1 February 2005

Activation of guarantees (contingent assets) and constructive obligations

Issue 37 of the list of items to be reviewed when updating SNA93

Task Force on the Harmonisation of Public Sector Accounting – Team Report[1]

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CONTENTS

1 Introduction

1.1 Background to the issue

This paper examines various ways of accounting for guarantees in national accounts, and the implications for updating SNA93.

Guarantees, for the purpose of this paper, are understood to be arrangements whereby a unit borrows and government promises the lenders that they will be repaid whatever happens to the borrowing unit. Giving a guarantee is a way for government to subsidise economic activity without a need for an immediate cash outlay. They are a way of shifting possible costs into the future. It could be argued that a system of economic accounts should record guarantees when they are given, not just when actual payments are made under the guarantee, because that is when they influence economic behaviour and create potential costs for government. National accounts are sometimes criticised because some types of guarantees, that seem to be clear government liabilities, are not reflected in the government's balance sheet.

The paper develops the ideas presented at the TFHPSA Working Group II meeting at OECD in February 2004. It takes into account the discussion at that meeting and at the meeting of the Eurostat task force on guarantees held in April 2004 which discussed guarantees in the context of their impact on government deficit and debt as measured for the European Union's Excessive Deficit Procedure.

In considering alternative recording methods it is important to consider the impact on all sectors, not just the government sector, and the implications for the coherence of integrated statistical system - the SNA family of statistical standards.

1.2 Ideal solution for harmonisation with public sector accounts

From a TFHPSA perspective, the ideal solution would be one that updates SNA so that is aligned with the treatment of guarantees under Generally Accepted Accounting Practice (GAAP). This would allow for a harmonised approach in accounting and statistics, and would be a step forward in fostering transparency of the government financial situation. In some countries, the corresponding GAAP is IPSAS19 on provisions[2] and contingent assets. Under this standard, if the guarantee is more likely than not to be called, a liability would be recorded on government's balance sheet for the net present value of the expected amount to be called, and government expenditure would be recorded for the same

[2] "Provisions" here are defined as liabilities for which the timing and amounts of the required future payments are uncertain, but some payment is thought to be more likely than not. Provisions in this sense are not defined as reserves, or stocks of earmarked assets, or adjustments to the value of financial assets.

amount3. In subsequent years, changes in expectations would be reflected in the value of the liability in the balance sheet and also be recorded as government expenditure (increase in liability) or revenue (reduction in liability) for the amount of the change. A call on the guarantee would be a financial transaction redeeming all or part of the liability.

This solution (which may follow closely the method applied in IPSAS 19, or only some of the corresponding features) would require a change to SNA93 to allow for the recording of provisions when related to guarantees, using the precedent and logic of the way insurance provision are currently recorded in SNA93.

One disadvantage of applying the IPSAS19 method in national accounts is that for countries where the government accounts do not apply IPSAS19, or something similar, there would be no data source for the estimates required by statisticians. It would also require recording changes in provisions for guarantees, arising after a guarantee is first given, as distributive transactions with an impact on the government deficit. It would not be appropriate to treat these as other flows below the line4. This might be viewed as conflicting with the usual national accounts' practice of treating holding gains and losses as other flows. In particular, in case guarantees are not called, a revenue will have to be booked, which may be seen as rather artificial and reflecting mainly bad forecasting by governments. Last, considering only guarantees with a probability of more than 50% may be awkward in a number of cases, e.g. of a large number of guarantees having each a low probability of being called, or guarantees with a probability close to 50% of being called. Other provisions methods would not necessarily have the same disadvantages, in particular regarding the 50% criterion or the treatment of changes in provisions.

1.3 The Eurostat Task Force method

The Eurostat task force (whose main objectives referred to the interpretation and application of current standards) did not consider all types of guarantees. It restricted itself to non-tradable one-off guarantees given by government for another unit's borrowing. It recommended re-routing government guaranteed borrowing through government for guarantees that are very likely to be called[5]. Eurostat is devising a set of operational criteria to determine when a guarantee should be regarded as "very likely to be called". Guarantees that are not likely to be called would not be recorded when they are given. Under the re-routing treatment, when the guarantee is given there is no impact on government deficit or its net wealth but gross debt increases. There is an impact on the government deficit when the guarantee is called for the actual amount actually paid.

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[3] Government revenue would also be recorded if the government received a fee for the giving the guarantee.
[4] Except for guarantees of a type that are traded in a market which could be treated like derivatives.
[5] These are guarantees for which IPSAS19 would record a provision (a financial liability) on the government's balance sheet, rather than record as a contingent liability off balance sheet in the notes to the accounts, or not record at all.

The method proposed by the Eurostat task force has the advantage of not requiring estimates for the amounts to be recorded in national accounts. It is a way of recording something in the government's balance sheet to reflect its exposure to a likely outflow of resources. It does so in a way that does not require complex accounting in the government non-financial accounts, and has no impact on the accounts of the lender and borrower.

The disadvantage of the method is that it is not consistent with the way that existing accounting standards such as IPSAS19 deal with the recording of guarantees as provisions. Although the method to identify which guarantees should be brought onto balance sheet would be similar, the threshold for selecting guarantees to be recorded on balance sheet and the accounting treatment differs. The "provision option" records expenditure, and a balance sheet liability, for the expected value of payments under the guarantee – a statistical estimate – whereas the Eurostat task force proposal would record government borrowing and on-lending for the actual amount of the guaranteed borrowing, and no government expenditure until the guarantee is called. Also, the method would have consequences for GDP through the split of the allocation of FISIM to market and non-market sectors, but this could be solved by ignoring re-routed transactions when allocating FISIM.

1.4 Other methods

At the meeting of the TFHPSA in February 2004 there was a proposal that guarantees should be recorded through regular imputed subsidy payments from government to fund imputed regular purchases of insurance. In the Eurostat task force there was some opposition to use of insurance for recording guarantees within the existing framework of ESA95. However it might be possible to update SNA93 for the recording of insurance such that guarantees could be treated as the regular purchase of insurance.[6]

A disadvantage of such an approach is that it would not be consistent with IPSAS19 and so it is unlikely that there would ever be a convenient suitable data source for the estimated size of the imputed insurance purchases for national accounts. Also, it would require SNA93 to be updated in respect of insurance to make a simple recording possible for guarantees.

Another option would be to record regular subsidies as above but choose a transaction other than insurance for the return payment. None have been identified as completely satisfactory. For example property income does not seem right because there is no actual asset generating the income.

A disadvantage of the subsidy method is that giving a guarantee is more like a balance sheet event, affecting the relative wealth of the guarantor and the guaranteed unit, rather than a current transaction

with possible GDP implications. In any event, the guaranteed unit's reduced cost of borrowing[7] is already reflected in the current account in national accounts.

2 Summary of methods for recording guarantees

Six different methods are described for recording guarantees in national accounts. They are summarised in the table at 2.1. Section 3 looks at the accounting treatments in more detail, and section 4 gives a numerical example for each option as applied to the same guarantee and set of events.

Some of the options could be viewed as adapting the existing SNA 93 and would only need some elaboration in an updated SNA93. Three would require a more substantial change to SNA93.

In each of the first three methods there is a particular way of handling guarantees that are "likely to be called"[8]. For other guarantees, under those methods, nothing is recorded when the guarantee is given, and government payments of capital grants are recorded when the guarantee is called.

The fourth category – insurance funded by subsidies – would apply to all guarantees. The fifth category, financial derivatives, would apply only the guarantees that are traded and is probably not relevant for the public sector.

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[6] For example, through a simple recording of unbalanced D.71 and D.72 without consequences for output or the financial accounts.

[7] and the impact for example on the unit's saving and net borrowing

[8] "Likely to be called" is used for brevity. The conditions determining when the special treatment applies vary in each of those three options according to how likely it is that the guarantee will be called and some other factors.

2.1 Table showing possible treatments of guarantees in national accounts

Treatment	Description
EMGDD[9] method Debt assumption in rare cases, otherwise not recorded	This is the methodology of the Eurostat Deficit and Debt manual. In a few cases, where it is obvious that government will be servicing all the debt itself, a capital transfer is recorded for the full amount of the debt to the borrowing unit and government acquires a financial liability for the full amount (full debt assumption).
Eurostat Task Force proposal Re-route guaranteed borrowing through government if very likely to be called , otherwise not recorded	A borrower borrows from a lender with a government guarantee: the national accounts would show the government borrowing from the lender, and government lending to the borrower, the same amount. Consistent with SNA93 advice on re-routing, but an updated SNA93 could refer specifically to this application of re-routing.
Recording as provision (possibly as in IPSAS19) Treat like provisions if more likely than not to be called, otherwise not recorded	SNA93 would need to be updated to accommodate a new type of financial liability (provision for a guarantee) and a new type of non-financial transaction (to account for the creation and change in value of such provisions). The national accounts would show government expenditure and a financial liability for the net present value of the expected cost of the guarantee, and further non-financial transactions for any changes in the value of the provision. This would have a similar logic to the way in which SNA93 has special transaction categories for insurance provisions.
Insurance funded by subsidy For all guarantees: regular repeated purchase of insurance funded by regular subsidies over the life of the guarantee.	The treatment of insurance in SNA93 would need to be updated to allow for a simplified recording of premia and claims to represent the purchase of guarantees (D.71) and payments under calls (D.72). This simplification would have to avoid the consequences of insurance on the measurement of output and financial transactions, otherwize it would be inappropriate for recording guarantees.
Purchase of insurance contract	Similar to previous option, but relies on the recording of a global amount regarding the "expected claim", and involves recording in the financial account some F62 Prepayment of premiums and reserves against outstanding claims
Financial derivative, Only those that are traded on a market[10]	Would be consistent with existing SNA93, but perhaps it could be updated to say more about which types of guarantees could be treated as derivatives. Probably not significant for the government sector.

[9] Eurostat Manual on Government Deficit and Debt

[10] Some TFHPSA members have suggested that non tradable guarantees could be treated as "derivatives", rather than "financial derivatives". This approach would be close to creating a new instrument (as in "IPSAS 19 method", though making clearer the link between guarantees and some financial derivatives.

2.2 Table listing the accounting entries for different treatments[11]

Treatment	Recording when guarantee given	Recording when guarantee called		Other entries
		Guarantee is activated	Payments are made	
EMGDD method	Grant from government to borrower (D.9) equal to the value of the debt assumed. Borrowing unit redeems debt and government acquires liabilities (F3, F4 depending on the actual debt instrument).	Guarantee is deemed to be called continuously.	Repayments of interest and capital by government as debt servicing becomes due.	
Eurostat Task Force proposal	Imputed government transactions in assets and liabilities in the financial instrument used by the borrower. Borrower and lender's accounts are unchanged.	Guarantee is deemed to be called continuously.	Government account would show payments of capital grants to the borrower to cancel part of the imputed debt it owes government.	Each period would show government payments of interest and capital to the lender and government receipts of interest and capital from the borrower (assuming no call on guarantee)
Provision (possibly as in IPSAS19)	New type of distributive transaction: a payment from government to the borrower for the net present value of expected payments. Creation of a financial asset (asset of borrower, liability of government) of the same value.	Financial transaction	Financial transaction between government and the corporation that provides the corporation with the funds to repay the lender	The increase in the value of the financial asset due to the passage of time unwinding the discount, and other changes due to revised estimates of probabilities, would be recorded as further distributive transactions.
Insurance funded by subsidy	Subsidies (D.3) are recorded every year for the life of the guarantee to pay insurance premia (D.71)	Non-financial transaction (D72)	Financial transaction	Subsidies (D.3) are recorded every year for the life of the guarantee to pay insurance premia (D.71)
Purchase of insurance contract	Grant from government to the borrower (D9) equal to the discounted value of the expected claim. This grant is used to finance an insurance contract (F62) by the government to the borrower.	Financial transaction	Financial transaction	The increase in the value of the financial asset due to the passage of time unwinding the discount would be recorded as further distributive transactions.

[11] In each case, a "corporation" borrows from a "lender" with a government guarantee to repay the lender if the corporation does not do so.

Financial derivative	Grant from government to borrower (D.9) equal to the market value of the guarantee when given. Purchase of derivative (F34) for same value: asset of borrower; liability of government	Transaction in derivatives (F.34)	Financial transaction	Other flows (K.11, holding gains and losses) is used to account for changes in the value of the derivative including the increase in value when called and the unwinding of any discount.

3 Description of options for recording guarantees in an updated SNA93

The following examples intend to clarify the possible methods for recording the creation of guarantees, their activation and subsequent payments in the accounts. Of course, a number of features of the recording could be combined, resulting in a much larger number of possibilities for the recording. Furthermore, some assumptions have been made in the examples below, e.g. that liabilities of the government would be vis-à-vis the borrower, which may again be modified, for some of the transactions, or possibly for all of them, as suggested by some members of the TFHPSA.

3.1 No recording in the core accounts when the guarantee is given

This treats guarantees as contingent liabilities and does not record anything in the core accounts when the guarantee is given, in accordance with the existing SNA guidance on the usual treatment of contingent liabilities. Along the lines of the current SNA, it may be recommended that "where contingent positions are important for policy and analysis (…) supplementary information be collected and presented as supplementary data in the SNA"(SNA93, paragraph 11.26). A variant of this approach would be to require a detailed recording reflecting guarnatees in the form of a satellite account.

When a guarantee is called the government account would record a capital transfer from government to the borrowing unit to enable to pay that instalment of the debt servicing. Note the capital transfers would cover only the amounts actually paid by government, when paid by government: they would not normally be set equal to the full amount of outstanding debt. That would be a suitable recording method only when government formally takes responsibility for paying all of the outstanding debt (full debt assumption).

Accounting details are at 4.1.

3.2 Full debt assumption when guarantee is given for some unusual guarantees

Under this method, guarantees would not normally be recorded in national accounts when given (as in 3.1 above), except when it is clear that government itself will be making all servicing of the guarantee debt. The method is described in ESA95 paragraph 4.165f, and is the treatment described as the "special case" in the Eurostat Deficit and Debt Manual section II.4.3. It is applied only in exceptional and rare cases

The method records a capital transfer from government to the guaranteed borrowing unit for the full amount of the guaranteed borrowing when given. This liquidates the borrower's debt and transfers it onto the government's balance sheet. Actual government payments are recorded as payments of interest and capital to the lender. Even if these payments are made to the original borrower, the borrower is just

regarded as a post box and not as a party to the transactions. Recording problems would arise if, contrary to initial expectations, the borrowing unit were to start making debt repayments from its own resources. Would these be negative adjustments to the initial capital transfer ?

This treatment shows government making a "gift" of the full amount borrowed to the borrowing unit. It only seems a suitable method when it is clear that government will be taking responsibility for all of the debt repayments because there is strong evidence to suggest that the entity will be unable to do so.

Accounting details are at 4.2.

3.3 Re-route the guaranteed borrowing through government when call very likely

This is the proposal of the Eurostat task force.

The re-routing treatment described below would only be applied to guarantees that are very likely to be called. Eurostat are devising some operational rules to use to determine whether the guarantee is "very likely to be called" for this purpose.

Under this treatment, government would be placed between the borrowing unit and lender when recording the borrowing flows. In other words, the borrowing would be re-routed through government. The imputed government borrowing from the lender would add to government gross debt; and the imputed on-lending by government to the borrowing unit would add to government financial assets. The accounts of the borrowing unit and the lender would not be changed. The payments of interest and capital redemption would also be re-routed through government.

This works well when there is a mixture of debt servicing paid by government and the borrowing unit. It has the advantage of not needing estimates, and it does not change the accounts of the borrower and lender.

This treatment increases government's financial liabilities and financial assets when the guarantee is given, but there is no impact on the deficit. There is an impact on the deficit only when the guarantee is called, and then only for the amounts actually paid. A call would be recorded as a capital transfer from the government to the borrower in respect of the cancellation of part of the imputed debt the borrower owes government. The government's imputed transactions with the lender, and debt owed to it, would not be affected by a call on the guarantee.

Accounting details are 4.3.

3.4 Record provisions (possibly as in IPSAS 19)

International Public Sector Accounting Standard 19 (IPSAS 19) deals with provisions and contingent liabilities. It describes the treatment of various types of guarantees. IPSAS19, and similar standards, are part of the Generally Accepted Accounting Practice (GAAP) applied in some countries when compiling audited accounts for government entities. Annex 5 describes IPSAS19 and annex 7 provides some text from International Accounting Standard 37 upon which IPSAS 19 is based.

SNA would be updated to record provisions in respect of guarantees with a greater than 50% chance of being called. This is in line with IPSAS 19, which records a provision for that type of guarantee, and records a contingent liability off balance sheet for guarantees with a less than 50% chance of being called[12].

The treatment would be as follows.

1) Record provisions (government expenditure and an increase in financial liabilities in the balance sheet) for the net present value of amounts expected to be called.

2) Changes in expectations would be recorded as changes in provisions in the balance sheet arising from equal and opposite financial and non-financial transactions (government expenditure or revenue). This would also take account of the increase in the net present value of the provisions due to the passage of time ("unwinding the discount").

3) Actual payments under a call on the guarantee would be recorded as a redemption of financial liabilities (borrower's asset) and not affect the government deficit.

Note that the amounts actually paid under a call on the guarantee would be the same as the impact on the deficit over the life of the guarantee but recorded at different moments in time[13]. This equality would not exist if changes in the provision were recorded as other flows and so is not recommended for that reason.

It would be necessary to determine which transaction categories to use, or create new ones, for the non-financial and financial transactions in provisions.

Accounting details are at 4.4.

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[12] Provisions are also recorded when a large number of similar guarantees are given, for example a warranty in respect of mechanical breakdown within the first year when a new product is sold. In some countries, such as Sweden and USA, public accounts apply the IPSAS19 recording methodology is to all guarantees.

[13] This is because transactions in the non-financial instrument representing provisions would follow any change in the provision in the balance sheet and eventually equal the amount of expenditure funded by the release of the provision)

3.5 Impute annual subsidies to purchase annual insurance policies

Record the purchase of insurance policies in each accounting period for the life of that accounting period (i.e. record the purchase of annual insurance policies when presenting annual government accounts). This was the option suggested by some members of the TFHPSA. The imputed government "gift"[14] given to the borrowing unit to acquire the insurance policies would be spread over the life of the guarantee as regular subsidies rather than a single one-off payment when the guarantee is given.

The imputed annual[15] subsidies, from government to the borrower to acquire annual insurance policies could be computed in two ways.

a) The estimated annual expected payments under a call on the guarantee.

b) The reduction in the borrower's cost of borrowing due to having a government guarantee. This approach does not work if the borrower would not be able to borrow at all without the guarantee.

To keep this method feasible the SNA93 treatment of non-life insurance would need to be updated so that a simple treatment could be applied for guarantees. This would be to record D.71 resources for the imputed purchases of insurance, and D.72 uses when calls on the guarantee are made, and nothing else. The impact on output and F.6 would be ignored, as would the inequality of D.71 and D.72 each year.

Accounting details are at 4.5.

3.6 Purchase of an insurance contract

This method is similar to the previous one, but relies on the recording of a global amount regarding the "expected claim", and involves recording in the financial account some F62 Prepayment of premiums and reserves against outstanding claims. The borrower records the initial creation of the financial asset as being funded by a subsidy, and subsequent changes in the value of the provision are recorded in a new non-financial instrument – D.82.

Accounting details are at 4.6.

3.7 Financial derivative

Treatment as a financial[16] derivative would apply when there is a market of similar instruments and observable market prices. In such cases, there is no need for statisticians or accountants to estimate a net present value of the expected payments under the guarantee.

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[14] Assuming the guarantee is not purchased by the borrowing unit at the market price.
[15] Or whatever the accounting period is, could be quarterly for example.

If the tradable guarantee is given away for free to the borrowing unit by government it would be necessary to record an imputed grant (D.9), or perhaps a subsidy (D.3), from government to the borrowing unit to represent the "gift". A transaction in F.34 (liability of government, asset of the borrower) would record the borrower's acquisition of a financial asset. Changes to the market price would be recorded as other flows and change the balance sheet, but not as transactions. Actual payments under a call on the guarantee would be recorded as redemption of financial liabilities. I.e. following this method, only the initial "gift" (market price of the financial derivative) will affect deficit and not subsequent changes to this price (calls on the guarantee).

Accounting details are at 4.7.

4 Accounting tables

In each case:

a) At the start of year 1, the borrower borrows 100 from the lender for 5 years;

b) Interest rate is 5%;

c) Loan capital is due to be repaid in full at the end of year 5;

d) Lender starts with cash of 100; other units have none; and

e) Government borrows via F.31 to fund any cash requirement (it is assumed that the lender buys the F.31 government securities, to keep the accounting enclosed).

4.1 No recording in the core accounts when the guarantee is given

This is the method that would be used for the majority of guarantees under the EMGDD, re-routing, and IPSAS19 options. In each of those options there is a particular way of handling guarantees that are "likely to be called"[17]. For other guarantees nothing is recorded when the guarantee is given, and government payments of capital grants are recorded when the guarantee is called.

In this example the guarantee is called in year 5, and government pays 25 of the interest (5) and capital repayment (100) due, borrower pays the rest from own resources.

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[16] Some TFHPSA members have suggested that non tradable guarantees could be treated as "derivatives", rather than "financial derivatives". This approach would be close to creating a new instrument (as in "IPSAS 19 method", though making clearer the link between guarantees and some financial derivatives.

[17] "Likely to be called" is used for brevity. The conditions determining when the special treatment applies vary in each of those three options according to how likely it is that the guarantee will be called and some other factors.

Year 1						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.41			+5			+5
B.9	0		-5		+5	
F.4				+100	+100	
F.2			+95		-95	
B.9f check	0		-5		+5	
End year stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			95		-95[18]	
AF.4				100	100	

[18] The figures shown regarding positions refer to the impact on these positions of the transactions recorded during corresponding years. This is why they may be negative in some cases.

Year 2,3,4						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.41			+5			+5
B.9	0		-5		+5	
F.2			-5		+5	
B.9f check	0		-5		+5	
End year 4 stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			80		-80	
AF.4				100	100	

Year 5						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.41			+5			+5
D.9	+25			+25		
B.9	-25		+20		+5	
F.2			-80		+80	
F.31		+25			+25	
F.4				-100	-100	
B.9f check	-25		+20		+5	
End year 4 stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2					0	
AF.31		25			25	

4.2 Full debt assumption when guarantee is given

In this method, the government is shown as taking full responsibility for repaying all of the debt and interest when the guarantee is given. This treatment would apply only in a few special cases.

Year 1						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.9	+100			+100		
D.41	+5					+5
B.9	-105		+100		+5	
F.4		+100			+100	
F.31		+5			+5	
F.2			+100		-100	
B.9f check	-105		+100		+5	
End year stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			100		-100	
AF.31		5			5	
AF.4		100			100	

Year 2,3,4						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.41	+5					+5
B.9	-5		0		+5	
F.31		+5			+5	
B.9f check	-5		0		+5	
End year 4 stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			100		-100	
AF.31		20			20	
AF.4		100			100	

Year 5						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.41	+5					+5
B.9	-5				+5	
F.31		+105			+ 105	
F.4		-100			-100	
B.9f check	-5				+5	
End year stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			100		-100	
AF.31		125			125	

4.3 Re-route the guaranteed borrowing through government

In this method, the government is shown borrowing from the lender and on-lending to the borrower. The guarantee is called in year 5, and government pays 25 of the interest (25) and capital repayment (100) due, borrower pays the rest from own resources.

Year 1						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.41	+5	+5	+5			+5
B.9	0		-5		+5	
F.4	+100	+100		+100	+100	
F.2			+95		-95	
B.9f check	0		-5		+5	
End year stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			95		-95	
AF.4	100	100		100	100	

Year 2,3,4						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.41	+5	+5	+5			+5
B.9	0		-5		+5	
F.2			-5		+5	
B.9f check	0		-5		+5	
End year 4 stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			80		-80	
AF.4	100	100		100	100	

Year 5						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.41	+5	+5	+5			+5
D.9	+25			+25		
B.9	-25		+20		+5	
F.2			-80		+80	
F.31		+25			+25	
F.4	-100	-100		-100	-100	
B.9f check	-25		+20		+5	
End year 5 stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2						
AF.31		25			25	

4.4 IPSAS19 – record as a provision

Net present value of expected payments under calls on guarantee = 12 when the guarantee is given at start of year 1. Discount rate = 3.13%. No change in expectations till start of year 5. The guarantee is called in year 5, and government pays 25 towards the interest and capital repayment due, borrower pays the rest from own resources.

In this method, a new financial instrument F.63 is used to record the provision that would be recorded under IPSAS19 for a guarantee, and new non-financial transaction D.82 is used to record the impact above the line, including the unwinding of the discount.

Year 1						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.41			+5			+5
D.82 [19]	+ 12			+ 12		
D.82 [20]	+0.4			+0.4		
B.9	-12.4		+7.4		+5	
F.4				+ 100	+100	
F.2			+95		-95	
F.63		+12.4	+12.4			
B.9f check	-12.4		+7.4		+5	
End year stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			95		-95	
AF.63		12.4	12.4			
AF.4				100	100	

[19] The initial setting up of the provision.
[20] Unwinding the discount

Years 2,3,4						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.41			+5			+5
D.82	+0.4			+0.4		
B.9	-0.4		-4.6		+5	
F.2			-5		+5	
F.63		+0.4	+0.4			
B.9f check	-0.4		-4.6		+5	
End year 4 stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			80		-80	
AF.63		13.6	13.6			
AF.4				100	100	

Year 5						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.9						
D.41			+5			+5
D.82 [21]	+ 0.4			+ 0.4		
D.82 [22]	+ 11			+11		
B.9	- 11.4		+ 6.4		+5	
F.4				- 100	- 100	
F.2			- 80		+ 80	
F.62 [23]		+ 11.4	+ 11.4			
F.62 [24]		- 25	- 25			
F.31		+ 25			+25	
B.9f check	- 11.4		+ 6.4		+5	
End year stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2						
AF.31		25			25	

[21] Unwinding the discount
[22] Revaluation of provision due to observed cost of call on guarantee
[23] Changes in value of provision for reasons in foot notes above
[24] Release of provision to fund government's actual expenditure under the call on the guarantee

4.5 Treatment as subsidy and regular insurance policies

The guarantee is called in year 5, and government pays 25 towards the interest and capital repayment due, borrower pays the rest from own resources. It is estimated that the value of the guarantee is 3 each year. This is estimated as either the average annual expected payment from a call on the guarantee; or as the interest cost reduction achieved by the guarantee.

The method uses the non-financial transactions D.71 and D.72 and assumes that under an updated SNA93 these could be recorded on their own without any implication for government output or financial transactions.

Years 1						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.3	+3			+3		
D.41			+5			+5
D.71		+3	+3			
B.9	0		-5		+5	
F.4				+ 100	+100	
F.2			+95		-95	
B.9f check	0		-5		+5	
End year 4 stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			95		-95	
AF.4				100	100	

Years 2,3,4						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.3	+3			+3		
D.41			+5			+5
D.71		+3	+3			
B.9	0		-5		+5	
F.2			-5		+5	
B.9f check	0		-5		+5	
End year 4 stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			80		-80	
AF.4				100	100	

Year 5						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.3	+3			+3		
D.41			+5			+5
D.71		+3	+3			
D.72	+25			+25		
B.9	-25		+ 20		+5	
F.4				- 100	- 100	
F.2			- 80		+ 80	
F.31		+ 25			+25	
B.9f check	-25		+ 20		+5	
End year stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2						
AF.31		25			25	

4.6 Purchase of insurance contract

As in previous examples, the net present value of expected payments under calls (i.e. expected claim) is 12, when the guarantee is given at the start of year 1. Discount rate=3.13%. No change in expectations till year 5. The guarantee is called in year 5, and government pays 25. The borrower pays the rest.

In this method, the debt corresponding to the expected claim is booked under F62, and a new non-financial transaction D82 is used to record the unwinding of the discount and the movement in the value of the provision that occurs just before the claim is paid.

Years 1						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.3	+12			+12		
D82[25]	0.4			0.4		
D.41			+5			+5
B.9	-12.4		+7.4		+5	
F.4				+ 100	+100	
F.2			+95		-95	
F62		+12.4	+12.4			
F						
B.9f check	-12.4		7.4		+5	
End year 4 stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			95		-95	
AF.4				100	100	
AF62		12.4	12.4			

[25] Unwinding the discount.

Years 2,3,4						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.41			+5			+5
D.82	+0.4			+0.4		
B.9	-0.4		-4.6		+5	
F.2			-5		+5	
F.62		+0.4	+0.4			
B.9f check	-0.4		-4.6		+5	
End year 4 stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			80		-80	
AF.62		13.6	13.6			
AF.4				100	100	

Year 5						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D3						
D.41			+5			+5
D.82[26]	11[27]			11		
D.82 [28]	+ 0.4			+ 0.4		
B.9	-11.4		+ 6.4		+5	
F.4				- 100	- 100	
F.2			- 80		+ 80	
F.62		+11.4	+11.4			
F.62		-25[29]	-25			
F.31		25			25	
B.9f check	- 11.4		+ 6.4		+5	
End year stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2						
AF.31		25			25	

[26] D.82 also used here for changes in the value of the expected claim for reasons other than unwinding the discount.
[27] As actual claim is 25 and the borrower has received so far a subsidy of (12+04+04+04+04+04=14), he receives a further transfer of 25-14=11.
[28] Unwinding the discount.
[29] Release of "insurance" liability to fund government's actual expenditure under the call on the guarantee.

4.7 Financial derivative

Market value of guarantee = 12 when the guarantee is given at start of year 1. Market value of guarantee remains unchanged till start of year 5. The guarantee is called in year 5, and government pays 25 of the interest (5) and capital repayment (100) due, borrower pays the rest from own resources.

Year 1						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.9	+12			+12		
D.41			+5			+5
B.9	-12		+7		+5	
F.4				+ 100	+100	
F.2			+95		-95	
F.34		+12	+12			
B.9f check	-12		+7		+5	
End year stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			95		-95	
AF.31						
AF.34		12	12			
AF.4				100	100	

Years 2,3,4						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.41			+5			+5
B.9	0		-5		+5	
F.2			-5		+5	
B.9f check	0		-5		+5	
End year 4 stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2			80		-80	
AF.31						
AF.34		12	12			
AF.4				100	100	

Year 5						
ESA95 item	**Government**		**Borrower**		**Lender**	
Annual flows	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**	**Uses / δA**	**Res / δL**
D.9						
D.41			+5			+5
B.9	0		- 5		+5	
F.4				- 100	- 100	
F.2			- 80		+ 80	
F.34		- 25	- 25			
F.31		+ 25			+25	
B.9f check	0		- 5		+5	
K.11, AF34		+13	+13			
End year stock	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
AF.2						
AF.31		25			25	

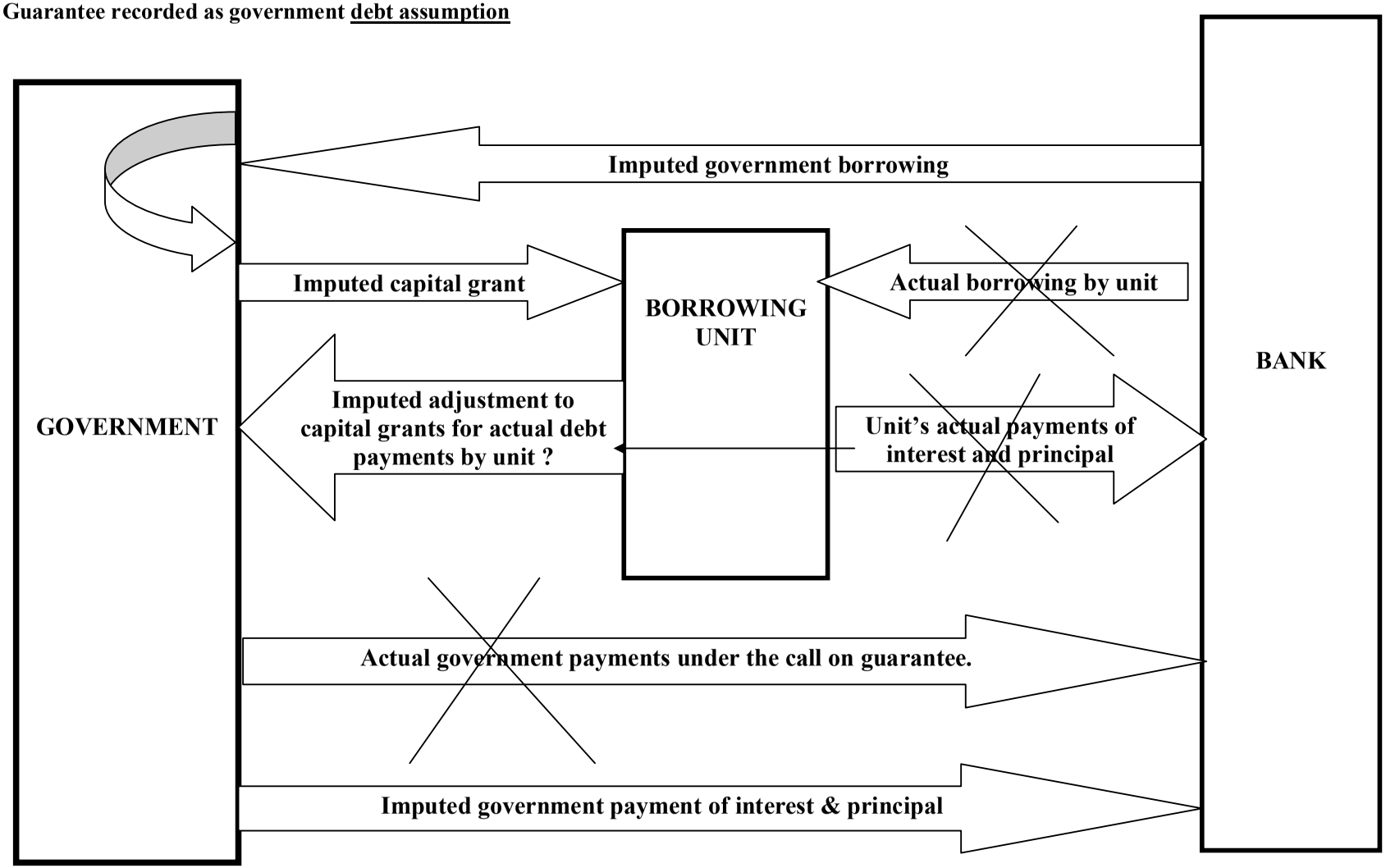
5 Diagrams: Accounting for guarantees

The diagrams on the following pages illustrate the transactions required for each of the methods for recording guarantees discussed above.

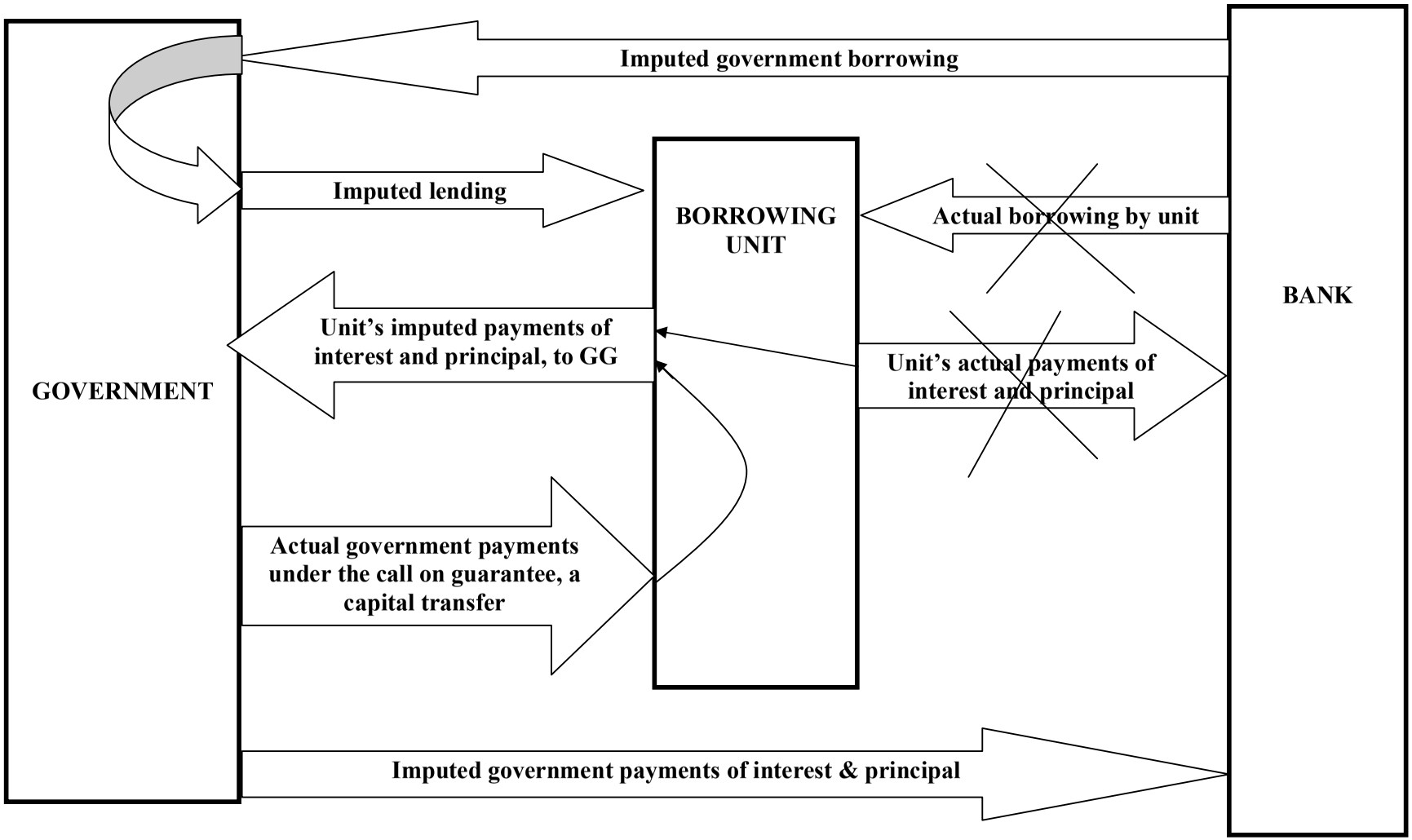
Some flows are shown as being crossed out. This indicates a real world flow that would be recorded as something else in national accounts under the proposed treatment.

Reimund Mink and Pierre Sola

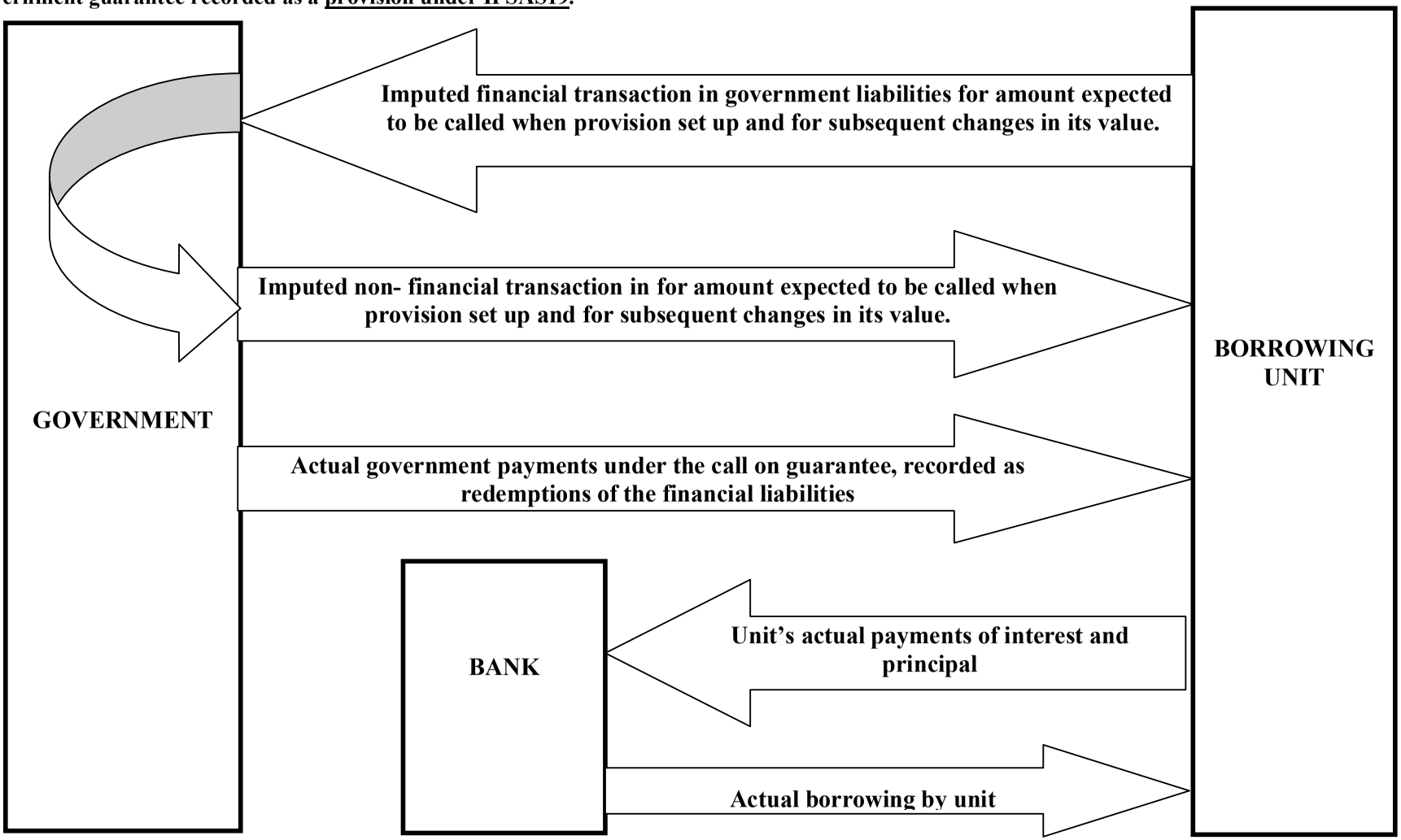
Guarantee recorded as government <u>debt assumption</u>



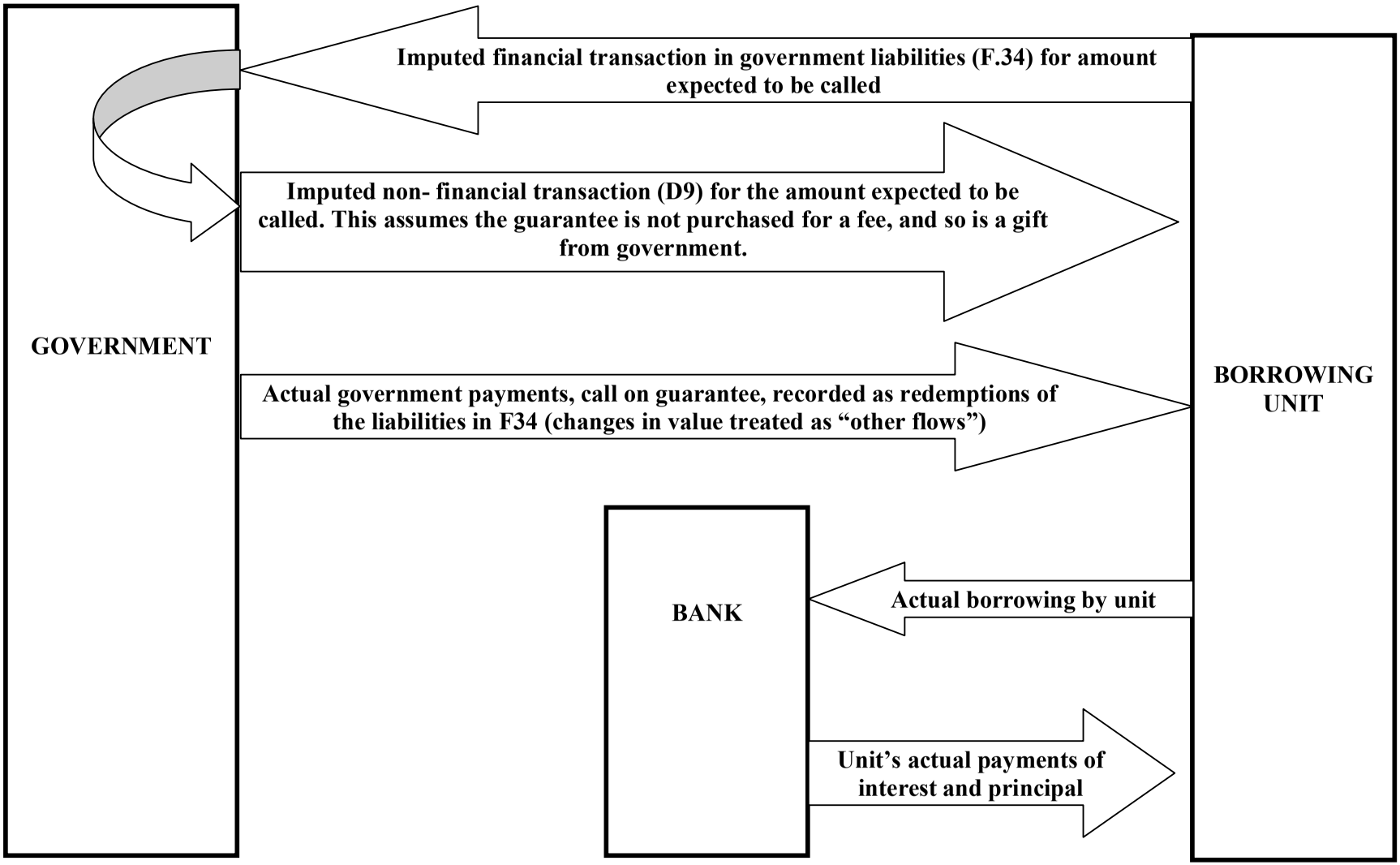
Guarantee recorded as government borrowing and on-lending



Government guarantee recorded as a provision under IPSAS19.



Government guarantee recorded as a financial derivative.



Annex 1

Background to the issue

Guarantees for the purpose of this paper are understood to be arrangements whereby a non-government unit borrows and government promises the lenders that they will be repaid whatever happens to the borrowing unit.

Governments give guarantees to public corporations and units in the private sector. The usual motive for giving a guarantee to a public corporation is to help it reduce its borrowing costs and hence increase the dividends it pays to government, or reduce the subsidies it needs or the prices charged to customers.

The motive for giving a guarantee to a private sector organisation would normally be to encourage a particular type of economic activity through lowering the costs of the activity, but without the need for an actual cash payment by government. Guarantees given to a private sector organisation would normally be part of a package that involves sharing the pain in the event of financial failure and the need for a call on the guarantee. Without such arrangements there is no incentive for the unit to act in ways that make a call more unlikely.

Giving a guarantee is therefore a way for government to subsidise economic activity without a need for an immediate cash outlay. They are a way of shifting possible costs into the future. It could be argued that a system of economic accounts should record guarantees when they are given, not just when actual payments are made under the guarantee, because that is when they influence economic behaviour and create potential costs for government.

Annex 2

Types of guarantees

A "call" on the guarantee is the word used here to describe the events that take place when the borrowing unit or lender asks government to act on its promise. Guarantee contracts usually give the lenders the right to demand that the borrowing unit takes advantage of the guarantee (where the guarantee has been given to the borrowing unit rather than the lender).

The government action, when the guarantee is called, can take various forms, as described below.

Debt assumption

Government agrees formally to become the debtor. It takes on the obligation to make all future repayments. As part of the arrangement, government might acquire a financial claim on the original borrower.

Grants given

Government gives a grant to the borrowing unit so that it can pay the next instalment of debt repayment or interest. Under an explicit guarantee the amounts and timing of the grants would be determined when the interest and debt repayment become due and would depend on the financial situation of the borrowing unit at that time.

In some cases, although there is no explicit guarantee, government might agree with the borrowing unit to pay a stream of future grants of fixed amounts and timing, which form part of the unit's income. The unit uses its income to finance interest and debt repayment, and other expenses. If the government grants are the main source of income of the unit, and if debt servicing is the unit's main cost, it starts to look like the unit has government guaranteed borrowing. This can be made more direct through the securitisation of the government payments[30], which is when the stream of grants is assigned to the lender.

In some cases government grants are given to avoid a call on the guarantee. Although the immediate cash cost to government would be the same (a call on guarantee or pre-emptive grant), the grant is preferred because of other possible secondary consequences of a call on the guarantee required under the guarantee contract (such as legal costs, dismissal of managers, restructuring of the unit).

Credit facility

Government lends to the borrowing unit so that it can pay the next instalment of interest or debt repayment. This raises the question as to whether the loan from government will ever be repaid and whether it should be recorded in national accounts as a loan or as a grant to recognise the economic reality.

Further guarantees

Government provides further guarantees to the borrowing unit so that it can borrow more funds on the market to meet its debt repayments. The unit's debt keeps rising.

Put and call contracts

[30] Dealt with in part V of the EMGDD.

The lender has the right to demand full repayment from the Government at short notice, and government has the right to make a full repayment at short notice. The latter can be useful when government wants to restructure the debt of a failing unit.

Guaranteed streams of future grants

Governments might guarantee future payments of grants or subsidies to a unit, rather than guaranteeing its debt, perhaps in the context of a securitisation of the payments by the recipient unit. The ESA95 treatment of these sorts of guarantees is not considered in detail in this paper, and it might need some elaboration in an updated SNA93.

Under GAAP the decision on whether to record such guaranteed future payments as liability on the balance sheet, or not, depends on whether the commitment is viewed as an executory contract (off-balance sheet) or as an onerous contract (a liability on the balance sheet). An executory contract is where the payments are linked to the future provision of goods and services to government, or some actions that deliver government's policy objectives. An onerous contract is where the future payments have to be made unconditionally (do not depend on any action by the recipient, and the payer does not have the legal right to cancel the obligation).

Annex 3

Some issues for the Task Force to consider

General questions

The general questions for national accounts are:

a) what, if anything, to record when the guarantee is given;

b) what to record if perceptions change after the guarantee is given;

c) what to record when the guarantee is called.

Some specific questions

a) If government charges a fee for giving a guarantee, such that fee reflects the risks and costs of call on the guarantee, should it be regarded as evidence of being traded and so be recorded as a derivative ? The payment of fees for guarantees is common in the field of government support for exporters, where government guarantees the payment by the purchaser of the exports. The arrangements are usually recorded like insurance.

b) How should a fee be classified if the guarantee is not recorded as a derivative or insurance policy ? The fee needs to be classified in national accounts, but it raises a problem if the guarantee is not recorded in the system since there is no counterpart to the cash receipt.

c) Does the re-routing of guaranteed borrowing and interest flows through government cause problems for allocation of FISIM and measurement of GDP[31] ?

d) If it is thought appropriate to record the acquisition of an insurance policy, should this be recorded when the guarantee is given (for the full amount of the value of the insurance policy over the life of the guarantee) or be recorded every year as if a new guarantee were given every year. Assuming the borrowing unit does not actually pay for the guarantee, the former treatment would require recording a capital grant when the guarantee is given whereas the latter would require the recording of regular subsidies[32].

e) Should something be recorded in the balance sheet under ESA95 even when IPSAS 19 does not do so but records a contingent liability instead ?

f) If a call on a guarantee is implemented through a loan from government rather than a grant, should the loan being treated as a grant to reflect better the economic reality ?

g) How to determine the likelihood of a call under the guarantee ? Under some recording options, judgements on how to record guarantees can depend on assessing the probability of the guarantee being called. This is not something that national accountants can quantify, but there may be some qualitative indicators in the guarantee contract Guarantees are likely to have a low probability of being called when there are severe consequences, such as dismissal of the managers of the

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[31] This question was raised at the TFHPSA meeting in February 2004

[32] The UK's ONS imputes regular subsidies for some guarantees, but the subsidies are shown as financing interest payments to government (therefore no impact on the deficit) rather than the acquisition of insurance or a financial derivative.

borrowing unit, or when they can only be called in exceptional circumstances such as the insolvency of the borrowing unit.

h) Should guarantees be used as indicators of sector classification? ESA95 distinguishes between public sector and private sector units by considering who controls a unit. Accounting standards used by businesses, in determining whether a unit is a subsidiary of another, consider exposure to economic risks and rewards, as well as control. Perhaps, under ESA95, when the control test is inconclusive, the existence of a government guarantee should tip the balance towards public sector classification. The existence of guarantees can also play a part in judging the balance of risks and rewards when classifying leases, PPPs and securitisations.

Annex 4

Rationale for the Eurostat Task Force proposal

The treatment of one-off non-tradable of guarantees, where the probability of a call is not remote, as derivatives or insurance policies raises the problem of estimating the value of the asset acquired (and hence the impact on the deficit since an imputed grant would be recorded to finance the acquisition of the asset). Calls on the guarantee become financial transactions, and so would have no impact on the government deficit. This approach seems unreliable until at least a time when most countries are recording provisions for guarantees in audited public accounts in line with IPSAS 19 or similar[33]. The proposal (re-routing the borrowing through government) does not require estimates to be made.

Under GAAP any changes in the value of a provision after it is set up would be recorded in the profit and loss account (shows surplus/deficit). This means the initial valuation of the provision is not too critical for the profit and loss account since subsequent changes can be made with an impact on that account. Under the existing SNA93 these holding gains and losses appear as other flows, not as transactions. Consequently, under SNA93, the different treatment of holding gains and losses means that the treatment of guarantees like provisions does not work as well as it does under GAAP in giving the intuitively correct result for the surplus/deficit.

The proposal identifies a category of non-tradable individual guarantees for which re-routing is applied. The category corresponds approximately to guarantees that are treated as provisions under IPSAS19, rather than as contingent liabilities. This has the advantage of being consistent with the identification of appropriate guarantees (for the re-routing treatment) in public accounts' balance sheets in those countries applying IPSAS 19 or similar methods. Those that are treated as contingent liabilities in those public accounts, or not disclosed, would not be recorded in national accounts in line with the general rule for contingent liabilities in ESA95.

IPSAS19 has a distinction based on a 50% probability borderline. It does not seem completely satisfactory to have two very different treatments depending on whether a guarantee is judged to have a 49% or 51% chance of being called. On the other hand, it can be argued that consistency with IPSAS 19 would provide statisticians with a relevant source of data in those countries adopting IPSAS 19. Guarantees with a greater than 50% chance of being called might be rare given that most one-off guarantees are given under the assumption that they will not be called. It is more likely that any guarantees with such a high probability of being called have emerged as a result of changed expectations during the lifetime of the guarantee some time after it was first given. This is why the Eurostat TF proposal says that a guarantee should be reclassified (from not being recorded in the balance sheet to being recorded) if during the life time of the guarantee it becomes clear that there is now a greater than 50% chance of being called.

The proposal says that when judging whether a guarantee should be given the re-routing treatment it is necessary to consider only the borrowing unit's existing legal contracts and the economic conditions and policies under which it operates. This is to deal with the situation where calls under a guarantee are regularly avoided by special government intervention, in the form of a grant or loan, to fund a borrowing unit's immediate debt servicing. This proposed rule does not apply to grants that are agreed in advance, and are of predetermined amounts and timing, in order to subsidize a particular activity under an existing policy. In those cases the future subsidies are taken into consideration when determining the likelihood of a call under the guarantee because the borrowing unit will plan its borrowing on the basis of what it can afford including the subsidy receipts. The proposal aims to identify those cases where the government

[33] As in USA or Sweden for example.

intervention is not fixed in advance but is in the form of emergency action and the amounts paid are more directly related to the immediate needs of the borrowing unit's debt servicing.

Eurostat will develop some guidelines to identify suitable guarantees for the proposed re-routing treatment, acknowledging that the application of IPSAS19 is not widespread.

Annex 5

Treatment of Guarantees under GAAP

Under some circumstances, a guarantee would be recorded as a provision under GAAP. The following text examines IPSAS19 developed by the IFAC public Sector Committee from the International Accounting Standard 37.

International Public Sector Accounting Standard 19 (IPSAS 19)

IPSAS 19 requires that:

- provisions should be recognised in the balance sheet when, and only when:

  an enterprise has a present obligation (legal or constructive) as a result of a past event;

  it is probable (i.e. more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation;

  and a reliable estimate can be made of the amount of the obligation.

Guarantees that do not satisfy these conditions are treated as contingent liabilities and are not recognised in the balance sheet.

Additional guidance says:

- provisions should be measured in the balance sheet at the best estimate of the expenditure required to settle the present obligation at the balance sheet date, in other words, the amount that an enterprise would rationally pay to settle the obligation, or to transfer it to a third party, at that date.

- a provision should not be recognised for future operating losses;

- a provision should be recognised for an onerous contract - a contract in which the unavoidable costs of meeting the obligations under the contract exceed the expected economic benefits.

Application of IPSAS 19 to guarantees

IPSAS 19 paragraphs 32 and 47, and example 9, are relevant. Briefly:

a) a one-off guarantee should not be recorded on balance sheet if there is a less than 50% chance that it will be called;

b) a one-off guarantee should be recorded on balance sheet if there is a higher than 50% chance that it will be called. For example, a guarantee might have been given initially on the assumption of a low probability of being called. However, the financial situation of the borrowing unit might deteriorate to the point where a call on the guarantee seems to be more likely than not, under existing policies, in which case the guarantee should be recorded as a liability in the government's balance sheet. It might be that the government could intervene to ensure that the call is not needed, but the accounting treatment should not make any assumptions about changes in government policies or legal contracts when determining whether a call is likely. The amount recorded should be the net present cost of the expected amount to be paid under a call on the guarantee.

c) if a large number of similar guarantees are given they should be treated as a class and recorded as a liability on the government's balance sheet at the net present cost of the expected value of the amount that government will have to pay under calls on the guarantees ?

Points to note are the different treatment of individual guarantees and groups of similar guarantees[34], and that the amount recorded on balance sheet, when it is recorded, is the expected payment under calls under the guarantee which will usually differ from the actual amount of outstanding guaranteed borrowing[35]. Note also that IPSAS 19 does not record anything on the balance sheet for individual guarantees with a less than 50% chance of being called even though the statistical expected value of payments would be non-zero[36].

[34] ESA95 paragraph 5.05 footnote 1 alludes to the different treatment of individual guarantees and groups of guarantees. It does so by saying that for individual policy holders, insurance contracts are contingent liabilities of insurance companies, but when considering all policies they are unconditional liabilities because of the statistical averaging of the likely claims.

[35] So it is not the same as full debt assumption.

[36] This contrasts with the methods used in Sweden and USA where an estimate of the expected payment is made for all guarantees.

Annex 6

Existing guidance in SNA93 and ESA95

Treatment as contingent assets

SNA93 and ESA95[37] refer to guarantees in the context of contingent assets / liabilities. Contingent assets are future transactions that are conditional on events outside of the control of the units holding the contingent assets and liabilities. In general, contingent assets are not recorded in the system. Transactions are recorded only when they actually happen. In the context of guarantees, this would be when there are calls on the guarantee – typically recorded as capital transfers.

There is a question as to whether the capital transfer should be equal to the amounts paid, or be for the full amount of the outstanding debt when a first call on the guarantee is made.

The current ESA95 treatment (contingent liabilities generally not recorded in the balance sheet) is the IPSAS 19 treatment for one-off guarantees that are not expected to be called.

It is the method described in the EMGDD[38] (part II.4.3).

Recording provisions in ESA95

"Provisions", in the GAAP sense and in this document, are liabilities of uncertain value. The value is uncertain because the future payments depend on future events. Both the amount to be paid, and its timing, are uncertain, but it is probable that some payment will be made. They are generally not traded on a market so there is no observable market price.

Note that the word "provisions", in the sense used here, does not mean a stock of assets held to meet a particular future cost, nor is it an adjustment to a stock of financial assets to take account of bad debts.

As a general rule ESA95 does not record provisions. For many provisions it is not possible to identify the asset holder, so they would not be suitable for recording as financial instruments in an integrated system like ESA95. However there are exceptions to this general rule, most notably insurance technical reserves (F.6), which are provisions under GAAP and are recorded in ESA95. Also some non-traded derivatives can have the characteristics of provisions and are recorded as assets in ESA95.

Treatment as a derivative

ESA95 says that contingent assets should be recorded as financial assets only when the contractual arrangement itself has a market value because it is tradable or can be offset on the market. It refers to such guarantees in the context of derivatives (F.34).

This raises the question as to whether the receipt by government of a fee for a guarantee is an example of tradability and a market price. SNA93 paragraph 11.26 says that any payments of fees related to the establishment of contingent arrangements are treated as payments for services, and that transactions are recorded in the financial account only when an actual financial asset is created or changes ownership. However, in the paragraphs on derivatives[39] it is clear that payments should be divided into those that relate to the cost of arranging the contract[40], which are to be treated as a payment for services, and those

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[37] ESA95 paragraphs 5.05, 7.12c and 7.22.
[38] Eurostat's ESA95 Manual on Government Deficit and Debt
[39] SNA93 paragraphs 11.34 to 11.43
[40] Such as legal and administrative expenses

that relate to the expected payments under the derivative contract, which should be treated as transactions in financial assets and liabilities.

SNA93 discusses arrangements whereby a future payment is conditional on certain events taking place. It explains[41] that country practices[42] vary in determining which of these conditional arrangements are considered contingent liabilities (not recorded in the balance sheet) and which are to be considered as financial liabilities that are recorded in the balance sheet (as a provision since the conditionality means that the timing and amounts of future payments are uncertain). It describes bankers' acceptances as an example of a conditional instrument that should be treated as a financial asset.

SNA93 notes the need for flexibility in determining which conditional instruments should be treated as contingent assets (not in the balance sheet) and which as financial assets.

The conclusion to be drawn from the SNA93 text on contingent assets and derivatives, and the IPSAS19 on provisions, is that it would be consistent with ESA95 to record guarantees in ESA95 in the same way as in GAAP. In other words, treat as a contingent liability (not recorded in the balance sheet) those one-off guarantees where a call is unlikely, or as a financial liability in the balance sheet, those one-off guarantees where a call is likely and for groups of similar guarantees.

Rerouting and recognising the principal party

ESA95 paragraph 1.39 says

A transaction that appears to the units involved as taking place directly between units A and C may be recorded as taking place indirectly through a third unit B. Thus, the single transaction between A and C is recorded as two transactions: one between A and B, and one between B and C.

This sort of re-routing could be applied to government guaranteed borrowing by recording the government as borrowing from the lender and on-lending the amount to the borrowing unit. Interest and capital repayments would be similarly re-routed.

ESA95 paragraph 1.41 says

> When a unit carries out a transaction on behalf of another unit the transaction is recorded exclusively in the accounts of the principal.

This might be relevant where a non-government unit is given a government guarantee in order for it to borrow funds to finance a government policy that it undertakes on behalf of government.

ESA95 annex II explains how borrowing is re-routed when recording finance leases.

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[41] SNA93 paragraph 11.27

[42] Presumably here it is referring to the generally agreed accounting practice (GAAP) in different countries.

Annex 7

International Accounting Standard 37

International Public Sector Accounting Standard 19 is consistent with IAS37 but uses some different terms and examples to fit better the public sector context.

IAS 37: Provisions, Contingent Liabilities and Contingent Assets

IAS 37 was approved by the IASC Board in July 1998 and became operative for annual financial statements covering periods beginning on or after 1 July 1999.

Summary of IAS 37

IAS 37 requires that:

provisions should be recognised in the balance sheet when, and only when: an enterprise has a present obligation (legal or constructive) as a result of a past event; it is probable (i.e. more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation; and a reliable estimate can be made of the amount of the obligation;

provisions should be measured in the balance sheet at the best estimate of the expenditure required to settle the present obligation at the balance sheet date, in other words, the amount that an enterprise would rationally pay to settle the obligation, or to transfer it to a third party, at that date. For this purpose, an enterprise should take risks and uncertainties into account. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. An enterprise should discount a provision where the effect of the time value of money is material and should take future events, such as changes in the law and technological changes, into account where there is sufficient objective evidence that they will occur;

the amount of a provision should not be reduced by gains from the expected disposal of assets (even if the expected disposal is closely linked to the event giving rise to the provision) nor by expected reimbursements (for example, through insurance contracts, indemnity clauses or suppliers V warranties). When it is virtually certain that reimbursement will be received if the enterprise settles the obligation, the reimbursement should be recognised as a separate asset; and

a provision should be used only for expenditures for which the provision was originally recognised and should be reversed if an outflow of resources is no longer probable.

IAS 37 sets out three specific applications of these general requirements:

a provision should not be recognised for future operating losses;

a provision should be recognised for an onerous contract - a contract in which the unavoidable costs of meeting the obligations under the contract exceed the expected economic benefits; and

a provision for restructuring costs should be recognised only when an enterprise has a detailed formal plan for the restructuring and has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it. For this purpose, a management or board decision is not enough. A restructuring provision should exclude costs - such as retraining or relocating continuing staff, marketing or investment in new systems and distribution networks - that are not necessarily entailed by the restructuring or that are associated with the enterprise's ongoing activities.

IAS 37 prohibits the recognition of contingent liabilities and contingent assets. An enterprise should disclose a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote, and disclose a contingent asset if an inflow of economic benefits is probable.

Annex 8

US Federal Accounting Standards Advisory Board, Statement of Federal Financial Accounting Standards (SFFAS) 2

SFFAS 2: Accounting for Direct Loans and Loan Guarantees

SFFAS 2 is consistent with US federal government budgeting for direct loans and loan guarantees, which has accounted for direct loans and loan guarantees on a present value basis since the budget for fiscal year 1992.

SFFAS 2 was issued in August 1993 and became effective for fiscal years ending September 30, 1994, and thereafter.

EXECUTIVE SUMMARY

Direct loans disbursed and outstanding are recognized as assets at the present value of their estimated net cash inflows. The difference between the outstanding principal of the loans and the present value of their net cash inflows is recognized as a subsidy cost allowance.

For guaranteed loans outstanding, the present value of estimated net cash outflows of the loan guarantees is recognized as a liability.

Disclosure is made of the face value of guaranteed loans outstanding and the amount guaranteed.

For direct or guaranteed loans disbursed during a fiscal year, a subsidy expense is recognized. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the loans minus the present value of estimated cash inflows.

The subsidy cost allowance for direct loans and the liability for loan guarantees are re-estimated each year, taking into account all factors that may have affected the estimated cash flows. Any adjustment resulting from the re-estimates is recognized as a subsidy expense (or a reduction in subsidy expense).

When direct loans or loan guarantees are modified, the cost of modification is recognized at an amount equal to the decrease in the present value of the direct loans or the increase in the present value of the loan guarantee liabilities measured at the time of modification.

Upon foreclosure of direct or guaranteed loans, the acquired property is recognized as an asset at the present value of its estimated future net cash inflows.

The standards permit but do not require restating pre-credit reform direct loans and loan guarantees at present value.