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AUDITOR-GENERAL

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PUBLIC ACCOUNT

1996 - 1997

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25 September 1997

President
Legislative
HOBART

Speaker
House of Assembly
HOBART

Dear Mr President
Dear Mr Speaker

In accordance with the provisions of Section 57 of the Financial Management and Audit Act 1990, I present my Report on the audit of the Public Account for the year ended 30 June 1997.

Yours sincerely

A J McHugh
AUDITOR-GENERAL

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KEY FINDINGS

On 12 September 1997 an unqualified audit report was issued on the Treasurer's Financial Statements for the 1996-97 financial year.

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The 1996-97 Treasurer's Financial Statements included for the first time, disclosure of activities of Government on an 'outputs' basis for consistency with departmental outputs as described in Budget Paper No. 2. This is a major shift in reporting particularly as outputs incorporate outlays funded not only out of the Consolidated Fund but also certain balances available in the Special Deposits and Trust Fund and revenues generated by departments that are not required to be paid into the Consolidated Fund.

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A major step has been taken to redress the limitations in the financial reporting of those departments previously using only cash accounting. All departments were required to introduce accrual reporting with effect from the 1996-97 financial year. Accrual reporting was achieved for that year by the majority of departments continuing to use cash accounting with modifications being made as at the beginning and end of the accounting period to recognise assets and liabilities and at least all materially accruable transactions.

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Despite the intention that the Tasmanian State Service Workers' Compensation Scheme be fully-funded, estimates of the unfunded liability had progressively increased to a peak of $52.8 million at 30 June 1995. The reduction in the liability during 1995-96 to $47.2 million was the first recorded in the history of the Scheme. In 1996-97 the unfunded liability decreased further to $38.7 million.

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Estimates of the State's unfunded liability for inner-Budget employees' entitlements to long service leave and recreation leave are not aggregated and reported in the Treasurer's Financial Statements. However, disclosure of these liabilities is made in each agency's financial statements and they totalled some $179 million at 30 June 1996. The amounts to be reported by agencies as at 30 June 1997 are expected to increase by around 10% due to a changed method in calculation that requires recognition of certain salary oncosts that were previously not included.

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In meeting their 1996-97 budgetary targets the Department of Community and Health Services (DCHS) and the former Regional Health Boards complied with the financial directives applying to the cash based budgetary setting within which they operated. However, this was associated with a substantial further decline in the negative working capital of the former Boards now assumed by DCHS. In response to this situation a “Regional Health Deficits Account” having an overdraft facility of $21.5 million has been established within the Special Deposits and Trust Fund. In the absence of a strategy that has more than just a “cash” measure of budgetary rectitude there would appear to be little alternative to periodic interventions to retrieve the finances of the health system.

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THE PUBLIC ACCOUNT

The Public Account is comprised of the Consolidated Fund and the Special Deposits and Trust Fund (SD&TF) established under the Public Account Act 1986.

The Consolidated Fund relates to items of expenditure which have been reserved by law through specific provisions in legislation or which have been appropriated by Parliament for the financial year. The Consolidated Fund also includes moneys received in accordance with various statutes and administrative arrangements as outlined in the State Budget.

The SD&TF relates to transactions and balances in respect of moneys deposited in separate accounts within the SD&TF in accordance with various statutes and administrative arrangements, and moneys received from the Commonwealth Government and other outside sources for expenditure on particular projects and purposes. Expenditure from the SD&TF is not subject to appropriations by the Parliament and up to 1995-96 has not generally received comprehensive coverage in supporting Budget Papers. This has been largely redressed with the change in 1996-97 to Outputs based Budgeting and the mandatory use by agencies of operating accounts in the SD&TF for expenditure of appropriations out of the Consolidated Fund.

Treasurer's Financial Statements

The transactions and balances of the Public Account for each year are reported to Parliament through the Treasurer's Financial Statements in accordance with Section 26 of the Financial Management and Audit Act 1990 and the Financial Management and Audit Regulations 1990. Regulation 5 prescribes the minimum information to be shown in the Statements.

The Statements contain detailed as well as summarised information on transactions and balances within the Public Account. Disclosures of certain other financial assets and liabilities which are related to but are not part of the Public Account, and in respect of which records are maintained by the Department of Treasury and Finance, are also included in the Statements.

The 1996-97 Treasurer’s Financial Statements included for the first time, disclosure of activities of Government on an ‘outputs’ basis for consistency with departmental outputs as described in Budget Paper No. 2. This is a major shift in reporting particularly as outputs incorporate outlays funded not only out of the Consolidated Fund but also certain balances available in the SD&TF and revenues generated by departments that are not required to be paid into the Consolidated Fund.

Under this “total funds” approach to budgeting and reporting, the funds provided to departments out of the Consolidated Fund represent the “net appropriation” required after recognition of funds available from all other sources.

On 12 September 1997 I issued an unqualified audit report on the Treasurer's Financial Statements for the 1996-97 financial year. A copy of my audit report was published with those Statements.

Basis of Accounting

Management of the Public Account and hence the State Budget is limited by the cash basis of accounting underlying the operation of the Account.

Consistent with the provisions of the Public Account Act many transactions recorded in the Public Account result from non-cash or “book” transfers of amounts between individual items in the Consolidated Fund and / or accounts in the SD&TF.

Although some of these transfers are used, in effect, to "mimic" the establishment of accruals and provisions normally only available through the more flexible accrual based system of accounting, more effective management of the State Budget is restricted by the limitations inherent in the cash system of accounting on which the Public Account is based.

A major step towards redressing these limitations has now been taken with a requirement for all departments to introduce accrual reporting with effect from the 1996-97 financial year. Accrual reporting was achieved for that year by the majority of departments continuing to use cash accounting with modifications being made as at the beginning and end of the accounting period to recognise assets and liabilities and at least all materially accruable transactions.

Departments will be expected to implement accrual accounting by 30 June 1998 and to introduce accrual-based financial management by 30 June 1999.

Other Financial Management Reforms

In July 1996 the Department of Treasury and Finance issued a booklet titled Tasmania’s Financial Management Reform Strategy with the slogan “towards a more commercial approach to managing public finances”.

The booklet is extremely informative from the perspective of various stakeholders and anyone having an interest in public finances.

That publication describes the reforms achieved in recent years and outlines numerous proposed reforms, many of which are already in their preliminary stages, such as the requirement for assets controlled by departments and statutory authorities to be valued uniformly using the “deprival” method and for the adoption of accrual accounting by departments. While it speculates about the possibility of extending the reforms to include reporting on an accrual basis the financial performance and financial position for the State as a whole, it does not include any firm commitment to such whole-of-government reporting.

Since then the Australian Accounting bodies have issued Accounting Standard AAS 31 “Financial Reporting by Governments”. AAS 31 provides for consolidated reporting by governments (including state governments) of their operations and financial position on an accrual basis commencing with effect from 1998-99.

Whilst compliance with AAS 31 is not mandatory, a review of the format of the Treasurer’s Financial Statements is proposed during 1997-98 when Tasmania will trial the preparation of a whole of Government Balance Sheet, linked with the development of systems and processes to enable presentation of data in accordance with the Uniform Presentation Framework approved by Loan Council, and endorsed by Heads of Treasuries.

Objectives of This Report

It is not my intention to provide in this Report a systematic commentary on the operations of the Public Account for the financial year ended 30 June 1997. The Treasurer's Financial Statements for 1996-97 together with the documentation accompanying the recently presented 1997-98 Budget, provide adequate disclosure in that regard.

The main objectives of this Report are to provide information on certain transactions or balances included in the Treasurer’s Financial Statements which have been selected for comment due to some unusual issues involved or because of their public interest potential.

MEASURING PERFORMANCE IN THE PUBLIC ACCOUNT

There is no single and precise indicator available for the Public Account as depicted by the Treasurer's Financial Statements, for reliably measuring or reporting overall performance of Government in terms of financial management. This is due largely to the complex nature of government activity and the interactions between the Consolidated Fund and the SD&TF.

Net Financing Requirement

The Net Financing Requirement (NFR) shown in Statement 2 of the Treasurer's Financial Statements should not be seen as the sole indicator as to the management of the State Debt or the financial performance of the Public Account.

The NFR is merely a construct for financial reporting purposes which highlights the size of the gap existing at the end of a financial year between Consolidated Fund receipts and expenditure which was filled by borrowings. It is not a reflection of the performance of the Public Account as a whole.

The NFR style of presentation has been used since 1989-90 and has greatly assisted in firmly establishing debt control as a key issue in public sector financial management and successive Budget strategies.

A financial management objective announced by Government in 1992 was to achieve a NFR of zero by 1996-97. That objective was reassessed in 1994-95 in the context of a new financial strategy extending over a 5 year period to June 2000.

Implicit in that fiscal strategy as documented in 1997-98 Budget Paper No 1 (pages 8-10) together with progress made towards achieving specific targets, is that during the term of the strategy the NFR should not exceed $35 million per annum in order to achieve the June 2000 net debt targets outlined in the strategy. Those targets are that:

- Real General Government net debt per Tasmanian Household will be reduced by one fifth between June 1994 and June 2000; and

- General Government net debt as a proportion of Gross State Product will be reduced from 14.9 per cent to 10 per cent over the same period.

The actual reported NFR for 1996-97 was $31.7 million, or $1.9 million more than the estimate of $29.8 million included in the 1996-97 Budget.

When the NFR is fully met from new borrowings, as has been the case every year since 1990-91, those new borrowings directly influence the level of total State Debt. However, it is important to understand that even under these circumstances the NFR does not reflect the actual change in total State Debt during the year.

This is due to various aspects of debt management actually occurring outside of the Consolidated Fund. They include:

- application of proceeds from major asset sales directly to debt reduction;
- receipt of Commonwealth Compensation Funds for purposes of debt redemption;
- reclassification as State Debt of previous borrowings by certain statutory authorities;
- use of active debt management strategies; and
- fluctuations in the levels of internal borrowings through the SD&TF.

Internal borrowings, using the technique of overdrawing accounts in the SD&TF, have been a major feature of the State's financial management strategy since 1990-91. The levels of internal borrowings, used mainly in financing payments to redundant employees, have been as follows:

June 1992	June 1993	June 1994	June 1995	June 1996	June 1997
$90.7 m	$83.8 m	$72.4 m	$78.0 m	$87.6 m	$94.1 m

The amounts shown above represent the cumulative borrowings from internal sources at the end of the financial year as disclosed in various overdrawn accounts in the SD&TF. The funds borrowed in this way are applied to a variety of purposes. Some relate to commercial activities such as TASFleet and State Purchasing and Sales in which case they are backed by assets arising from the particular activity. Others relate to the costs of redundancy programs and arrangements exist for the progressive repayment out of the Consolidated Fund of the overdrawn amounts, together with interest.

Active Cash Management

Due to the net credit balances which are typically available in the accounts comprising the SD&TF, there is not a need during any financial year for the State to maintain borrowings at the levels reported in the Treasurer's Financial Statements at 30 June.

At the start of the financial year much of the liquidity available in short-term investments is used to redeem short-term borrowings. During the year the available cash holdings are actively managed at a level which minimises the need for borrowings. Because interest on borrowings is typically higher than interest on investments for a similar term, the consequential savings amount to the difference between the amount of interest which would have been earned by investing the cash reserves and the amount of interest which would have been paid on borrowings of an equivalent amount.

Conversely, at the end of the financial year, an amount is borrowed “overnight” to re-establish total borrowings at the level required to bring the balance of the Consolidated Fund to nil. The amount borrowed overnight at 30 June 1997 for this purpose was $196 million.

This arrangement is artificial to the extent that the amount borrowed is not required to finance any obligations to external parties. However, since the borrowing is essentially only overnight, it is virtually costless and thus consistent with sound cash management practice.

At least one government business enterprise and one city council in the State have engaged in similar overnight borrowing activity at 30 June albeit on a considerably smaller scale.

TASMANIAN STATE SERVICE WORKERS' COMPENSATION SCHEME

The Tasmanian State Service Workers' Compensation Scheme was established with effect from 1 July 1989, by Cabinet Decision, as a fully funded self-insurance system to provide for work-related injury claims made by employees of participating agencies.

The Scheme is a non-legislative arrangement which is oversighted by the Tasmanian State Service Workers' Compensation Committee with claims being processed by a Fund Manager contracted from the insurance industry. Administrative support is provided by the Department of Treasury and Finance and the State Actuary.

Contributions by agencies are credited to the Tasmanian State Service Workers' Compensation Account T837, an account controlled by the Department of Treasury and Finance and maintained in the SD&TF. The costs of claims and other expenses such as the Fund Manager's fee, the cost of externally provided catastrophe insurance cover, and the Workers' Compensation Board levy, are paid from the Account.

The Scheme's transactions and balances are reported on an accrual basis and in compliance with Accounting Standard AAS 26 "Financial Reporting of General Insurance Activities".

Draft financial statements for 1996-97 have already been prepared. These unaudited statements disclose a surplus Underwriting Result of $4.1 million compared with a surplus of only $1.9 million for 1995-96. This surplus has contributed to the reported reduction during 1996-97 in the State's estimated unfunded liability under the Scheme.

The estimated future costs of claims (including an adjustment for administration expense) and the estimated unfunded liability, after allowing for the balance of funds available in the Account through which the Scheme operates, have been as follows at 30 June during the last 5 years:

	1993 **$m**	**1994** **$m**	**1995** **$m**	**1996** **$m**	**1997** **$m**
Estimate of Future Claims Costs	26.2	33.0	48.1	47.2	50.4
Funds Available in the Scheme's Account	2.7	3.5	(4.7)	0.0	11.7
Net Unfunded Liability	23.5	29.5	52.8	47.2	38.7

As can be seen from the above table, despite the intention that the Scheme be fully-funded, estimates of the unfunded liability had progressively increased to a peak of $52.8 million at 30 June 1995. The reduction in the liability during 1995-96 to $47.2 million, is the first recorded in the history of the Scheme. In 1996-97 the unfunded liability decreased further to $38.7 million.

DISCLOSURE OF THE STATE'S LIABILITY FOR EMPLOYEE ENTITLEMENTS

Statement 12 in the Treasurer's Financial Statements provides information on selected contingent and other liabilities.

While the Statement includes actuarially determined estimates of employee entitlements to superannuation benefits and compensation for work-related injuries, it does not include estimates of the State's liability for various types of paid leave of absence such as long service leave, recreation leave and sick leave.

Disclosure of these liabilities, calculated in accordance with Treasurer's Instructions, is required to be made separately in each agency's financial statements which are made available to Parliament before the end of November in each year as a component of agencies' annual reports. The details of these liabilities relating to some agencies are typically still not available in a reliable form at the time of preparation of the Treasurer's Financial Statements.

To obtain an indication of the extent of these liabilities Audit reviewed the details published in departments' and regional health boards' 1994-95 and 1995-96 audited financial statements and found that the liability relating to sick leave was generally not reported due to its non-materiality. However the liability for long service leave and recreation leave was significant; this is summarised as follows:

	Long Service Leave		**Recreation Leave**		**Total Leave (excluding Sick Leave)**	
	1994-95 **$m**	1995-96 **$m**	1994-95 **$m**	1995-96 **$m**	1994-95 **$m**	1995-96 **$m**
Government Departments	79.8	90.4	31.1	35.7	110.9	126.1
Regional Health Boards	34.0	30.0	27.0	22.5	61.0	52.5
Total	**113.8**	**120.4**	**58.1**	**58.2**	**171.9**	**178.6**

Note: The basis of valuing the long service leave liability varies between agencies and regional health boards. Agencies' calculations are at nominal rates of pay for pro-rata and actual entitlements after 7 years service. The boards' calculations are in accordance with Accounting Standard AAS 30 which requires recognition of estimated liability for service prior to 7 years (preconditional entitlements), as well as entitlements after 7 years. The Standard also requires some discounting of nominal rates of pay to present values.

The rate of increase in total leave liability shown in the above table is around 4% and is almost entirely attributable to increase in the liability for long service leave.

It is not possible to determine whether this rate of increase is representative of earlier years. Agencies were not previously required to report their leave liability in their annual financial statements.

Under the accrual reporting arrangements applying to agencies as from the 1996-97 financial year, all agencies will report their leave liabilities in accordance with Accounting Standard AAS 30 “Accounting for Employee Entitlements”. Calculation of all leave liability under AAS 30 requires inclusion of salary oncosts such as pay-roll tax and employer superannuation contributions; and in relation to long service leave:

- recognition of the probability of all current employees qualifying for an entitlement, and

- discounting to present values of payments anticipated to be made more than one year after reporting date.

It is likely that calculation in accordance with AAS 30 will increase the reported overall liability for inner-Budget by around 10% due to the inclusion of salary oncosts in the calculations. However early indications are that using probabilities and discounting in calculations of liability for long service leave will not significantly alter the amount of liability calculated by the previously used more direct approach.

No provision is made to fund the liability for these entitlements except by certain business units that operate on an accrual accounting basis and have cash-backed provisions. However the impact of such funding would not be considered material in the context of the overall unfunded liability for entitlements to leave.

Existing Budget arrangements require each agency to finance the full leave costs paid to its employees even if part of that leave was accrued while the employees worked at another agency. Under these arrangements it is possible for some agencies, particularly the smaller ones, to be disadvantaged when they appoint employees having substantial leave entitlements accrued in other agencies.

On the question of entitlements to long service leave, Treasury has recognised a need to formulate a policy and procedures to enable provisions to be established by agencies for funding the accruing liability.

BUDGETARY COMPLIANCE BY THE DEPARTMENT OF COMMUNITY AND HEALTH SERVICES AND REGIONAL HEALTH BOARDS

Throughout 1996-97 hospital services were delivered through the three Regional Health Boards. With effect from 1 July 1997 these services have been transferred to the Department of Community and Health Services (DCHS).

The 1996-97 Budget for the DCHS totalled $570.789 million. This comprised $531.655 million for Recurrent Services and $39.134 million for Works and Services. An additional amount of $3.159 million was authorised as the result of an increase in Commonwealth receipts and additional proceeds from the sale of surplus assets. Actual expenditure of $573.948 million for the year complied with these allocations. The additional amount authorised represents an excess of .55% compared with an average annual excess of 1.76% during the previous 4 years.

Thus all formalities associated with financial directives imposed on the DCHS under the Financial Management and Audit Act 1990, the Public Account Act 1986 and Appropriation Acts were complied with.

However, the Budget results were achieved in a regionalised service delivery framework and an environment of cash management practices which provided DCHS and the former Regional Health Boards with the ability to not discharge certain categories of liabilities or obligations during a particular financial year, and to defer their settlement to future accounting periods.

Prior to the establishment under the Health (Regional Boards) Act 1991 of the three Regional Health Boards which replaced all of the former local Hospital Boards, a new form of cash management was imposed on Hospital Boards. This involved a reduction of Hospital Boards' bank balances to reflect actual cash requirements and was achieved through withdrawal of forward funding of, for example, cheques issued by Boards in relation to creditors, group tax deductions etc but not yet presented to banks. This placed the majority of Hospital Boards in a situation of having deficits in their cash book balances roughly equivalent to their average levels of unpresented cheques. Meanwhile their bank accounts were maintained with positive balances.

Subsequently the legislation under which Regional Health Boards were established also empowered them to operate bank overdrafts. That power together with other cash management practices such as the deferral of creditor payments, provided scope for DCHS and the Regional Health Boards to cope with budgetary constraints.

Some Examples of cash management practices follow.

Employer Superannuation Contributions

Employer Superannuation Contributions totalling approximately $5 million due principally from the three Regional Health Boards relating to salaries paid up to 30 June 1997, were not paid into the Superannuation Provision Account maintained by Treasury. Some arrears of contributions dated back as far as April 1997.

According to a memorandum dated 12 February 1996 from Treasury to the then Secretary of DCHS, remittances should have been made for 50% of the expected monthly contribution on the 15th day of each month in which the payment is due and the balance paid on the last pay day of that month.

Creditors

The former Regional Health Boards utilised cash management practices to delay payment of creditors, thereby deferring the settlement of these liabilities from one financial year to the next and, at the same time, increasing their capacity for containment of current year expenditure.

As at 30 June 1997 out of a total $26.6 million owing to creditors by DCHS (including debts assumed from the former Regional Health Boards), $12.6 million related to amounts owing for less than 30 days. The remaining $14 million related to amounts owing for more than 30 days. Some $6.8 million had been owing for more than 60 days.

Regional Health Deficits Account

Working capital for the three Regional Health Boards declined from **negative** $64.5 million at June 1996 to **negative** $74.4 million at June 1997 (the latter is unaudited). This indicates a probable serious lack of liquidity although only a careful and detailed analysis of future cash flows would confirm the case.

With effect from 1 July 1997 all the assets and liabilities of the former Boards have been assumed by the DCHS operations.

The former Regional Health Boards were empowered to borrow money by using bank overdrafts for cash management purposes. Because future funding of public hospitals will be on a direct appropriation basis without access to overdraft facilities, there is now a need to address the situation.

In response to this need an account entitled the “Regional Health Deficits Account” has been established within the Special Deposits and Trust Fund. Authority has been provided for the Account to be overdrawn up to a maximum level of $21.5 million. The overdrawn limit available to DCHS will reduce to zero over a period of three years.

Audit has been assured by the Secretary of DCHS that all of the above obligations have been factored into the 1997-98 budget and forward estimates.

Monitoring Financial Activity in an Accrual Setting

The previous controls over financial activity have not proved effective other than in the very narrow sense that cash budget targets have been met. The controls have concentrated exclusively on the cash position. This permitted activity in the past that led to increases in short to medium term liabilities which simply shifted the budgetary difficulty from the current to future periods.

The three Regional Boards reported accurately on their financial situation on an accrual basis in 1995-96 and in previous years. Commentary in the Auditor-General's Report of November 1996 drew attention to the deterioration in the financial position of the Southern and North West Boards and the operating loss of the Northern Board.

From 1996-97 onwards, full accrual financial statements will also be available for DCHS itself and all other departments.

There is no point in providing accrual information if it is not to be fully utilised.

In this context it may be necessary to caution against an inappropriate concentration on the final "operating surplus" in the financial statements. In 1995-96 the respective losses for the Northern, and North West Boards were $3.930 million, and $6.681 million and a surplus of $8.353 million for the Southern Board. These losses and surpluses should be adjusted for capital grants to indicate how operating revenue compares with operating expenses. The respective **operating losses** were $10.769 million, $11.708 million and $8.745 million.

Conceivably these losses should also be adjusted to show a greater loss depending on whether the funding policy is that depreciation is funded by specific annual works and services grants or included in the overall operating grant.

The point is that an appropriate monitoring strategy on the financial operations of the Boards, now subsumed within DCHS and the Department itself must now utilise more than one measure of budgetary rectitude. It will be necessary for targets to be set for liquidity (defined in an appropriate manner) and the operating loss (defined in an appropriate manner and excluding at a minimum the influence of major capital grants) in addition to the requirement to achieve the budgetary cash outcome.

In the absence of such a strategy there is little alternative to periodic interventions to retrieve the finances of the health system.

In his response to the matters referred to in this segment of the Report, the Secretary of DCHS stated that:-

> *"The Department of Community and Health Services is well aware that an appropriate monitoring strategy for the financial operations of the former Boards, whose operations now form part of the Department, will utilise more than one measure of financial rectitude and this has been the case for the past 12 months.*
>
> *An extremely detailed analysis was carried out in 1996/97 on the demand and cost pressures impacting on the Department and this has formed the basis of subsequent management policies and practices.*
>
> *I do not believe the report acknowledges the work that has been undertaken over the past 12 months, or the recent major review of the Department, in this respect and the positive impact this will have in avoiding the types of interventions referred to in ... this section of the report, which in my view is outdated."*

To summarise, I am advocating that monitoring financial activity requires consideration of at least three aspects

- compliance with cash appropriation limits
- attention to the Statement of Financial Position and especially movements in current assets and current liabilities
- the operating result adjusted for funding earmarked for new construction and the acquisition of non-current assets.

This applies to every department.

The requisite information is available to all departments as from 30 June 1997.

I understand that Treasury is considering how to further develop the Output methodology, particularly in establishing a total link and clear articulation between budgeting, accounting and reporting. This would build on the approach outlined in "Tasmania's Financial Reform Strategy" wherein it is stated that departments will introduce accrual-based financial management by 30 June 1999. However nothing in that document should be taken to preclude departments from utilising immediately, all the information at their disposal.