

Fiscal Indicators and the Financial Statements



A Guide to How Fiscal Indicators Are Compiled from the Financial Statements

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1. Purpose

This note explains the key components of the Government financial statements, such as the Statement of Financial Performance, Statement of Financial Position and Statement of Cash Flows. These statements are prepared in accordance with generally accepted accounting practice (GAAP).

The note explains the headline indicators most commonly used to communicate the Government's fiscal strategy and where these can be found within the financial statements. It also reconciles total Crown operating balance before gains and losses (OBEGAL) with core Crown residual cash and net core Crown debt.

Although the financial statements are complex, this note sets out a stylized representation of the various parts and how they fit together.

For further reading see:

The Treasury (2005) A Guide to the Public Finance Act, August 2005

The Treasury (2011) Putting It Together: an Explanatory Guide to New Zealand's State Sector Financial Management

The Treasury (2013) Financial Statements of the Government of New Zealand for the year ended 30 June 2013.
<http://www.treasury.govt.nz/government/financialstatements/yearend/jun13>

2. The Government reporting entity

The Public Finance Act 1989 requires that consolidated financial statements be prepared for the government reporting entity – which comprises the legislative, executive and judicial branches of government, including commercial interests. As the financial statements of the government report on the whole of government they are sometimes referred to as group accounts. This whole-of-government group is known as the “total Crown”. The total Crown is a useful unit of analysis for assessing the overall financial operations and financial position of the whole of government and its impact on the wider economy.

The largest part of the total Crown is core Crown, which comprises ministers, departments, offices of Parliament, the New Zealand Superannuation (NZS) Fund and the Reserve Bank of New Zealand. The core Crown is a useful unit of analysis for considering fiscal management because spending approved by Parliament via appropriation acts is administered by departments – over which Ministers tend to exercise most direction.

The total Crown comprises the core Crown, Crown entities and state-owned enterprises (SOEs). The financial statements for the total Crown net off any financial flows between these three institutional groupings. Known as inter-segment eliminations, these eliminations remove transactions and balances between the segments so that only transactions and balances external to the whole of Crown group are reported.

Crown entities perform a range of functions, including service delivery, regulatory oversight, and funds administration. They are named in the Crown Entities Act 2004 and operate with varying levels of independence from ministerial direction, usually being accountable to boards appointed by Ministers. Some examples of Crown entities are: Accident Compensation Corporation, District Health Boards, the Earthquake Commission, the Financial Markets Authority and the Commerce Commission.

SOEs were established under the State-Owned Enterprises Act 1986 with the objective of operating as profit-oriented businesses. Boards of directors are appointed by shareholding ministers to be responsible for running each company, with government’s role being that of owner. Examples of SOEs are: Airways Corporation, New Zealand Post and Solid Energy. Air New Zealand is treated as part of the SOE segment for disclosure purposes. Where entities are not fully owned by the Crown (e.g. Air New Zealand, Mighty River Power), the non-government shareholding¹ or “minority interests” are identified separately.

¹ As the Government will retain control of these entities they will continue to be fully consolidated in the Financial Statements of the Government.

Figure 1: The Government Reporting Entity



3. Financial statements of the Government

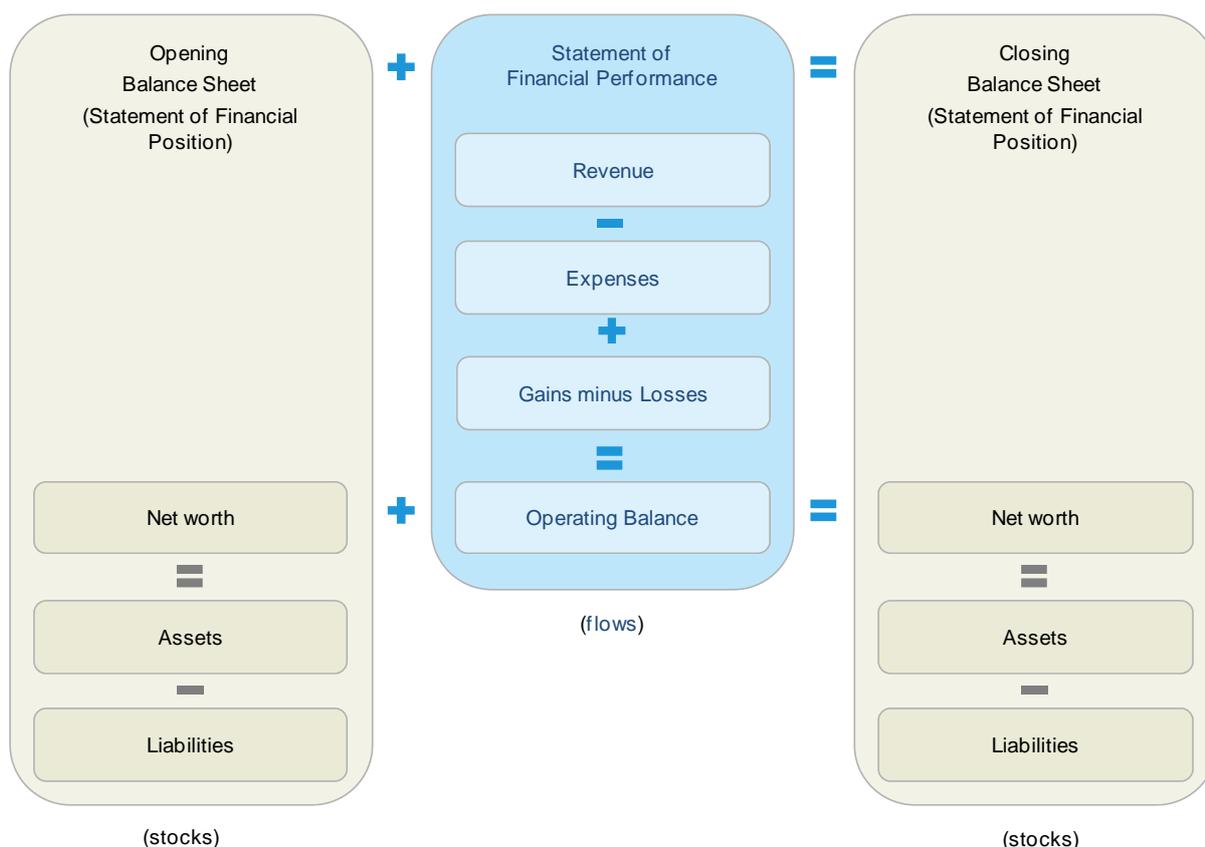
The government reports on its financial performance over a given period and on its financial position at a point in time. The Public Finance Act 1989 requires that the financial statements of the government be prepared in accordance with generally accepted accounting practice (GAAP) in New Zealand. GAAP requires the financial statements to comply with NZ International Financial Reporting Standards (IFRS) as appropriate for public benefit entities. This ensures that an independently determined set of rules governs the recognition and measurement of financial elements such as assets, liabilities, revenues and expenses.

The Treasury prepares annual financial statements soon after the end of the fiscal year on 30 June. Monthly statements are also prepared during the fiscal year (except for the end of July and August). The Treasury also prepares financial forecasts for the Budget Economic and Fiscal Update and the Half-Year Economic and Fiscal Update on the same basis as the annual and monthly financial statements. The major financial statements are produced for the total Crown and are also disaggregated into the core Crown, Crown entity, and SOE segments. Two key statements generally receive the most attention:

- ▶ **Statement of Financial Performance** – this shows the government’s operating transactions over a period of time, including revenue, expenses and the operating balance;
- ▶ **Statement of Financial Position** – also known as the balance sheet, this shows the government’s assets and liabilities and net worth at a point in time.

Figure 2 shows the Statement of Financial Performance. This statement can be thought of as showing flows between an opening balance sheet and a closing balance sheet for a given period.

Figure 2: Statements of Financial Position and Performance as stocks and flows



The financial statements are prepared on an accrual basis, so that a financial event is recognised when it occurs rather than when the cash settlement occurs. For example, tax revenue is recognised at the time the debt to the Crown is incurred, rather than when the tax is paid. The accrual basis provides more comprehensive information than cash accounting and is less subject to manipulation in terms of the timing of transactions.

3.1 Statement of Financial Performance

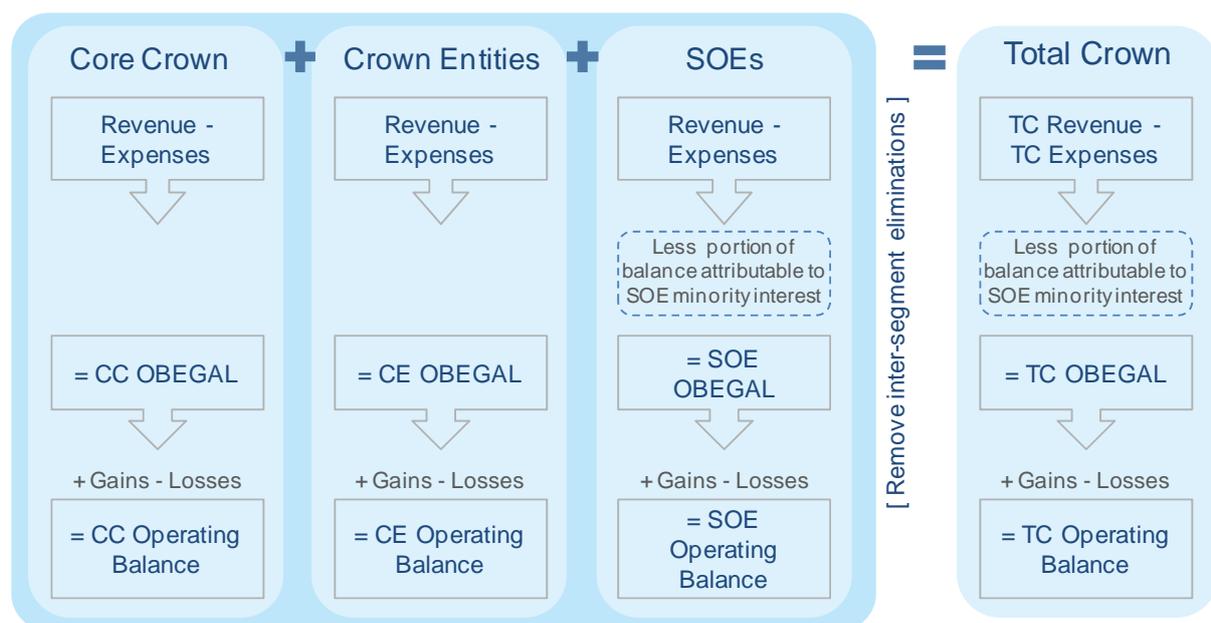
The Statement of Financial Performance presents the government's operating activities over a period of time, including the flows of revenue expenses incurred, and valuation gains/losses. The residual of these components is called the operating balance.

The Statement begins with revenue, which includes taxation revenue and other revenue levied through the Crown's sovereign power (e.g. levies and court fines). Revenue is also sourced from the operations of government, such as from the sales of goods and services, interest revenue and dividends, royalties and rental income.

Expenses are presented in terms of inputs, such as personnel, depreciation and amortisation, interest, insurance, and transfer payments and subsidies. The same expenses are also presented using a functional classification, which is based around government service areas such as social welfare, health, education, defence, core government services etc. This analysis is available for the core Crown and the total Crown and is based on the *Classification of Functions of Government* as developed by the OECD.

The difference between revenue and expenses is the operating balance before gains and losses, which is also known as OBEGAL. Gains and losses arise from changes in the value of the government's assets and liabilities. These gains and losses can be volatile due to a range of external factors, including changes in market prices of equity investments, revaluation of long-term liabilities such as ACC, impacts of foreign exchange rate changes, and the economic cycle. Adding in the gains and losses produces the operating balance, which is an overall picture of operating performance. Figure 3 depicts these high-level relationships within the Statement of Financial Performance.

Figure 3: Statement of Financial Performance – an illustration



The OBEGAL can provide a more direct indication of underlying fiscal management than the operating balance, as it is more closely linked to activities over which Ministers have more day to day control. This is particularly so for the core Crown OBEGAL, where Ministers tend to have more control, than for the total Crown OBEGAL, which includes the revenues and expenses of Crown entities and SOEs. Nevertheless, both core Crown OBEGAL and total Crown OBEGAL are subject to volatility in flows of tax revenue due to, for example, changes in economic activity.

3.2 Statement of Financial Position – the Balance Sheet

The Statement of Financial Position presents the government's assets and liabilities, with the residual representing the government's net worth at a point in time. It is also known as the total Crown balance sheet. Balance sheets for the core Crown, Crown entity and SOE segments are also

prepared, although the total Crown balance sheet is most useful when considering the overall financial strength of the government.

Assets include financial assets (e.g. tax receivables, share investments, marketable securities such as bonds and debentures, and advances such as student loans) and property, plant and equipment (e.g. land, buildings, electricity generation assets, highways, military equipment) and 'other assets' such as intangible assets (e.g. computer software) and goodwill (e.g. Air New Zealand's reputation etc).

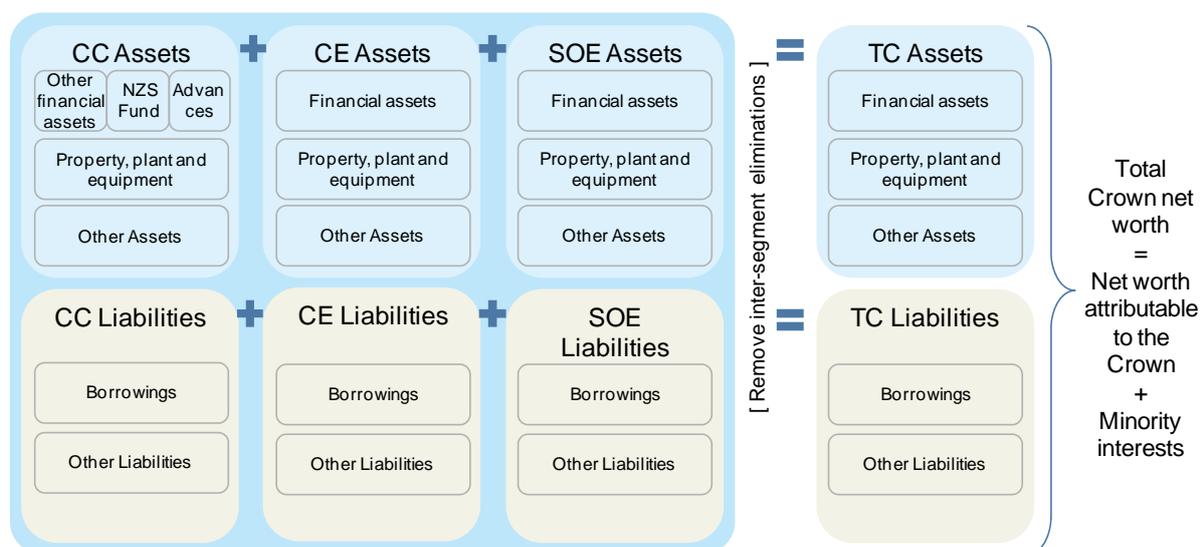
Liabilities include borrowings, such as Government Stock (i.e. fixed-term debt securities with a maturity of one year or more) and Treasury Bills (i.e. fixed-term debt securities with a maturity of one year or less). It also includes 'other liabilities', which comprise insurance liabilities (e.g. ACC, EQC), and retirement plan liabilities (e.g. GSF) as well as Provisions (e.g. ETS credits).

The broadest indicator of the overall strength of the balance sheet is total Crown net worth, which is the sum of all assets less liabilities. Total Crown net worth includes the full value of the assets less liabilities of entities controlled by the government, including the non-government "minority interest" shares. The Crown share of net worth is referred to as "net worth attributable to the Crown" and is commonly used as an indicator of the strength of the Crown balance sheet.

As noted above, changes in the value of assets and liabilities on the balance sheet – gains & losses – affect the operating balance. Similarly, changes in financial flows affect the assets and liabilities on the balance sheet. Some key channels include:

- ▶ investing activities, such as the sale or purchase of assets (financial and physical), including contributions to the NZS Fund; and
- ▶ financing activities, such as the issuing or repayment of debt.

Figure 4: Statement of Financial Position – an illustration



The Treasury has also developed a portfolio breakdown of the Crown balance sheet. It classifies assets and liabilities into commercial, financial, and social groupings, according to their primary role. This breakdown can be found in the *Investment Statement of the Government of New Zealand*.

4. Fiscal indicators

The Public Finance Act 1989 requires the government to set a fiscal strategy in accordance with the principles of responsible fiscal management. A government makes choices about fiscal indicators to use to measure progress towards its fiscal strategy, depending on its long-term objectives and short-term intentions. Fiscal indicators can be drawn directly from elements in the financial statements, prepared in accordance with GAAP, or they may be constructed from some of those elements.

4.1 Net core Crown debt

The current fiscal strategy is anchored by a long-term debt objective. Whereas gross debt has sometimes been used in the past as an indicator of the debt constraint facing the government, the current objective uses net debt. Net debt can be seen as better reflecting the underlying strength of the Crown balance sheet because it incorporates gross debt and as well as liquid financial assets held by the government.

The Government developed a new definition of net debt in 2009, as there are legitimate choices about which financial assets to include. Net core Crown debt excluding NZS Fund and advances, referred to as net core Crown debt, is a core Crown measure and more closely correlates with fiscal policy decisions made by the government. The indicator includes gross debt issued by the Sovereign (i.e. core Crown borrowings in the form of Government Stock and Treasury Bills) as well as relatively liquid core Crown financial assets such as cash, cash equivalents and marketable securities.

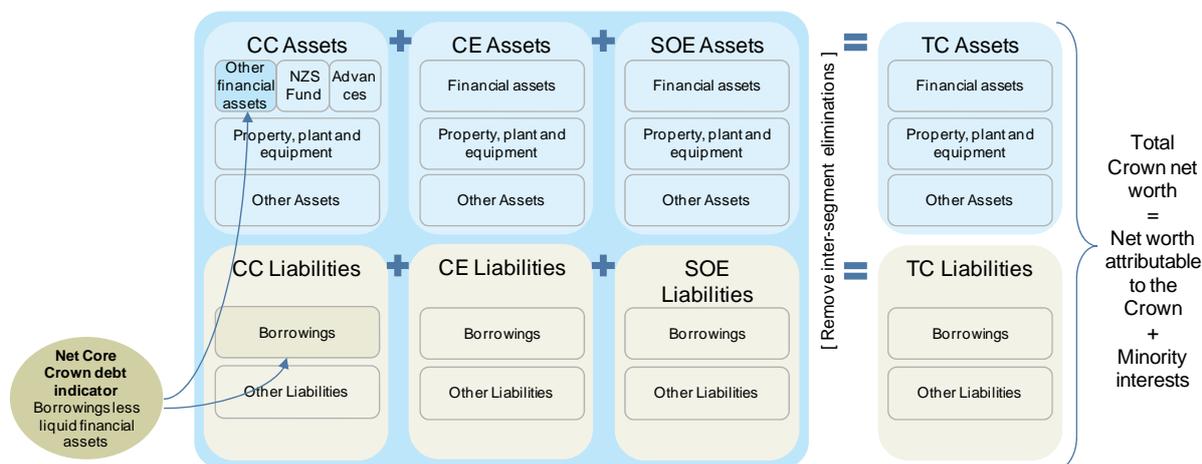
Two classes of core Crown financial assets are excluded:

- ▶ advances (eg, student loans), as these are less liquid than other financial assets and the advances tend to be made for public policy reasons rather than treasury management purposes; and
- ▶ NZS Fund financial assets, as these are ring-fenced for long-term fiscal pressures and their time-varying and volatile nature can complicate communication of a net debt target.²

Figure 5 shows the total Crown balance sheet by segment. It also shows how the net core Crown debt indicator is composed of several elements from the balance sheet. Net core Crown debt is not shown directly on the balance sheet, but its calculation is shown in the Statement of Borrowings.

² See *Fiscal Strategy Report 2009* for an explanation of the change to Core Crown net debt as fiscal anchor.

Figure 5: Core Crown net debt and the balance sheet



4.2 Link between net core Crown debt and total Crown OBEGAL

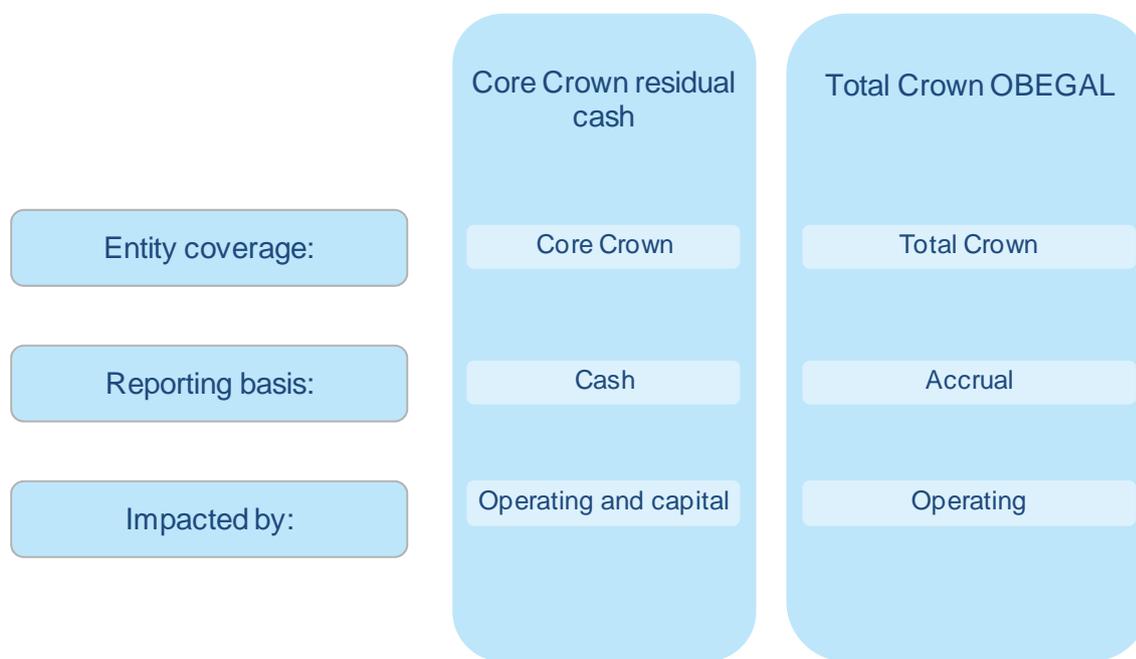
The current fiscal strategy is built around a long-term objective for debt and a short-term intention for the operating balance.

- ▶ The long-term objective for debt is to ensure net core Crown debt remains consistently below 35% of GDP, and is then brought back to a level no higher than 20% of GDP by 2020. This is to rebuild the fiscal buffers that were used following the global financial crisis and Canterbury earthquakes.
- ▶ The short-term indicator of progress is an intention to return the total Crown OBEGAL to surplus as soon as practical and no later than 2014/15, subject to any significant shocks. The *Fiscal Strategy Report 2013* provides more information.

The two fiscal indicators involved – net core Crown debt and total Crown OBEGAL – tend to receive more attention and so are sometimes referred to as headline indicators. These indicators are linked, but there is not a 1:1 relationship between the two. The long-term objective focuses on the ‘stock’ of net debt accumulated by the core Crown, whereas total Crown OBEGAL is a ‘flow’ indicator, measuring the residual balance between accrued flows of revenue and expenses across the whole of government.

The change in net core Crown debt from year to year is primarily driven by core Crown residual cash. Core Crown residual cash measures the core Crown cash surplus (or deficit) after the government’s operating and investing requirements are met. There are three key differences between core Crown residual cash and total Crown OBEGAL (see Figure 6).

Figure 6: Differences between core Crown residual cash and total Crown OBEGAL



1. **Entity coverage:** The total Crown OBEGAL is a *total Crown* indicator, whereas residual cash is a *core Crown* indicator. This means that even the cash element of the total Crown OBEGAL surplus/deficit will not be fully reflected in core Crown residual cash because some of that surplus/deficit will reflect entities outside of the core Crown segment.
2. **Reporting basis:** The total Crown OBEGAL is prepared on an accrual basis, whereas core Crown residual cash is influenced by cash transactions. This means some of the items included in the OBEGAL such as depreciation will not impact on core Crown residual cash.
3. **Impact of capital:** The total Crown OBEGAL is only impacted by the operating activities of the Government, whereas residual cash is influenced by both the operating and capital activities (e.g. issuing student loans, purchasing physical assets) of the government.

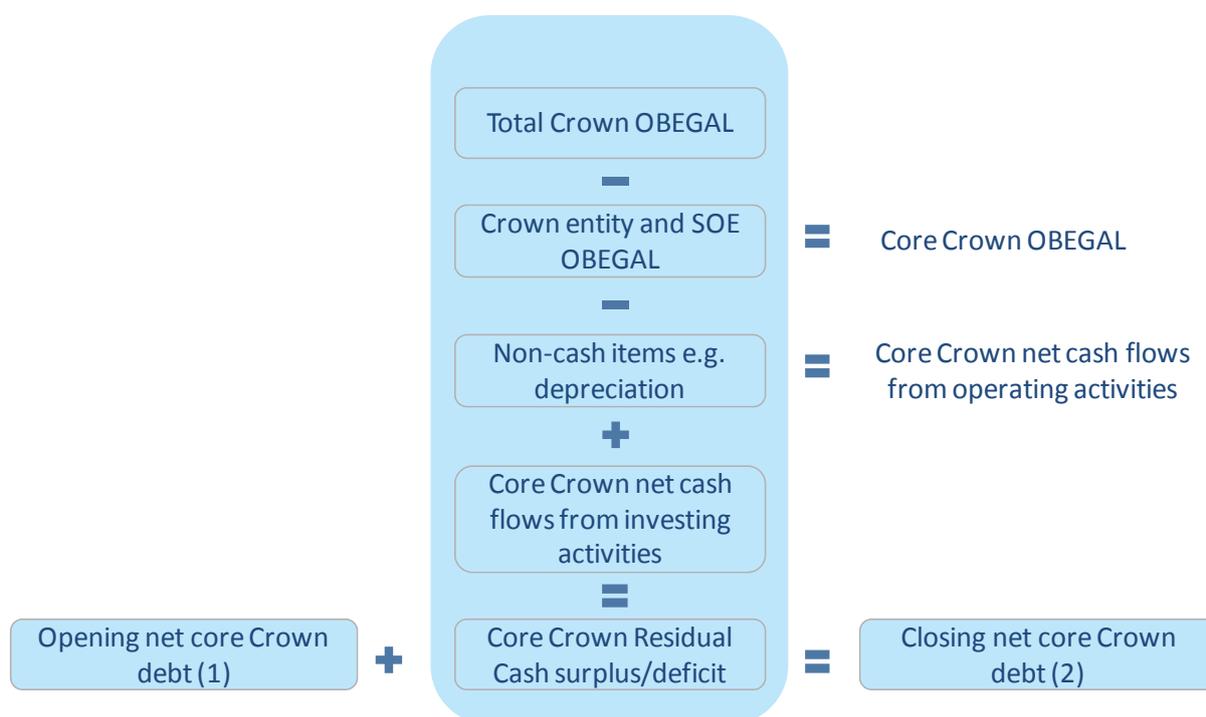
4.3 Reconciling the total Crown OBEGAL to net core Crown debt

Several steps are involved in determining how the total Crown OBEGAL affects net core Crown debt. Firstly, the core Crown's net cash flow from operations is derived from total Crown OBEGAL by removing:

- ▶ any retained surpluses held by Crown entities, state owned enterprise, and the NZS Fund;
- ▶ non-cash items within the core Crown (e.g. depreciation, impairments); and
- ▶ working capital movements within the core Crown (e.g. increases/decreases in receivables or inventories).

Core Crown net cash flows from operations can then be reconciled to core Crown residual cash by adding core Crown net cash flows from investing activity, e.g. sale of assets, purchase of physical assets and investments, advances, and NZS Fund contributions. A core Crown residual cash surplus is available for the government to repay debt or invest. A negative balance increases borrowings or reduces financial assets and means an increase in net core Crown debt.

Figure 7: Reconciliation between total Crown OBEGAL and net core Crown debt



(1) Refer Figure 5 for calculation

(2) Closing position is also impacted by fair valuation movements, which are generally minimal.