NSW GOVERNMENT | The Treasury

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Guide for Audit & Risk Committees: Understanding Financial Statements

What are Financial Statements?

The financial statements comprise the:

- Statement of Financial Position (Balance Sheet)
- Statement of Profit or Loss and other Comprehensive Income (Comprehensive Income Statement)
- Statement of Cash Flows (Cash Flow Statement)
- Statement of Changes in Equity.

Collectively these are called the Primary Financial Statements and are accompanied by a series of notes. Financial statements can be prepared as at any date, and covering any period, but are usually prepared as at the last day of the financial year, covering the preceding year (Annual Financial Statements).

The Public Finance and Audit Act (1983) requires the Annual Financial Statements to give a true and fair view of an agency's financial performance for the financial year and financial position as at the last day of the financial year.

Annual Financial Statements in the public sector context form a key mechanism for Agencies to discharge their accountabilities to the users of financial information including Parliament, Ministers and the Community. All departments, statutory bodies and the entities they control in the General Government Sector (GGS) must prepare separate Annual Financial Statements in accordance with Australian Accounting Standards, the Public Finance and Audit Act (1983), Treasurer's Directions and NSW Treasury Circulars and Policies.

How Are Annual Financial Statements Prepared?

To ensure uniformity and comparability in the preparation of Annual Financial Statements, a set of guidelines and rules must be followed. These are commonly referred to as Australian Generally Accepted Accounting Principles. As part of this, Agencies within the GGS must adhere to Mandates of Options and Major Policy Decisions under Australian Accounting Standards, a Treasury Circular that is released annually. To assist Agencies with preparing their Annual Financial Statements, Treasury also publishes a model set of Annual Financial Statements called the Financial Reporting Code (FRC). The FRC outlines the form and content of the Annual Financial Statements and provides guidance on the interpretation and application of Australian Accounting Standards within the GGS.

The NSW Auditor-General is the independent auditor of the NSW public sector. An external audit of the Annual Financial Statements is undertaken each financial year by auditors appointed by the NSW Audit Office. The purpose of the external audit is to provide reasonable assurance to all stakeholders that the Annual Financial Statements, as presented, give a true and fair view of the Agency's financial performance and position, in accordance with Australian Accounting Standards, and comply with relevant laws, such as the Public Finance and Audit Act 1983. Further, the audit assesses whether any material judgements, assumptions and estimates made in preparing the Annual Financial Statements are reasonable. The audit will also consider the applicability of legislation, regulations and policies where these have a material impact on the Annual Financial Statements.

What is the Role of the ARC?

One of the fundamental responsibilities of the Audit & Risk Committee (ARC) is to provide oversight of an Agency's financial information, including Annual Financial Statements. There are various stages involved in the preparation of financial information including:

- collection and collation of financial data
- generation of financial information from that data
- presentation of that information in a clear and accurate manner as to present a true and fair view of the Agency's financial position and activities.

Internal Audit and Risk Management Policy for the NSW Public Sector (TPP 15-03) outlines a number of specific tasks associated with providing oversight of an Agency's financial information, including review of an agency's Early Close and year-end procedures[1].

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[1] Refer to clause 3.2.3 and the responsibilities in the Audit & Risk Committee Model Charter at Annexure B to TPP 15-03.

What is Early Close?

Treasury's Early Close procedures are designed to deliver a smoother year-end process, provide for more effective resolution of issues and improve the quality of Annual Financial Statements. Preparing financial statements at the Early Close date is a good test of an Agency's processes and controls over the preparation process and can identify specific financial reporting risks for early resolution.

Early Close procedures require the preparation of a set of pro-forma financial statements and the preparation of non-financial asset valuations and associated disclosures as at 31 March. The purpose of these procedures is to ensure the integrity of the year-to-date position and highlight issues to be resolved before the end of the financial year. If the agency undertakes Early Close procedures, the ARC should review the strength of the processes around Early Close and any interim external audit findings. It is the responsibility of the ARC to follow up on whether the findings of the auditor's Early Close review have been adequately addressed in the Annual Financial Statements.

The ARC has an important role in reviewing the Annual Financial Statements of the Agency prior to audit. This involves ensuring that key risk areas (such as the completion of asset revaluations) have been addressed and the Annual Financial Statement preparation procedures are robust. The ARC can also reinforce and track the resolution of audit findings from prior years to minimise the risk of repeat audit findings for known problem areas in the current financial year. Towards the end of the audit of the Annual Financial Statements, the external auditors will also issue a client service report setting out the audit findings for consideration prior to the issue of their formal audit opinion. This is also provided to the ARC and gives a final opportunity to review and seek resolution of any material issues.

The aim of the ARC's review of the Annual Financial Statements is to:

- confirm sound financial management frameworks and processes are in place
- ensure the Annual Financial Statements represent a true and fair view of the Agency's financial position and activities
- provide the Agency Head with a recommendation that the Annual Financial Statements are in order for signing.

The ARC should meet to discuss the Annual Financial Statement preparation process shortly after the end of the financial year.

What Should Each Primary Financial Statement Contain?

Balance Sheet

The Balance Sheet portrays the financial strength of an Agency by showing an Agency's assets, liabilities and equity. It can be thought of as a snapshot of the financial position as at the end of a financial year.

The Balance Sheet is presented in two sections, being the Assets & Liabilities and the Owners' Equity. The Balance Sheet must always conform to the accounting equation:

ASSETS – LIABILITIES = OWNERS' EQUITY

Comprehensive Income Statement

The Comprehensive Income Statement represents how an Agency has generated revenue and incurred expenditure during the financial year. It reports how an Agency performed during the year and shows whether operations have resulted in a surplus or deficit (profit or a loss). The Comprehensive Income Statement also includes other comprehensive income that is required by particular Accounting Standards to be reported outside of the profit or loss, such as revaluations of property, plant and equipment, and certain actuarial gains and losses.

The Comprehensive Income Statement shows the Revenue, Appropriations and Grants the Agency received throughout the year alongside the Expenditure incurred in delivering on the Agency's objectives. The net result after deducting the Total Expenditure from Total Revenue is the surplus or deficit for the year. Total comprehensive income then reflects the net result and other comprehensive income.

Cash Flow Statement

The Cash Flow Statement sets out the effect of an Agency's cash flows throughout the financial year on its cash balance. The ability to effectively generate and manage cash is important because an Agency needs to have enough cash to meet its payment obligations in a timely manner.

The Cash Flow Statement includes cash inflows and outflows in the reporting period, even if the transaction relates to the prior or following accounting period (e.g. prepaid expenses). The Cash Flow Statement also excludes items that do not involve a cash inflow or outflow (e.g. depreciation).

The bottom line of the Cash Flow Statement shows whether there was a Net Cash Inflow or a Net Cash Outflow over the course of the entire financial year.

The Cash Flow Statement is divided into the following sections:

- Operating Activities: cash flows that relate directly to the Agency's operations (e.g. Government Grants Received for Operating Purposes, Payments to Suppliers and Employees)
- Investing Activities: cash flows that relate to long-term assets including capital investments (e.g. Government Grants Received for Capital Purposes, Purchase and / or Disposal of Assets)
- Financing Activities: cash flows that relate to borrowing and other financing activities, as well as equity (e.g. Loan Proceeds and Repayments, Interest Payments).

The Statement of Changes in Equity

The Statement of Changes in Equity reconciles the activity in the equity section of the Balance Sheet from year-to-year. Common changes in equity are the result of asset revaluation surpluses or deficits, or a change in net assets from equity transfers (e.g. due to Machinery of Government changes).

Notes to the Annual Financial Statements

The Notes to the Annual Financial Statements provide narrative descriptions or breakdowns of items presented in the Primary Financial Statements (e.g. expense, revenue, asset and liability breakdowns, asset valuations, leases) and information about items that are not recognised in the Primary Financial Statements (e.g. contingent assets and liabilities). They also include information on the Agency's significant accounting policies and material events that occurred after the end of the reporting period.

The notes can also include information that an Agency would like to disclose but which cannot be incorporated into the Primary Financial Statements. The Australian Accounting Standards promote the presentation of note disclosures that are material in nature.

What Else Should the ARC Consider?

It is important to note that this section does not provide an exhaustive list and that each individual Agency will have a unique combination of systems, environmental factors and operating contexts that will be relevant to the ARC's review of the Annual Financial Statements. ARC members should keep this in mind when identifying areas for consideration.

The following issues may be pertinent when reviewing the Annual Financial Statements:

1 Materiality

Information is material if omitting or misstating it has the potential to mislead users of financial information when they are making decisions. The nature and size of items that are material will differ between Agencies depending on the Agency's size, purpose and operations. The Annual Financial Statements should present a true and fair view of the Agency's activities and financial position in all material respects.

2 Information Provided by Management

Management should provide a briefing explaining all material issues the ARC should be aware of, including any unresolved issues raised by the auditors where they could result in an audit qualification.

Large variations in account balances between the current year and previous years should be explained by management, as should large deficits or surpluses. These may reflect significant changes in activity, unusual transactions or inaccurate financial planning.

Management should also provide proper documentation outlining the basis for significant management judgements or assumptions and their impact on the Annual Financial Statements, as well as details of, and justifications for, any new accounting approaches that have been adopted.

The ARC should be able to obtain whatever information it deems necessary from the Agency's management in order to undertake a review of the Annual Financial Statements.

3 Agency Context and Operations

When reviewing the Annual Financial Statements, the ARC should remain cognisant of:

- issues identified in previous audits, particularly any that remain unresolved
- the impact of any Machinery of Government changes on the Annual Financial Statements, including the transfer in / out of service delivery responsibilities and the associated assets and resources
- the use of new or alternative means of financing projects or acquiring assets (e.g. using Private Finance Initiatives or finance leases) and the accounting treatments used to account for these
- their own knowledge of the agency and its operating environment.

Glossary

The Glossary has been provided to assist ARC members in their understanding of common terminology used.

Accounts Payable	Accounts Payable represents amounts that an Agency owes to its suppliers where it has received products or services but has yet to pay for them. Agencies in NSW should make arrangements to pay their suppliers within 30 days. Accounts Payable balances should therefore relate to goods and services received close to the end of the reporting period. Accounts Payable are classified as current liabilities on the Balance Sheet.
Accounts Receivable	Accounts Receivable relates to the amounts due from customers but not yet collected. This occurs, for example, where an invoice has been issued but the customer has not yet paid the account. The collectability of receivables is reviewed on an ongoing basis. Where it is deemed unlikely that future cash inflows will be received in respect of a receivable, the value of Accounts Receivable on the Balance Sheet is reduced accordingly. This is called an impairment or provision for bad debts. Accounts Receivable are generally classified as a current asset on the Balance Sheet.
Accrued Revenue / Expenses	Accrued Revenue / Expenses are adjustments made where goods and services are delivered / received prior to the end of the reporting period but the associated revenue / expense has not been received / paid by the end of the reporting period. Accruals ensure that the Annual Financial Statements for the year reflect all activity that occurred in that year – even when invoices have not been issued or received by the reporting date. Accrued Revenue is classified as an asset and Accrued Expenses are classified as a liability on the Balance Sheet.
Amortisation	Amortisation is a process similar to Depreciation but is related to intangible non-current assets. It involves spreading the cost of the asset, less the asset's residual value, over its useful life. Amortisation is classified as an expense on the Income Statement.
Appropriations and Grants	Appropriations and Grants represent the levels of Government funding involved in the delivery of services and products to the public by Agencies. Appropriations are approved each year by an Act of Parliament. An Appropriation is made to a portfolio Minister through the Appropriations Act for the services of the Department. Once formal Appropriation has been made via the Appropriations Act, the resources are transferred to the Department from the NSW Government's Consolidated Fund. Departments are the lead Agency for clusters, which contain a number of related Agencies. Other Agencies within the cluster are funded by the department through Grants. Appropriations are also made directly to special offices which benefit from greater independence (for example, the Public Service Commission and the Independent Commission against Corruption).

	Grants may also be received from organisations, including non-related Agencies and the Federal Government. Where provided these are likely to be ring-fenced for the delivery of a specified capital project, service objective or policy priority and may be covered by a service level agreement (in the case of inter-Agency Grants). Appropriations and Grants are classified as revenue on the Income Statement.
Assets	An Asset is a resource that is controlled by an entity as a result of past events, from which future economic benefits are expected to flow to the entity.
Australian Accounting Standards	Australian Accounting Standards set out the correct accounting treatments for a wide range of events and the financial transactions that result from them. There remains, however, a degree of flexibility for Agencies to determine the accounting policies that are most suitable for their particular operational environment and situation. There will also be a need for Agencies to exercise a degree of judgment and apply measurement methodologies and assumptions in the preparation of Annual Financial Statements, and these approaches will need to be disclosed. The Agency may also need to demonstrate that it has applied relevant changes in accounting standards.
Cash	Cash includes physical notes and coins on hand and the balance in the Agency's transactional bank account. Cash is classified as a current asset on the Balance Sheet.
Cash Equivalents	Cash Equivalents are highly liquid, very safe investments that can be converted to cash at short notice, for example short-term deposits with NSW Treasury Corporation. Deposits must be for no longer than three months and cash must be accessible at short notice without penalty to be classed as a Cash Equivalent. The Treasurer, in conjunction with the lead Minister, has the power to set the investment powers of Agencies under the *Public Authorities (Financial Arrangements) Act (1987)*. Cash Equivalents are classified as current assets on the Balance Sheet.
Contingent Assets / Liabilities	Contingent Assets / Liabilities are similar to provisions but are either dependent on the occurrence of an uncertain future event, or the resource impact is either not probable or cannot be reasonably estimated. They are not recognised on the Balance Sheet but are disclosed in the notes to the Annual Financial Statements.
Current Assets	Current Assets are those that, the Agency expects, during the normal course of operations, to be converted into cash or used to produce goods and services within a year of the Balance Sheet date, as well as assets held primarily for trading and cash and cash equivalents.

Current Liabilities	Current Liabilities are liabilities an Agency either expects to settle in the normal operating cycle, are due to be settled within the next year, or are primarily held for trading. Liabilities are also Current Liabilities if the agency does not have an unconditional right to defer payment beyond the next year. Current Liabilities include Borrowings, Leases, Tax Liabilities (where applicable) and Accounts Payable.
Depreciation	Depreciation is the systematic allocation of the cost of an asset (or other amount substituted for cost), less its residual value, over its useful life. As an asset is used to deliver products and services over a number of financial years it is not appropriate to charge the full cost of the asset to the Income Statement as an expense in the year of acquisition. Depreciation is an allocation reflecting the use of an asset over the asset's estimated useful life and is classified as an expense on the Income Statement. To ensure Depreciation remains accurate both the asset's value and useful life are reviewed and adjusted as necessary. Depreciation is applied to all tangible non-current assets with a useful life greater than one year, excluding land.
Early Close Procedures	Early Close Procedures are required to be performed by nominated Agencies in order to mitigate the risk of audit qualification and increase management assurance over the Annual Financial Statements. This involves preparing interim Primary Financial Statements for the financial year to 31 March along with selected Note disclosures covering, for example, the application of new and revised accounting standards. Treasury issues an annual Treasury Circular with Early Close Procedures that must be followed, and a checklist of key risk areas for Agencies to review which must be signed by Chief Financial Officers and submitted to Treasury.
Expenses	Expenses are operational costs that result in a depletion of assets or the incurrence of liabilities. The majority of Expenses result in an outflow of cash (e.g. staffing costs, electricity, vehicle maintenance), however others may result in a decrease to the value of a non-current asset (e.g. depreciation, amortisation). Expenses can also include taxation (where applicable).
Financial Assets	Financial Assets usually include cash, cash equivalents and financial instruments. Financial Assets are classified as either current or non-current assets on the Balance Sheet, depending on how and when the Agency is able, or intends, to use them.
Financial Reporting Code	The *Financial Reporting Code for NSW General Government Sector Entities* sets out the financial reporting framework for all NSW General Government Sector Agencies. It outlines best practice form and content for Annual Financial statements, including the accompanying Note disclosures.

General Government Sector	General Government Sector is an institutional sector comprising all Government units and non-profit institutions controlled and mainly financed by Government. They usually deliver services outside the market mechanism.
Goods & Services Tax / Fringe Benefits Tax / Payroll Tax Payable	Goods & Services Tax / Fringe Benefits Tax / Payroll Tax Payable is the liability for tax to be paid to the Office of State Revenue or the Australian Taxation Office. The tax amounts payable will vary between different types of NSW Agencies.
Income / Revenue	Income / Revenue is an economic inflow arising from the activities of an Agency. It may come in the form of an increase in assets (e.g. cash) or a decrease in liabilities. Revenue does not include equity contributions from owners.
Liabilities	Liabilities are an Agency's obligations as a result of past events that are expected to result in an outflow of resources (such as cash).
Non-Current Assets	Non-Current Assets are all assets that are not classified as current assets, and includes assets an Agency controls or is able to use to make products or provide services to its customers over a number of financial years. Non-Current Assets can be made up of Tangible and Intangible Assets. Tangible Assets include physical property, such as land, buildings, plant, vehicles and equipment. Intangible Assets are non-monetary assets without physical substance which nevertheless exist and have value, such as trademarks and patents.
Non-Current Liabilities	Non-Current Liabilities are liabilities expected to fall due after more than one year, and where the agency has the unconditional right to settle after more than one year. They can include leasing costs, borrowings, provisions and other long-term liabilities.
Owner's Equity	Owners' Equity, in this context, represents the ownership interests of the Government in an Agency.
Prepaid Expenses	Prepaid Expenses result from an Agency making payments for goods and services that are to be received, or relate to, or are to be used, in the future or over time (e.g. insurance premiums). Prepaid Expenses are classified as an asset on the Balance Sheet.
Property, Plant and Equipment	Property, Plant and Equipment are non-current assets that are used by an Agency in the course of its operational activity. This category includes buildings, machinery, equipment, furniture, automobiles and trucks. It also includes land (although land is not depreciated). Although the life-span of these assets (useful economic life) varies according to the asset type, they are all used to support operational activity over more than one financial year. These assets are initially recorded on the Balance Sheet at cost price, and then routinely revalued to ensure the value (gross carrying amount) on the Balance Sheet remains reasonable. The Balance Sheet value of an asset should not exceed the value an Agency could expect to achieve if it were to sell the asset or continue to use it.

Provisions	Provisions are estimates of liabilities that relate to past events, but which are uncertain in timing or amount. However, the requirement to pay is probable and a reliable estimate of the amount can be made.
Reserves	Reserves are a component of equity within the Balance Sheet, and can be distributable or non-distributable. Distributable reserves represent actual cash and can be used to set aside funding for a specific purpose or retain funds for general purposes.
Retained Earnings	Retained Earnings, also known as Accumulated Funds, are an accumulation of an Agency's retained surpluses and deficits. Retained Earnings increase each year when an Agency achieves a surplus, and decrease when an Agency makes a deficit. Retained Earnings are classified as equity on the Balance Sheet.
Total Equity	Total Equity is shown as the amount owners have invested in the Agency (owners' equity) plus or minus the Agency's retained earnings and reserves. It should always equal net assets (i.e. total assets less total liabilities).