

June 9, 2004

To: Jeff Golland

From: Bob Kilpatrick  
U.S. Office of Management and Budget

Subject: Comments on draft paper: accounting for guarantees in the national accounts

Thank you for this carefully reasoned, informative, and clearly written draft paper on accounting for guarantees in the national accounts. It was stimulating to read through it and think about the alternatives. I have written a few general comments about the ideal solution and then more detailed comments section-by-section.

For background, I should say that I am not a national income accountant and my comments do not purport to represent the views of the U.S. Bureau of Economic Analysis. I am an economist by training, but my work for many years has been primarily on the budget with a supplementary interest in financial accounting. I helped develop the budgetary and financial accounting treatment of loan guarantees for the U.S. federal government, to which you refer. Last February I discussed the U.S. budgeting and accounting for loan guarantees and direct loans with Lucie Laliberte at the OECD meetings and sent her the two papers on this subject that I was presenting. I presume she sent you copies. If not and if you are interested, I can forward them to you.

### **I. General Comments about the Ideal Solution**

The paper does not develop a benchmark that would serve as a conceptual ideal for comparing the substance of the alternative ways of accounting for guarantees in the national accounts. The advantages and disadvantages mentioned throughout the paper make good sense. However, they might have been strengthened if they had been based on an explicit benchmark, and a benchmark might have led to more analysis of the advantages and disadvantages.

This bears upon (a) the recommendation in section 1.1, (b) the title and first sentence of section 1.2, where IPSAS 19 is called the ideal solution “from a TFHPSA perspective,” and (c) the conceptual benchmark that I would use as an ideal, which underlies a number of my comments.

Recommendation in section 1.1. – Section 1.1 recommends the method proposed by the Eurostat Task Force. In the absence of a conceptual ideal, it is not clear whether you believe this recommendation is conceptually the best or whether you believe it is conceptually the best given the constraint of available data sources. The distinction is important because of its implications for the SNA revision after the present one, at which time more countries may have accounting and/or budgetary data that would allow a

solution closer to IPSAS 19 or similar methods such as US credit budgeting and accounting.

IPSAS 19 as the ideal from a TFHPSA perspective. – Calling IPSAS 19 the ideal from a TFHPSA perspective raises three points:

- How closely is the TFHPSA bound to using the IPSAS as they stand today as the ideal solution to harmonizing financial accounting and national accounting? I do not know the answer, although I realize the role that the IFAC Public Sector Committee played in originating this project and the crucial importance of the IPSAS as a reference point for harmonization. Nevertheless, I would presume that substantive merit should also be considered, as this paper does. I would also presume that much of the value of harmonizing the national accounts with IPSAS would lie in harmonization with IPSAS's general approach – as an excellent representation of financial accounting generally – rather than following the IPSAS in every detail.

Moreover, as we know, the IPSAS themselves may change in the future as the IASB revises the international standards. According to the May 2004 "IASB Update" (page 4), an Exposure Draft is being prepared that would amend IAS 37. I do not know whether it would have any implications for the accounting discussed in this paper.

- To say that IPSAS 19 is the ideal "from a TFHPSA perspective" suggests that it is not necessarily the ideal from other perspectives. In one place in the paper this is explicit. You say that the IPSAS "distinction based on a 50% probability borderline . . . does not seem completely satisfactory" (page 38); and you imply it is not satisfactory on page 41. I agree. The US uses the net present value of expected cash flows for all guarantees, without the use of any borderline; footnote 7 says Sweden does also; and although I could be mistaken, I would suppose that New Zealand and Norway do the same.
- The previous two points suggest that substantial harmonization could be accomplished by an accounting that was similar in general spirit to IPSAS 19 but not identical in all characteristics. For example, I would suggest that it would be conceptually better and similar in general spirit to use the net present value of expected cash flows for all guarantees. (This is not to say that it is practicable for most countries to use this method at the present time, any more than it is practicable to use IPSAS 19.)

Conceptual benchmark for a number of my comments. – I would start my evaluation of the alternatives from the base of a conceptual benchmark, while recognizing that data might not be available to put it into practice at the present time or that principles of national accounting may call for some differences. My conceptual benchmark for loan guarantees is to record the full cost of loan guarantees as an expenditure and a liability when the guaranteed loans are disbursed. The full cost is on a

net present value basis where cash outflows and inflows are statistical estimates of the expected value (or a more refined method such as options pricing is employed).

This benchmark is consistent with my comments above, and it underlies the financial accounting standards and budgetary principles for loan guarantees for the US federal government. As summarized in annex 8, these standards and principles are similar in general spirit to IPSAS 19 but differ in several respects. The most important differences in terms of the issues in this paper are:

- A provision is recorded for all guarantees, as you point out. One-off guarantees where the probability of default is less than 50% are treated like all other guarantees.
- The method of measuring the provision is not prescribed, but as a first approximation it is the expected value in a statistical sense regardless of the probability of the guarantee being called. The method is the same in principle for one-off guarantees and classes of guarantees.
- Cash inflows are an offset to cash outflows in calculating the provision (both at present value). The cost is thus the present value of expected cash outflows over the life of the loan minus the present value of expected cash inflows. Netting cash inflows against cash outflows affects the treatment of (i) fees and (ii) revaluations when expectations improve.

## **II. Comments Section-by-Section**

### **Contents**

1. Annex 5 and Annex 8. – Modify titles as suggested in comments #6 and 33.

### **Section 1.1**

2. Page 3, par. 2: the meaning of “cost”. – I would suggest that the guarantee cost is incurred at the time when the guarantee becomes effective. It is then that the government enters into a legal commitment to sacrifice resources to achieve a specific objective, even though the amount of the cost can only be estimated at that time because the size and timing of the outflow of resources are uncertain and will not take place until the future. As a result of incurring a cost, the government has incurred a liability, and the private lender and borrower have changed their balance sheets and economic behavior.

I would therefore suggest that line 5 say “possible cash outflows” instead of “possible costs”; and that lines 7-8 say “create costs” or “create potential cash outflows” instead of “create potential costs”.

3. Page 3, par. 5: recommendation. – See general comments.

4. Page 3, par. 5, line 4. -- The last two words are hanging.

## Section 1.2

5. Title and first sentence: the ideal solution. – See general comments.

6. Page 3, last paragraph: the use of the term “GAAP”. – I would suggest that the IPSAS not be called “GAAP”. As the paper says on page 39, “the application of IPSAS 19 is not widespread”. The same is of course true for the IPSAS in general. In the US, if not in other countries as well, the term “GAAP” is limited to standards that an authoritative national body has designated in some way as GAAP (such as by designating a standard setter). It would be enough to refer to “IPSAS” rather than “GAAP.”

This comment applies many places throughout the paper, not just in this paragraph.

7. Page 3, last paragraph: line 4. “more likely than not to be called” as the criterion for recognizing an expenditure and a liability. – This paragraph, and corresponding statements in some other places throughout the paper, sounds as though “more likely than not” applies to every single loan guarantee evaluated individually. However, as noted on page 41, a large number of similar guarantees are treated as a class under IPSAS 19 rather than individually. The standard says: “Where there are a number of similar obligations . . . the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognized (if the other recognition criteria are met).” (IPSAS 19, par. 32)

For the sake of clarity, this part of IPSAS 19 should be explained. It is an important clarification for the US, where most guarantees are in programs that have a significant number of similar guarantees, and very few programs have a small number of individualized guarantees. (I do not know about other countries.) Because of its importance (if the US is at all representative), I suggest it be explained in the main body of the text of section 1.2 to set the stage for understanding IPSAS 19 and the rest of the paper. Footnote 7 comes too late and, because it is a footnote, it could be overlooked. For subsequent use, an abbreviated term is fine.

8. Page 3, last paragraph, line 5: the use of the expected value to measure the expenditure and liability. – IPSAS 19 prescribes the expected value only for provisions that involve a class with a large number of similar items (IPSAS 19, par. 47). It does not prescribe a method for one-off guarantees, although it does not preclude the expected value (par. 48). (The general concept in par. 44-45 sounds to me like “fair value,” but that is not pursued in the following paragraphs.)

9. Page 4, par. 3: disadvantages of applying the IPSAS 19 method. – Two other disadvantages might be suggested, although an alternative to IPSAS 19 could be devised

(such as US accounting) that is within its general spirit but does not have these disadvantages:

- IPSAS 19 makes a distinction in recognizing a provision for one-off guarantees based on a 50% probability borderline, even though “for individual guarantees with a less than 50% chance of being called . . . the statistical expected value of payments would be non-zero” (to quote this paper on page 41). You indicate this is a disadvantage on pages 38 and 41, and I agree. As a conceptual ideal, the statistical expected value (or some other statistical measure such as options pricing) should be applied to all guarantees regardless of the probability of their being called.
- The entity’s expected cost ideally should be reflected equally in its expenditures -- for the guarantee and the associated interest -- and in its liabilities. This equality holds at the inception of the guarantee under IPSAS 19, but it would not continue to hold when the expected cash outflows decrease (based on the sentence in this paper that starts on page 3 and ends on page 4). The liability decreases, but revenue increases and expenditures are the same. As a result, the cumulative expenditure (for the guarantee and interest) is more than the liability for the guarantee. This could be fixed by recording an offset to expenditures instead of revenue.

10. Page 4, par. 3(b): the treatment of holding gains and losses. – If one wants to maintain “the usual national accounts’ practice of treating holding gains and losses as other flows” below the line, why would it be inappropriate to treat changes in expectations in the same way? You explain your reason on page 10 (paragraph 2), but it is needed here.

### Section 1.3

11. Page 4, par. 4 and footnote 4: “very likely to be called”. – I do not understand why guarantees “very likely to be called” under the Eurostat task force proposal are the same as those for which IPSAS 19 would record a provision.

- “Very likely” sounds stronger than “more likely than not.” The former would seem to require a higher probability of being called than 51%.
- The task force limited its proposal to one-off guarantees. At least for the US, that would be a big difference between the task force and IPSAS 19.

12. Page 4, last paragraph: substantive disadvantages of Eurostat task force proposal. – The substantive disadvantages of this method might be spelled out, in addition to saying that it does not harmonize with IPSAS 19:

- Re-routing would not affect the recorded expenditures until the guarantee was called, which would be later than the time when the government provides a subsidy to the borrower, influences economic behavior, and incurs a cost.
- The proposal would cover the treatment of fewer guarantees than IPSAS 19. The exact extent of coverage would depend on (a) the criteria for “very likely” and (b) whether classes of similar guarantees comprise most of the guarantees in other countries besides the US. As stated in my general comments, I would suggest that the coverage of IPSAS 19 is itself too limited.
- The proposal would measure the government’s liabilities and assets as though the full principal of the guaranteed loan was expected to be called.
  - If re-routing is limited to guarantees where that is a good approximation, the coverage of this proposal would be extremely limited.
  - If re-routing is applied more widely, the liability would not reflect the expected outflow of resources for the guarantees covered. This would create a difference between the concept of liability and the amount of liability measured.
- The paper does not explain how the Eurostat task force proposal would apply to partial guarantees. Would they be excluded from this treatment? If so, that would limit its applicability even further. Would they be included in the full amount of the guaranteed loan? If so, that would misrepresent the economic reality of the guarantee. Would borrowing and lending be recorded only to the extent that the loan was guaranteed? That would be complicated, and it might misrepresent economic reality if the partial coverage was anything but a straight percentage.
- Re-routing would not provide a reasonable representation of the government’s assets.
- Re-routing may be a reasonable representation of the liability (but not the timing of the expenditure) for guarantees that (a) have a very high probability of being called in the full amount of the principal and (b) are for the full principal of the loan. Re-routing is not a reasonable representation otherwise. Because many or most guarantees do not meet these criteria – if the US is at all representative – this method at best would be a very limited solution to the problem of recording guarantees in the national accounts.

13. Page 4, last par., last two lines: FISIM. – Spell out FISIM the first time the abbreviation is used.

## Section 1.4

14. Page 5, par. 4: disadvantage of the insurance subsidy method. – The paragraph might be clarified to say explicitly that this method would make annual subsidy payments for a given guarantee. Clarification is needed because the term “subsidy” could be used in a different way to mean a single payment upfront for the full amount of the insurance policy over the life of the guarantee. (This latter usage is an option in question (d) in annex 3, page 36.) The sentence might be modified as follows:

A disadvantage of the annual insurance 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 annual current transactions with possible repeated GDP implications.

**Deleted:** a

## Section 3.4

15. Page 9, par. 5: reference to annexes. – Since the US public accounts are similar in general spirit to IPSAS 19, as footnote 10 points out, it might be worthwhile to cross-reference annex 8 as well as annexes 5 and 7.

16. Page 9, footnote 10: references to other countries. – While the US is similar in general spirit to IPSAS 19, it is not identical. I would suppose that Sweden and other countries are the same. It might be better to re-word the last part of the sentence to say something such as the following:

In some countries, such as Sweden and USA, public accounts apply methods similar to the IPSAS19 recording methodology to all loan guarantees.

**Deleted:** is

## Section 4.1

17. Page 13, par. 1: method used for the majority of guarantees. – If IPSAS 19 were adopted, this method would not be used for the majority of guarantees in the US. Most guarantees are in classes of similar guarantees, so a provision would be recognized. I do not know about other countries.

## Section 4.3

18. Page 17, par. 1: identification of the proposal. – It might be useful to identify this proposal as having been made by the Eurostat task force.

## Section 4.4

19. Page 19, par. 1.

- Why is the discount rate 3.13% when the interest rate is assumed to be 5% (page 12)?

- It would be helpful to add that the “change in expectations” is an increase in expected cash outflows.

### Annex 1

20. Page 33, par. 4: the meaning of “cost”. – See comment #2.

### Annex 3

21. Page 36, question (a): fees and derivatives. – My answer is very tentative, because I do not understand derivatives and their accounting.

Consider three groups of guarantees: (i) guarantees for which the fee reflects the full risk and cost of call, (ii) guarantees for which the fee reflects only the partial risk and cost of call, and (iii) guarantees for which no fee is charged. These three groups are similar with respect to expected cash outflows and differ only with respect to the extent that the government covers its estimated risk and cost of call by charging fees (from full coverage to zero coverage). I believe they should be accounted for in the same way for the sake of consistency and comparability (with the method including an offset for fees).

If I understand the question correctly, recording the guarantee as a derivative would be a possibility only if the fee reflected the estimate of the full risks and cost of call. If this assumption is not correct and groups (i) and (ii) would be treated in the same way, group (iii) would be treated differently so my basic answer is unchanged.

22. Page 36, question (b): classification of fees. – In US budgeting and accounting, fees are offsets to the gross cost so that the budget outlays or the financial costs of operations reflect the net cost of making guarantees. I do not know whether that would be appropriate under national accounting concepts.

As indicated under my general comments, I would ideally record all guarantees in the system and therefore would always have a counterpart to the cash receipts.

23. Page 36, question (c): FISIM and GDP. – No comment.

24. Page 36, question (d): insurance payments. – If guarantees were treated as the acquisition of an insurance policy, I would record the full amount of the value of the insurance policy over the life of the guarantee when the guarantee is given. This follows from my general comments about an ideal benchmark, because it would recognize the full cost of the legal obligation when it was incurred and economic behavior was influenced. It would be more consistent with the rationale of IPSAS 19 (and other methods that are similar in general spirit such as US budgeting and accounting) than recording an amount every year as if a new guarantee were given every year.

25. Page 36, question (e): balance sheet when a contingent liability is recorded under IPSAS 19. – I am not sure whether this question (i) asks about the ideal treatment or (ii) asks whether a liability should be recorded on the balance sheet under ESA 95 even if only a contingent liability (without an expenditure) is recorded under IPSAS 19.

(i) In concept, as I wrote in my general comments, I would record a provision where IPSAS 19 records a contingent liability. I would therefore ideally always record a liability on the balance sheet under ESA 95 (and an expenditure) when IPSAS 19 would record a contingent liability.

(ii) However, suppose that a contingent liability is recorded consistent with IPSAS 19 (and likewise no expenditure is recorded). IPSAS 19 records a contingent liability rather than a provision only if the probability of a call for a one-off guarantee is less than 50%. It would not reflect economic reality to record the principal as a liability if the probability of call was less than 50% and the expected cash outflow at the time of call was a fraction of the principal. The net present value of expected cash flows might, for example, be only 5% or 10% of the principal. I would therefore think it doubtful to record the principal as a liability on the balance sheet. I presume there would be no way to record a fraction of the principal, since the national accountant would not have a good estimate of the expected value of cash outflows.

26. Page 36, question (f): implementing a call through a loan. – I may not understand the question.

If the initial guarantee contract with a lender requires the government to make a loan under specified conditions, the expected value of cash flows from the loan should be included in estimating the cost of the guarantee. In general, it would not reflect economic reality to treat a loan as a grant if the government expected to receive any interest or principal repayments.

27. Page 37, question (g): likelihood of a call. – The answer may depend on the exact question asked. The US has had a dozen years of experience in estimating the net present value of expected cash flows for the budgeting and accounting of loan guarantees and direct loans. This requires a great deal of work; it needs both good historical accounting data and good models for estimation; and it needs review and oversight to provide assurance. As you say, “this is not something that national accountants can quantify.”

On the other hand, one might ask simply whether the probability of call for an individual guarantee is more than 50%. It would probably be easy to say that individual guarantees in the US rarely meet this criterion.

However, the latter determination would not be very helpful by itself for those guarantees that did meet this criterion. This is because it would indicate very little about the present value of expected cash payments in the event of a call. Therefore, it would not be sufficient information to apply IPSAS 19. Re-routing could be used, but it would have the disadvantages I suggested in comment #12.

28. Page 37, question (h): guarantees as an indicator of sector classification. – Guarantees should be considered one of the elements in judging sector classification, because they are one of the ways by which the government may provide resources to an entity.

#### Annex 4

28. Pages 38-39: general comments. -- Some of my discussion of the substantive disadvantages of the task force proposal (comment #12) is relevant to this annex.

30. Page 38, par. 2: holding gains and losses. – The reasoning in page 10, paragraph 2, would strengthen the conclusion.

31. Page 38, par. 4: rarity of guarantees with a greater than 50% chance of being called. – I agree that it would be rare for a one-off guarantee to have a greater than 50% chance of being called when it is originated. However, as mentioned on page 41 of this paper, IPSAS 19 also requires recognizing a provision for classes of similar guarantees.

#### Annex 5

32. Pages 40-41, the paragraph on both pages: other relevant applications of IPSAS 19 to guarantees. – I would suggest that paragraphs 48 and 53 of IPSAS 19 are also relevant. The following might be said:

- d) for a one-off guarantee the individual most likely outcome may be the best estimate of the liability, but the entity should consider other possible outcomes.
- e) where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation.

#### Annex 8

33. Page 46: title of annex 8. – The title of annex 8 should be changed to “US Federal Accounting Standards Advisory Board Standard”. This standard is for the federal government only and differs from the standard for private business. The standard-setter for the federal government is the Federal Accounting Standards Advisory Board (FASAB), whereas the Financial Accounting Standards Board (FASB) is the standard-setter for the private sector.

The same comment applies to the title of annex 8 in the table of contents.

34. Page 46: reference to FASAB standard. – You might wish to cite the reference to the U.S. federal government standard for direct loans and loan guarantees, just as you cite references in annexes 5 and 7 to IPSAS 19 and IAS 37. The citation is: Federal

Accounting Standards Advisory Board (FASAB), Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees* (August 23, 1993).

35. Page 46, last sentence: pre-credit reform direct loans and loan guarantees. – The last sentence may not be fully understood by readers. It could be clarified by the following bracketed insert:

The standards permit but do not require restating pre-credit reform direct loans and loan guarantees [i.e., those direct loans obligated and loan guarantees committed before fiscal year 1992] at present value.

36. Page 46: private sector standards for guarantees. – You might be interested in a reference to private sector standards for guarantees in the US. See FASB (Financial Accounting Standards Board) Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (November 2002). Paragraphs 8-12 set the standard for the initial recognition and measurement of the liability for a guarantor's obligation. The main theme is indicated by the following excerpt from paragraph 9:

“At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. Except as indicated in paragraph 10, the objective of the initial measurement of the liability is the fair value of the guarantee at its inception.”

cc: Brooks Robinson  
Tim Dobbs  
Michael Palumbo  
Susan McIntosh  
Rochelle Antoniewicz  
Courtney Timberlake  
Sue Lind