Results of audit: Queensland state government financial statements 2011-12

Report to Parliament 7 : 2012-13

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QUEENSLAND

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The Honourable F Simpson MP
Speaker of the Legislative Assembly
Parliament House
BRISBANE QLD 4000

Dear Madam Speaker

This report is prepared under Part 3 Division 3 of the *Auditor-General Act 2009*, and is titled *Results of audit: Queensland state government financial statements 2011-12.*

In accordance with s.67 of the Act, would you please arrange for the report to be tabled in the Legislative Assembly.

Yours sincerely

Andrew Greaves
Auditor-General

Contents

Summary **1**
Conclusions 1
Timeliness and quality of the state government financial statements 1
Financial performance and position 2
Financial sustainability 3
Recommendations 3
Reference to agency comments 3

1. Financial audit context **5**
1.1 Legislative requirements 5
1.2 Scope of report 6
1.3 Audit responsibilities 6
1.4 Common terminology 6
1.5 Report structure 7

2. Results of audit **9**
2.1 Background 10
2.2 Conclusion 10
2.3 Timeliness of financial statements 10
2.4 Quality of financial statements 11
2.5 Recommendation 14

3. Financial performance and position **15**
3.1 Background 16
3.2 Conclusion 16
3.3 Financial performance 16
3.4 Financial position 21

4. Financial sustainability **27**
4.1 Background 28
4.2 Conclusion 28
4.3 Financial sustainability 29
4.4 Recommendation 35

Appendices **37**
Appendix A - Comments 39
Appendix B - General Government Sector (GGS) 45
Appendix C - Public Non-Financial Corporations and Public Financial Corporations 47

Summary

The financial statements for the state of Queensland are required to be audited each year, and an independent audit opinion expressed thereon. The audit opinion adds credibility to the financial information presented. The audited consolidated financial statements 2011-12 — Government of Queensland (state government financial statements) are included as part of the *Report on State Finances* tabled in Parliament by the Treasurer.

This report has been prepared to provide further information on the results of the audit beyond the independent audit opinion. It contains insights into the Total State Sector's (TSS) and General Government Sector's (GGS) financial performance in 2011-12, their position at the end of the year, and factors impacting on the financial sustainability of the state. GGS represents those public sector entities funded mainly by government appropriations. TSS comprises of GGS entities, public financial corporations (PFCs) and public non-financial corporations (PNFCs). PFCs and PNFCs are entities funded through sources other than government appropriations. Appropriations are monies provided by the state to entities to fund the delivery of agreed outcomes.

Conclusions

The audit opinion on the state government financial statements was unqualified. This means that the state government financial statements were prepared in accordance with Australian Accounting Standards and present a true and fair view of the financial position and performance of the GGS and TSS.

Two accounting matters were identified by Queensland Treasury and Trade (QTT) during the audit that required adjustments before the statements were finalised. These did not impact on the overall audit opinion, but did have a positive effect on the GGS overall financial position.

Even with these factors and the receipt of Australian Government grants in advance, four key ratios derived from the state government financial statements over the past five years show a decline in the state's financial sustainability.

Timeliness and quality of the state government financial statements

Although later than last year, legislative timeframes were met for the completion and certification of the state government financial statements. Government structural changes meant that a number of departments and statutory bodies could not complete their own financial statements by the legislated date. This in turn caused the state government financial statements to be delayed.

The quality of the state government financial statements and supporting work papers provided for audit were generally satisfactory. Adjustments were made by QTT to the state government financial statements to correct two past errors. These required changes to accounting policies and adjustments of prior period amounts. The changes in accounting policies meant that at 30 June 2012, the GGS net worth of $170.7 billion was higher by $6 billion than would otherwise have been, had these adjustments not been made. The GGS net worth of $170.7 billion includes GGS investments in PFCs ($0.6 billion) and PNFCs ($21 billion).

Differences were also noted in the way land under roads is valued between the different Australian states. These differences have the potential to impact on a reader's ability to compare the financial positions of each Australian state.

Financial performance and position

Financial performance

This year's results show a reversal in the TSS financial performance from the previous year, with the GGS financial performance returning to 2008-09 and 2009-10 levels. The TSS and GGS use net operating balance as their primary measure of financial performance within the state government financial statements. For the purposes of this report, a positive net operating balance will be referred to as a net operating surplus and a negative net operating balance will be referred to as a net operating deficit.

For 2011-12, the TSS recorded a net operating deficit of $2.1 billion which is lower than the net operating deficit of $3.8 billion in the previous year. Within the GGS, the net operating deficit of $233 million for 2011-12 was significantly lower than the recorded deficit of $1.5 billion in the previous year.

This apparent improvement however, needs to be understood in terms of the significant grants received in advance of need from the Australian Government for natural disaster recovery. The receipt of these grants in the form of national partnership payments in advance of requirement meant that the GGS net operating deficit was $233 million instead of $1.8 billion. From a TSS perspective, the impact of the advance in national partnership payments reduced the TSS net operating deficit from what would have been $3.7 billion to $2.1 billion. The flow-on effect of receiving Australian Government grants in advance means that net operating balance in future years will be affected when these grants are spent.

Financial position

The net worth of the TSS declined for the fifth consecutive year based on an analysis over the past five years. Net worth is the difference of assets over liabilities held.

At 30 June 2012, the net worth of the TSS was $162 billion. This has decreased by $31.8 billion (16.4 per cent) from $193.8 billion at 30 June 2008. This decrease has arisen from a number of factors which include five consecutive years of net operating deficits, write downs to assets (particularly as a result of the recent natural disasters), and changes in the valuation of assets held by the state.

In the past year, the total net worth of the TSS decreased by $11 billion from $173 billion at 30 June 2011. Over half of this decrease was a result of a $5.7 billion increase in the value of superannuation liabilities. This was mainly a result of the decline in actuarially adjusted Australian Government bond yields used to calculate the present value of future superannuation liabilities.

Included within the net worth of the GGS and TSS at 30 June 2012 is $42 billion in land under roads assets which was first recognised within the state government financial statements in 2008-09 as required by Australian Accounting Standards. Net worth at 30 June 2012 would have been $119.9 billion for the TSS and $107.1 billion within the GGS if land under roads had not been recognised. The GGS net worth of $107.1 billion also excludes investments in PFCs ($0.6 billion) and PNFCs ($21 billion). These were excluded because the GGS holds investments in PFCs and PNFCs. The GGS, PFCs and PNFCs combine to make up the TSS.

Financial sustainability

The state's financial sustainability is important to its ability to fulfill its economic, social and environmental obligations both now and into the future. Like any organisation, it must live within its means, and soundly manage its finances over the long term.

While the state budget includes fiscal principles, the state does not report performance against a comprehensive set of financial sustainability indicators that are used in the longer term. Four key ratios used in this report focus on the information included in the state government financial statements. These show that the state's financial sustainability has declined in relative terms over the past five financial years.

The growth in public sector expenditure and ongoing net operating deficits erode the state's capacity to self-finance acquisitions of property, plant and equipment.

The state's stock of non-financial assets is being added to at a faster rate than existing assets are depreciating, but this rate has been in decline for the past three years. The growth in borrowings required to finance asset acquisitions has been greater than the growth in state revenues, thereby reducing the state's capacity to repay debt from its own-sourced revenues.

There are risks to the state's financial sustainability. These risks include the qualification of the Commonwealth expenditure reimbursement financial statements for almost 39 per cent of the $2.5 billion in Natural Disaster Recovery and Relief Arrangement expenditure over the past three financial years.

Recommendations

It is recommended that Queensland Treasury and Trade:

1. **work with other states to agree on a consistent approach to value and disclose land under roads**
2. **develop a comprehensive suite of financial sustainability indicators for use over the longer term. The indicators should include measures for operating performance, capital expenditure and financing, and should measure performance over time against set targets.**

Reference to agency comments

In accordance with Section 64 of *the Auditor-General Act 2009,* a copy of this report was provided to the Under Treasurer as the accountable officer for Queensland Treasury and Trade**,** and the Treasurer with a request for comments.

Their views have been considered in reaching our audit conclusions and are represented to the extent relevant and warranted in preparing this report.

The full comments received are included in Appendix A of this report.

1. Financial audit context

1.1 Legislative requirements

Section 25 of the *Financial Accountability Act 2009* requires the Treasurer to prepare each financial year, financial statements for the Total State Sector (TSS) and General Government Sector (GGS). Together these statements are called the audited consolidated financial statements 2011-12 — Government of Queensland (state government financial statements).

The Treasurer, through Queensland Treasury and Trade, is responsible for the preparing and presenting the state government financial statements fairly in accordance with prescribed accounting requirements identified in the *Financial Accountability Act 2009* and with Accounting Standard AASB 1049 *Whole of Government and General Government Sector Financial Reporting (AASB 1049)*.

The state government financial statements must be prepared within six months after the end of each financial year, or a later date agreed between the Treasurer and the Auditor-General.

The Treasurer, the Under Treasurer, and the most senior officer of the department responsible for preparing the state government financial statements must each sign and certify whether, in their opinions, the state government financial statements have been properly drawn up, under the prescribed requirements, to present a true and fair view of:

- the financial operations and cash flows of the Government of Queensland for the financial year
- the financial position of the Government of Queensland at the end of the financial year to which the state government financial statements relate.

As soon as practicable after the state government financial statements have been prepared and certified, the Treasurer must send the state government financial statements to the Auditor-General. The Treasurer must table the state government financial statements and report in the Legislative Assembly within 14 days of the Auditor-General returning the audited state government financial statements to the Treasurer.

1.1.1. General Government Sector (GGS)

AASB 1049 defines the GGS as comprising all government units and non-profit institutions controlled and mainly financed by government appropriations. For the purposes of Queensland Government, the GGS includes all departments and statutory bodies as defined within Sections 8 and 9 of the *Financial Accountability Act 2009*. Included in the GGS are 57 entities which are listed in Appendix B.

1.1.2. Total State Sector (TSS)

The TSS includes all GGS entities, together with the three public financial corporations (PFC) and 23 public non-financial corporations (PNFC). These entities are listed in Appendix C.

AASB 1049 defines:

- PFC as comprising of resident government controlled corporations mainly engaged in financial intermediation or provision of auxiliary financial services
- PNFC as comprising resident government controlled corporations mainly engaged in the production of market goods and/or non-financial services.

In Queensland, PFCs and PNFCs are mainly government-owned corporations for the purposes of the *Government Owned Corporations Act 1993*, with a profit-making objective. PFCs and PNFCs are mainly financed from sources other than government appropriations.

1.2 Scope of report

The public sector entities consolidated into the state government financial statements were those controlled by the state and considered to be material. Public sector entities are generally considered material if they meet either of the following criteria: net operating result in excess of $4 million, or net assets in excess of $50 million.

Entities specifically excluded from consolidation into the state government financial statements include those not directly controlled by the state. These include local governments and public universities.

1.3 Audit responsibilities

Section 42 of the *Auditor-General Act 2009* requires the audit of the state government financial statements and the preparation of a report about them. The report must state whether:

- the Auditor-General has received all the information and explanations required by the Auditor-General
- the financial report has been drawn up under prescribed requirements, so as to present a true and fair view, of the financial operations and cash flows of the Government of Queensland for the financial year and of the financial position at the end of that year.

As soon as reasonably practicable after the Auditor-General prepares the report, the Auditor-General must give the state government financial statements and the report to the Treasurer.

The auditor's report, which includes the audit opinion, provides assurance about the reliability of the financial report, including compliance with legislative requirements. In accordance with Australian Auditing Standards, one or more of the following audit opinion types may be issued:

- Unqualified opinions are issued where the financial statements comply with relevant accounting standards and prescribed requirements.
- A qualification is issued when the financial statements as a whole comply with relevant accounting standards and legislative requirements, with the exceptions noted in the opinion.
- An adverse opinion is issued when the financial statements as a whole do not comply with relevant accounting standards and legislative requirements.
- A disclaimer of opinion is issued when the auditor is unable to express an opinion as to whether the financial statements comply with relevant accounting standards and legislative requirements.

An emphasis of matter paragraph may be included with the audit opinion to highlight an issue which the auditor believes the users of the financial statements need to be aware of. The inclusion of an emphasis of matter paragraph does not modify the audit opinion.

1.4 Common terminology

All references to assets or net worth of the GGS and TSS at 30 June 2008 include land under roads of $40 billion which was restated within the comparatives to the 2008-09 state government financial statements.

A positive net operating balance is referred to as a net operating surplus and a negative net operating balance is referred to as a net operating deficit in this report.

1.5 Report structure

This report is structured as follows:

- Chapter 2 discusses the results of the audit, including the audit opinion issued, and overall quality and timeliness of the state government financial statements.
- Chapter 3 provides an analysis of the state's financial performance and position in 2011-12.
- Chapter 4 contains information about the state's financial sustainability, including risks that are likely to impact the future financial performance and position of the state.
- Appendix A contains responses received.
- Appendix B contains a list of entities included in the GGS.
- Appendix C details those entities not part of the GGS but included as part of the TSS.

2. Results of audit

In brief

Background

The audited consolidated financial statements 2011-12 — Government of Queensland (state government financial statements) provide users with information about the financial management of the General Government Sector (GGS) and the Total State Sector (TSS) by the Queensland Government. They also detail the financial position, performance, and cash flows of the GGS and TSS.

Key findings

- An unqualified audit opinion was issued on the state government financial statements meaning that the financial statements were properly drawn up under prescribed requirements to present a true and fair view.
- The 2011-12 state government financial statements were provided for audit on 23 November 2012, eight weeks later than last year. The delay was mainly due to the extensions of time granted to departments and 29 statutory bodies to complete their financial statements. The state government financial statements were, however, certified within statutory timeframes.
- The quality of the state government financial statements and supporting work papers were generally satisfactory. More work is required on the valuation of land under roads to improve the comparability of valuations between states.
- Two errors to the prior year state government financial statements were identified this year and retrospective adjustments were made totaling $4 711 million at 1 July 2010 and $580 million for the 2010-11 financial year. These adjustments:
  - corrected a prior period accounting policy by retrospectively changing the basis by which GGS debt is valued from fair value to amortised cost. This change decreased the value of debt recorded in the GGS by $475 million at 1 July 2010 and by $33 million between 1 July 2010 and 30 June 2011.
  - de-recognised GGS investments in public sector entities where they were negative, that is where liabilities exceed the value of assets. As a result, GGS investments in public sector entities increased by $4 236 million at 1 July 2010.
- These changes meant that at 30 June 2012, the GGS net worth of $170.7 billion was $6 billion higher than otherwise would have been had these accounting policies not changed.

Recommendation

1. It is recommended that Queensland Treasury and Trade work with other states to agree on a consistent approach to value and disclose land under roads.

2.1 Background

The state government financial statements outline the operations of the Queensland Government on an accrual basis, as required by Australian Accounting Standards.

Their purpose is to provide users with information about:

- the financial management of the General Government Sector (GGS) and Total State Sector (TSS) and accountability for the resources entrusted to it.
- the financial position, performance, and cash flows of the GGS and TSS.

The audit opinion provides assurance about the reliability of the financial report, including its compliance with legislative requirements.

2.2 Conclusion

An unqualified audit opinion was issued on the state government financial statements. An unqualified audit opinion is issued when prescribed requirements relating to the keeping of accounts has been complied with, and the state government financial statements present a true and fair view.

Although later than last year, legislative timeframes were met for the completion and certification of the state government financial statements.

The quality of draft state government financial statements and supporting work papers prepared for audit were generally satisfactory. Adjustments were required to be made to the state government financial statements to correct two past errors.

These corrections resulted in an increase to the reported net worth of the GGS. Further work is also required in valuing land under roads to improve the comparability of financial statements between different states.

2.3 Timeliness of financial statements

The legislative timeframe for the preparation and audit of the state government financial statements by 31 December 2012 was met.

The state government financial statements were provided for audit on 23 November 2012, compared to 30 September in 2011. The audit opinion was issued on 14 December 2012, eight weeks later than in 2010-11.

The additional time required to prepare the state government financial statements was caused by changes to government structures as outlined within Administrative Arrangements Order (No 3) 2012. These changes resulted in new entities being established and responsibilities of existing entities being redistributed.

Extensions of time were granted to all departments and to 29 statutory bodies to provide them sufficient time to deal with these structural changes and finalise their own financial statements. These extensions affected the date by which the state government financial statements could be completed and audited.

2.4 Quality of financial statements

The quality of the state government financial statements and supporting work papers provided were generally satisfactory. More work is required on the valuation of land under roads to improve comparability between states.

Two prior year errors were identified by management and required adjustments to the GGS financial statements. These were:

- a change in the valuation methodology used to value debt from fair value to amortised cost
- de-recognition of investments in public financial corporations (PFCs) and public non-financial corporations (PNFCs) with liabilities exceeding the value of assets.

These adjustments meant that at 30 June 2012, the GGS net worth of $170.7 billion was higher by $6 billion than otherwise would have been had these adjustments not been made. Figure 2A summarises the impact of these changes in prior periods.

Figure 2A
Retrospective adjustments

	1 July 2010	2010-11
Revenue from transactions	Nil	Nil
Expenditure from transactions	Nil	Nil
Assets	Increase by $4 236 million	Decrease of $613 million
Liabilities	Decrease of $475 million	Decrease of $33 million
Equity	Increase of $4 711 million	Decrease of $580 million

Source: QAO

2.4.1. Changes to the values of loans held by GGS entities

Loans held by the GGS previously recorded at fair value are now recorded at amortised cost.

Fair value is the market value of debt which entities must pay if they terminate their loan agreements before the date of maturity. Fair values are impacted by market interest rates. The economic circumstances prevailing during 2011-12 meant generally that the fair value of debt rose, leading to significant unrealised losses for loans valued on this basis.

In contrast, amortised cost is the present value of the remaining principal and interest repayments to be paid over the remaining term of each loan. It is determined by using the contracted loan interest rate and generally does not fluctuate according to the market.

Under Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* amortised cost should have been used to value debt held by GGS entities in prior years, as historically they carry their loans through to maturity, and there is no management intention to terminate them before maturity. This basis of measurement is used also by other states for their GGS, and in this respect the change by Queensland also provides for greater comparability between jurisdictions.

This meant that prior year balances were misstated and changes were required to the comparative balances reported in the state government financial statements in order to apply the change in accounting policy retrospectively.

Figure 2B summarises the changes made to the state government financial statements to apply the change in valuation of loans from fair value to amortised cost.

Figure 2B
Retrospective adjustments due to change in valuation methodology

	1 July 2010	2010-11
Accumulated surplus	Increase by $475 million	Increase by $33 million
Borrowings	Decrease by $475 million	Decrease by $33 million
Interest expense from market movements	Nil	Decrease by $33 million

Source: QAO

The valuation of GGS loans using amortised cost instead of fair value meant that the GGS net worth of $170.7 billion at 30 June 2012 was $2.3 billion higher than otherwise would have been.

2.4.2. GGS investments in PFCs and PNFCs

In prior years, the value of GGS investments in certain public sector entities have been understated because they were recorded as a negative amount when they should have been recorded at zero. Australian Accounting Standard AASB 1049 *Whole of Government and General Government Sector Financial Reporting (AASB 1049)* prohibits recording the book value of the investment in an entity where the total liabilities of that entity exceed the value of its assets. In such circumstances, the investment must be recorded at a zero value rather than as a 'negative' asset.

The GGS investments in entities where liabilities exceeded assets include the Queensland Treasury Corporation (QTC) and the SEQ Water Grid Manager. At 30 June 2012, QTC had $2.2 billion and the SEQ Water Grid Manager had $1.5 billion of liabilities in excess of assets.

QTC's $2.2 billion of liabilities in excess of its assets is the result of a decision in 2008-09 to shift the assets held to fund long-term liabilities off the books of the GGS and into the accounts of QTC, in exchange for a fixed rate of return. These long-term assets are held to fund superannuation, long service leave, and insurance liabilities. QTC is a PFC and is consolidated into the TSS, but not into the GGS. At 30 June 2012, the market value of the assets held by QTC was $29.2 billion and fixed rate of return required by the GGS of QTC was $31.9 billion. This resulted in a net liability of $2.7 billion which contributes to the overall $2.2 billion of liabilities in excess of assets in the accounts of QTC.

The SEQ Water Grid Manager has accumulated $1.5 billion of liabilities in excess of assets because it pays more for the water supplied to it by bulk water entities, than it charges the water retailers and local government councils who buy the water. This cost-price differential means that the SEQ Water Grid Manager has been accumulating significant debt over time to cover its operating costs.

Figure 2C summarises the changes required to the state government financial statements to comply with AASB 1049.

Figure 2C
Retrospective adjustments due to change in recording of investments

	1 July 2010	2010-11
Investments in public sector entities	Increase by $4 236 million	Decrease by $613 million
Reserves	Increase by $4 236 million	Decrease by $613 million

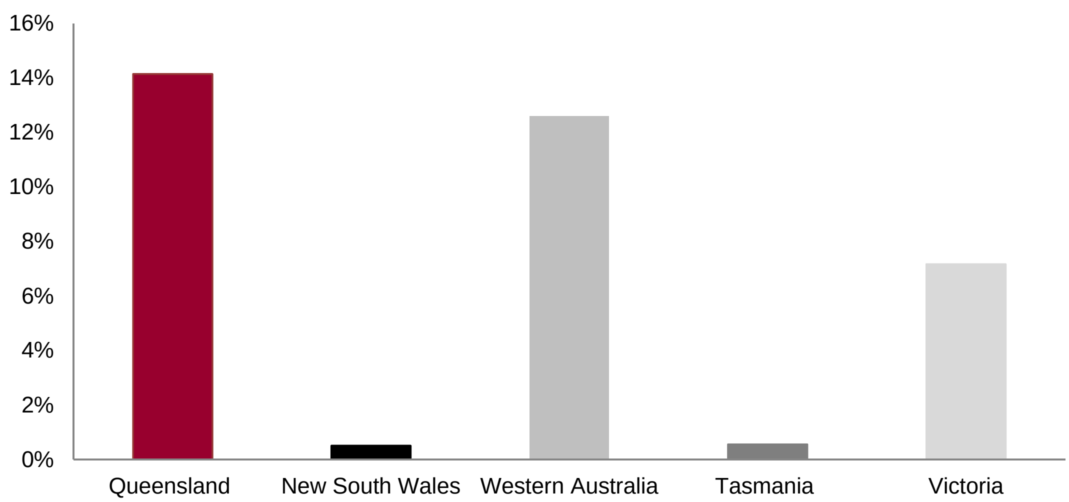
Source: QAO

The effect of this change is that GGS investments in public sector entities of $21.6 billion at 30 June 2012 were $3.7 billion higher than would otherwise have been reported.

2.4.3. Inconsistencies in the way land under roads is valued and disclosed between states

Land under roads is valued differently across the various Australian states. Figure 2D compares the value of land under roads between different states as a percentage of their respective TSS assets. It highlights the impact of the different approaches to valuing land under roads, including the use of different criteria that jurisdictions have in determining roads controlled by the state and roads controlled by other entities such as local governments.

Figure 2D
Land under roads as a proportion of TSS Assets



Source: QAO

Inconsistencies between the jurisdictions undermine a reader's ability to compare the financial position of each jurisdiction. This issue has been raised with the Valuer-General, Queensland Treasury and Trade, and other jurisdictions' Auditors-General to seek a solution.

2.5 Recommendation

1. It is recommended that Queensland Treasury and Trade work with other states to agree on a consistent approach to value and disclose land under roads.

3. Financial performance and position

In brief

Background

Financial performance relates revenues to expenditures, and whether these are consistent with principles of prudent financial management and longer-term sustainability.

The financial position of the General Government Sector (GGS) and Total State Sector (TSS) is represented by its net worth, or the value of assets in excess of liabilities.

Key findings

- The net operating deficit of the TSS decreased to $2.1 billion from $3.8 billion (44.7 per cent) the previous year.
- Within the GGS, net operating deficit decreased to $233 million from $1.5 billion the previous year (84.5 per cent).
- The TSS net operating deficit of $2.1 billion would have been $3.7 billion and the GGS net operating deficit of $233 million would have been $1.8 billion if Australian Government grants of $1.6 billion were not received in advance of requirements.
- The net worth of the TSS decreased from $193.8 billion at 30 June 2008 to $162 billion at 30 June 2012 (16.4 per cent). Over the last year, net worth decreased by $11 billion from $173 billion at 30 June 2011 (6.4 per cent).
- Across the GGS, net worth decreased from $172.3 billion at 30 June 2008 to $149.1 billion (13.5 per cent) at 30 June 2012. Over the past year, GGS net worth decreased by $6.4 billion from $155.5 billion at 30 June 2011 (4.1 per cent). All references to GGS net worth in this chapter exclude investments in public financial corporations (PFCs) of $0.6 billion and public non-financial corporations (PNFCs) of $21 billion.
- Impacting on net worth across both the GGS and TSS were:
  - Increases to superannuation liabilities of $5.7 billion in the TSS and $5.4 billion in the GGS from the previous year. These increases were mainly the result of a decline in actuarially adjusted Australian Government bond yields.
  - Land under roads has also been included in the net worth of both the TSS and GGS since 2008-09. At 30 June 2012, TSS net worth would have been $120 billion instead of $162 billion and GGS net worth would have been $107.1 billion instead of $149.1 billion without the value of land under roads. To assist with comparability, all references to net worth at 30 June 2008 in this report have been restated to include land under roads.
- Impacting only on the GGS net worth over the past year were changes in accounting policies relating to the valuation of GGS loans from fair value to amortised cost. The GGS net worth at 30 June 2012 would have been $2.3 billion lower if GGS loans had continued to be valued using fair value at 30 June 2012.

3.1 Background

The financial performance and position of the General Government Sector (GGS) and Total State Sector (TSS) are measured by the net operating balance and net worth respectively in the consolidated financial statements 2011-12 — Government of Queensland (state government financial statements).

The net operating balance indicates the extent to which the GGS and the TSS received sufficient operating revenues to meet operating expenditures. Net worth is the value of assets in excess of liabilities at 30 June each year.

The GGS, PFCs and PNFCs combine to make up the TSS. For the purposes of this chapter, GGS net worth ($149.1 billion) and GGS total assets ($222 billion) exclude investments in PFCs ($0.6 billion) and PNFCs ($21 billion). This is to aid with comparability with the TSS net worth.

Reported in the state government financial statements was GGS net worth of $170.7 billion and GGS total assets of $243.6 billion.

All other references to net operating balance and net worth are sourced from the state government financial statements.

3.2 Conclusion

The financial performance of the GGS and TSS has improved this year however, the net worth of the GGS and TSS has continued to decline.

The GGS net operating deficit of $233 million is an improvement from the $1.5 billion deficit last year. The TSS net operating deficit of $2.1 billion also improved compared with the $3.8 billion deficit last year.

Financial performance was, however, significantly impacted by Australian Government grants received in advance of requirement. Within the GGS, net operating deficit would have been $1.8 billion instead of $233 million and TSS net operating deficit would have been $3.7 billion instead of $2.1 billion if $1.6 billion in Australian Government grants were not received in advance of when they were required in 2011-12.

The net worth of the GGS and TSS has continued to decline over the past five years. At 30 June 2012, the net worth for the GGS was $149.1 billion and the net worth for the TSS was $162 billion. Contributing to this decline has been the net operating deficits across both the GGS and TSS, write downs in the value of assets (particularly as a result of recent natural disasters), and changes to the value of superannuation liabilities as a result of decreases in actuarially adjusted Australian Government bond yields. Land under roads of $42 billion at 30 June 2012 continues to have a significant impact on the TSS and GGS financial positions since it was initially recognised in 2008-09.

Impacting only on the GGS net worth were changes in the valuation of GGS loans from fair value to amortised cost. This change in valuation methodology meant that at 30 June 2012, GGS net worth was $2.3 billion higher.

3.3 Financial performance

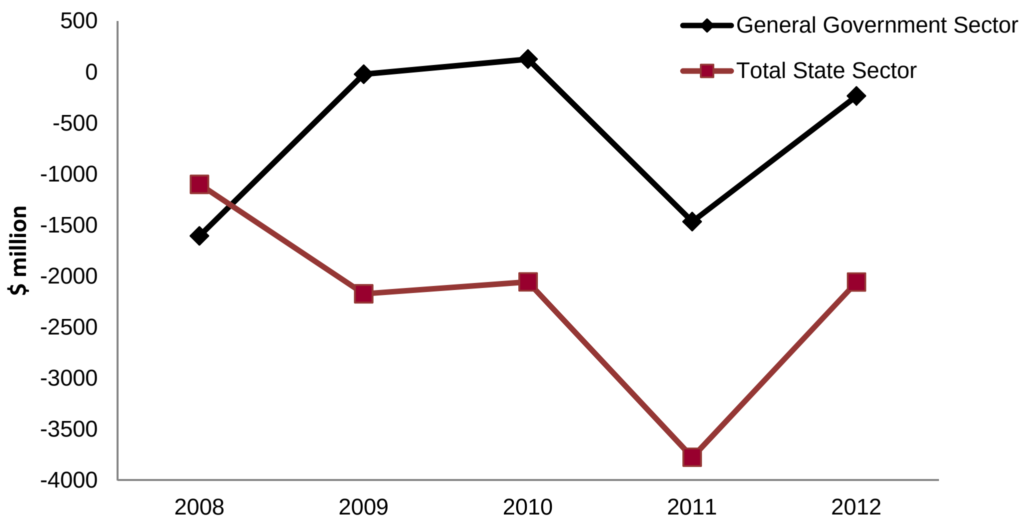
This year's results show a reversal in the TSS net operating deficits from the previous years, with the GGS operating performance returning to 2008-09 and 2009-10 levels.

The GGS result this year however, was significantly improved by the receipt of $2.9 billion in grant money from the Australian Government as part of payments made under the National Partnership Agreement (NPA) for disaster recovery. Of the $2.9 billion received, $1.6 billion had yet to be spent at 30 June 2012. Had these funds been paid during 2012-13 when needed, the operating deficit would have increased to $1.8 billion for the GGS and $3.7 billion for the TSS.

Other factors impacting on financial performance over the past five years include increases to revenue received from the sale of goods and services across the TSS. This was offset by increases in employee expenses within the GGS which in turn impacted on the TSS' financial performance as the GGS forms part of the TSS.

Figure 3A provides an overview of the net operating balance of both the GGS and TSS across the past five years. It shows that the GGS net operating deficit of $233 million returned to levels closer to those achieved in 2008-09 and 2009-10, when a deficit of $21 million and subsequent surplus of $127 million in the following year was achieved.

Figure 3A
State's net operating balance over the past five years



Source: QAO

3.3.1 Revenue

Annual result

TSS revenue of $52.7 billion was $4.9 billion (10.1 per cent) higher in 2011-12 and GGS revenue of $45.7 billion increased by $3.8 billion (9 per cent). The main reasons for these increases were:

- Grant revenue was $2.3 billion higher than last year across both the GGS and TSS. This increased revenue was mainly the result of a $2.9 billion payment of NPA monies from the Australian Government to fund natural disaster relief and recovery arrangement payments towards infrastructure projects. At 30 June 2012, $1.6 billion of the $2.9 billion remained unspent.
- Revenue from the sale of goods and services of $5 billion was $0.8 billion higher than last year within the GGS and $2 billion higher than last year within the TSS. Within the TSS, increases in revenue were mainly the result of increases in recoverable works, sale of electricity, coal rebates, sale of water, and other goods and services.

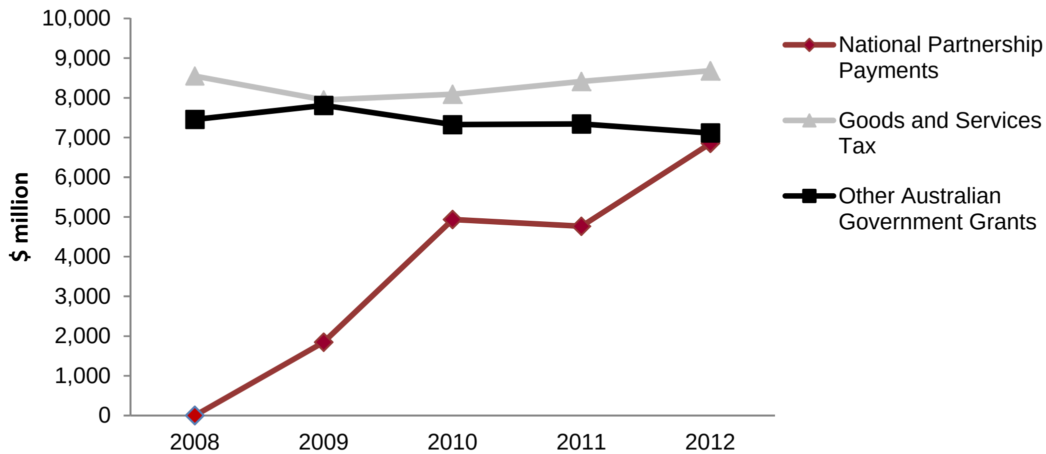
Over the past five years

GGS revenues have increased by 9.9 per cent and the TSS revenue by 6.6 per cent on an average annual compound basis.

The two main streams of revenue within the GGS are state taxes and grant revenue from the Australian Government. Revenue from TSS entities not part of the GGS comprises mainly of sales of goods and services.

Increases in grants from the Australian Government to the GGS has accounted for about half of all increases in revenue over the past five years. Figure 3B shows the break-up of grant revenue over the past five years.

Figure 3B
Australian Government grant revenue over the past five years



Source: QAO

The increase in grant revenues to the GGS is attributable to NPA payments towards the Nation Building and Jobs Plan Program in 2009-10 and NDRRA in 2011-12:

- The Nation Building and Jobs Plan Program is a $36 billion program to invest in road and rail infrastructure across Australia over a six-year period from 2008-09 to 2013-14. In Queensland, $8.7 billion of work has been planned, with $6 billion spent to date. The balance of $2.7 billion is expected to be spent in the next two financial years.
- Since 2008-09, the Australian Government has contributed $5 billion in grants towards NDRRA payments in Queensland, mainly for reconstruction of infrastructure affected by the Queensland floods and Cyclone Yasi. At 30 June 2012, $1.922 billion of this funding had been acquitted and spent on infrastructure projects throughout the state.

3.3.2 Expenditure

Annual result

TSS expenditure increased by $2.7 billion (5.2 per cent) to $54 billion from 2010-11, while GGS expenditure increased by $2.5 billion (5.9 per cent) to $46 billion.

These increases were caused by:

- Employee expenditure within the TSS increased to $19.8 billion from $18.2 billion (or 8.8 per cent) in the previous year. In terms of the GGS, employee expenditure increased to $18.3 billion from $16.8 billion (8.9 per cent) last year. The increases were mainly attributable to promotions, salary increases of about 3-4 per cent across the pay classifications, and payments from the previous government's voluntary redundancy program (VRP) ($476 million in the GGS). This increase was offset by a minor decrease in the number of full-time-equivalent employees from 210,467 at 30 June 2011 to 209,879 at 30 June 2012 (a decrease of 0.3 per cent) within the GGS.
- Across the GGS, interest expense increased by $534 million (47 per cent) from 2010-11, while borrowings increased by $5 billion (or 20 per cent) over the same period. Interest expense increased by almost two and half times that of borrowings from the previous year even with declining interest rates. The difference relates to interest on additional borrowings of $7.5 billion to fund GGS capital commitments as per the state borrowing program. These loans were transferred to the GGS in the last quarter of 2010-11. Consequently, in 2011-12, a full year of interest expense was recognised on the additional $7.5 billion of borrowings in the accounts of the GGS.

Over the past five years

GGS expenditure increased on average by 8.6 per cent on an annual compound basis, from $33 billion in 2007-08 to $46 billion in 2011-12. Across this same period, TSS expenditure grew by 6.9 per cent on an average annual compound basis from $42 billion in 2007-08 to $54.8 billion in 2011-12.

Within the GGS, the main area of expenditure which has increased over the past five years is employee expenses. Other areas of expenditure that have experienced significant increases in the past five years include grant expenditure. Increases in grant expenditure are reflective of the increase in National Partnership Payments from the Australian Government as outlined in Figure 3B.

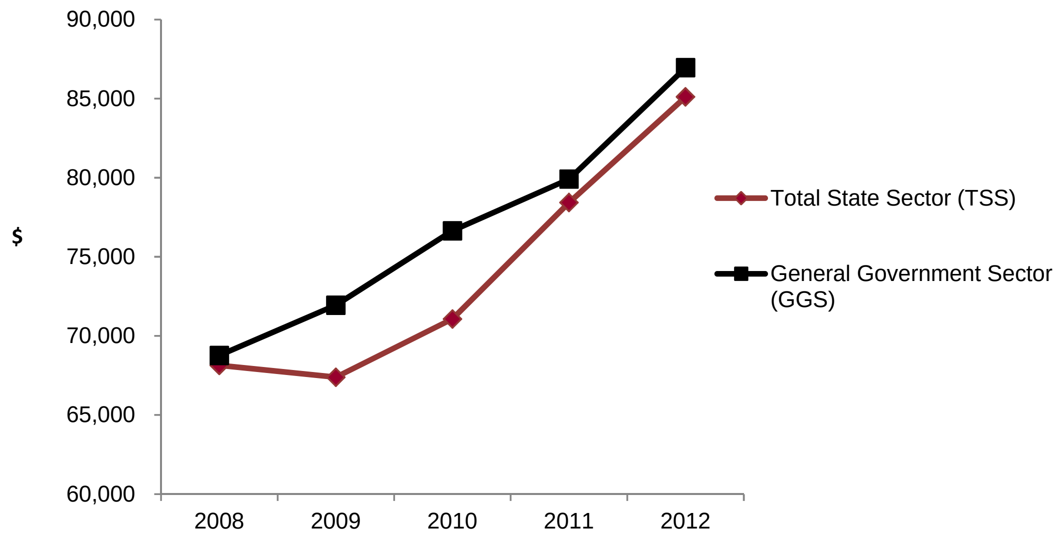
Employee expenses

Employee expenses have grown on average each year by 8.5 per cent in the GGS and 7 per cent in the TSS on an annual compound basis. In 2011-12, employee expenses within the GGS accounted for $18.3 billion of the $46 billion in total expenditure. Within the TSS, employee expenses accounted for $19.8 billion of the $54.8 billion in total expenditure in 2011-12.

The growth in employee expenses within the TSS can be attributed to a 'quantity' increase of 10 877 full-time-equivalent employees between June 2008 and June 2012. In addition to promotions, there was also a 'price' increase in pay rates across the pay classifications of mostly between 3 per cent and 7 per cent.

Figure 3C below illustrates the cost of each full-time-equivalent employee to the GGS and TSS across each of the past five years. As can be seen by the figure below, GGS employee expenses per full-time-equivalent employee increased from $68 770 in 2007-08 to $86 955 in 2011-12 (26.4 per cent) and TSS from $68 143 to $85 100 (24.9 per cent) across the same period. GGS employee expenses include $476 million in VRP in 2011-12. The increases in both sectors are in line with the increase of 29.7 per cent in full-time average total weekly earnings across Queensland over this period.

Figure 3C
Average employee expenses per full-time employee



Source: QAO

3.4 Financial position

Net worth is used to measure both the GGS and TSS financial positions within the state government financial statements.

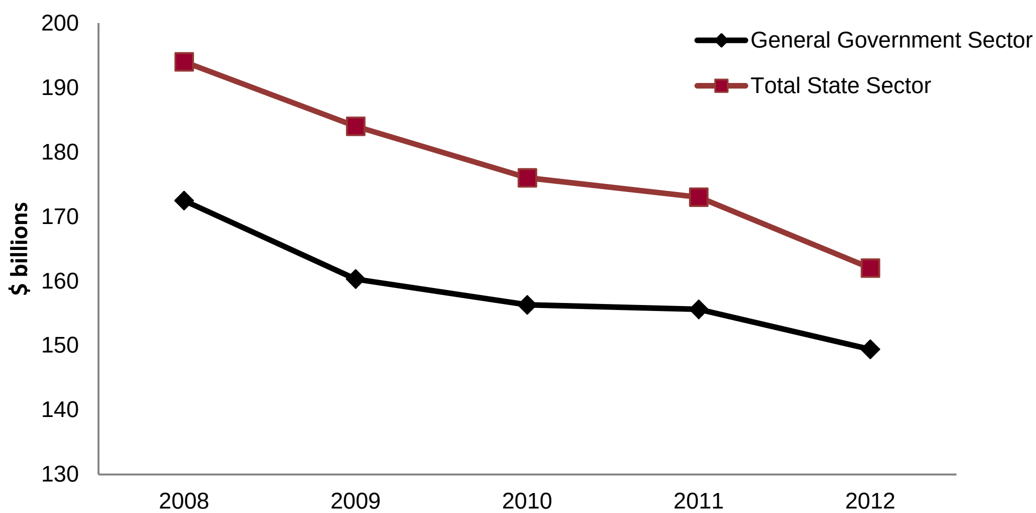
The continuing decline in the net worth of the TSS from $193.8 billion at 30 June 2008 to $162 billion at 30 June 2012 (16.4 per cent) largely reflects the persistent net operating deficits across the past five years. This has reduced TSS accumulated surpluses to $76.2 billion from $94.7 billion five years ago (19.5 per cent). Across the GGS, net worth has decreased from $172.3 billion at 30 June 2008 to $149.1 billion at 30 June 2012.

Other factors contributing to the decline in net worth across the GGS and TSS include write downs in the value of assets (particularly as a result of recent natural disasters), and changes to the value of superannuation liabilities as a result of decreases in actuarially adjusted Australian Government bond yields. Land under roads of $42 billion at 30 June 2012 also continues to have a significant impact on the TSS and GGS financial positions since it was initially recognised in 2008-09.

Impacting only on GGS net worth were changes in the valuation of GGS loans from fair value to amortised cost. This change in valuation methodology meant that at 30 June 2012, GGS net worth was $2.3 billion higher.

Figure 3D outlines the decline in the GGS and TSS net worth over the past five years.

Figure 3D
State's net worth over the past five years



Source: QAO

GGS liabilities increased by $34.5 billion (89.8 per cent) from $38.4 billion at 30 June 2008 to $72.9 billion at 30 June 2012. Over the same period GGS assets increased by $11.2 billion (5.3 per cent) from $210.7 billion at 30 June 2008 to $222 billion at 30 June 2012.

Within the TSS, liabilities increased by $55 billion (66 per cent) from $82.8 billion five years ago, to $137.8 billion at 30 June 2012. Across the same period, TSS assets increased by $23.1 billion (8.4 per cent) from $276.6 billion at 30 June 2008 to $299.7 billion at 30 June 2012.

3.4.1 Assets

Year-end position

TSS assets increased by $6.3 billion (2.2 per cent) to $299.7 billion at 30 June 2012 from the previous year. Across the same period GGS assets increased by $4.4 billion (2 per cent), to $222 billion, from the previous year.

The main reasons for the increases within the TSS were:

- Asset acquisitions and capital infrastructure projects across the transport, health and energy sectors added $11.8 billion to the gross book values of property, plant and equipment: $2.5 billion on the supply of electricity throughout the state; $4.9 billion in new road and transport infrastructure; and $1.3 billion in hospitals and other projects at Queensland Health. This increase was offset by net write downs in assets of $2 billion, and $4.7 billion in depreciation of this property, plant and equipment.
- Asset acquisitions were partly funded by $2.9 billion in Australian Government grants which were received in 2011-12. These grants were received under the NPA to fund natural disaster relief and recovery arrangement payments following the recent natural disasters experienced by the state.
- Decreases in securities other than shares of $1 billion. Securities other than shares comprise a number of financial instruments managed by entities that include QTC and the Queensland Investment Corporation (QIC). Examples include money market deposits, and the state's interest in bonds issued by the federal and other jurisdictions. While investments managed by the QIC increased by $1.2 billion from the previous year, other securities such as money market deposits held mainly by QTC decreased by $2.4 billion.

Over the past five years

TSS assets of $299.7 billion at 30 June 2012 increased by $61.5 billion (or 25.8 per cent) from $238.2 billion at 30 June 2008 as per the 2007-08 state government financial statements. The main reason for this increase relates to the recognition of $42 billion in land under roads within the GGS and TSS which was first recognised on the balance sheet in 2008-09. Land under roads was first recorded as a result of the introduction of Australian Accounting Standard AASB 1051 *Land Under Roads*, and accounts for 67 per cent of the increase in TSS assets between 30 June 2008 and 30 June 2012.

Of the remaining $19.5 billion increase, about $9 billion relates to increases in property, plant and equipment other than land under roads across the same five-year period.

Figure 3E
Breakdown of TSS property plant and equipment (PPE)

	$ billion
PPE at 30 June 2008	216
Acquisitions	57
Disposals	-4
Revaluation decreases and impairment	-15
Depreciation and amortisation	-18
Decrease in book value from the asset sale program	-11
PPE at 30 June 2012	**225**

Source: QAO

Figure 3E reconciles the net $9 billion increase in PPE. In recent years, acquisitions of $57 billion include works for the Queensland floods and cyclone in 2011. The $11 billion decrease in book value from the asset sale program was mainly due to the float of QR National, sale of the Port of Brisbane, and sale of Queensland Motorways Limited.

3.4.2 Liabilities

Year-end position

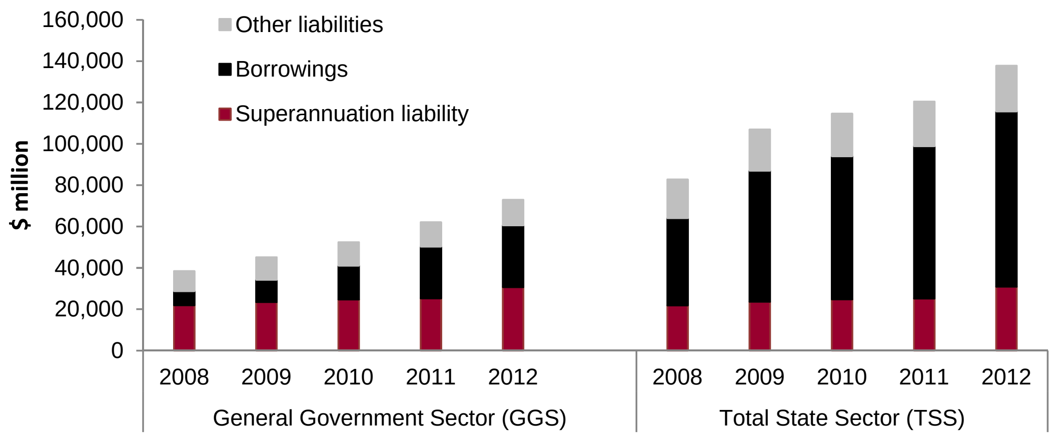
TSS liabilities increased by $17.3 billion (14.4 per cent) to $137.8 billion in 2011-12; while GGS liabilities increased by $10.8 billion (17.4 per cent) to $72.9 billion across the same period. The main reasons for the increases were:

- Borrowings within the TSS increased by $11.4 billion (15.3 per cent) to $85.9 billion at 30 June 2012. Of this increase, $6.1 billion was net new borrowings by the GGS and the remainder arose mainly through increases in market value offset by $2.3 billion in principal debt repayments. Within the GGS, borrowings increased by $4.9 billion (20 per cent) to $29.5 billion at 30 June 2012. This increase of $4.9 billion would have been $7.2 billion if it were not for a decision to correct the valuation of GGS loans from fair value in previous years to amortised cost in 2011-12.
- The present value of the TSS superannuation liability increased this year by $5.7 billion (22.6 per cent) to $30.9 billion; and for the GGS by $5.4 billion (21.4 per cent) to $30.6 billion. In accordance with Australian accounting standards, expected future superannuation obligations are discounted to today's present values using the actuarially adjusted Australian Government bond yields. As this discount rate falls the valuation of the liability goes up. Actuarially adjusted Australian Government bond yields declined during the year by 2.1 per cent, to 3.2 per cent at 30 June 2012. While there are yearly fluctuations in the accounting value of the liability, the actuarial assessment of 30 June 2012 showed that the state has investments that are expected to be sufficient to pay for these obligations when they become due.

Over the past five years

Figure 3F shows the break-up of GGS and TSS liabilities across the past five years. The graph below shows that borrowings have increased from $6.3 billion at 30 June 2008 to $29.5 billion at 30 June 2012 in the GGS, or about 4.7 times what it was five years ago. Across the TSS, borrowings have increased from $42.7 billion at 30 June 2008 to $85.9 billion at 30 June 2012, around twice that from five years ago. Figure 3F illustrates the impact of increased borrowings on GGS and TSS liabilities across the past five years.

Figure 3F
GGS and TSS liabilities over the past five years



Source: QAO

Other than borrowings, superannuation liabilities also have a significant impact on GGS and TSS liabilities from year to year. The defined benefits scheme superannuation liability for the GGS and the TSS is measured by estimating today's value of future expected benefit obligations. Variables in the calculation of superannuation liabilities include salary increases, inflation and other assumptions derived by the State Actuary.

Decreases in the actuarially adjusted Australian Government bond yields can significantly influence increases in superannuation liabilities. Figure 3G shows the superannuation liability and the actuarially adjusted Australian Government bond yields over the past five years. The figure highlights the impact of declining bond yields on superannuation liabilities.

Figure 3G
Superannuation liability over the past five years

Superannuation liability	2007-08	2008-09	2009-10	2010-11	2011-12
Value of liability – GGS	$21,913m	$23,424m	$24,687m	$25,236m	$30,626m
Value of liability –TSS	$21,860m	$23,554m	$24,782m	$25,159m	$30,856m
Actuarially adjusted Australian Government gross bond yields at 30 June	6. 5 %	5.6 %	5.3 %	5.3 %	3.2 %

Source: Report on State Finances (2007-08, 2008-09, 2009-10, 2010-11, and 2011-12)

Funding of long-term employee and other liabilities

The State Government holds long-term assets to fund employer contributions for defined benefits superannuation and other expected long-term obligations, such as insurance and long service leave. On 1 July 2008, long-term assets of $20.5 billion were transferred by the state government to QTC in exchange for a fixed rate of return to fund these employer contributions. Two subsequent transfers totalling $6.4 billion were made during 2010-11.

At 30 June 2012, the value of long-term assets held to fund these long-term obligations was $29.1 billion (up from $28.2 billion at 30 June 2011). Over the same period, the value of TSS superannuation liabilities, long service leave and insurance liabilities that these assets were held to fund increased to $35.6 billion from $29.2 billion the previous year mainly due to the decline in actuarially adjusted Australian Government bond yields.

Consequently, at 30 June 2012, long-term assets held to fund long-term obligations were less than the corresponding superannuation, long service leave and insurance liabilities. While there are yearly fluctuations in the accounting value of the liability, the actuarial assessment of 30 June 2012 showed that the state has investments that are expected to be sufficient to pay for these obligations when they become due.

4. Financial sustainability

In brief

Background

The state's long-term financial sustainability depends ultimately on its revenue and expenditure policies. Users of financial statements can obtain a better understanding of the sustainability of these policies by calculating and analysing key financial indicators based on information in the audited consolidated financial statements 2011-12 — Government of Queensland (state government financial statements):

- operating ratio — indicates the capacity to meet recurrent operating expenditure from recurrent operating revenues
- net operating cash flow to net purchases of non-financial assets — indicates the ability to self-finance asset acquisitions from operating activities, rather than relying on debt
- capital replenishment ratio — indicates whether the rate of capital outlays on non-financial assets is keeping pace with the rate of depreciation of those assets
- net financial liabilities to operating revenue ratio — indicates the capacity of the state to repay debt principal and interest.

Key findings

- The four indicators of the state's financial sustainability used for this report based on the state government financial statements have declined over the past five financial years.
- The persistent negative operating ratios experienced over this period are not sustainable in the long term.
- Significant future financial risks remain to fund the replacement and renewal of state infrastructure, particularly those affected by natural disasters.
- The borrowing program of the state increased faster than the growth in state revenues over the past five years, and accordingly its capacity to reduce debt is worse than five years ago.
- While the state budget includes fiscal principles, the state does not report performance against a comprehensive set of financial sustainability indicators and associated targets which are used in the longer term. Indicators of financial sustainability should include operating performance, capital expenditure and financing.

Recommendation

2. **It is recommended that Queensland Treasury and Trade develop a comprehensive suite of financial sustainability indicators for use over the longer term. The indicators should include measures for operating performance, capital expenditure and financing, and should measure performance over time against set targets.**

4.1 Background

The state's financial sustainability is a critical element of its ability to meet its economic, social and environmental obligations both now and into the future. Like any organisation, it must live within its means, and soundly manage its finances over the long term.

Over the long term, total state revenues must equal or exceed state operating and capital expenditures. Debt must ultimately be repaid from future operating revenues, and in this sense simply represents funding of deferred expenditure.

Prudent financial management dictates, therefore, that continuing net operating deficits are unsustainable, and that modest net operating surpluses are required, if the renewal and replacement of assets are to be funded without significant ongoing borrowings and interest charges.

In addition, past investments in the public sector's asset base, its capital, reflected largely in the value of the specialised infrastructure assets and buildings it uses to provide essential public services, should not be eroded by the failure to maintain and replace these assets.

The ultimate measure of financial sustainability is that the state can absorb reasonably foreseeable adverse financial risks and exposures without having to significantly alter its revenue settings. This includes market-driven risks, such as changes to interest rates; demand-side risks for services in relation to their access, timeliness and quality; and supply-side risks in relation to the cost of inputs to service delivery, including salaries and the total cost of ownership of assets.

Over time the accrual information presented in state government financial statements allows assessments to be made about financial management and whether past and current revenue and expenditure policies are sustainable. While the state budget includes fiscal principles, the state does not report performance against a comprehensive set of financial sustainability indicators and associated short and long-term targets which are used in the longer term. Indicators of financial sustainability should include operating performance, capital expenditure and financing.

4.2 Conclusion

The four key sustainability ratios analysed in this report show that the state's financial sustainability declined over the past five financial years.

Total State Sector (TSS) expenditures remained higher than revenues and the persistent net operating deficits indicate that the state has less capacity to self-finance acquisitions of property, plant and equipment from operating cash flows.

Cash in the General Government Sector (GGS) has decreased and net operating cash flows across both GGS and the TSS have only funded a limited portion of the asset acquisition program, leading to fiscal deficits. A fiscal deficit is a negative fiscal balance and is calculated as the net operating balance less the net acquisitions of non-financial assets (purchases of non-financial assets less depreciation).

The state's stock of non-financial assets is being added to at a faster rate than existing assets are depreciating, although this rate has been declining for the past three years. The state government financial statements currently do not separately report capital expenditure on replacement of existing assets and acquisition of new assets and, therefore, further analysis of the state's capital replenishment is limited.

The growth in borrowings required to finance asset acquisitions has been greater than the growth in state revenues, reducing the state's capacity to repay debt from its own-sourced revenues.

4.3 Financial sustainability

Figure 4A summarises the results of four key indicators of financial sustainability developed based on information reported in the state government financial statements. These financial sustainability indicators will be refined over time, and performance targets developed and reported in future reports to Parliament.

Figure 4A
Results of key financial sustainability indicators

<table>
<tr><th></th><th></th><th>2007-08</th><th>2008-09</th><th>2009-10</th><th>2010-11</th><th>2011-12</th><th>Five yr average</th></tr>
<tr><td rowspan="3">Operating ratio (%)
Capacity to meet recurrent operating and capital expenditures from recurrent operating revenue
= Net operating balance divided by total operating revenue</td><td>GGS</td><td>-5.1%</td><td>-0.1%</td><td>0.3%</td><td>-3.5%</td><td>-0.5%</td><td>-1.8%</td></tr>
<tr><td>TSS</td><td>-2.7%</td><td>-5.2%</td><td>-4.6%</td><td>-7.9%</td><td>-3.9%</td><td>-4.8%</td></tr>
<tr><td colspan="7">A negative operating ratio means that the state has not earned sufficient operating revenue to cover its operating expenditure.
Five-year trend — persistently negative other than one year for GGS</td></tr>
<tr><td rowspan="3">Net operating cash flow ratio (%)
Capacity to self-finance non-financial asset acquisitions
= Net cash flows from operating activities (excludes depreciation) divided by net purchases of non-financial assets (as reported in the Cash Flow Statement)</td><td>GGS</td><td>7.4%</td><td>55.6%</td><td>38.9%</td><td>26.3%</td><td>36.6%</td><td>33.0%</td></tr>
<tr><td>TSS</td><td>20.2%</td><td>23.3%</td><td>29.5%</td><td>15.7%</td><td>25.7%</td><td>22.9%</td></tr>
<tr><td colspan="7">On average, approximately only a third of GGS and less than a quarter of TSS non-financial asset purchases are being financed through operating cash flows, indicating a reliance on other funding sources including debt.
Five-year trend — the state's ability to finance non-financial asset acquisitions from operating cash flows improved this year, but has declined since 2009-10. The same trends are evident for the GGS but the decline is more substantial compared with 2008-09.</td></tr>
<tr><td rowspan="3">Capital replenishment ratio (times)
Net rate of replacement of non-financial assets
= Ratio of net purchases of non-financial assets to depreciation expense</td><td>GGS</td><td>2.9</td><td>2.6</td><td>3.5</td><td>3.2</td><td>2.8</td><td>3.0</td></tr>
<tr><td>TSS</td><td>3.8</td><td>3.7</td><td>3.4</td><td>2.8</td><td>2.4</td><td>3.2</td></tr>
<tr><td colspan="7">A ratio greater than 1 means the state is replacing its property, plant and equipment asset base at a rate faster than it is being depreciated.
Five-year trend — asset replenishment rate remains favourable, but is declining.</td></tr>
<tr><td rowspan="3">Net financial liabilities ratio (%)
Capacity of the state to repay debt and interest
= Net financial liabilities divided by total operating revenues</td><td>GGS</td><td>18.0%</td><td>31.4%</td><td>48.4%</td><td>54.5%</td><td>71.8%</td><td>44.8%</td></tr>
<tr><td>TSS</td><td>67.3%</td><td>111.2%</td><td>126.7%</td><td>106.1%</td><td>127.6%</td><td>107.8%</td></tr>
<tr><td colspan="7">The growth in borrowings has been greater than the growth in state revenues resulting in a reduced ability to repay debt and interest.
Five-year trend — the growth in debt has been significantly greater than the growth in revenues</td></tr>
</table>

Source: QAO

The state budget includes four fiscal principles: stabilise then significantly reduce debt (Non-financial Public sector), achieve and maintain a General Government Sector fiscal balance by 2014-15, maintain a competitive tax environment for business, and target full funding of long-term liabilities such as superannuation in accordance with actuarial advice.

The four key ratios used in this report focus on the information included in the state government financial statements rather than the four fiscal principles in the state budget.

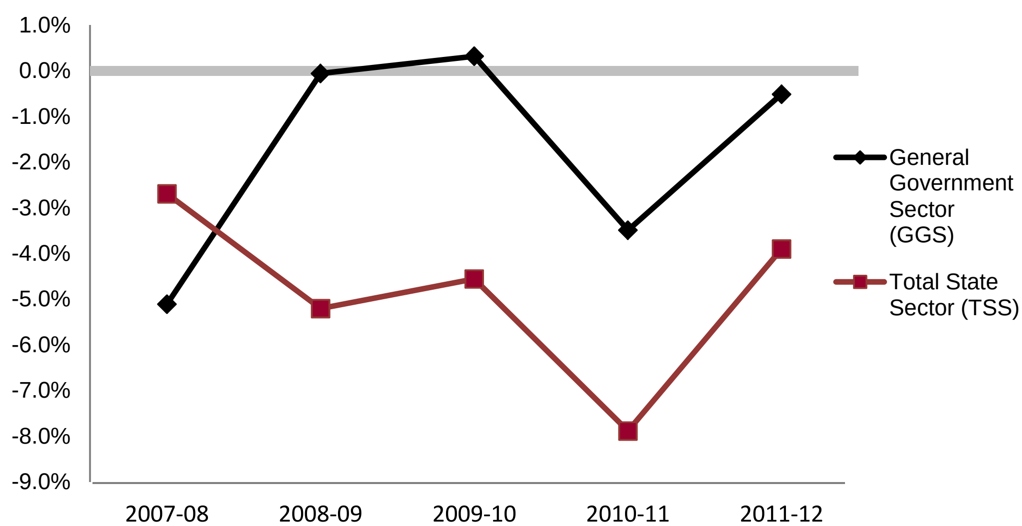
4.3.1 Operating sustainability

The state reported net operating deficits in the TSS for the past five years and in the GGS for four of the past five years, meaning it has consistently spent more than it earns. The growth in TSS operating expenditure has not been matched by similar growth in revenues.

Two key ratios that can be used to measure operating sustainability are the operating ratio and ratio of net operating cash flow to net purchases of non-financial assets.

The operating ratio in Figure 4B is the net operating balance expressed as a percentage of total operating revenue and shows the capacity of the state to meet operating expenditures from operating revenue.

Figure 4B
Operating ratio



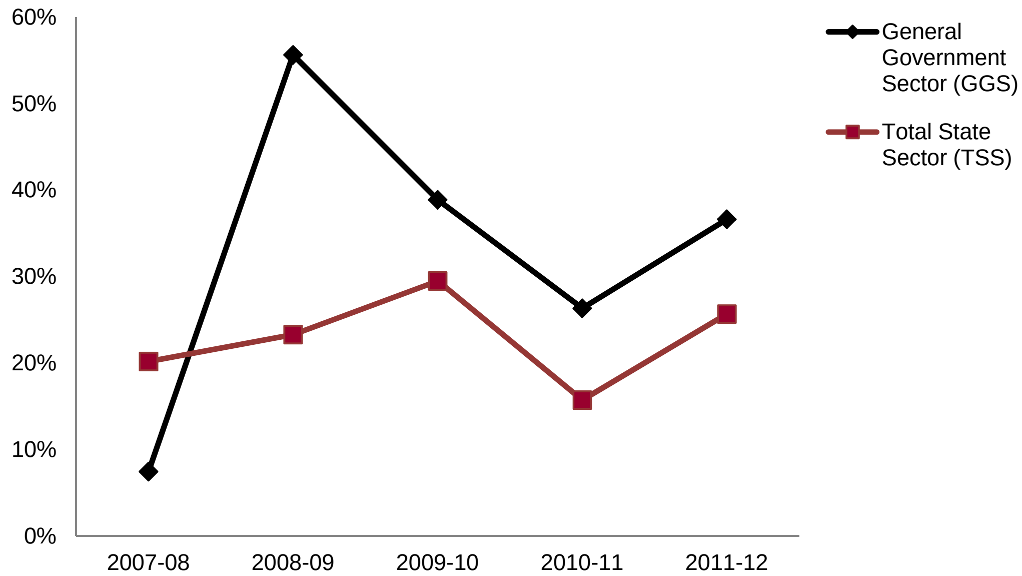
Source: QAO

This ratio needs to be positive over the medium to long-term for the state to remain financially sustainable. Ongoing negative ratios indicate insufficient operating revenue to fund operating and capital expenditure, leading to large fiscal deficits and depletion of cash reserves.

The ratio of net operating cash flow to net purchases of non-financial assets, shows the state's capacity to self-finance acquisitions of property, plant and equipment from operating activities rather than sources such as borrowings or asset sales. This ratio has been derived from the cash flow statement.

Similar to the operating ratio, there may be temporary periods where this ratio is negative to allow the state to support economic activity such as infrastructure construction however, this ratio should generally be positive. The higher the percentage, the more effectively the state is able to replace its assets using cash generated from its operating activities, and the better placed it is to achieve a fiscal balance.

Figure 4C
Net operating cash flow to net purchases of non-financial assets



Source: QAO

Figure 4C shows that the ratio of net operating cash flow to net purchases of non-financial assets has remained positive across the past five financial years for both GGS and TSS. However, the state has funded on average only 33 per cent (GGS) and 23 per cent (TSS) of net purchases of non-financial assets through operating cash flows over the five years. This has resulted in significant increases in government borrowings. While the funding of a portion of long-term critical infrastructure through long-term debt is financially sound, the state must ensure that it has capacity to repay the debt including interest.

Risks to operating sustainability

Risks to the state's future revenues and its operating and capital expenditures that require close attention include:

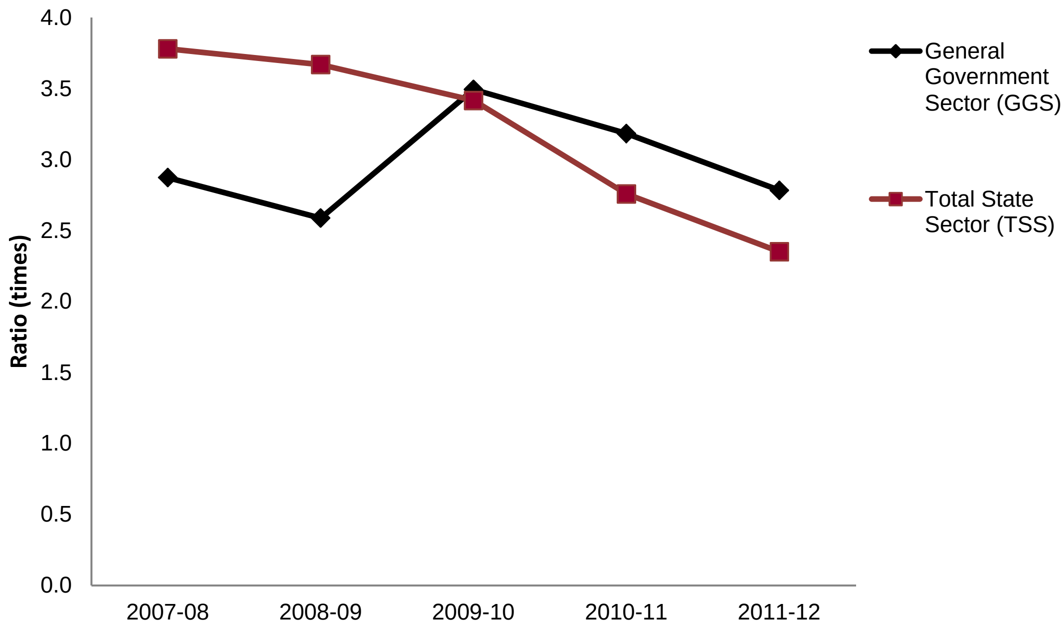
- At 30 June 2012, there was still an estimated $7.2 billion in work outstanding to repair and replace infrastructure assets damaged by past natural disasters under Natural Disaster Relief and Recovery Arrangements (NDRRA). In respect of repair works not impacted by the recent natural disasters of 2012-13, the Queensland Government must ensure that these works are performed in accordance with NDRRA funding conditions and completed by 30 June 2014, otherwise putting at risk the Australian Government's contribution of about $5.1 billion to remaining work and increasing the net cost to the state. Almost 39 per cent of the $2.5 billion in NDRRA expenditure over the past three financial years could not be verified by audit as being spent in accordance with funding conditions.
- Estimated future net cash outflows of $2.722 billion are required for the state's 14 social and economic public private partnership agreements. While the state's financial risk and exposure is generally minimised for economic public private partnerships, such as the Airport Link project, social public private partnerships, such as the Southbank Education and Training Precinct and Gold Coast Rapid Transit expose the state to greater risks in the event that the partner fails to comply with deed requirements and needs to be replaced.
- The funding required for the facilities and staging of the 2018 Gold Coast Commonwealth Games (Games) is currently estimated at $2.4 billion. The state has guaranteed to cover any budget shortfalls for the Games as incurred by the Organising Committee. A significant capital works program is required to deliver the necessary facilities, including the athletes' village. Ticket, television rights, sponsorship and merchandising revenues to offset cost cannot be ‘locked in’ at this stage and are subject to general economic conditions and highly sensitive to market supply and demand prevailing closer to, and at the time of, the Games.

4.3.2 Investing sustainability

The state's property, plant and equipment assets were valued at $225.7 billion at 30 June 2012, with just over half of this balance comprising buildings and infrastructure. There is a significant long-term obligation to fund both the maintenance and replacement of existing assets and build new assets to meet the needs of a growing population.

The capital replenishment ratio compares the annual net expenditure on non-financial assets (predominantly property, plant and equipment) to annual depreciation. Figure 4D shows that the ratio over the past five years both for the GGS and TSS is well above one, meaning that assets are generally being built or refurbished at a faster rate than the non-financial asset base is being depreciated.

Figure 4D
Capital replenishment ratio



Source: QAO

From a peak in 2009-10, the ratio for GGS has declined over the past two years. It continues to decline across the forward estimates published in the State Budget Mid-Year Fiscal and Economic Review for 2012-13. This partly reflects anticipated reductions in capital spending as a number of large infrastructure projects and natural disaster repairs are completed. The use of PPPs to deliver social infrastructure, including the Sunshine Coast University Hospital and the SEQ Schools Project, also 'defers' capital expenditures by spreading them over the life of the asset.

The annual net expenditure on non-financial assets used in this calculation includes capital expenditure on both new and existing assets. Given the state's large infrastructure building program in recent years, any underspending on the upgrade or refurbishment of existing assets may not be apparent from this ratio (nor does it contemplate the quality or project cost control of asset additions). It is therefore recommended that the state separately identify and report capital expenditure on the replacement of existing assets and the acquisition of new assets.

Risks to investing sustainability

The state is currently replacing its existing non-financial asset base faster than it is being depreciated, with the capital replenishment ratio above 1, however consideration should be given to risks to the financial sustainability of the state's assets and associated capital program, including:

- Ensuring the state's capital works program, including $12.3 billion forecast in 2012-13, particularly across the health, energy, and transport and main roads sectors, is subject to rigorous project planning, evaluation and management controls to avoid cost overruns. Report to Parliament 5:2012-13 highlighted the overall 68 per cent increase in the latest estimated costs of four major health infrastructure projects under construction in 2011-12 compared with their original budgets.
- As the non-current asset base grows, so does the associated future maintenance costs. Report to Parliament 5:2012-13 highlighted that the maintenance of state-owned infrastructure assets is a significant burden on the state finances. In addition, the state is not regularly monitoring building maintenance or performance at a whole-of-government level, making it difficult to quantify the level of deferred maintenance. Buildings represent 14 per cent of the value of the state's property, plant and equipment.
- The condition of the state's information and communication technology (ICT) systems indicates significant future funding requirements. An interim audit by the government's Chief Information Officer has identified that more than half of the ICT systems are outdated, with 10 per cent of the network requiring urgent replacement at a cost of about $196 million.

4.3.3 Debt sustainability

Debt sustainability requires that the state can pay its debts and interest charges while maintaining its assets and community services. The state also must meet its long-term obligations to its employees and insurance schemes.

The ratio of net financial liabilities to operating revenue is an indicator of the capacity of the state to repay debt and interest from its revenues. This ratio includes the results of Public Financial Corporations (Queensland Treasury Corporation, QIC Limited and WorkCover Queensland).

Figure 4E shows that the growth in net financial liabilities, primarily due to an increase in borrowings, has been greater than the growth in state revenues across the past five financial years for both the GGS and TSS. While this ratio is more volatile than the debt to revenue ratio, it does take into account the state’s defined benefit superannuation, long service leave and insurance assets and liabilities.

Figure 4E
Net financial liabilities to operating revenue ratio

Source: QAO

Increased borrowings have been used to fund buildings and infrastructure, however, they also have contributed to the downgrade in the state's credit rating.

The state has long-term liabilities associated with the insurance fund and for employees, including the defined benefit superannuation scheme and long service leave. While there are yearly fluctuations in the liability resulting from discount rate changes, the latest actuarial assessment of 30 June 2012 showed that the state has investments that are expected to be sufficient to pay for these obligations when they become due. This assessment was prior to consideration of damage caused by the natural disasters in 2012-13.

Risks to the sustainability of the state's debt

Borrowings by the GGS have grown by 338.5 per cent between 2008 and 2012. The increase in borrowings over this time has increased risks to the long-term financial sustainability of the state, particularly:

- downgrades to the state's credit rating where financing ratios exceed targets set by ratings agencies. The state is likely to continue to pay higher costs for funding while it holds the AA+ credit rating compared with the AAA rating previously held. For the GGS, annual interest expenses increased from $347 million in 2007-08 to more than $1.65 billion in 2011-12.
- Queensland's borrowing program was the largest of the Australian states and territories in 2012.

4.4 Recommendation

2. **It is recommended that Queensland Treasury and Trade develop a comprehensive suite of financial sustainability indicators for use over the longer term. The indicators should include measures for operating performance, capital expenditure and financing, and should measure performance over time against set targets.**

Appendices

Appendix A — Comments 39

Appendix B — General Government Sector 45

Appendix C — Public Non-Financial Corporations and Public Financial Corporations 47

Appendix A — Comments

Auditor-General Act 2009 (Section 64) — Comments received

Introduction

In accordance with Section 64 of the *Auditor-General Act 2009,* a copy of this report was provided to Queensland Treasury and Trade with a request for comment.

Responsibility for the accuracy, fairness and balance of the comments rests with the head of this agency.

Comments received

Response provided by the Under Treasurer, Queensland Treasury and Trade on 26 February 2013.

QUEENSLAND GOVERNMENT

Queensland Treasury and Trade

Our Reference: TRY-03020
Your Reference: 10605

Mr A Greaves
Auditor-General of Queensland
Queensland Audit Office
PO Box 15396
CITY EAST QLD 4002

Dear ~~Mr Greaves~~ Anthony

I refer to your letter of 31 January 2013 concerning your proposed Report to Parliament on the Queensland State Government Financial Statements 2011-12 (the Report).

Queensland Treasury welcomes public debate on important issues of financial sustainability facing the State.

Please find attached a copy of my formal response to the revised draft Report provided on 20 February 2013 for inclusion in your Report to Parliament. The most significant issues are summarised below.

In relation to the valuation of land under roads, Queensland complies with AASB1051 in recognising the value of land under roads. The value attached to these assets is determined by the Valuer-General. Queensland Treasury acknowledges that land under roads is valued differently in jurisdictions and that this is clearly far from ideal. However, this is an issue that can not be readily resolved by Queensland Treasury. It is a matter for valuers in each jurisdiction and Queensland Treasury supports valuers agreeing on a common approach. Until the matter is resolved, Queensland Treasury will continue to comply with the relevant accounting standard and will adopt the value provided by the Valuer-General, as it does with all other non-financial assets.

In relation to financial sustainability, the key for governments is to pick a small number of appropriate measures to drive decision making and for public reporting purposes. The Queensland Government has picked four key measures for this purpose and publishes these in its Budget, Mid Year Fiscal and Economic Review and end of year reports. As you are aware, the Government's measures were informed by the considerable work undertaken by the Commission of Audit on the strategies required to improve the State's finances.

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Comments received

Response provided by the Under Treasurer, Queensland Treasury and Trade on 26 February 2013.

As you are aware, the Queensland Government also publishes a full suite of financial statements three times each financial year to allow interested parties such as ratings agencies to measure financial sustainability based on their own preferred set of measures.

Thank you for the opportunity to comment on the Report.

Yours sincerely

Helen Gluer
Under Treasurer

Encl.

Comments received

Response provided by the Under Treasurer, Queensland Treasury and Trade on 26 February 2013.

Queensland Treasury and Trade's Comments on The Queensland Auditor General's Report to Parliament on the Queensland State Government Financial Statements 2011-12

The Under Treasurer was provided with a copy of the Auditor-General's Report to Parliament (the Report) for comment on 31 January 2013 and a revised version on which to provide comments on 20 February 2013. The comments below constitute Queensland Treasury and Trade's (Treasury's) comments on the most significant of the issues identified in the Report provided on 20 February 2013.

Land under roads valuation methodologies

The Report states that land under roads is valued differently across Australia and that these inconsistencies undermine a reader's ability to compare the position of each jurisdiction.

Queensland complies with AASB1051 in recognising the value of land under roads. The value attached to these assets is determined by the Valuer-General.

Treasury agrees that land under roads is valued differently across jurisdictions. However, Treasury does not consider this is an issue that can be resolved by Queensland Treasury or state treasuries and regards it as a matter for the valuers in each jurisdiction.

Until the matter is resolved, Treasury will continue to comply with the relevant accounting standard and will adopt the value provided by the Valuer-General, as it does with all other non-financial assets. Treasury also notes that key users of financial statements such as ratings agencies have not indicated any particular concerns.

Financial sustainability

There are a number of potential measures of the financial sustainability of government finances. Generally though, most measures of fiscal sustainability include the deficit and debt positions of jurisdictions. In terms of deficit measures, the IMF has indicated that the fiscal balance is perhaps the most widely cited measure of a jurisdiction's fiscal situation. A strength of the fiscal balance is its close relationship to changes in the stock of debt. The key for governments is to pick a small number of consistent measures to drive decision making and for public reporting purposes. The Queensland Government has picked four key measures for this purpose. These are:

- Stabilise then significantly reduce debt (currently measured by net financial liabilities to revenue ratio and debt to revenue ratio in the Non-financial Public sector)
- Achieve and maintain a General Government sector fiscal balance by 2014-15
- Maintain a competitive tax environment for business
- Target full funding of long term liabilities such as superannuation in accordance with actuarial advice.

Comments received

Response provided by the Under Treasurer, Queensland Treasury and Trade on 26 February 2013.

In preparing its interim Report, the Independent Commission of Audit undertook a substantial analysis of State's fiscal sustainability and made explicit recommendations on how it could be achieved. The Government's response to that work resulted in the significant fiscal repair measures announced as part of the 2012-13 Budget and the establishment of the fiscal principles outlined above.

The Queensland Government also publishes a full suite of financial statements three times each financial year to allow interested parties such as ratings agencies to measure financial sustainability based on their own preferred set of measures.

Consequently, Treasury is satisfied that the principles currently in place to measure fiscal sustainability are appropriate, will drive decision making going forward and, if achieved, will lead to the long run fiscal sustainability of the State.

Appendix B — General Government Sector (GGS)

- Anti-Discrimination Commission
- Australian Agricultural College Corporation
- Board of the Queensland Museum
- City North Infrastructure Pty Ltd
- Commission for Children and Young People and Child Guardian
- Crime and Misconduct Commission
- Department of Aboriginal and Torres Strait Islander and Multicultural Affairs (created on 3 April 2012)
- Department of Agriculture, Fisheries and Forestry (created on 3 April 2012)
- Department of Communities, Child Safety and Disability Services (renamed on 3 April 2012)
- Department of Community Safety
- Department of Education, Training and Employment (renamed on 3 April 2012)
- Department of Energy and Water Supply (created on 3 April 2012)
- Department of Environment and Heritage Protection (renamed on 3 April 2012)
- Department of Housing and Public Works (renamed on 3 April 2012)
- Department of Justice and Attorney-General
- Department of Local Government (renamed on 3 April 2012)
- Department of National Parks, Recreation, Sport and Racing (created on 3 April 2012)
- Department of Natural Resources and Mines (created on 3 April 2012)
- Department of the Premier and Cabinet
- Department of Science, Information Technology, Innovation and Arts (created on 3 April 2012)
- Department of State Development, Infrastructure and Planning (renamed on 3 April 2012)
- Department of Tourism, Major Events, Small Business and the Commonwealth Games (created on 3 April 2012)
- Department of Transport and Main Roads
- Electoral Commission of Queensland
- Gold Coast 2018 Commonwealth Games Corporation
- Gold Coast Institute of TAFE
- Health Quality and Complaints Commission
- Legal Aid Queensland
- Legislative Assembly
- Library Board of Queensland
- Motor Accident Insurance Commission
- Nominal Defendant
- Office of the Governor
- Office of the Information Commissioner
- Office of the Ombudsman
- Prostitution Licensing Authority
- Public Service Commission
- Queensland Rural Adjustment Authority (QRAA)
- Queensland Art Gallery Board of Trustees
- Queensland Audit Office
- Queensland Building Services Authority
- Queensland Future Growth Corporation
- Queensland Health (renamed on 3 April 2012)
- Queensland Performing Arts Trust

- Queensland Police Service (renamed on 3 April 2012)
- Queensland Reconstruction Authority
- Queensland Treasury and Trade (renamed on 3 April 2012)
- Queensland Studies Authority
- Residential Tenancies Authority
- South Bank Corporation
- Southbank Institute of Technology
- The Council of the Queensland Institute of Medical Research
- The Public Trustee of Queensland
- Tourism Queensland
- TransLink Transit Authority
- Urban Land Development Authority
- Workers' Compensation Regulatory Authority (QComp).

Appendix C — Public Non-Financial Corporations and Public Financial Corporations

Public Non-Financial Corporations

- CS Energy Ltd
- ENERGEX Ltd
- Ergon Energy Corporation Limited
- Far North Queensland Ports Corporation Limited
- Gladstone Area Water Board
- Gladstone Ports Corporation Limited
- Mount Isa Water Board
- North Queensland Bulk Ports Corporation Limited
- Port of Townsville Limited
- Powerlink Queensland
- Queensland Bulk Water Supply Authority
- Queensland Bulk Water Transport Authority
- Queensland Manufactured Water Authority (transferred to Queensland Bulk Water Supply Authority on 1 July 2011)
- Queensland Rail Limited
- Queensland Treasury Holdings Pty Ltd
- Queensland Water Infrastructure Pty Ltd (ceased 31 March 2012)
- SEQ Water Grid Manager
- Southern Regional Water Pipeline Company Pty Ltd (transferred to Queensland Bulk Water Supply at 30 June 2012)
- Stadiums Queensland
- Stanwell Corporation Limited
- SunWater Limited
- The Trustees of Parklands Gold Coast
- ZeroGen Pty Ltd (wound up at 30 June 2012).

Public Financial Corporations

- QIC Limited
- Queensland Treasury Corporation
- WorkCover Queensland.

Auditor-General Reports to Parliament

Tabled in 2012-13

Report number	Title of report	Date tabled in Legislative Assembly
1	Racing Queensland Limited: Audit by arrangement	July 2012
2	Follow up of 2010 audit recommendations	October 2012
3	Tourism industry growth and development	November 2012
4	Queensland Health – eHealth Program	November 2012
5	Results of audits: State public sector entities for 2011-12	November 2012
6	Implementing the National Partnership Agreement on Homelessness in Queensland	February 2013
7	Results of audit: Queensland state government financial statements 2011-12	March 2013

Reports to Parliament are available at www.qao.qld.gov.au