurement of all relevant assets at fair value for reporting periods commencing on or after 1 July 2008 and further expedite processes for fair valuing infrastructure assets and include early consultation with external audit **(Recommendation 4.1)**.

RESPONSE provided by Treasurer

I welcome the Auditor-General's report, which endorses the State's strong financial performance for 2007–08 and reaffirms the continuing strength of the State's financial condition.

The audit report acknowledges the significant achievement in 2007–08, of the earliest ever audit sign-off of the Financial Report for the State of Victoria (the AFR), but also notes scope for further improvement in the timeliness and quality of input to the AFR from public sector agencies. To this end, I confirm that the Department of Treasury and Finance (DTF) will continue to work closely with agencies to identify improvement opportunities, particularly focusing on the provision of timely advice on accounting policy and data submission requirements.

To ensure the production of continuing high quality Annual Financial Reports, DTF also has in place comprehensive quality assurance processes and seeks to refine these processes on an ongoing basis. The learnings from recent experiences, particularly in the context of new reporting requirements, are a key input to this continuous improvement process.

In relation to the new accounting requirement for 2008-09 to 'fair value' the State's infrastructure assets, DTF will continue to demonstrate strong leadership in facilitating whole-of-government compliance by actively engaging with all relevant agencies. The expectation is the issuing of a new Financial Reporting Direction later in the year, consistent with the requirements of this new accounting standard.

Finally, I would like to thank your audit team for conducting a highly professional and timely audit, which has added value to the quality of the AFR.

2 Results of audit

At a glance

Background

The *Financial Management Act 1994* requires a Victorian whole-of-government and general government sector (GGS) Annual Financial Report (AFR) audited by the Auditor-General, to be tabled in Parliament. The AFR is contained within the *Financial Report for the State of Victoria 2007–08* (the Financial Report), and is a key constituent of the government's accountability 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 over 300 public sector entities, each of which is separately audited by the Auditor-General. Of these entities, 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 24 September 2008, the earliest timeframe achieved since the inception of the AFR, and tabled on 14 October 2008. In the prior year, an unqualified audit opinion was provided on 27 September 2007 and tabled on 10 October 2007
- Opportunities exist to improve the processes used for the preparation of the AFR
- Only 17 material entities (36 per cent) met the timeframe set by DTF for submission of their draft financial statements for audit
- Only 10 material entities (21 per cent) met the timeframe set by DTF for the certification of their financial statements.

At a glance – *continued*

Key recommendations

- DTF should:
  - in consultation with material entities establish an agreed timetable by March each year
  - improve their quality assurance processes over data provided by entities **(Recommendation 2.1)**.

- Material entities should:
  - allocate sufficient resources to achieve the AFR timetable
  - develop adequate contingency plans to address possible complications to their processes in providing data for the AFR **(Recommendation 2.2)**.

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 AFR.

This chapter presents the results of the audit of the AFR.

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 consolidated financial statements for the state and the GGS to be prepared annually, audited by the Auditor-General, and tabled in Parliament by 15 October each year.

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 the *Financial Report for the State of Victoria 2007–08* (the Financial Report).

DTF prepare the AFR in accordance with the requirements of the FMA and Australian accounting standards, primarily Australian Accounting Standard *AAS 31 Financial Reporting by Governments*[1].

The accounting standards deem the AFR to be a consolidated general purpose financial report of the Victorian Government. Government departments, state-owned enterprises and other entities controlled by the state are, therefore, included in the AFR. Under these standards, the AFR does not include entities such as local government, superannuation funds, universities and denominational hospitals.

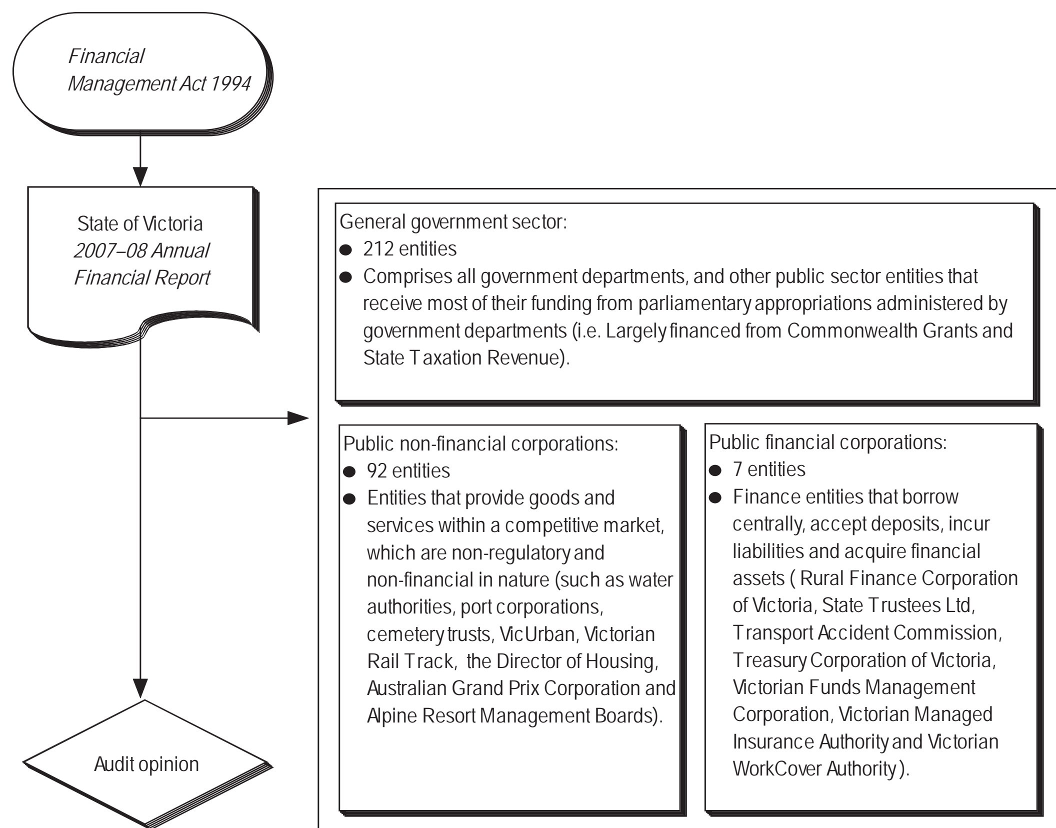
Australian Accounting Standard *AAS 31 Financial Reporting by Governments* requires disaggregation of the consolidated financial result and balances into three sectors of government:

- general government sector (GGS)
- public non-financial corporations (PNFC)
- public financial corporations (PFC).

[1] AAS 31 has been withdrawn for reporting periods commencing on or after 1 July 2008. The 2007–08 AFR is the last prepared under the requirements of AAS 31, with future years AFR to be prepared in accordance with *AASB 1049 Whole of Government and General Government Sector Financial Reporting.*

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

Figure 2A
Entities included in the 2007–08 AFR



Source: Victorian Auditor-General's Office.

2.3 Results of the audit of the 2007–08 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 that assists users of the AFR, by attesting to its accuracy and reliability.

An unqualified audit opinion on the 2007–08 AFR was issued on 24 September 2008, the earliest timeframe achieved since the inception of the AFR, and included in Chapter 4 of the Financial Report that was tabled in Parliament on 14 October 2008. In the prior year, an unqualified audit opinion on the AFR was issued on 27 September 2007 that was tabled on 10 October 2007.

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

2.4 Preparation of the AFR

DTF is responsible for preparing the AFR. It has consolidated the financial results of over 300 public sector entities controlled by the state in terms of Australian accounting standards. Note 39 to the AFR lists all controlled public sector entities included in the AFR. Forty-seven of these entities are designated as material because collectively, they comprise more than 90 per cent of the state's assets, liabilities, revenue and expenditure.

To complete the AFR, all public sector entities are required to transmit financial data, based upon their audited financial statements, via electronic data feeds into DTF's Business Management System (BMS) in accordance with the AFR timetable. These data feeds are subsequently verified by audit with reference to the entities' audited financial statements.

2.4.1 Quality of draft financial statements

Material error was identified by audit in the draft disclosure notes to the financial statements for financial instruments and commitments. The amounts disclosed in the draft AFR did not agree to the audited balances included in individual entities financial statements. This was compounded by twenty-eight (60 per cent) of the material entities not undertaking appropriate quality assurance processes, resulting in inaccurate data being submitted to DTF. Further, DTF's quality assurance processes over the draft AFR did not detect material variances between new financial instrument note disclosures and financial instrument values reported in the AFR, however these were corrected in the final AFR.

2.4.2 Timeliness of AFR preparation

The timely preparation and audit of the AFR depends on public sector entities achieving the AFR preparation timetable.

While the AFR was able to be certified and the audit finalised three days earlier than last year, a small number of material entities and DTF did not achieve key interim milestones included in the AFR timetable. This increases the risk of material error in the financial statements as their preparation and the audit process are compressed to achieve the statutory reporting date of 15 October for the tabling of the Financial Report in Parliament.

While audit acknowledges that DTF's preliminary timetable of key dates (on a rolling 12 month basis) was published on its website in December 2007, and distributed and discussed with all departmental chief financial officers and senior budget management staff at that time, DTF did not communicate the final AFR timetable to the entities required to provide consolidation data until May 2008.

2.4.3 Timeliness of material entity financial statements

The FMA requires public sector entities to have their financial statements completed and ready for audit within eight weeks of balance date each year. The *Audit Act 1994* requires the Auditor-General to express an opinion within four 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.

Those entities designated as material are required by DTF to prepare financial statements earlier than the legislated timeframes so as to enable timely transmission of audited data feeds to DTF for preparation of the AFR. In 2007–08, entities were required to provide:

- complete draft financial statements for audit by 25 July 2008 (25 July in 2007)
- audited financial data to DTF by 14 August 2008 for GGS entities and 18 August 2008 for PNFC's and PFC's (16 August in 2007).

Of the 47 material entities, only 17 (36 per cent) provided complete draft financial statements for audit by 25 July, an improvement compared with 10 entities (21 per cent) that met this requirement in 2006–07.

Of the 47 material entities, only 10 entities (21 per cent) had audited financial statements completed by 14 August, compared with 2 entities (4 per cent) in the previous year. The majority of material entities were unable to provide audited data to DTF in a timely manner in accordance with the DTF initiated arrangements.

While an improvement on last year, the timeliness results continue to be disappointing. There is a need for material entities to improve their planning and preparation for this annual financial reporting process. This is a pre–requisite to the timelines established between DTF and material entities being adhered to.

Recommendations

2.1 DTF should:

- in consultation with material entities establish an agreed timetable by March each year
- improve their quality assurance processes over data provided by entities.

2.2 Material entities should:

- allocate sufficient resources to achieve the AFR timetable
- develop adequate contingency plans to address possible complications to their processes in providing data for the AFR.

RESPONSE provided by Treasurer

Please refer to the detailed response contained in the 'Executive Summary' section of this report.

3 The state's financial result

At a glance

Background

The Annual Financial Report provides information on the financial performance for the year and the financial position at the end of the year, for the State of Victoria and for the general government sector (GGS).

This chapter provides analysis on the financial results for the state and the GGS. It identifies a set of challenges to the state's long term ability to sustain operations and respond to changing community requirements.

Key findings

- In past years, strong economic growth at both state and national levels resulted in larger than anticipated net results for the state. However, in 2007–08 the net result (including transactions and economic flows) was negative $3 107 million (surplus $7 668 million, 2006–07) largely reflecting revaluation losses recognised in relation to the state's defined benefit superannuation plans and similar losses on financial instruments resulting from financial market conditions.
- The net result from transactions for the state was a surplus of $1 452 million in 2007–08 ($1 217 million, 2006–07), while the GGS net result from transactions was a surplus of $1 482 million in 2007–08 ($1 335 million, 2006–07). This reflects a strong operating performance for the year.
- A significant challenge for the state is both to maintain existing infrastructure, and to provide for the new infrastructure required to meet the state's social, economic and environmental objectives.
- Financial market volatility is and will continue to be a significant challenge for the state, impacting on the net result.

3.1 Introduction

To assist readers to make assessments about the state's financial performance and position, we:

- provide an overview of the state's financial results for the period 2004–05 to 2007–08[1]
- provide an overview of selected general government sector (GGS) results for the period 2004–05 to 2007–08
- highlight financial management challenges faced by the state.

3.2 Financial results

Every year the State of Victoria tables two key financial documents – the Statement of Finances[2] and the Annual Financial Report[3] (AFR).

The Statement of Finances includes the state's estimated financial statements for the GGS.

The AFR details the Victorian Government's cost of operations, income, impacts of market re-measurement on the value of assets and liabilities, the value of what it owns and what it owes. In the AFR, the government provides this information for the State of Victoria and the GGS.

3.2.1 Financial performance

Two key measures of financial performance and sustainability are provided in the AFR, namely, the net result from transactions and the net result. Net result from transactions is income less expenditures that can be directly attributed to government policy. The net result is derived by adding the net result from transactions to the total of other economic flows. Other economic flows represent changes in the values of assets and liabilities due to market re-measurements such as actuarial gains and losses that primarily reflect the movement in the state's superannuation liability that is not directly attributable to government policy.

Net result

Figure 3A shows the net results for the state and the GGS (including transactions and economic flows) for the last four financial years.

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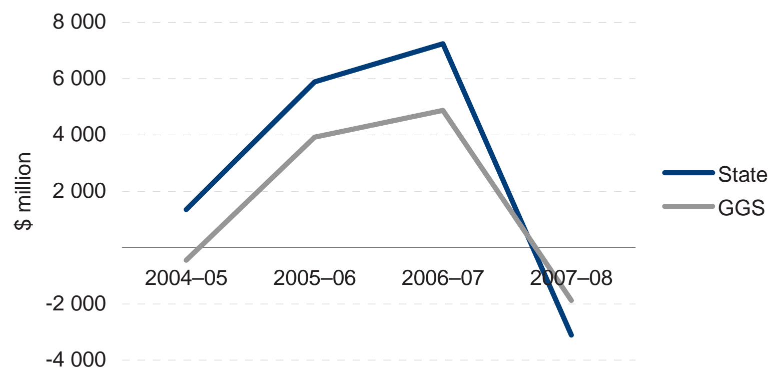
[1] Audit analysis covers the 4 year period 2004–05 to 2007–08 and is based on reported balances prepared under Australian Equivalents to International Financial reporting Standards (A–IFRS). Prior to this period, balances were determined on the then existing Australian Generally Accepted Accounting Principles (A–GAAP) reporting frameworks.

[2] Statement of Finances (incorporating Quarterly Financial Report No. 3) Budget Paper No. 4.

[3] Annual Financial Report (incorporating Quarterly Financial Report No 4).

Figure 3A
Net results—State of Victoria and general government sector



Source: Victorian Auditor-General's Office.

The 2007–08 net result of the state (including transactions and economic flows) was negative $3 107 million (surplus $7 668 million, 2006–07). For the GGS, the net result was negative $1 876 million (surplus $5 307 million, 2006–07). The negative result is primarily attributed to the actuarial losses of the state's defined benefit superannuation plans of $3 398 million[4], and losses on financial instruments measured at fair value totalling $1 452 million, comprising realised losses of $379 million and unrealised losses of $1 073 million. These losses are a direct result of the decline in asset values in the financial markets.

Each year, an actuarial gain or loss on the state's superannuation liability is recognised in the net result to reflect the impact of variations between assumptions and actual experience as well as the impact of changes in assumptions. Apart from the impact of investment returns, a small change in key assumptions can cause large variations in the liability and associated actuarial gain or loss. For example, a 0.01 per cent change in the Commonwealth Government Bond rate (which underpins the discount rate that is used to value the superannuation liability) is estimated to change the value of the superannuation liability by approximately $30 million. Such a movement also gives rise to an actuarial gain or loss of the same amount. As illustrated above, actuarial gains and losses on superannuation can have a significant impact on the net result.

Under the requirements of Australian accounting standards, the state's equities and managed investments, debt securities and derivative financial instruments have to be re-measured at fair value each balance date. The revaluation is shown as a gain or loss on revaluation of financial assets. While the Victorian Government benefited from a strong economy during 2005–06 and 2006–07, the downturn in financial markets in 2007–08 has resulted in a $1 452 million fair value loss this year.

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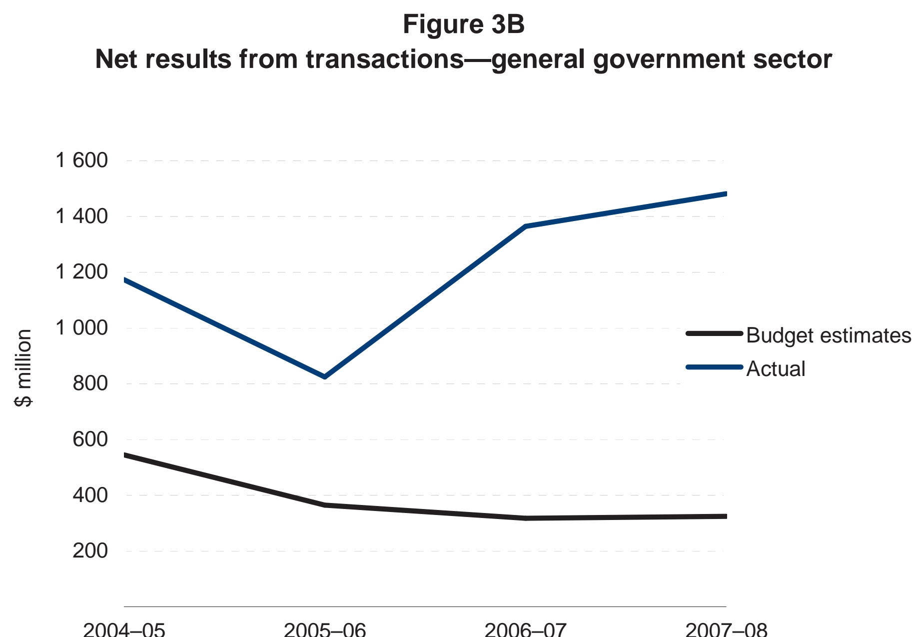
[4] The actuarial loss includes the impact of lower than expected returns on superannuation plan assets of $2 987 million.

Net result from transactions

Figure 3B shows the GGS net result from transactions in comparison with the original budget estimates for the last four financial years.

Figure 3B
Net results from transactions—general government sector



Source: Victorian Auditor-General's Office.

The net result from transactions is the government's key measure of short-term financial performance. The operating statement for 2007–08 shows that the consolidated net result from transactions for the state was a surplus of $1 452 million ($1 217 million, 2006–07). The net result from transactions for the GGS was a surplus of $1 482 million compared to the original budgeted net result from transactions of $324 million ($1 335 million, 2006–07 compared to the original budget of $317 million). This reflects a strong operating performance for the year. Precision in estimating the budget is difficult given the inherent uncertainties in determining budgets and the nature of estimations. The final outcomes also reflect the impact of new policy decisions by government since the budget.

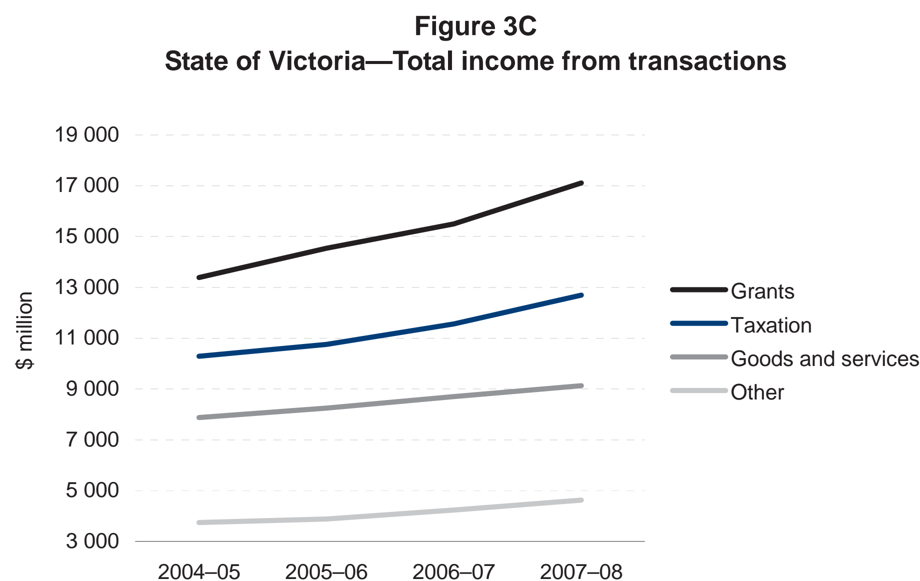
The government had a key financial objective for 2007–08 to achieve a net result from transactions of at least $100 million for the GGS. This objective was achieved in 2007–08. From 2008–09 the government has set a target of maintaining a substantial net result from transactions for the budget sector of at least one per cent of income in each year.

Income

Commonwealth grants and state taxation are the primary sources of income for the state. Total income has risen from $35 296 million in 2004–05 to $43 555 million in 2007–08, an increase of 23 per cent. Income growth in recent years primarily reflects a combination of higher levels of funding from the Commonwealth and strong economic growth resulting in increased levels of income from taxation.

Figure 3C shows the major sources of income for the state for the last four financial years.

Figure 3C
State of Victoria—Total income from transactions



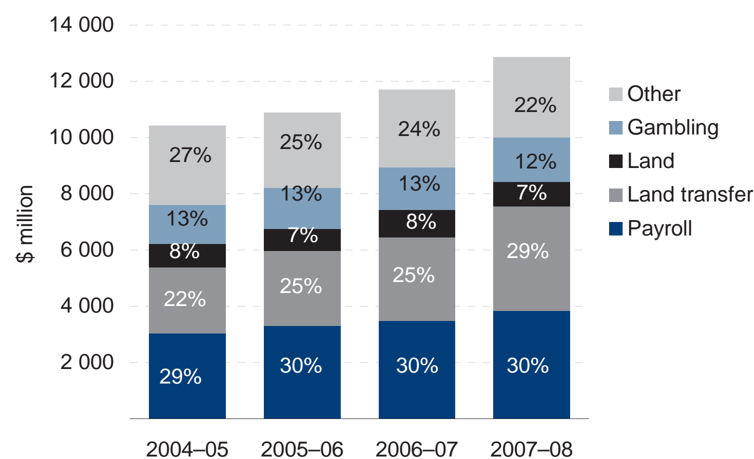
Source: Victorian Auditor-General's Office.

Commonwealth grants have increased by 28 per cent, from $13 394 million in 2004–05 to $17 109 million in 2007–08. In 2007–08, grant income represented 39 per cent of the state's total income from transactions. The state is highly dependent on Commonwealth funding which comprises GST income and specific purpose payments from the Commonwealth. The performance of the national economy, individual state economies and policy decisions of the Commonwealth Government can impact on the level of funding provided to the state. The recent downturn in financial markets is now expected to be accompanied by slower economic growth. This will most likely reduce GST income transferred as grants to the state, although the outcome will also depend on developments in price inflation, movements in Commonwealth Grants Commission relativities and other factors.

Taxation income reported for the state is derived from taxation reported for the GGS less taxes paid by state government entities (including payroll tax) that are eliminated upon consolidation. In 2004–05, the GGS earned taxation income of $10 415 million, increasing by 24 per cent to $12 863 million in 2007–08.

The major sources of taxation income are payroll tax, land transfer duty and gambling tax. Figure 3D provides a breakdown of the components of taxation income for the last four financial years.

Figure 3D
Taxation Income—general government sector



Source: Victorian Auditor-General's Office.

While total taxation receipts each year have grown, and are estimated by the state to continue growing, the state’s relative dependency on any one source of taxation remains largely unchanged.

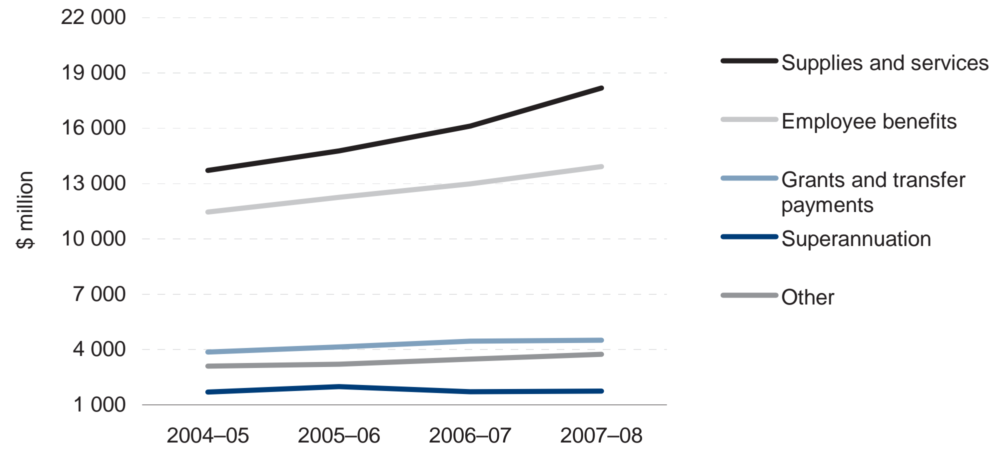
Taxation income as a share of nominal Gross State Product (GSP) was 4.84 per cent in 2007–08. During the period from 2004–05 to 2007–08, taxation income has ranged between 4.61 per cent and 4.84 per cent of nominal GSP.

The state’s estimates for taxation income for the period 2008–09 to 2011–12 are based on real economic growth forecasts of 3 per cent and inflation forecasts of 3 per cent in 2008–09 declining to 2.5 per cent by 2011–12. The flow-on effect to the Victorian economy of the recent severe downturn in financial markets has created greater uncertainty about these growth and inflation forecasts. These would be subject to review as part of the annual mid–year budget update process.

Expenditure

Total expenditure for the state rose from $33 817 million in 2004–05 to $42 103 million in 2007–08, an increase of 25 per cent. This reflects increased levels of service provision and the impact of inflation on expenditure. Figure 3E shows the major types of expenditure for the state for the last four financial years. Employee benefits and payments for supplies and services are the primary costs incurred by the state, together making up around 76 per cent of total expenditure in 2007–08.

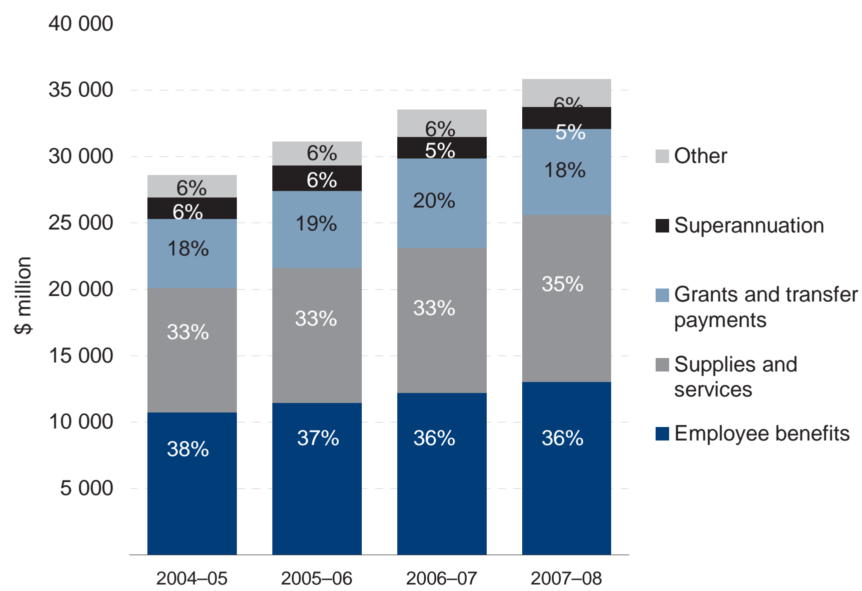
Figure 3E
Total expenses from transactions—State of Victoria



Source: Victorian Auditor-General's Office.

Figure 3F provides a breakdown of the GGS expenditure for the last four financial years.

Figure 3F
Total expenses from transactions—general government sector



Source: Victorian Auditor-General's Office.

Employee costs

The state's total employee costs (excluding superannuation expenses) have increased from $11 449 million in 2004–05 to $13 927 million this year, an average annual increase of around 6.8 per cent for the period 2004–05 to 2007–08.

In 2007–08 the GGS employee costs, have increased from $12 187 million to $13 034 million, an increase of 7 per cent from the prior year. This is slightly above the average increases experienced in the period 2004–05 to 2007–08. Employee costs are estimated to reach $16 845 million (40 per cent of total expenditure) by 2011–12.

Increased employee costs from 2006–07 to 2007–08 are primarily attributed to:

- an increased public sector workforce: analysis of the material entities, which comprise 85 per cent of the employee costs for the state, shows that employee numbers, measured in terms of full-time equivalents (FTE) for these entities grew by 2.3 per cent from 134 700 last year to 137 800 this year
- increased average wages: average employment costs per FTE increased by 3.57 per cent. This increase is in line with Victoria's wage growth of 3.8 per cent.

3.3 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 that are not reflected in the consolidated balance sheet.

Notwithstanding the investment losses for the year, revaluation of assets have improved the state's net asset position by $5 323 million to $91 650 million ($86 327 million, 2006–07).

Commentary is provided in this section on two significant aspects of the state's financial position, namely, infrastructure renewal and state financial liabilities.

3.3.1 Infrastructure renewal

The state's public infrastructure, primarily road and intrastate rail networks, ports and water assets was valued at $25.6 billion at 30 June 2008[5]. It grew by just over $2.0 billion (8.5 per cent) from 2006–07 to 2007–08. Much of this growth related to new assets such as the Pakenham and Dandenong bypasses; the channel deepening project; and various water projects, including the Goldfields super pipe; as well as the replacement or renewal of existing assets. A further portion of this growth is also attributable to the revaluation of road assets.

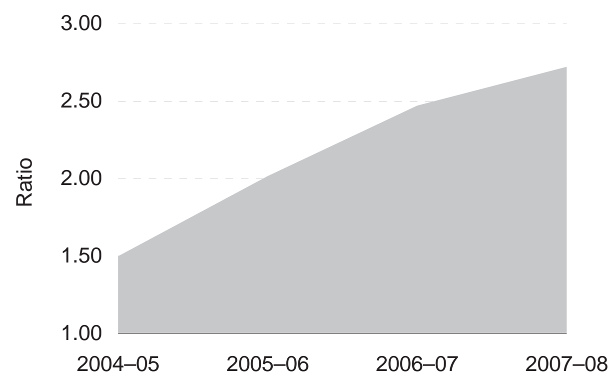
[5] This excludes infrastructure subject to certain public private partnership (service concession) arrangements such as Citylink and Eastlink.

A significant challenge for the state is to maintain existing infrastructure and to provide for the new infrastructure required to achieve the state's social, economic and environmental objectives.

One measure of the state's financial performance in relation to infrastructure maintenance is the difference between the rate at which existing infrastructure is being used up and the rate at which it is being replaced. Financially, this can be measured by comparing the annual depreciation charge on these assets with the amount spent investing in their renewal. A renewal ratio higher than 1:1 would indicate that infrastructure expenditure exceeds depreciation.

Figure 3G shows the results calculated for infrastructure replacement for the financial periods 2004–05 to 2007–08.

Figure 3G
Infrastructure replacement analysis



Source: Victorian Auditor-General's Office.

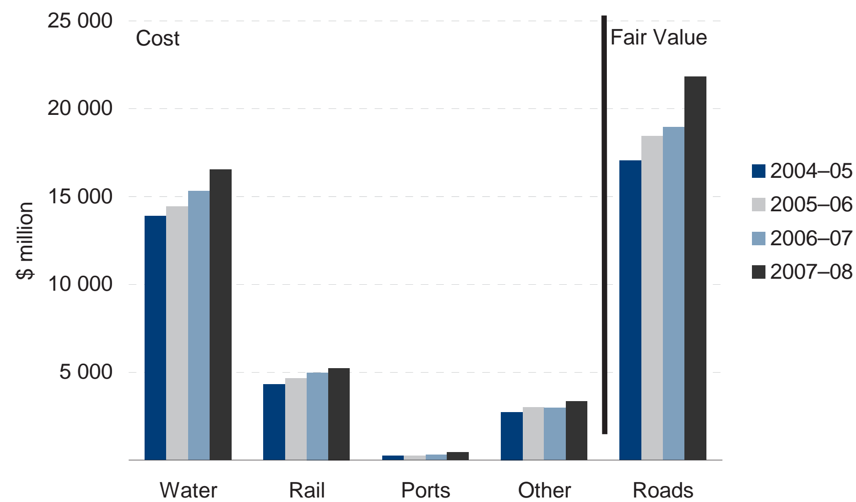
Based on reported balances the infrastructure replacement ratio for the state increased from 1.5:1 in 2004–05 to 2.7:1 in 2007–08. This indicates prima facie that the state is investing in infrastructure at a rate faster than its service potential is being consumed.

However, caution is required in interpreting these results for two reasons:

- most infrastructure assets are currently recorded at their historic cost rather than fair value, thus producing a lower annual depreciation expense
- annual expenditure on infrastructure includes both upgrade of existing assets and acquisition of new assets. Therefore, it is not clear to what extent asset upgrades alone are keeping pace with consumption (depreciation expense) of those assets.

To better understand the results, Figure 3H shows the current recorded values for road networks, earthworks, infrastructure systems, plant and equipment controlled by the state for the financial periods 2004–05 to 2007–08.

Figure 3H
Property, plant and vehicles, and infrastructure systems by type



Source: Victorian Auditor-General's Office.

Presently only the state's road network assets (not including land under roads) are recorded at fair value, determined by reference to the asset's depreciated replacement cost. All other major infrastructure, including water storage and supply systems, rail, ports and channels are recorded at cost[6]. The depreciation charge on these assets, which is currently reflected in the state's net result, is likely to be significantly less than it would be if the assets were recorded at fair value. Accordingly, the net result from transactions for the state would also be lower under this scenario.

AASB 1049 Whole of Government and General Government Sector Financial Reporting applicable for financial reporting periods commencing from 1 July 2008, requires that all infrastructure assets are recorded at fair value. The likely resulting higher depreciation charge will be a more relevant measure to use in the calculation of the replacement ratio.

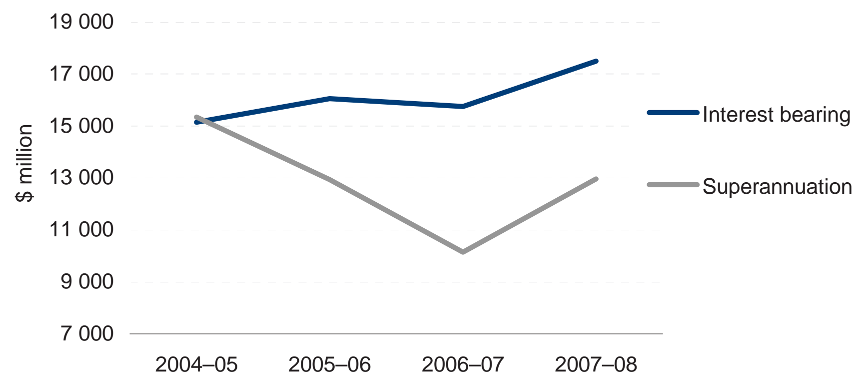
3.3.2 Financial liabilities

Interest bearing liabilities, provisions for insurance claims and the superannuation liability are the major obligations of the state. Total state liabilities increased from $53 614 million in 2004–05 to $58 109 million in 2007–08, an increase of $4 495 million (or 8 per cent) over the four year period.

Figure 3I shows the major liabilities for the state for the last four financial years.

[6] Current valuation at cost is appropriate and in accordance with Financial Reporting Direction FRD 103C *Non–Current Physical Assets*.

Figure 3I
Interest bearing and superannuation liability—State of Victoria



Source: Victorian Auditor-General's Office.

Interest bearing liabilities are the largest liability category of the state. The state's interest bearing liabilities were $17 490 million at 30 June 2008, compared with $15 752 million in the previous year. Interest bearing liabilities comprise public sector borrowings ($15 273 million) raised domestically and overseas through the Treasury Corporation of Victoria and finance leases ($2 217 million) entered into by public sector entities. Public sector borrowings predominately comprise domestic fixed rate instruments.

In 2007–08, the net increase in interest bearing liabilities contributed to:

- funding water infrastructure projects $811 million
- reducing the superannuation liability by $400 million
- maintaining working capital liquidity of $600 million
- funding the construction of the new Royal Women's Hospital – a finance lease of $249 million was recognised.

The state borrows either to finance gaps between expenditure and income (a deficit) or where accumulated surpluses are insufficient to fund the state's infrastructure program.

While the state projects surpluses for the GGS for the period 2008–09 to 2011–12, it also projects increased net debt. Net debt for the GGS is projected to increase from $2 182 million at 30 June 2008 to $9 465 million at 30 June 2012.

Gearing[7] is a key measure of the extent of the state's reliance on borrowings to fund asset acquisition and growth. A lower ratio indicates less reliance on debt to fund assets and lower exposure to rising finance costs associated with increased interest rates.

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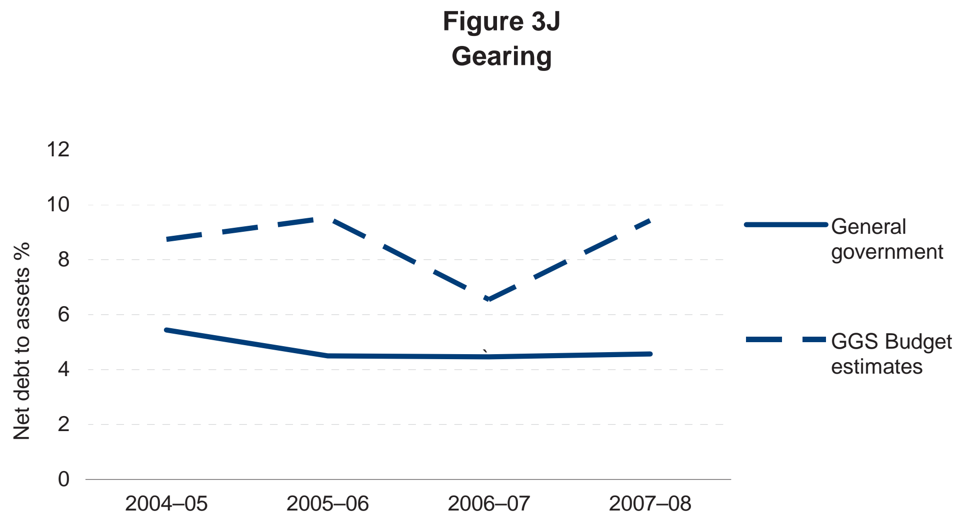
[7] The gearing ratio is calculated by net debt (interest bearing liabilities, advances received and deposits held less cash and cash equivalents, advances paid and other financial assets) over net assets.

Figure 3J shows the GGS's gearing ratio for the last four financial years.

In 2007–08, the gearing ratio for the GGS has moved slightly upwards, indicating that the state's debt levels have increased during the course of 2007–08 relative to the state's asset base.

Figure 3J
Gearing



Source: Victorian Auditor-General's Office.

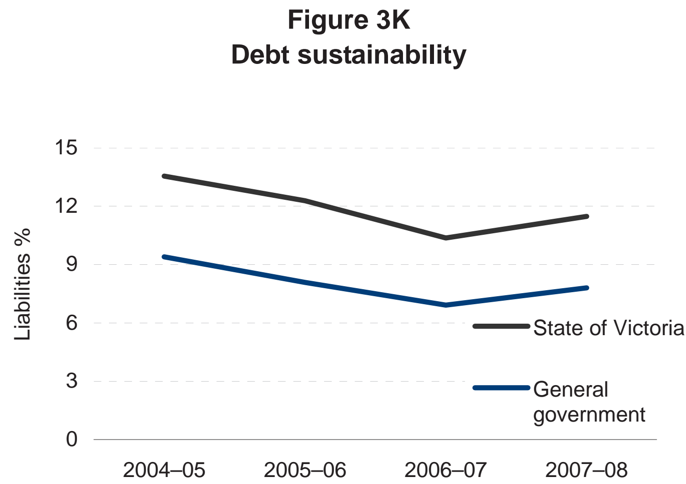
3.3.3 Debt sustainability

Debt sustainability is the ratio of interest bearing liabilities and the superannuation liability to GSP and 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.

Reduced levels of state debt resulted in a reduction of this ratio over the financial periods 2004–05 to 2006–07. In 2007–08, the ratio increased from 10.4 per cent to 11.5 per cent for the state, and from 6.9 per cent to 7.8 per cent for the GGS.

Figure 3K shows the state's and GGS's debt sustainability for the last four financial years.

Figure 3K
Debt sustainability



Source: Victorian Auditor-General's Office.

The increased debt levels reflect the government's commitment to growing the state's infrastructure, represented through an increased capital program.

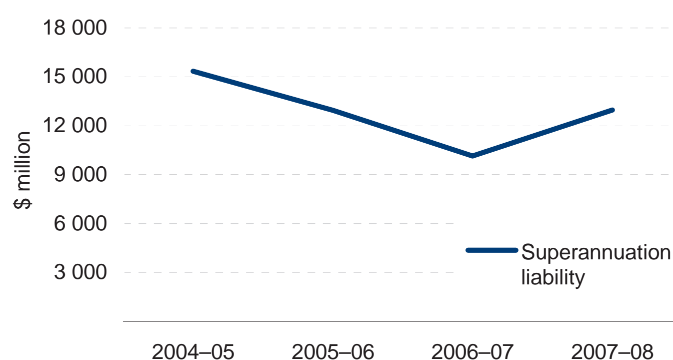
3.3.4 Superannuation liability

The superannuation liability represents the difference between the present value of superannuation benefits accrued to date and the value of superannuation plan assets.

The state's superannuation liability increased by $3 044 million for the 12 months ended 30 June 2008, an increase of 30.1 per cent. However, this liability has decreased from $15 345 million in 2004–05 to $12 959 million in 2007–08, a decrease of 16 per cent over 4 years. This reduction is mainly attributed to strong returns on superannuation plan assets prior to 2007–08 and the government's adoption, in 2000, of a funding framework aimed at fully funding the liabilities in the State Superannuation Fund by 2035.

Figure 3L shows the year on year changes in the balance of the state's superannuation liability over the four year period to 2007–08.

Figure 3L
Superannuation liability—State of Victoria



Source: Victorian Auditor-General's Office.

The expected long term investment return on the assets invested by the state's major superannuation fund increased to 8 per cent[8] in 2005–06 (previously 7.5 per cent). In 2007–08, the Emergency Services and State Superannuation Fund's (ESSSuper) investment return was negative 7.1 per cent. The average investment return for ESSSuper over the period 2004–05 to 2007–08 was a positive investment return of 10.2 per cent. This fund represents 97.1 per cent of the state's superannuation liability.

As the average investment return is above the state's long term expected return, there is no immediate threat to the state's long term strategy to fully fund the superannuation liability by 2035, but the volatility of the investment market continues to be a risk for the state.

Declining global economic conditions resulted in lower than expected investment returns on superannuation plan assets. This was the major factor for the increase in the state's superannuation liability in 2007–08. The lower than expected returns were primarily attributed to negative performance in the International and Australian equity markets, particularly during the second half of the financial year. This was mainly caused by a tightening in the supply of credit stemming from the US sub prime crisis. International and Australian equity markets retreated by around 20 per cent and 17 per cent respectively in 2007–08.

[8] Annual Financial Report of the State of Victoria 2007–08.

3.4 Conclusion

The state's recent past and current surpluses from transactions indicate continued sustainability.

Both the state and the GGS net results from transactions are again in surplus, but there exists a current underlying tension that the slow-down in economic conditions now forecast may place income estimates at risk. This would inevitably put pressure on the result from transactions. For example, the recent growth in wages brought about by increases in service delivery and related public sector employees and wage bargaining outcomes will be difficult to reverse in the short to medium term, particularly as demand for services has a direct correlation with population growth.

When looking at the 'bottom line' by taking into account other economic flows, the significant deficit in the 2007–08 net result clearly demonstrates the state's exposure to financial markets and economic conditions outside its control. These factors can put at risk longer-term financial sustainability and will need to continue to be monitored closely, to ensure that current income and expenditure policy settings remain sustainable.

4 Financial reporting framework and issues in financial reporting

At a glance

Background

The state and individual state entities prepare their financial statements in compliance with Australian Accounting Standards (AAS). These standards are set by the Australian Accounting Standards Board (AASB) and are based on standards issued by the International Accounting Standards Board (IASB). In this chapter, we highlight the impact of changes in the financial reporting framework on the 2007–08 Annual Financial Report (AFR) and, to assist entities prepare for the next financial period, we outline the impacts of changes required to be implemented for reporting periods commencing on or after 1 July 2008.

Key changes in public sector financial reporting for the 2008–09 reporting period are a result of the AASB's objective of issuing transaction-neutral standards and its consideration of public sector operations, including the harmonisation of the Government Finance Statistics (GFS) and the Australian Generally Accepted Accounting Principles (A–GAAP).

Key finding

- AASB 1049 *Whole of Government and General Government Sector Financial Reporting* will require the measurement of all infrastructure assets at fair value for the state's 2008–09 AFR, except for those assets that cannot be reliably measured.

Key recommendations

- DTF should:
  - act to amend FRD 103C *Non-Current Physical Assets* to incorporate the measurement of all relevant assets at fair value for reporting periods commencing on or after 1 July 2008.
  - further expedite processes for fair valuing infrastructure assets and include early consultation with external audit **(Recommendation 4.1)**.

4.1 Impact of changes in the financial reporting framework

During 2007–08 entities were required to comply with the following changes to the financial reporting framework which were applicable for the first time during the year:

- AASB 7 *Financial Instruments: Disclosures*
- Financial Reporting Direction (FRD) 103C *Non-Current Physical Assets.*

Below, we discuss the changes which have had a significant impact on the state's AFR and entities' financial statements.

4.1.1 Financial instrument disclosures

AASB 7 *Financial Instruments: Disclosures* supersedes the disclosure requirements of AASB 130 *Disclosures in the Financial Statements of Banks and Similar Institutions* and AASB 132 *Financial Instruments: Presentation* and is applicable to annual reporting periods commencing on or after 1 January 2007. The new AASB 7 requires entities to make up to 70 additional disclosures relating to financial instruments.

While the impact of AASB 7 varied depending on the extent of the individual entity's use of financial instruments and the risks it is exposed to, the most significant impact for the AFR related to entities in the Public Financial Corporation (PFC) sector. Entities are required to:

- disclose the significance and the impact of financial instruments on their financial position and performance
- disclose both qualitative and quantitative information about their exposures 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: interest rate risk, foreign currency risk and equity price 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 entity is exposed to, based on information used by management to measure and manage risk.

The implementation of this standard resulted in additional disclosure of financial instruments in the AFR.

In the implementation of this standard:

- difficulties were experienced in obtaining timely information from the custodians appointed by the state's funds managers, resulting in compressed financial statement preparation and audit timetables for entities in the PFC sector
- material errors were identified by audit in the draft AFR disclosures for financial instruments. These errors, which were corrected in the final AFR, were attributed to material entities and DTF not undertaking appropriate quality assurance processes over the data provided by entities to DTF.

4.1.2 Revaluation of non-current physical assets

Financial Reporting Direction (FRD) 103C *Non-Current Physical Assets* prescribes the requirements for the classification, initial measurement and revaluation of non-current physical assets for entities defined as either a public body or a department under section 3 of the FMA. The main requirements of the FRD are as follows:

- non-current physical assets are to be primarily classified by the 'purpose' for which the assets are used, according to one of six 'Purpose Groups' based upon the Government Purpose Classifications (GPC)
- detail the required measurement of non-current physical assets, being, at cost or valuation, subsequent to initial recognition
- within each 'Purpose Group', each class of assets that are measured on the valuation basis to be revalued within the same financial year
- asset classes which are measured at valuation to be revalued every 5 years, with timing based upon the applicable 'Purpose Group' classification, and at least, in each annual reporting period, assets shall be subject to fair value assessments for indications of material changes in value.

Changes were made to FRD 103B *Non-Current Physical Assets* with the release of FRD 103C in February 2008 which are applicable to reporting periods beginning on, or after, 1 July 2007. The main changes to FRD 103C, which were supported by audit, are as follows:

- subject to specific criteria, allowing the use of indices to revalue land assets between scheduled revaluations (managerial valuation)[1]
- providing greater guidance on the requirements and procedures to be followed for the revaluation of assets, including the use of materiality and its impact on revaluation procedures.

The application of changes to this FRD resulted in asset revaluations of approximately $5 670 million based upon managerial valuations. This is approximately 67 per cent of the total revaluation increment for land, buildings, roadworks, earthworks and cultural assets of $8 425 million.

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[1] A managerial revaluation is a revaluation conducted using management (or internal) expertise, performed as a result of a fair value assessment indicating that the difference between the fair value of an asset class and the class' carrying amount is potentially greater than 10 per cent. Asset values are revalued by applying the relevant indexation factor or other fair value indicator to the carrying amount. Managerial revaluations are not certified by an external valuer.

Figure 4A details the major revaluations of non-current physical assets undertaken by material entities in 2007–08.

Figure 4A
Asset revaluation by material entities

Entity	Type	Revaluation $ million
Roads Corporation (VicRoads)	Managerial	2 684
Director of Housing	Managerial	2 128
Department of Education and Early Childhood Development	Independent	2 067
Department of Sustainability and Environment	Independent	-1 722
National Gallery of Victoria	Independent	802
Victorian Rail Track	Managerial	378
Hospitals	Managerial	296
Port of Melbourne Corporation	Independent	278
Parks Victoria	Managerial	185
All TAFE entities	Independent	161

Source: Victorian Auditor-General's Office.

4.2 Developments in financial reporting

The state and individual entities prepare their financial statements in compliance with Australian Accounting Standards (AAS). These standards are set by the Australian Accounting Standards Board (AASB) and are based on standards issued by the International Accounting Standards Board (IASB). To assist reporting entities prepare for the next financial period, in this chapter, we outline the impacts of changes required to be implemented for reporting periods commencing on or after 1 July 2008.

Key changes in public sector financial reporting for this reporting period are a result of the AASB's objective of issuing transaction-neutral standards and its consideration of public sector operations, including the harmonisation of the Government Finance Statistics (GFS) and the Australian Generally Accepted Accounting Principles (A–GAAP). The AASB has:

- issued new topic based standards
- transferred requirements in existing public sector standards to transaction–neutral standards
- withdrawn specific public sector standards.

In addition, DTF issues Financial Reporting Directions (FRD) to clarify and assist in the application of the AASB's standards and to prescribe additional reporting practices for Victorian government entities.

4.2.1 Harmonisation of A–GAAP and GFS financial reporting requirements

Different financial reporting frameworks have been used by the various governments in Australia for the preparation of annual budgets and financial statements. The use of GFS[2] financial reporting for the preparation of budgets and A–GAAP for the preparation of financial statements has previously resulted in a lack of comparability between jurisdictions and between government outcomes and their relevant budget statements.

In 2002, the Financial Reporting Council issued the AASB with a strategic direction to harmonise the A–GAAP and GFS reporting framework as a matter of urgency. The objective of the AASB's project to harmonise A–GAAP and GFS was to develop an Australian accounting standard that requires governments to produce financial statements which combine the current A-GAAP and GFS requirements. Recent results of this project are:

- In October 2007, the AASB issued AASB 1049 *Whole of Government and General Government Sector Financial Reporting*, operative for reporting periods commencing on or after 1 July 2008. This standard replaces the whole-of-government requirements included in AAS 31 *Financial Reporting by Governments*.
- In September 2008, the AASB came to the view that GAAP/GFS harmonisation for entities within the GGS could also be achieved. The AASB is considering an exposure draft that proposes amendment to AASB 101 *Presentation of Financial Statements* to achieve the objective and it is intended that the proposal would apply to all entities within the GGS.

The main requirements of the new standard for whole-of-government reporting include:

- application of other Australian accounting standards, except as specifically varied by AASB 1049
- application of the principles and rules in the ABS GFS manual[3] where they do not conflict with A–GAAP
- reporting, on the face of the financial statements, the following for each sector:
    - the operating result and the 'comprehensive result', with income and expenses classified between transactions and other economic flows according to GFS principles
    - investing cash flows for policy purposes separately disclosed from investing cash flows for liquidity management purposes
    - balance sheet to be presented in liquidity order
    - specified key fiscal aggregates[4] used in GFS, measured in accordance with A–GAAP

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[2] 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.

[3] Australian System of Government Finance Statistics: Concepts, Sources and Methods, 2005 (latest issue released 31 July 2006)

- where the measurement of a key fiscal aggregate differs between GFS and A–GAAP, a reconciliation of the two amounts, presented in a note, with an explanation of the differences
- description of the government's broad functions and the assets and expenses that can be reliably attributed to those functions
- where budget financial statements are tabled in Parliament[5] presentation of the original budgeted financial statements and explanations of major variances between budget and actual
- recognition of the GGS equity investments in other sectors (i.e. Public Financial Corporation/Public Non-Financial Corporation) as an asset on the balance sheet.

The state's 2008–09 budget was prepared in accordance with AASB 1049, demonstrating sufficient preparation by DTF for the additional disclosure requirements.

The 2007–08 AFR and previous reports have adopted the recognition and disclosure of items classified between transactions and other economic flows. In the preparation of the 2008–09 AFR, the following differences between A–GAAP and GFS will need to be considered and implemented:

- Classification AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* allows classification of a future economic liability to be recorded as a provision if it meets certain criteria, whereas GFS requires any such item to be classified as accounts payable
- Measurement under the GFS framework – assets that are within the scope of AASB 116 Property, Plant and Equipment and AASB 138 Intangible Assets are required to be at market value, being fair value less selling costs (where these can be reliably measured), whereas under A–GAAP, assets may be recorded at cost or fair value. Currently, the State of Victoria requires, under FRD 103C Non-Current Physical Assets, water and rail infrastructure to be measured at cost. These assets will need to be measured at fair value under AASB 1049, hence significantly impacting on the asset base of such assets within the state. DTF has commenced discussions with relevant sectors to facilitate compliance with this requirement.

[4] AASB 1049 requires the reporting of the following key fiscal indicators: net worth; net operating balance; total change in net worth; net lending/borrowing; and cash surplus/deficit. The calculation of these fiscal indicators is described in the ABS GFS manual.

[5] The Victorian Government tables a budget in Parliament for the General Government Sector only.

Recommendations

4.1 DTF should:

- act to amend FRD *103C Non-Current Physical Assets* to incorporate the measurement of all relevant assets at fair value for reporting periods commencing on or after 1 July 2008
- further expedite processes for fair valuing infrastructure assets and include early consultation with external audit.

RESPONSE provided by Treasurer

Please refer to the detailed response contained in the 'Executive Summary' section of this report.

4.2.2 Review of public sector accounting standards

The AASB is continuing with its approach to issue transaction-neutral, topic-based standards rather than industry-based standards with the objective of having one set of accounting standards for all financial reporting entities across all sectors. This process has also resulted in the clarification of public sector requirements and additional guidance on areas of contention.

In February 2008, the AASB withdrew the government specific standards, AAS 27 *Financial Reporting by Local Governments*, AAS 29 *Financial Reporting by Government Departments*, and AAS 31 *Financial Reporting by Governments*, effective from 1 July 2008. The requirements of these standards have been relocated into existing or three new topic based standards:

- AASB 1050 *Administered Items*. This standard contains requirements on administered items, substantially unchanged from AAS 29 and applicable only to government departments
- AASB 1051 *Land Under Roads*. This standard:
  - allows an entity to elect to recognise or not to recognise, as an asset, land under roads acquired before 30 June 2008. This election is required to be made effective as at 1 July 2008. The Department of Treasury and Finance has elected to not to recognise land under roads acquired before 30 June 2008 in the preparation of the state's AFR.
  - allows the entity to measure land under roads acquired before 30 June 2008 at fair value at the date of election or can take the fair value at that date as deemed cost and therefore not need to revalue the assets in future periods
  - requires recognition of land under roads acquired after 1 July 2008 as an asset.
- AASB 1052 *Disaggregated Disclosures*. This standard contains requirements, unchanged, from AAS 29 on reporting service costs and achievements by activity, applicable only to government departments.

These new and revised standards are applicable to annual reporting periods commencing on or after 1 July 2008.

The withdrawal and relocation of AAS 27, 29 and 31 to existing standards will not significantly change the recognition, measurement and presentation of entity financial statements.

The AASB is also working on a number of other public sector issues. The AASB's work program for the public sector is detailed in its Public Sector Policy Paper, February 2008. Significant areas of coverage are discussed below.

4.2.3 ITC 14 proposed definition and guidance for not-for-profit entities

In Victoria, DTF issued FRD 108 *Classification of Entities as For-Profit*. This FRD removed uncertainties in the classification of entities by providing a list of for-profit entities within the Victorian public sector.

Differentiating between a 'for-profit' and 'not-for-profit' entity can be subject to judgement and has been an area of concern within the accounting profession, given that an entity's classification and measurement requirements would be dependent on whether it meets the definition of a 'for-profit' or 'not-for-profit' entity. The absence of AASB guidance to accompany the definition creates a risk that entities with similar characteristics might apply different financial reporting requirements.

In December 2007, the AASB issued an Invitation to Comment ITC 14 *Proposed Definition and Guidance for Not-for-Profit Entities* requesting comment on:

- whether there should be one definition of a 'not-for-profit entity' that covers both the public and private sectors
- whether to adopt the New Zealand Financial Reporting Standards Board's definition and guidance for 'public benefit entities'[6]
- whether entities should be required to disclose that they are 'for-profit' or 'not-for-profit'.

At its May 2008 meeting, the AASB agreed not to adopt the New Zealand term of 'public benefit entity' but to maintain the existing definition and term 'not-for-profit entity'. The AASB also agreed to develop guidance in consultation with key stakeholders including the New Zealand Financial Reporting Standards Board, the Heads of Treasuries Accounting and Reporting Advisory Committee and the Australasian Council of Auditors-General.

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[6] Public benefits entities are defined in the New Zealand Standard *NZ IAS 1 Presentation of Financial Statements* as 'reporting entities whose primary objective is to provide goods or services for community or social benefit and where any equity has been provided with a view to supporting that primary objective rather than for a financial return to equity holders'.

4.2.4 Income from non-exchange transactions

In December 2006 the International Public Sector Accounting Standards Board (IPSASB) released IPSAS 23 *Revenue from Non-Exchange Transactions (taxes and transfers).* This standard addresses a range of matters critical to financial reporting of taxation revenue, including the basis on which a wide range of taxes should be recognised and measured. The standard also addresses non-exchange transactions for transfers (primarily government grants); in particular, requirements on how conditions and restrictions on the use of transferred resources are to be recognised in the financial statements (i.e. recognition of revenue, assets and potential liabilities).

The principal issues in recognising and measuring revenue from non-exchange transactions include:

- determining whether the transaction gives rise to an item that meets the definition of an asset
- determining whether the entity satisfies the present obligations related to income from non-exchange transactions.

The standard requires an entity to recognise an asset/liability when it gains/loses control of the resources and revenue is recognised at the amount of the increase in asset/equity. It also assists in identifying whether the transfer constitutes a contribution by owners.

In recent times, there have been requests from the public sector for further guidance on determining what constitutes a non-exchange transaction; particularly given the existing pronouncements are subject to differing interpretations.

During 2007, the AASB discussed potential alternative short-term approaches to amending the requirements for not-for-profit entities in relation to accounting for income from non-exchange transactions.

The AASB believe that a longer-term conceptual project on income from non-exchange transactions should be continued, however, recommendations on potential short-term solutions to the issues have also been developed as follows:

- possibility of withdrawing AASB 1004 *Contributions* and requiring not-for-profit entities to apply AASB 118 *Revenue*
- adoption of the IPSASB standard, IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)*, or adopting IPSAS 23 with limited modifications in Australia
- matching principle, whereby income is recognised over periods necessary to match the inflow of the asset with the related costs it is intended to compensate on a systematic basis
- potential application of IAS 18 *Rendering of Services* and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* where income is recognised in a non-exchange transaction when revenue recognition criteria in IAS 18 are met.

The AASB preferred view is that:

- if restrictions are attached to the transferred asset, then recognise income when the transferred asset is received to the extent that the return obligation is recognised
- if no restrictions exist, recognise income upon receipt of the transferred asset.

Areas of interest to public sector entities include the timing of revenue recognition for grants due to stipulations and other conditions imposed, and potential differences in the recognition of assets and liabilities on receipt of non-exchange transfers.

4.2.5 Development of a public sector pronouncement for service concession arrangements

Interpretation 12 *Service Concession Arrangements* issued by the AASB in February 2007 provides guidance on recognition of assets from concession arrangements for private sector entities as the operators of such arrangements and explicitly excludes any guidance for public sector grantors.

Due to the absence of specific guidance for public sector grantors, the IPSASB issued a consultation paper on accounting and financial reporting for service concession arrangements. Following the release of the consultation paper the AASB issued ITC 16 *Request for Comment on IPSASB Consultation Paper Accounting and Financial Reporting for Service Concession Arrangements*. The AASB's invitation to comment closed on 30 June 2008 with comments on the IPSASB consultation paper due on 1 August 2008.

The consultation paper proposed a control approach, consistent with Interpretation 12, to determine whether the grantor should recognise the infrastructure relating to a service concession arrangement as an asset. It proposed that the grantor controls the infrastructure assets where:

- the grantor controls or regulates what services the operator must provide with the underlying property, to whom it must provide them and the price ranges or rates that can be charged for services
- the grantor controls through ownership, beneficial entitlement or otherwise, the residual interest in the underlying property at the end of the arrangement.

When both of the above criteria are met, the consultation paper proposed that the property is recognised by the grantor together with a liability for the obligation to provide cash or non-cash compensation to the operator for the property. This may result in the recognition of concession arrangements in the state's and relevant controlled entities balance sheets, to the extent that the relevant assets and liabilities can be reliably determined and measured.

4.2.6 Development of a public sector conceptual framework

Australia's current conceptual framework (based on the IFRS framework) was primarily developed around the needs of 'for profit' entities in the private sector. As a result, concerns have arisen regarding the relevance of using this framework for 'not-for-profit entities', whose primary focus of financial reporting is to ensure accountability, stewardship of assets and transparency of financial information.

Given these concerns, in July 2006, the IPSASB and a number of national standard-setting bodies, including the AASB, decided to commence a collaborative project to develop a public sector conceptual framework.

The objective of this 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 entities, including, but not necessarily limited to, financial statements.

The proposed framework will deliver explicit concepts that impact financial reporting in the public sector. The framework is to be developed on the requirements of 'not-for-profit' entities, for example, consideration of government performance objectives.

Given this, the development of the Public Sector Conceptual Framework is anticipated to deliver guidance on reporting issues currently faced by public sector entities. The final framework is expected to be issued in 2012.

Auditor-General's reports

Reports tabled during 2008–09

Report title	Date tabled
Managing Complaints Against Ticket Inspectors (2008-09:1)	July 2008
Records Management Checklist: A Tool to Improve Records Management (2008-09:2)	July 2008
Investing Smarter in Public Sector ICT: Turning Principles into Practice (2008-09:3)	July 2008
Private Practice Arrangements in Health Services (2008-09:4)	October 2008
Working with Children Check (2008-09:5)	October 2008
CASES21 (2008-09:6)	October 2008
School Buildings: Planning, Maintenance and Renewal (2008-09:7)	November 2008
Managing Acute Patient Flows (2008-09:8)	November 2008
Biosecurity Incidents: Planning and Risk Management for Livestock Diseases (2007-08:9)	November 2008
Enforcement of Planning Permits (2008-09:10)	November 2008

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