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Item 6 of the Agenda

**EPSAS issue paper on the accounting treatment of
provisions, contingent assets, contingent liabilities and
financial guarantees**

*Paper by PwC on behalf of Eurostat
- for discussion*



**Accounting treatment of provisions,
contingent assets, contingent
liabilities and financial guarantees
with a view to financial reporting
requirements under the future
European Public Sector Accounting
Standards (EPSAS)**

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1 Objectives of the issue paper

The aim of this issue paper is to summarise the approaches taken at the accounting standard level concerning the most important types of provisions, contingent assets, contingent liabilities and financial guarantees in at least two Member States (MSs) with high accounting maturity. It addresses the approaches which are being used under the existing international financial reporting frameworks (IPSAS, EU Accounting Rules [AR], IFRS and ESA 2010, including where relevant and applicable the Manual on Government Deficit and Debt [MGDD]), or are likely to be developed.

Based on the request from Eurostat, the issue paper addresses the following questions:

- What are the most important categories of provisions, contingent assets, contingent liabilities and financial guarantees, and for which may problematic points/ issues with regards to definition, recognition, measurement and presentation arise?
- Which accounting / disclosing guidance is available for provisions, contingent assets, contingent liabilities and financial guarantees in IPSAS, EU Accounting Rules [AR], national accounting standards in three EU MSs, IFRS and ESA 2010 and, where relevant and applicable, also MGDD?
- How do the analysed approaches in the two MSs differ from the treatment under IPSAS (please list the main elements/ aspects)?
- For the main categories of provisions, contingent assets, contingent liabilities and financial guarantees, what are the advantages and disadvantages of the existing approaches to recognition, measurement and disclosures under the existing standards (IPSAS, EU AR, national accounting standards in EU MSs, IFRS and ESA 2010 and, where relevant and applicable, also MGDD)?
- What are the main difficulties/ issues when accounting / making disclosures for the main categories of provisions, contingent assets, contingent liabilities and financial guarantees?
- If/ how a European harmonisation could be achieved in accounting / making disclosures for the main categories of provisions, contingent assets, contingent liabilities and financial guarantees?
- Taking into account costs and benefits, what way forward in practice would PwC recommend for EPSAS on provisions, contingent assets, contingent liabilities and financial guarantees?
- What were the consequences of the recommended way forward for a possible convergence between IPSAS / EPSAS and ESA 2010 (and if relevant and applicable, also MGDD)?

Based on the analysis performed, an approach for organising the future discussion on the treatment of provisions, contingent assets, contingent liabilities and financial guarantees with the EPSAS stakeholders is proposed.

2 Background of the issue

Accounting for provisions and disclosing contingent assets and liabilities is a particular area of concern for the EU Member States. Provisions are those liabilities which will probably need to be paid at some point in the future, but where there is uncertainty around the timing or amount of that payment. Provisions are reported on the balance sheet. By comparison, contingent liabilities are possible obligations or present obligations for which a cash outflow is not probable or whose cost cannot be estimated reliably. Contingent obligations are not recorded on the balance sheet but are disclosed in notes to the financial statements for information only. However, contingent liabilities can quickly increase, turn into liabilities and potentially result in significant costs for EU governments. Contingent assets are not recorded on the balance sheet either but are simply disclosed if the cash inflow associated to them is probable.

Provisions and contingent liabilities thus represent a significant and potential cash outflow for governments which they have to manage alongside other spending obligations and which may reflect an increase in governments' long-term risk profile.

At the same time, financial guarantees that are treated as financial instruments under IPSAS¹ should be recognised on the balance sheet, whereas in practice often only the relevant disclosures are made by the EU Member States. Issuing of financial guarantees by governments on borrowing of non-government entities is a significant activity in many EU Member States. Governments may issue financial guarantees for a variety of reasons, for example to support infrastructure projects, boost the economy or stabilise the financial market in times of distress, putting them at risk if the debtor defaults. Such financial guarantees may be provided to banks and other fund providers.

The Staff Working Document² accompanying the report from the Commission to the Council and the European Parliament COM(2013) 114 assessing the suitability of IPSAS for the EU Member States points out in Annex 6.1 on IPSAS 19 that *"for provisions which do not become payable for a significant length of time, the effect of the time value of money may be material. In that case, the amount of the provision recorded in the statement of financial position should be the present value of the expenditure expected to be required to settle the obligation. A discount (market) rate will need to be determined, which may be difficult in particular for long-lived provisions such as nuclear decommissioning. The choice of the discount rate can have a significant impact on the amount of the reported provision. The standard's requirement to also include provisions (net of recoveries) for onerous contracts is seen as problematic."*

The report commissioned by Eurostat and prepared by PwC in 2014³ indicates an average maturity of 48% regarding the accounting of provisions for the responding governments across the European Union, which represents the second lowest accounting maturity across the European Union after employee benefits. 17 central governments out of 28 declare having major obligations for

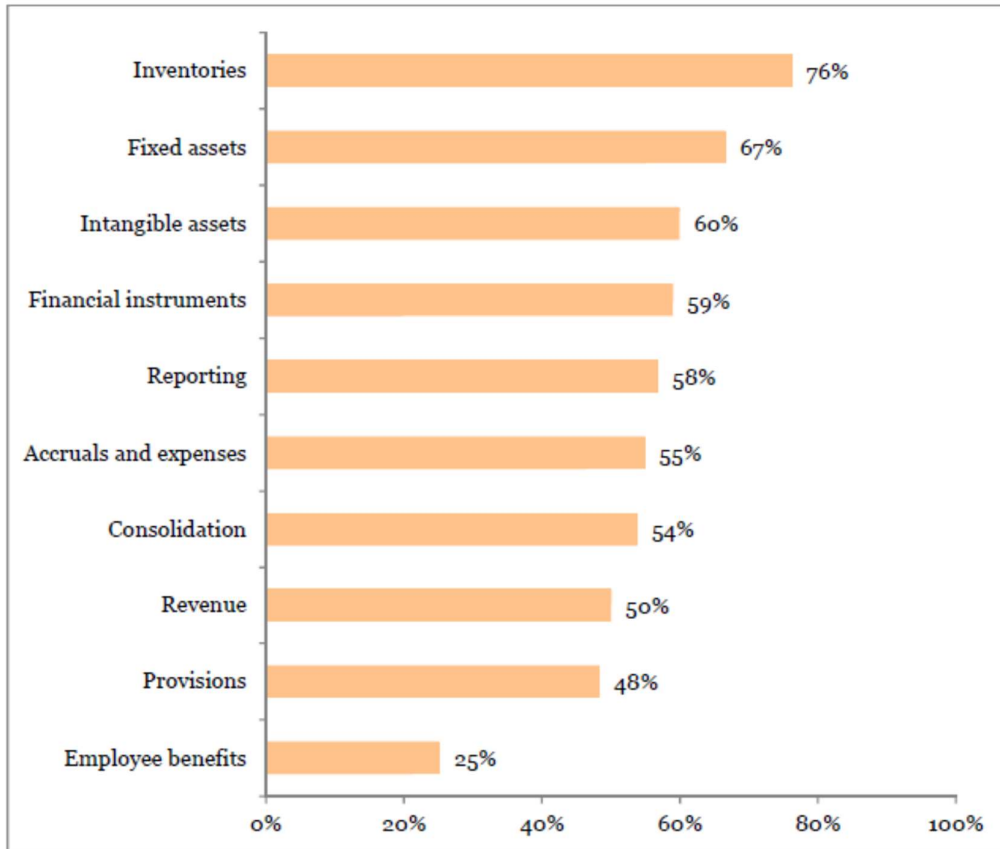
¹ Financial guarantees may also be treated as insurance contracts if such accounting treatment was previously applied. See 3.1.1.2 for further details.

² See Commission Staff Working Document (SWD) 2013 accompanying the report from the Commission to the Council and the European Parliament COM(2013) 114 assessing the suitability of IPSAS for the EU Member States, Brussels, 6 March 2013, p.113

³ See PwC, Collection of information related to the potential impact, including costs, of implementing accrual accounting in the public sector and technical analysis of the suitability of individual IPSAS standards, 2013/S 107-182395, 1 August 2014, pp 96 and 108

dismantling assets, decommissioning/site restoration, and environmental clean-up. Out of these 17 countries, 10 only recognise these obligations in the statement of financial position.

Figure 1: Average accounting maturity per accounting area across the EU⁴



Following the comment on IPSAS 19 ‘Provisions, contingent liabilities and contingent assets’ by a Member State⁵ *"IPSAS 19 might prove to be difficult to apply in practice (identification and data collection in respect of environmental obligations, identification of contingent liabilities and measurement of long term obligations)"*, PwC concluded that *"new information flows may need to be defined and processes implemented to identify existing and potential obligations, collect data and measure government obligations. This should be part of a good year-end closure process"*.

The topic was subsequently analysed more in-depth in the 2014 PwC study. As for provisions, the PwC report says⁶ *"...completeness of provisions is a particular point of attention, especially for entities starting from a cash-based environment. The existence of significant present obligations needs to be identified and a reliable estimate of the costs to be incurred needs to be made. This may be difficult especially for long-term environmental obligations. However, the volume of material transactions is not expected to be very significant and no major impact on the IT systems is anticipated"*.

⁴ See PwC, Collection of information [...], 1 August 2014, p. 96.

⁵ See PwC, Collection of information [...], 1 August 2014, p. 131

⁶ See PwC, Collection of information [...], 1 August 2014, p. 35

The report of the EPSAS Cell on First-Time Implementation mentions on recognition of provisions⁷: *"the recognition of provisions is also recommended. Nevertheless, as certain types of provisions (such as provisions for pension liabilities) require complex calculations in order to establish reliable measurement (e.g. on the basis of individual statistical calculations), their recognition may be deferred to the preparation of the first EPSAS opening balance sheet. In this case, the disclosure of pension schemes in the disclosure notes should provide both financial and non-financial information, and, where it exists, their estimated amount according to statistical calculations"*.

In this respect, it should be noted that provisions for pension liabilities fall under the scope of IPSAS 39 Employee Benefits (which replaces IPSAS 25 from 1 January 2018) and are not addressed in this issue paper⁸. Moreover, under IPSAS, there is currently no requirement related to the recognition and measurement of provisions for social benefits. Where an entity elects to recognise such provisions, it discloses the basis on which the provisions have been recognised and measured. Accounting for social benefits is currently being revisited and the plan is to issue a specific IPSAS standard on that topic.⁹

As for financial guarantees, the PwC report¹⁰ says *"for financial instruments, the main focus is on the accounting treatment of government debts and other financial arrangements, as well as of derivatives and financial guarantees. Although complex, these transactions are often managed centrally, involving a limited number of specialists (treasurers, etc.)"*. The PwC report also mentions¹¹ *"under IPSAS, financial guarantee contracts that are treated as financial instruments should be measured by the issuer at fair value on initial recognition. Only two central governments account for financial guarantees as a liability initially measured at fair value. Sixteen central governments do not reflect the risk associated with the guarantees issued in their financial position, even if the probability that they will need to pay is greater than 50%"*.

The PwC report however highlights that when governments enter into major and risky transactions using financial instruments, the accounting treatment of such transactions should reflect these risks and the substance of the arrangements, in the same way as for private companies, and appropriate disclosures should be presented on the risk exposure.¹²

When it comes to the recognition of complex financial instruments, such as financial guarantees, the report on first-time implementation also notes¹³ that the comprehensive recognition of financial instruments is strongly recommended. It also says that *"recognition of complex financial instruments, such as... financial guarantees, may be deferred to the preparation of the first EPSAS opening balance sheet. In this case, explanations of the instruments in the disclosure notes should be considered necessary"*.

⁷ See Eurostat - EPSAS Working Group, EPSAS Cell on First-Time Implementation, Luxembourg, 14 November 2016, p.12

⁸ See EY, EPSAS issue paper on the accounting treatment of employee benefits (pensions), EPSAS Working Group, Rome, 22-23 November 2016, 44 pages.

⁹ An Exposure Draft on social benefits was issued by the IPSASB in October 2017 with a 31 March 2018 comment deadline. See also See EY, EPSAS issue paper on the accounting treatment of social benefits, EPSAS Working Group, Rome, 22-23 November 2016, 80 pages.

¹⁰ See PwC, Collection of information [...], 1 August 2014, p. 35

¹¹ See PwC, Collection of information [...], 1 August 2014, p. 113

¹² See PwC, Collection of information [...], 1 August 2014, p. 132

¹³ See Eurostat - EPSAS Working Group, EPSAS Cell on First-Time Implementation, Luxembourg, 14 November 2016, pp 11-12

3 Description of accounting guidance available in international accounting frameworks and in statistical rules

Accounting guidance available is discussed below, successively for the following accounting and reporting frameworks: IPSAS, EU Accounting Rules, IFRS and ESA 2010 (including references to the MGDD).

IPSAS rules are explained more in-depth, because IPSAS has been viewed as a reference framework for the future EPSAS, EU Accounting Rules are based on them and IFRS rules are similar in many respects.

3.1 International Public Sector Accounting Standards (IPSAS)

3.1.1 Applicable standards and definitions

3.1.1.1 Provisions, contingent liabilities and contingent assets

Accounting rules relating to provisions, contingent liabilities and contingent assets are dealt with by IPSAS 19 “Provisions, contingent liabilities and contingent assets”.

The standard excludes from its scope social benefits provided by an entity for which it will not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of the benefits (i.e. for free or at a ‘not significant price’). Other exceptions from the scope of the standard are, notably, provisions resulting from executory contracts (other than where the contract is onerous), provisions arising in relation to income taxes and employee benefits (except for employee termination benefits that arise as a result of restructuring), and provisions covered by other IPSAS.

Paragraph 18 of IPSAS 19 defines provisions, contingent liabilities and contingent assets. Provisions can be distinguished from other liabilities such as payables and accruals¹⁴ because there is uncertainty about the timing or amount of the future expenditure required in settlement (IPSAS 19.19). Provisions are liabilities which result from present obligations and for which it is probable that an outflow of resources will be required to settle the obligations, but whose timing or amount are uncertain.

Examples of provisions include provisions for litigation, warranty provisions, restructuring provisions, environmental provisions (provisions for decommissioning, dismantling, depollution or site restoration).

¹⁴ The difference that is commonly accepted between the terms “accruals” and “payables” is that “payables” represent liabilities where an invoice has been received by the end of the reporting period, whereas “accruals” typically represent liabilities for which no invoice has been received by the end of the reporting period. Accruals and payables are presented together within “accounts payable” on the statement of financial position.

Contingent assets and liabilities are defined in IPSAS as possible assets and obligations arising from past events whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. A contingent liability may also be a present obligation that arises from a past event, but which is not recognised because an outflow of resources is not probable or the amount of the obligation cannot be measured with sufficient reliability.

3.1.1.2 Financial guarantees

The accounting treatment of financial guarantees is currently prescribed by the financial instruments standards IPSAS 28 'Financial instruments: presentation', IPSAS 29 'Financial instruments: recognition and measurement' and IPSAS 30 'Financial instruments: disclosures'.

Financial guarantees may however also be treated as insurance contracts under IPSAS if the public sector entity has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts. The issuer may make that election contract by contract, but the election for each contract is then irrevocable.

Financial guarantee contracts are those contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original terms of a debt instrument (IPSAS 29.10).

Financial guarantee contracts issued through non-exchange transactions are addressed in the application guidance of IPSAS 29 (IPSAS 29 AG92-AG97). IPSAS 29 prescribes recognition and measurement requirements only for the issuer of financial guarantee contracts. Only contractual financial guarantees (or guarantees that are in substance contractual) are within the scope of IPSAS 29. Non-contractual guarantees are not within scope of IPSAS 29 as they do not meet the definition of financial instruments (IPSAS 29 AG92).

If no reliable measure of fair value can be determined at initial recognition, either by direct observation of an active market or through another valuation technique, an entity is required to apply the principles of IPSAS 19 to the financial guarantee contract at initial recognition (IPSAS 29 AG97).

At its 2018 June meeting, the IPSASB approved IPSAS 41 'Financial instruments'. IPSAS 41 is largely based on its IFRS equivalent, IFRS 9 'Financial instruments' and replaces IPSAS 29. The new standard will be effective on 1 January 2022, with earlier application permitted. The changes brought by IPSAS 41 compared to IPSAS 29 are explained under 3.1.7 IPSAS new requirements relating to financial guarantees.

3.1.2 Recognition of provisions and financial guarantees

Paragraphs 22-43 of IPSAS 19 prescribe appropriate recognition criteria for provisions. Recognition of financial guarantees is dealt with in IPSAS 29.

3.1.2.1 Provisions

Three criteria should be met in order to recognise a provision as per IPSAS 19.22:

- the entity has a present obligation (legal or constructive) as a result of a past event;
- it is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

A present obligation may be either a legal obligation (arising from a law, regulation or contract) or a constructive obligation. An obligation may have indeed been constructed over time by the entity's established pattern of best practices/statements, creating a valid expectation towards some parties that the entity will accept certain responsibilities and discharge those.

For the purpose of IPSAS 19, "*an outflow of resources is regarded as probable if the event is more likely than not to occur*", i.e. "*the probability that the event will occur is greater than the probability that it will not*" (IPSAS 19.31). Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits or service potential is remote (with a very low degree of likelihood, much less than probable).

Provisions for onerous contracts

Public sector entities may enter into contracts for the exchange of assets or services under which the unavoidable costs of meeting the obligations exceed the economic benefits or service potential to be received. A provision should be recognised in respect of such contracts which are onerous.

Provisions for restructuring

A public sector entity may undertake a restructuring, i.e. a planned and controlled program that materially changes the scope of its activities or the manner in which they are conducted. This may entail termination or fundamental reorganisation of certain activities, dismissal of staff, etc.

Under IPSAS 19.82-83, a provision for restructuring is only recognised if the general recognition criteria for provisions are met. In particular, a constructive obligation to restructure arises only, and therefore a provision is recognised only, if the entity, at the reporting date, both:

- has a detailed formal plan (with minimum contents required) for the restructuring; and
- has raised a valid expectation in those affected (in practice mainly the personnel) that it will carry out the restructuring. This valid expectation is created if implementation of the plan has started or the main features of the plan have been announced to those affected by it.

Provisions for future operating losses and major repair or maintenance

Under IPSAS, provisions cannot be recognised for net deficits from future operating activities, nor for major maintenance or overhaul.

3.1.2.2 *Contingent liabilities and contingent assets*

Contingent assets and liabilities are not recognised by an entity in its financial statements, but are disclosed.

Contingent liabilities may however develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits or service potential has become probable (IPSAS 19.38). For example, a local government entity may have breached an environmental law but it remains unclear whether any damage was caused to the environment. Where, subsequently it becomes clear that damage was caused and remediation will be required, the entity would recognise a provision because an outflow of economic benefits is now probable.

Contingent assets are disclosed where an inflow of economic benefits or service potential is probable (IPSAS 19.42) and not recognised in financial statements since this may result in the recognition of revenue that may never be realised (IPSAS 19.41). An example of contingent asset is a claim that an entity is pursuing through legal processes, where the outcome is uncertain. However, when the realisation of revenue is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate (IPSAS 19.41).

Contingent assets are also assessed regularly to ensure that developments are appropriately reflected in the financial statements. If an inflow of economic benefits or service potential has become probable, an entity discloses the contingent asset. If it has become virtually certain that an inflow of economic benefits or service potential will arise and the asset's value can be measured reliably, the asset and the related revenue are recognised in the financial statements of the period in which the change occurs (IPSAS 19.43).

The table below summarises the meaning of various terms used in IPSAS to depict the degree of likelihood that should be considered to recognise or disclose certain items.

Figure 2: IPSAS terms used to depict the degree of likelihood of cash outflows

<i>IPSAS wording</i>	<i>What it means</i>
Virtually certain	A very high degree of likelihood. Much more than probable.
Probable	More likely than not. Likelihood > 50%.
Remote	A very low degree of likelihood. Much less than probable.

3.1.2.3 *Financial guarantees*

Financial guarantee contracts, like other financial liabilities, are required to be initially recognised at fair value (IPSAS 29 AG93). So no recognition threshold applies when the fair value of a financial guarantee contract can be determined reliably.

If however no reliable measure of fair value can be determined, an entity is required to apply the principles of IPSAS 19 to the financial guarantee contract at initial recognition. In such case, the recognition criteria of IPSAS 19 apply: in order for a liability to be recognised, it should be probable that a present obligation exists and that this will result in a cash outflow (IPSAS 19 AG97).

3.1.3 Measurement of provisions and financial guarantees

Paragraphs 44-72 of IPSAS 19 prescribe appropriate measurement bases for provisions, contingent liabilities and contingent assets.

3.1.3.1 Provisions, contingent liabilities and contingent assets

The amount recognised as a provision is the best estimate of the expenditure required to settle the present obligation at the reporting date (taking into account the risks and uncertainties that inevitably surround many events and circumstances in reaching the best estimate of a provision).

When a large population of items is involved in measuring the amount of provision, the expected value method of estimation should be used, by weighting all possible outcomes by their associated probabilities.

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. The increase in the provision that is due to the passage of time is recognised as an interest expense. The discount rate is a pre-tax rate reflecting current market assessments of the time value of money and the risks specific to the liability (not reflecting risks for which future cash flow estimates have been adjusted). The selection of an appropriate discount rate is further discussed in a separate issue paper.¹⁵

Provisions for onerous contracts

Provisions for onerous contracts should be recognised for the least net cost of exiting from the contract, i.e. the lower of the cost of fulfilling the contract and any penalty/indemnity to be paid to exit from the contract (IPSAS 19.79).

Provisions for restructuring

The amount of the restructuring provision should include only those costs directly entailed by the restructuring (dismissal costs, penalties to terminate a contract, etc.), but not those costs associated with the ongoing activity of the entity (the cost to train or relocate staff, to invest in new systems, etc.) (IPSAS 19.93).

Gains from the expected disposal of assets

Gains from the expected disposal of assets cannot be taken into account in measuring a provision. Such gains are recognised only when the entity is committed to the sale (through a binding agreement).

¹⁵ See PwC, EPSAS issue paper on applying discount rates under the future EPSAS, EPSAS Working Group, Luxembourg, 7-8 May 2018, 44 pages.

3.1.3.2 Financial guarantees

Initial measurement

General rules

Financial guarantee contracts that are treated as financial instruments should be measured by the issuer at fair value on initial recognition plus transaction costs that are directly attributable to the issue of the financial liability (IPSAS 29.45).

The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal operating considerations. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs (IPSAS 29.52). Application Guidance is provided in paragraphs AG101-AG115.

The fair value of a financial instrument on initial recognition is normally the transaction price (i.e. in the case of a financial liability the fair value of the consideration received) (IPSAS 29 AG82). In the case of a financial guarantee contract, it corresponds to the premium received in exchange for the financial guarantee issued, if any.

Public sector considerations

IPSAS 29 AG94 highlights that, in the public sector, guarantees are frequently provided by way of non-exchange transactions, i.e. at no or nominal consideration. This type of guarantee is provided generally to further meet the entity's economic and social objectives. The public sector characteristics therefore need to be considered in the measurement of financial guarantees issued. Where there is consideration for a financial guarantee, an entity should determine whether that consideration arises from an exchange transaction and whether the consideration represents a fair value. If the consideration does represent a fair value, entities should recognise the financial guarantee at the amount of the consideration. Where the entity concludes that the consideration is not a fair value, an entity determines the carrying value at initial recognition in the same way as if no consideration had been paid (IPSAS 29 AG94).

When guarantees are provided by way of non-exchange transactions, i.e. at no or nominal consideration, an entity firstly considers whether there are quoted prices available in an active market for financial guarantee contracts directly equivalent to that entered into. Where there is no active market for a directly equivalent guarantee contract, the entity considers whether a valuation technique other than observation of an active market is available and provides a reliable measure of fair value. Such a valuation technique may rely on mathematical models which consider financial risk, such as using the credit spread between what the coupon rate would have been had the issue not been backed by a government guarantee and the rate with the guarantee in place (IPSAS 29 AG94-97).

Fair value cannot be reliably determined

If no reliable measure of fair value can be determined, either by direct observation of an active market or through another valuation technique, an entity is required to apply the principles of IPSAS 19 to the financial guarantee contract at initial recognition. The entity assesses whether a present obligation has arisen as a result of a past event related to a financial guarantee contract, whether it is probable that such a present obligation will result in a cash outflow in accordance with the terms of the contract and whether a reliable estimate can be made of the outflow.

It is also possible that a present obligation related to a financial guarantee contract will arise at initial recognition where, for example, an entity enters into a financial guarantee contract to guarantee loans to a large number of small enterprises and, based on past experience, is aware that a proportion of these enterprises will default (IPSAS 29 AG97).

Additional considerations

In addition, the IPSASB Conceptual framework addresses in Chapter 7 ‘Measurement of assets and liabilities in financial statements’ fundamental principles relating to the measurement of financial liabilities. One fundamental concept consists in the assumption price, amount which the entity would rationally be willing to accept in exchange for assuming an existing liability¹⁶. Exchange transactions carried out on arms-length terms will provide evidence of assumption price. However, the IPSASB acknowledged the views of those who noted that, as many services are provided by public sector entities in non-exchange transactions, there will often not be an assumption price.

The IPSASB accepted that the circumstances under which assumption price will meet the measurement objective are limited. Nevertheless, the IPSAS insisted that financial guarantees are liabilities where assumption price might provide relevant and faithfully representative information. In such cases liabilities might be revalued at assumption price to reflect changes in risk premiums following initial recognition (Conceptual framework BC 7.42).

Subsequent measurement

After initial recognition, an issuer of a financial guarantee contract should measure it at the higher of:

- the amount determined in accordance with IPSAS 19 ‘Provisions, contingent liabilities and contingent assets’; and
- the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IPSAS 9 ‘Revenue from exchange transactions’ (IPSAS 29 AG93).

¹⁶ “Assumption price” is the term used in the context of liabilities to refer to the same concept as replacement cost for assets. Just as replacement cost represents the amount that an entity would rationally pay to acquire an asset, so assumption price is the amount which the entity would rationally be willing to accept in exchange for assuming an existing liability (Conceptual framework BC 7.42).

3.1.4 Disclosures for provisions, contingencies and financial guarantees

3.1.4.1 Provisions

An entity reporting under IPSAS should disclose specific information as defined in paragraphs 97-98 of IPSAS 19. Key disclosures for provisions include, by class:

- a reconciliation of the carrying amount at the beginning and end of the period,
- amounts used, unused, amounts reversed,
- the increase in the discounted amount,
- a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits or service potential,
- an indication of the uncertainties about the amount or timing of those outflows (including, where necessary, the major assumptions made concerning future events),
- and the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

3.1.4.2 Contingent liabilities and contingent assets

When it comes to contingent liabilities and contingent assets, an entity reporting under IPSAS shall disclose specific information as defined in paragraphs 100-105 of IPSAS 19.

Key disclosures for contingent liabilities include, by class:

- a brief description of the nature of the contingent liability,
- an estimate of the financial effect,
- an indication of the uncertainties relating to the amount or timing of any outflows,
- and the possibility of any reimbursement.

No disclosure is made if the likelihood of outflow of resources is remote (i.e. very low degree of likelihood).

Key disclosures for contingent assets include:

- a brief description of the nature of the contingent asset
- and, where practicable, an estimate of the financial effect.

No disclosure is made if the likelihood of inflow of resources is not probable.

The non-disclosure of the above is permitted only in rare circumstances, when such disclosure would seriously prejudice the position of the entity in a dispute with other parties. In extremely rare cases, disclosure of some or all of the information required by IPSAS 19.97-107 can be expected to prejudice seriously the position of the public sector entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, the entity need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed (IPSAS 19.109).

3.1.4.3 Financial guarantees

When it comes to financial guarantee contracts treated as financial instruments, an entity reporting under IPSAS should disclose specific information as defined in IPSAS 30 'Financial instruments: disclosures'. Key disclosures include:

- significance for financial position and financial performance;
- fair value and fair value hierarchy: information on level 1, level 2 and level 3 fair values;
- nature and extent of exposure to risks arising from financial guarantee contracts at the end of the reporting period, including credit risk (the maximum exposure to credit risk being the maximum amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognised as a liability [IPSAS 30 AG10c]) and liquidity risk (maturity analysis for issued financial guarantee contracts that shows the remaining contractual maturities, description of how it manages the inherent liquidity risk [IPSAS 30 paragraph 46]);
- for financial guarantee contracts issued through a non-exchange transaction, where no fair value can be determined and a provision is recognised in accordance with IPSAS 19: disclosure of the circumstances that result in a provision being recognised (IPSAS 30 AG5).

3.1.4.4 Key sources of estimation uncertainty

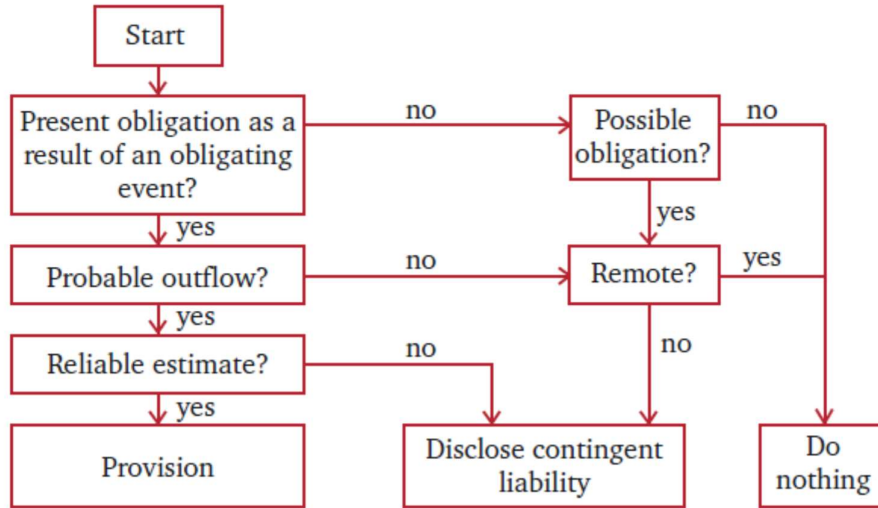
To value the assets and liabilities that appear in the statement of financial position, the entity necessarily has to make estimates and exercise its judgment in certain areas. Estimates can involve assumptions about such items as the risk adjustment to cash flows or discount rates used and future changes in prices affecting other costs. For example, various estimates and assumptions can be used as a basis for certain valuations (e.g. for long-term environmental provisions or financial guarantees), and estimations regularly need to be made in an uncertain context (e.g. in relation to the measurement of a provision subject to the future outcome of a litigation). These estimates and assumptions are determined on the basis of best available information on the reporting date. However, by definition, the estimates rarely correspond to actual realisations, even if they often approximate them, such that the resultant accounting valuations are inevitably subject to a certain degree of subjectivity.

Disclosures should be made of the estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amount of assets and liabilities within the next financial year: nature of the uncertainty, carrying amount of assets and liabilities concerned, sensitivity analysis if relevant, etc. (IPSAS 1.140).

3.1.5 Decision tree under IPSAS 19

The following decision tree below summarises the recognition and measurement rules relating to provisions and contingent liabilities.

Figure 3: Decision tree summarising the requirements of IPSAS 19



3.1.6 First-time adoption of accrual basis IPSAS as regards provisions and financial guarantees

IPSAS 33 ‘First-time adoption of accrual basis IPSASs’ allows some relaxation in accounting for provisions and financial guarantees by public sector entities that apply IPSAS for the first time. The standard provides a number of transitional measures in order to facilitate the transition towards accruals accounting.

3.1.6.1 Provisions, contingent liabilities and contingent assets

No transitional relief period is however provided for provisions in the scope of IPSAS 19. As a general rule, a first-time adopter should account for all its liabilities on the date of adoption of IPSASs.

One exception should however be noted: the IPSASB agreed that it would not be possible to recognise and/or measure provisions for the initial estimate of costs to dismantle and remove the item and restore the site on which it is located until such time as the relevant item of property, plant and equipment is recognised and/or measured in accordance with IPSAS 17. As per paragraph 48 of IPSAS 33, where a first-time adopter takes advantage of the IPSAS 33 exemption which allows a three year transitional relief period to not recognise and/or measure property, plant and equipment, it is not required to recognise and/or measure the liability relating to the initial estimate of costs of dismantling and removing the item and restoring the site on which it is located until the exemption for IPSAS 17 has expired, and/or the relevant asset is recognised and/or measured in accordance with IPSAS 17 (whichever is earlier).

3.1.6.2 Financial guarantees

A transitional relief period of three years is granted to first-time adopters for the recognition of guarantee contracts treated as financial instruments (for guarantees not recognised under previous basis of accounting) and measurement (for guarantees recognised under previous basis of accounting), in line with the relief period provided for financial instruments.

3.1.7 IPSAS new requirements relating to financial guarantees

The IPSASB recently issued IPSAS 41 'Financial instruments' which replaces IPSAS 29 'Financial instruments: recognition and measurement'. The objective is to align on the IFRS equivalent IFRS 9 'Financial instruments' while considering the specific characteristics of the public sector.

Additional amendments to IPSAS 28 'Financial instruments: presentation' and IPSAS 30 'Financial instruments: disclosures' are limited compared to the impact on IPSAS 29.

IPSAS 41 includes public sector specific guidance on financial guarantees issued through non-exchange transactions and examples illustrating how to apply the principles in IPSAS 41 to transactions that are unique to the public sector.

Under the new rules, financial guarantee contracts that are treated as financial instruments are also initially measured at fair value. Concerning financial guarantees issued through a non-exchange transaction (i.e. financial guarantee contracts entered into at nil or nominal consideration), the guidance included in IPSAS 41 is also carried forward from existing IPSAS 29 requirements.

However the rules for subsequent measurement, which are aligned on the IFRS 9 equivalent, differ from the current rules under IPSAS 29. Under the new proposed rules (IPSAS 41.45), the issuer measures the financial guarantee liability at the higher of:

- the amount of the loss allowance determined in accordance with paragraphs 73-93 of IPSAS 41; and
- the amount initially recognised less, when appropriate, the cumulative amount of amortisation recognised in accordance with the principles of IPSAS 9 'Revenue from exchange transactions'.

The amount determined in accordance with paragraphs 73-93 of IPSAS 41 is no longer the amount to be recognised under IPSAS 19 dealing with provisions and therefore differs from the previous IPSAS 29 requirements. It is the amount of impairment loss that should be recognised in accordance with the new expected credit loss model imposed by IPSAS 41.

This single forward-looking expected credit loss model, which builds on IFRS 9, applies to all financial instruments subject to impairment testing. For financial guarantee contracts issued, those are the ones that are treated as financial liabilities and are not measured at fair value through profit or loss.

The forward-looking model requires an entity to recognise expected credit losses at all times and results in earlier recognition of losses. The model uses a dual measurement approach whereby

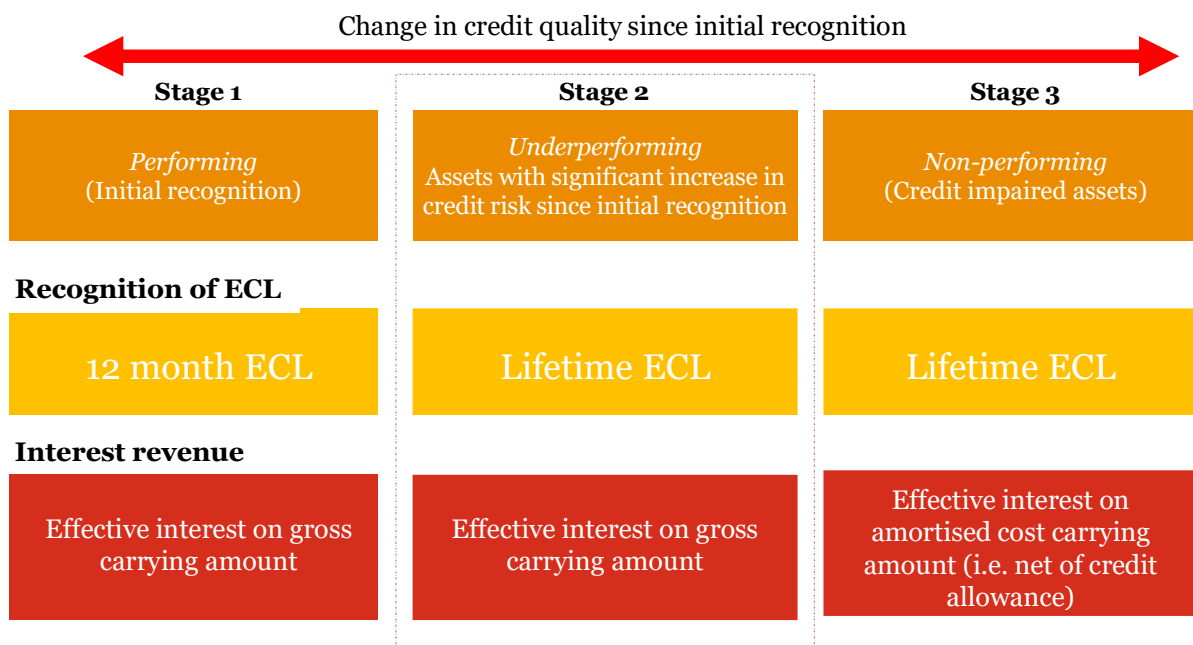
expected credit losses are measured as either 12-month expected credit losses or lifetime expected credit losses.

The new standard outlines a ‘three-stage’ model (‘general model’) for impairment based on changes in credit quality since initial recognition (see Figure 4 below).

The principles are presented from the point of view of impairment of a loan but apply mutatis mutandis to the calculation of the loss allowance to be recorded in relation to a financial guarantee contract issued, as the purpose of a financial guarantee is to provide a financial coverage in case the debtor of a loan defaults.

For a financial guarantee contract, management is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed. Accordingly, cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs, less any amounts that management expects to receive from the holder, the debtor or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee.

Figure 4: Overview of the expected credit loss model under IPSAS 41 (and IFRS 9)



Stage 1 includes financial instruments that have not had a significant increase in credit risk since initial recognition or that have low credit risk at the reporting date. For these assets, 12-month expected credit losses (‘ECL’) are recognised and interest revenue is calculated on the gross carrying amount of the asset (that is, without deduction for credit allowance). 12-month ECL are the expected credit losses that result from default events that are possible within 12 months after the reporting date. It is not the expected cash shortfalls over the 12-month period but the entire credit loss on an asset weighted by the probability that the loss will occur in the next 12 months.

Stage 2 includes financial instruments that have had a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date) but that do not have objective evidence of impairment. For these assets, lifetime ECL are recognised, but interest revenue is still calculated on the gross carrying amount of the asset. Lifetime ECL are the expected credit losses that result from all possible default events over the expected life of the financial instrument. Expected credit losses are the weighted average credit losses with the probability of default ('PD') as the weight.

Stage 3 includes financial assets that have objective evidence of impairment at the reporting date. For these assets, lifetime ECL are recognised and interest revenue is calculated on the net carrying amount (that is, net of credit allowance).

IPSAS 41 requires management, when determining whether the credit risk on a financial instrument has increased significantly, to consider reasonable and supporting information available, in order to compare the risk of a default occurring at the reporting date with the risk of a default occurring at initial recognition of the financial instrument.

PwC observation

The ECL model relies on a relative assessment of credit risk. This means that a loan with the same characteristics could be included in Stage 1 for one entity and in Stage 2 for another, depending on the credit risk at initial recognition of the loan for each entity.

Moreover, an entity could have different loans with the same counterparty that are included in different stages of the model, depending on the credit risk that each loan had at origination.

3.1.8 Illustrative example

The following example illustrates the accounting and reporting requirements relating to a financial guarantee contract issued under IPSAS 41.

Entity A issues a financial guarantee at arm's length terms and receives a premium of CU 125. Entity A is required to make payments only in the event of a default by the debtor in accordance with the terms of the debt instrument guaranteed to the holder. At initial recognition, the fair value of the guarantee equals the premium received of CU 125. The instrument has a contractual term of five years. There is no future premium due from the holder during the period of contract.

The instrument (the asset of the holder) is fully guaranteed. Therefore, the ECL estimate for the financial guarantee contract would be the same as the estimated cash shortfall estimate for the asset subject to the guarantee. Upon the event of default, the guarantor will incur a credit loss, up to the full estimated cash shortfall of the financial instrument subject to the guarantee. The total contractual cash flows of the debt instrument are CU 10,000.

Using reasonable and supportable information available to determine the credit risk of the debtor, and the economic outlook for the next 12 months, Entity A estimates that the guaranteed debt instrument at initial recognition has a probability of default (PD) of 5% over the next 12 months.

At the reporting date (one year after the initial recognition of the financial guarantee), there has been no change in the 12-month PD, and Entity A determines that there is no significant increase in credit risk since initial recognition.

Taking into consideration the present value of the expected payments to reimburse to the holder for a credit loss (reduced by any amounts that the grantor expects to receive from the holder, the debtor and any other party), Entity A determines the loss given default (LGD) using forward looking and a probability weighted approach. By doing so it determines that 25% of the contractual payments under the terms of the debt instrument will be lost if the debtor defaults, that is the LGD is 25% to the total contractual cash flows.

Entity A measures the loss allowance at an amount equal to 12-month ECL using the 12-month PD of 5%. Implicit in that calculation is the 95% probability that there is no default. At the reporting date, the loss allowance for the 12-month ECL is CU 125 ($5\% \times 25\% \times \text{CU } 10,000$).

Therefore, at the reporting date, the financial guarantee is measured at the 'higher of':

- The IPSAS 41 Expected Credit Loss (ECL) allowance (CU125), and
- The amount initially recognised (i.e. fair value of CU125) less any cumulative amount of income/amortisation recognised. Assuming a 5-year straight-line amortisation pattern, CU 100 is the initial fair value of CU 125 less cumulative amortisation of CU 25.

The carrying value of the financial guarantee at the reporting date is determined based on the IPSAS 41 expected credit loss of CU 125.

3.2 European Union Accounting Rules (EAR)

European Union Accounting Rules (EAR) constitute the accounting framework of the European Union institutions, including the European Commission (EC) and its agencies.

3.2.1 Provisions, contingent liabilities and contingent assets

EAR 10 'Provisions, contingent liabilities and contingent assets' defines provisions, contingent liabilities and contingent assets, and identifies the circumstances in which provisions should be recognised, how they should be measured and the disclosures that should be made about them. This rule also requires that certain information be disclosed about contingent liabilities and contingent assets in the notes to the financial statements to enable users to understand their nature, timing and amount (EAR 10.3).

EAR 10 is based on IPSAS 19 as regards the scope, recognition and measurement of provisions, contingent liabilities and contingent assets (please refer to section 3.1).

Specific guidance applicable to EC bodies is given regarding the calculation of the present value of a provision and the discount rate to be used. In line with IPSAS 19, EAR 10 specifies that the discount rate (or rates) should be a rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. As an illustrative example, EAR 10 states that the zero coupon Euro bond yield curve can often be used as discount rate suitable for EC bodies (EAR 10

point 5.3 paragraph 3). The selection of an appropriate discount rate is further discussed in a separate issue paper¹⁷.

3.2.2 Financial guarantees

EAR 11 'Financial Instruments' prescribes the accounting treatment of financial instruments and is also based on its IPSAS equivalent (here still IPSAS 29). It applies to the classification, presentation, recognition and measurement of financial instruments as well as to disclosures on financial instruments and the risk management in the context of financial instruments. It addresses more specifically the notion of financial guarantee contracts that require *'the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument'* (EAR 11.3).

Financial guarantee contracts are initially recognised at fair value. The premium received represents the fair value unless there is evidence to the contrary (EAR 11.5).

In the EU, several programmes provide financial guarantees to the participants at no or at nominal consideration. At initial recognition, where no fee is charged or where the consideration is below fair value, an EU entity should firstly assess whether there are quoted prices available in an active market for financial guarantee contracts directly equivalent to that entered into. If this is the case, the financial guarantee should be recognised as financial liability using the market price. In case no active market for a directly equivalent guarantee contract exists, the EU entity applies the principles of EU Accounting Rule 10 'Provisions, contingent liabilities and contingent assets' to the financial guarantee contract at initial recognition (EAR 11.6.1 paragraphs 5-6).

As additional guidance, EAR 11 distinguishes explicitly specific types of guarantee contracts (related to a co-operation agreement between the EC and the EIB) to which the principles of EAR 10 'Provisions, contingent liabilities and contingent assets' should be applied at initial recognition.

After initial recognition, an issuer of a financial guarantee contract should measure it at the higher of (EAR 11.6.2 paragraph 3c):

- (i) The amount determined in accordance with EU Accounting Rule 10 (Provisions); and
- (ii) The amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with EU Accounting Rule 4 (Revenue from exchange transactions).

The measurement rules for financial guarantees are based on the requirements of IPSAS 29.

¹⁷ See PwC, EPSAS issue paper on applying discount rates under the future EPSAS, EPSAS Working Group, Luxembourg, 7-8 May 2018, 44 pages.

3.3 International Financial Reporting Standards (IFRS)

3.3.1 Provisions, contingent liabilities and contingent assets

IPSAS 19 is drawn primarily from IAS 37 'Provisions, contingent liabilities and contingent assets'. Those rules are thus not repeated here.

The main differences between IPSAS 19 and IAS 37 are differences in terminology as well as scope exclusions and illustrative examples which in IPSAS 19 are more reflective of the public sector.

3.3.2 Financial guarantees

IPSAS 29 'Financial instruments: recognition and measurement' is drawn primarily from its IFRS equivalent IAS 39 'Financial instruments: recognition and measurement'. Similarly, the rules included in IPSAS 41 'Financial instruments' are based on the IFRS 9 'Financial instruments' equivalent, which is applicable from 2018 onwards.

The main difference between IPSAS and IFRS relates to the guidance to value financial guarantees issued through a non-exchange transaction (i.e. financial guarantee contracts entered into at nil or nominal consideration) which is unique to the public sector. Guidance included in IPSAS 41 is carried forward from existing IPSAS 29 requirements.

Apart from some differences in terminology, other requirements are similar in IPSAS and IFRS and are not repeated here.

3.4 ESA 2010

In macroeconomic statistics, a liability is not recognised until a claim by the counterparty exists. Maintaining symmetry in the macroeconomic statistical system is a fundamental principle. Therefore, ESA 2010 guidance is that probable exposures that may exist as a result of contingencies and one-off guarantees should be disclosed in memorandum items, until such time as these are called.

Under ESA 2010, a financial claim is the right of a creditor to receive a payment or series of payments from a debtor. Financial claims are financial assets that have corresponding liabilities (ESA 2010 5.05). Liabilities are established when a debtor is obliged to provide a payment or a series of payments to a creditor (ESA 2010 5.06).

3.4.1 Provisions, contingent liabilities and contingent assets

Contingent assets and contingent liabilities are agreements whereby one party is obliged to provide a payment or series of payments to another unit only where certain specific conditions prevail. As they do not give rise to unconditional obligations, contingent assets and contingent liabilities are not considered as financial assets and liabilities (ESA 2010 5.08).

Under ESA 2010, a liability is thus not recognised until a claim by the counterparty exists. Government liabilities should as a general rule be recorded in national accounts at their market value (ESA 2010 1.94)¹⁸.

3.4.2 Financial guarantees

Guarantees are arrangements whereby the guarantor undertakes to a lender that if a borrower defaults, the guarantor will make good the loss the lender would otherwise suffer (ESA 2010 B5.1.1).

ESA 2010 distinguishes three kinds of guarantees which may be provided by governments ('Government guarantees') (ESA 2010 B 5.1.2). These apply only to guarantees provided in the case of financial assets. No special treatment is proposed for guarantees in the form of manufacturers' warranties or other forms of guarantee.

The three types of guarantee are:

- Derivatives (such as CDS, Credit Default Swaps) which fall under the normal treatment of derivatives and do not require specific provisions for government transactions on this market. Derivatives are financial instruments under IPSAS and are not discussed further in the present issue paper.
- Standardised guarantees (introduced in 2008 SNA and ESA 2010), defined by ESA 2010 5.190 as guarantees which "*...are issued in large number, usually for fairly small amount, among identical lines...*". Examples of standardised guarantees include student loans (notably where university tuition is high), real estate loans to households (generally for low-income borrowers) and export credit. The general principle in national accounts for the treatment of standardised guarantees is based on the analogy with non-life insurance. Even though the degree of probability of any one standardised guarantee being called is uncertain, the fact that there are many similar guarantees means that a reliable estimate of the number of calls under the guarantee can be made. Standardised guarantees are treated as giving rise to balance sheet items and not contingencies.
- "One-off" guarantees are provided on a case-by-case approach, generally for rather significant amounts and under individual contractual arrangements. The associated risk cannot be calculated with any degree of accuracy, due to a lack of comparable cases. For the government, it is a contingent liability which is not recorded in ESA balance-sheet, but may be shown as memorandum item or a footnote.

Standardised guarantees

The only items to be recognised under ESA 2010 are provisions for calls under standardised guarantees (F.66). These are defined as provisions for calls under standardised guarantees and are financial claims that holders of standardised guarantees have against institutional units providing them (ESA 2010 5.188).

¹⁸ The main exception being loans/borrowings, which should be recorded at nominal value.

Provisions relating to calls under standardised guarantees are prepayments of net fees and provisions to meet outstanding calls under standardised guarantees. Like provisions for prepaid insurance premiums and reserves, provisions for calls under standardised guarantees include unearned fees (premiums) and calls (claims) not yet settled (ESA 2010 5.189).

Standardised guarantees are guarantees that are issued in large numbers, usually for fairly small amounts, along identical lines. Such arrangements involve three parties: the borrower, the lender and the guarantor. Either the borrower or the lender may contract with the guarantor to repay the lender if the borrower defaults. Examples are export credit guarantees and student loan guarantees (ESA 2010 5.190).

Although it is not possible to establish the likelihood of any particular borrower defaulting, it is usual to estimate how many out of a batch of similar borrowers will default. Much like a non-life insurer, a guarantor working on commercial lines will expect all the fees paid, plus the property income earned on the fees and any reserves, to cover the expected defaults and associated costs and leave a profit. Accordingly a similar treatment to that of non-life insurance is adopted for such guarantees, described as standardised guarantees (ESA 2010 5.191).

Standardised guarantees cover guarantees on various financial instruments like deposits, debt securities, loans and trade credit. They are usually provided by a financial corporation, including but not confined to insurance corporations, but also by general government (ESA 2010 5.192).

When an institutional unit offers standardised guarantees, it charges fees and incurs liabilities to meet the call on the guarantee. The value of the liabilities in the accounts of the guarantor is equal to the present value of the expected calls under existing guarantees, net of any recoveries the guarantor expects to receive from the defaulting borrowers. The liability is called provisions for calls under standardised guarantees (ESA 2010 5.193).

A guarantee may cover a multi-year period. A fee may be payable annually or up-front. In principle, the fee represents charges earned in each year the guarantee holds, with the liability decreasing as the period gets shorter (assuming that the borrower repays in instalments). Thus recording follows that of annuities with the fee paid as the future liability decreases (ESA 2010 5.194).

The nature of a standardised guarantee scheme is that there are many guarantees of the same type, though not all for exactly the same time period nor all starting and finishing on the same dates (ESA 2010 5.195).

Net fees are calculated as fees receivable plus fee supplements (equal to the property income attributed to the unit paying the fee for the guarantee) less administration, etc. costs. Such net fees may be payable by any sector of the economy and are receivable by the sector in which the guarantor is classified. Calls under standardised guarantee schemes are payable by the guarantor and receivable by the lender of the financial instrument under guarantee, regardless of whether the fee was paid by the lender or the borrower. Financial transactions refer to the difference between the payment of fees for new guarantees and calls made under existing guarantees (ESA 2010 5.196).

Standardised guarantees are distinguished from one-off guarantees according to two criteria:

- (a) Standardised guarantees are characterised by often repeated transactions with similar features and pooling of risks; and
- (b) Guarantors are able to estimate the average loss based on available statistics (ESA 2010 5.197).

One-off guarantees

One-off guarantees are individual, and guarantors are not able to make a reliable estimate of the risk of calls. The granting of a one-off guarantee is a contingency and is not recorded (ESA 2010 5.197). One-off guarantees exist where the conditions of the loan or the security are so particular that it is not possible for the degree of risk associated with the loan to be calculated with any degree of accuracy. In general, the granting of a one-off guarantee is considered a contingency and is not recorded as a financial asset/liability in the balance sheet of the guarantor (ESA 20.255).

In exceptional cases, one-off guarantees granted by governments to corporations in certain well-defined financially distressed situations (for example where the corporation has negative own funds), implying a very high likelihood to be called, are treated as if such guarantees were called at inception (ESA 20.256).

The activation of a one-off guarantee is treated in the same way as a debt assumption. The original debt is liquidated and a new debt is created between the guarantor and the creditor. The debt assumption implies the recording of a capital transfer in favour of the defaulting debtor. The capital transfer is offset by a financial transaction, the financial liability transferred from the corporation to government (ESA 20.257).

The activation of a guarantee may or may not require repayment of debt at once. The accrual principle for time of recording suggests that the total amount of debt assumed should be recorded at the time the guarantee is activated and the debt assumed. The guarantor is the new debtor, and principal repayments by the guarantor and interest accruals on the assumed debt should be recorded when these flows occur. Thus, when calls on guarantees solely involve the settlement of the debt service due on the debt during the accounting period, as in the case of cash calls, a capital transfer is recorded for the amounts settled. However when a pattern of partial calls are observed such as three times in succession, and is expected to continue, a debt assumption is recorded (ESA 20.258).

Debt assumptions are explained in detail in ESA 2010 paragraphs 20.221 to 20.232.

When the original debtor refunds the guarantor while an expenditure has been recorded on past guarantee calls, revenue is recorded by the guarantor. However this revenue should be tested for the super-dividend test when the debtor is controlled by the guarantor; any excess of the refund over the entrepreneurial income is recorded as withdrawal of equity (ESA 2010 20.259).

Guarantee call anticipation rules, in particular the 'three calls rule', are explained in MGDD VII.4.2.

3.5 Comparison between the different accounting frameworks

The table below provides an overview of the main rules applicable to provisions, contingent liabilities and contingent assets as well as financial guarantee contracts issued under the various international financial reporting frameworks (IPSAS, EAR, IFRS and ESA 2010).

Figure 5: Rules relating to provisions, contingent liabilities and contingent assets as well as financial guarantees in the various international financial reporting frameworks

	<i>IPSAS</i>	<i>EAR</i>	<i>IFRS</i>	<i>ESA 2010</i>
Provisions				
<i>Scope and definition</i>	Liabilities of uncertain timing and amount.	Based on IPSAS 19.	IAS 37 rules and IPSAS 19 is based on them.	N/A.
<i>Recognition</i>	Three recognition criteria: existence of a past event, probability of cash outflow and ability to measure the amount of the obligation reliably.	Based on IPSAS 19.	IAS 37 rules and IPSAS 19 is based on them.	N/A.
<i>Measurement</i>	Best estimate of the obligation. Measured on a net present value basis when the impact is material.	Based on IPSAS 19.	IAS 37 rules and IPSAS 19 is based on them.	N/A.
<i>Presentation</i>	Separately on the balance sheet.	Based on IPSAS 19.	IAS 37 rules and IPSAS 19 is based on them.	N/A.
<i>Disclosures</i>	Summary of accounting policies and details on amounts provided for. Key sources of estimation uncertainty.	Based on IPSAS 19.	IAS 37 rules and IPSAS 19 is based on them.	N/A.
Contingent liabilities and contingent assets				
<i>Contingent liabilities</i>	Possible obligations or present obligations for which the cash outflow is not probable or for which a reliable estimation cannot be made. Contingent liabilities are disclosed in the notes.	Based on IPSAS 19.	IAS 37 rules and IPSAS 19 is based on them.	Contingencies recorded as memorandum items.
<i>Contingent assets</i>	Possible assets. Contingent assets are disclosed in the notes.	Based on IPSAS 19.	IAS 37 rules and IPSAS 19 is based on them.	Contingencies recorded as memorandum items.
Financial guarantees				
<i>Scope and definition</i>	Contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a	Based on IPSAS 19.	IFRS 9 rules similar to IPSAS. IPSAS 41 rules are based on IFRS 9.	Arrangement whereby the guarantor will make good the loss the lender would otherwise suffer if the borrower defaults.

	<i>IPSAS</i>	<i>EAR</i>	<i>IFRS</i>	<i>ESA 2010</i>
	specified debtor fails to pay.			Standardised guarantees and 'one-off' guarantees are defined and treated separately.
<i>Recognition</i>	Recognition at fair value unless it cannot be estimated reliably. In such case, recognition criteria of IPSAS 19 apply.	Based on IPSAS 19.	IFRS 9 rules similar to IPSAS. IPSAS 41 rules are based on IFRS 9.	Standardised guarantees (similarly to non-life insurance) are recognised on the balance sheet. One-off guarantees are not recognised until they are called.
<i>Presentation</i>	Within financial liabilities.	Based on IPSAS 19.	IFRS 9 rules similar to IPSAS. IPSAS 41 rules are based on IFRS 9.	Provisions for calls under standardised guarantees presented within financial liabilities.
<i>Measurement</i>	Initially at fair value. Subsequently, at the higher of the amount determined under IPSAS 19 (or the loss allowance calculated under the new ECL model under IPSAS 41) and the amount initially recognised less cumulative amortisation under IPSAS 9.	Based on IPSAS 19.	IFRS 9 rules and IPSAS 41 rules are based on them.	At market value.
<i>Disclosures</i>	Information on fair values and risks arising from financial guarantees, including credit risk and liquidity risk. Key sources of estimation uncertainty.	Based on IPSAS 19.	IFRS 9 rules and IPSAS 41 rules are based on them.	One-off guarantees are disclosed as memorandum items.

3.5.1 IPSAS and IFRS

IPSAS 19 'Provisions, contingent liabilities and contingent assets' is drawn primarily from IAS 37. Apart from specific differences in terminology, both standards are largely identical in terms of scope, definition, recognition and measurement principles.

When it comes to financial guarantee contracts, IPSAS 29 'Financial instruments: recognition and measurement' is drawn primarily from IAS 39 'Financial instruments: recognition and measurement'. The main difference between IPSAS 29 and IAS 39 is as follows: IPSAS 29 contains additional application guidance to deal with financial guarantee contracts provided by way of non-exchange transactions.

IAS 39 is now superseded by IFRS 9 on which IPSAS 41 'Financial instruments' (which supersedes IPSAS 29) is aligned.

3.5.2 IPSAS and EAR

EAR 10 'Provisions, contingent liabilities and contingent assets' is based on IPSAS 19 as regards the scope, recognition and measurement of provisions, contingent liabilities and contingent assets and no significant differences exist.

EAR 11 'Financial instruments' prescribes the accounting treatment of financial instruments in line with the current IPSAS 29 'Financial instruments: recognition and measurement'.

3.5.3 IPSAS and ESA 2010

Scope and recognition

IPSAS provides for the recording of provisions defined to be liabilities of uncertain timing or amount (IPSAS 19.18), which also include obligations for which there is no specific counterparty, for example provisions for restructuring and environmental restoration. On the contrary, ESA 2010 rules "*do not record provisions because the national accounts system is necessarily symmetric and the values of assets and related liabilities must match*"¹⁹.

This difference with respect to liability recognition will have consequential differences either for expense recognition or asset recognition. For example, recognition of a provision for restructuring will, under IPSASs, require recognition of a related expense, because there is no compensating increase in asset value. Recognition of a provision for eventual site restoration during construction of a landfill will, under IPSASs, be capitalised, adding to the overall investment in the asset. Under IPSASs, it is also possible for an increase or decrease in the amount of a provision to occur due to an improved estimate. An increase could result in expense recognition, while a decrease could result in revenue recognition. Statistical rules would not recognise either these changes in assets/liabilities or the resulting revenue/expense until a point in the process where another party can be identified as receiving value.²⁰

Differences arise between ESA 2010 and IPSAS rules for financial guarantees because ESA 2010 treats uncertainty about future economic outflows differently from IPSAS. Though the gap was reduced when ESA 2010 introduced a three-way treatment of guarantees, there are several differences in the treatment of guarantees, with 'one-off guarantees' being disclosed as contingent liabilities under ESA 2010 while IPSAS requires all financial guarantees to be recognised on balance sheet at initial recognition.

Measurement

The measurement basis is different too. Government liabilities (with the exception of loans) should be recorded in national accounts at their market value under ESA 2010.

In contrast, IPSAS 19 requires to measure provisions at the best estimate of the cost to settle the obligation.

¹⁹ See Commission Staff Working Document (SWD) 2013 [...], 6 March 2013, p.74

²⁰ See IPSASB Consultation Paper 'IPSASs and Government Finance Statistics Reporting Guidelines', October 2012, p.13-14

Financial guarantees should be initially recognised at fair value under IPSAS but their subsequent measurement differs from the ESA 2010 measurement: in IPSAS, financial guarantee liabilities should be amortised in line with the revenue recognition principles applicable to exchange transactions or, if higher, the loss allowance calculated using the upcoming expected credit loss model under IPSAS 41 (or the amount determined under IPSAS 19 as long as IPSAS 29 is applicable).

4 Description of the main types of provisions and financial guarantees in selected EU Member States (United Kingdom and Austria)

4.1 EU accounting practices

As a reminder, the PwC study of 2014²¹ reveals that the average maturity for the accounting of provisions by governments across the European Union is low (48%). This represents the second lowest accounting maturity across the European Union after employee benefits. 17 central governments out of 28 declare having major obligations for dismantling assets, decommissioning/site restoration, and environmental clean-up. Out of these 17 countries, 10 only recognise these obligations in the statement of financial position.

Member States were asked to provide their comments on the application of IPSAS in an open way. The analysis of the comments made by Member States was targeted at assessing whether the accrual-basis IPSAS framework is a suitable reference point for the development of the accrual-basis EPSAS framework.

Out of the 147 comments received from the Member States, 50 were general comments and 97 comments relating to specific standards. Out of these 97 comments, eight were relating to IPSAS 19 'Provisions, contingent liabilities and contingent assets': five out of these eight comments related to the cost and complexity of preparation, 2 comments were of a more conceptual nature and one comment was categorised as 'other comment'.

Financial guarantees were included for the purpose of the analysis in the 'financial instruments' category. Nine comments were made on the cost and complexity of preparation and four comments were of a more technical/conceptual nature. One was specifically related to the cost and complexity of accounting with regard to financial guarantees.

The following figure summarises the accounting treatment of financial guarantees issued adopted by the 28 EU Member States.

²¹ See PwC, Collection of information related to the potential impact, including costs, of implementing accrual accounting in the public sector and technical analysis of the suitability of individual IPSAS standards, 2013/S 107-182395, 1 August 2014, p. 96

Figure 6: Accounting for financial guarantees by EU Member States²²

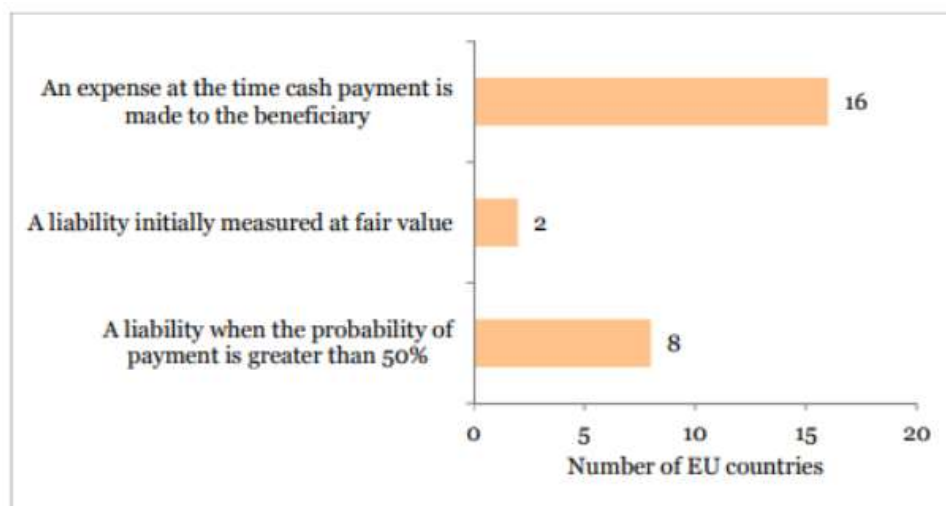


Figure 7 Total general government contingent liabilities and non-performing loans in EU Member States, 2016 (% of GDP*) presents information published in January 2018 by Eurostat on contingent liabilities and non-performing loans of government for the year 2016. These data have been provided by the EU Member States in the context of the reinforcement of European economic and fiscal governance (the "six-pack").

The contingent liabilities published in this table include data on government guarantees, liabilities related to public-private partnerships recorded off-balance sheet of governments and liabilities of government controlled entities classified outside general government (public corporations). The liabilities are contingent in the sense that they are only potential and can materialise as actual government liabilities only if certain specific conditions prevail.²³ Only government guarantees are within the scope of the present issue paper.

Guarantees are arrangements whereby the guarantor undertakes to a lender that if a borrower defaults, the guarantor will make good the loss the lender would otherwise suffer. A one-off guarantee is defined as individual, and guarantors are not able to make a reliable estimate of the risk of calls. One-off guarantees are linked to debt instruments (e.g. loans, bonds). Data refer to the total stock of debt guaranteed by government units. Standardised guarantees are guarantees that are issued in large numbers, usually for fairly small amounts, along identical lines. It is not possible to estimate precisely the risk of each loan being in default but it is possible to estimate how many, out of a large number of such loans, will default. Examples are mortgage loan guarantees, student loan guarantees, etc. Data refer to the total stock of assets covered by the standardised guarantees. While the provisions for standardised guarantees are considered an actual liability, the total stock of assets covered by standardised guarantee is regarded as a contingent liability.²⁴

²² See PwC, Collection of information [...], 1 August 2014, p.113

²³ See Eurostat News Release, 'What is the extent of contingent liabilities and non-performing loans in the EU Member States?', 30 January 2017, p.1

²⁴ See Eurostat News Release, 'What is the extent of contingent liabilities and non-performing loans in the EU Member States?', 30 January 2017, Annex 1, p.3

Figure 7: Total general government contingent liabilities and non-performing loans in EU Member States, 2016 (% of GDP*)²⁵

	Government guarantees**			Liabilities related to off-balance public-private partnerships (PPPs)	Liabilities of government controlled entities classified outside general government***			Non-performing loans (government assets)
	One-off	Standardised	Total		Entities involved in financial activities	Entities involved in other activities	Total	
Belgium	10.3	0.6	10.9	0.1	38.0	13.7	51.7	:
Bulgaria	0.4	0.1	0.5	0.0	5.0	8.1	13.1	0.1
Czech Republic	0.3	0.0	0.3	0.0	0.0	10.7	10.8	1.4
Denmark	9.9	0.0	9.9	0.2	10.9	18.2	29.1	0.3
Germany	14.3	0.0	14.3	0.0	96.4	4.3	100.7	0.1
Estonia	0.0	1.5	1.5	0.1	0.2	13.3	13.5	0.0
Ireland	1.9	0.0	1.9	0.7	36.4	6.4	42.8	0.8
Greece	6.1	0.0	6.1	0.1	136.1	8.1	144.2	0.2
Spain	7.7	0.0	7.7	0.3	22.7	3.0	25.7	0.2
France	3.0	2.2	5.2	0.0	42.8	19.2	62.0	:
Croatia	2.6	0.0	2.6	0.1	5.2	5.2	10.4	:
Italy	1.2	1.2	2.4	0.0	29.3	22.6	51.9	0.0
Cyprus	9.1	0.3	9.4	0.8	76.2	13.6	89.8	:
Latvia	0.9	0.5	1.5	0.0	-	20.7	20.7	0.2
Lithuania	0.2	0.7	0.9	0.0	0.1	5.8	5.9	0.1
Luxembourg	12.0	0.9	12.9	0.0	74.4	7.1	81.5	0.0
Hungary	7.9	0.2	8.1	1.7	9.3	5.0	14.3	0.0
Malta	14.1	0.0	14.1	0.1	3.2	16.2	19.4	0.0
Netherlands	3.3	0.4	3.7	0.4	88.3	15.6	103.9	0.0
Austria	20.5	0.0	20.5	0.1	14.6	13.4	28.0	1.1
Poland	6.5	0.7	7.1	0.0	21.9	12.8	34.7	0.3
Portugal	5.6	0.0	5.6	3.2	62.4	3.9	66.2	1.5
Romania	0.4	1.9	2.2	0.0	3.9	3.5	7.4	0.0
Slovenia	9.6	0.0	9.6	0.0	40.1	18.2	58.2	5.9
Slovakia	0.0	0.0	0.0	3.1	0.3	1.0	1.3	0.1
Finland	27.0	1.1	28.0	0.0	20.5	22.2	42.7	0.1
Sweden	10.5	0.0	10.5	0.0	19.4	24.4	43.8	0.7
United Kingdom	8.3	0.1	8.3	1.5	37.6	5.4	42.9	0.0

: data not available - not applicable
* GDP figures provided during the October 2017 Excessive Deficit Procedure notification are used for calculation.
** Data on guarantees do not include: 1) Government guarantees issued within the guarantee mechanism under the Framework Agreement of the European Financial Stability Facility (EFSF); 2) Derivative-type guarantees meeting the ESA2010 definition of a financial derivative; 3) Deposit insurance guarantees and comparable schemes; 4) Government guarantees issued on events which occurrence is very difficult to cover via commercial insurance (earthquakes, large scale flooding, etc.).
*** Only those entities whose liabilities exceed 0.01% of GDP are included in the aggregate of each Member State.

²⁵ Eurostat News Release, 'What is the extent of contingent liabilities and non-performing loans in the EU Member States?', 29 January 2018, p.5

4.2 Selection of countries

The following section provides a deeper analysis of the approaches taken to accounting for provisions and financial guarantees in two EU Member States (United Kingdom and Austria) that have been selected for illustration purposes.

The selection of countries considered Member States which obtained a high accounting maturity score at central government level in the 2014 PwC study, and the possibility to share best practices implemented with regard to accounting for provisions and financial guarantees:

- The UK, which applies IFRS as adapted for the public sector, has obtained the highest accounting maturity score (in terms of IPSAS compliance) in the 2014 PwC study and presents large amounts of provisions in its balance sheet.
- Austria has recently made the move to accrual-based standards based on IPSAS and discloses a high amount of financial guarantees in the table ‘Total general government contingent liabilities and non-performing loans in EU Member States, 2016 (% of GDP)’ published by Eurostat.

4.3 Methodology

To analyse the approaches taken to accounting for provisions and financial guarantees in selected Member States, PwC analysed publicly available information and led semi-structured interviews based on a questionnaire.

The first series of questions addressed the identification of provisions and financial guarantees and the related recognition criteria. The questionnaire then addressed the measurement and presentation of provisions and financial guarantees. The last questions focused on the first-time implementation of provisions and financial guarantees, as well as lessons learned. In the following pages, a summary of the results of the interviews is presented country by country.

4.4 United Kingdom

4.4.1 Identification of main types of provisions, contingent liabilities/contingent assets and financial guarantees

4.4.1.1 Provisions

The table below provides an overview of the provisions recorded by the UK government at 31 March 2016 in its whole-of-government accounts (WGA).

Figure 8: UK government provisions for liabilities and charges - disclosure note²⁶

	Nuclear decommissioning	Clinical negligence	Other provisions	2015-16 total	2014-15 total
	£bn	£bn	£bn	£bn	£bn
At 1 April	82.9	29.3	63.1	175.3	154.6
Pay-outs made in year	(0.6)	(1.2)	(7.1)	(8.9)	(7.9)
Increase in expected future pay-outs	3.3	6.0	7.6	16.9	35.4
Change in discount rate	94.8	25.4	5.0	125.2	-
Discount rate unwind	1.7	-	1.0	2.7	1.9
Provisions not required written back	(0.4)	(1.9)	(3.3)	(5.6)	(8.4)
Transfers to payables	-	-	(0.1)	(0.1)	(0.3)
At 31 March	181.7	57.6	66.2	305.5	175.3

The two largest types of provisions are the provision for nuclear decommissioning and the provision for clinical negligence.

Provisions are recognised when the government has a present obligation as a result of a past event and it is probable that the government will be required to settle that obligation. Provisions are measured at the best estimate of the expenditure required to settle the present obligation at the reporting date and are discounted to present value where the time value of money is material. Each year the government reviews its obligations against all provisions and reviews the assumptions and judgements used to estimate the value of each provision. The estimates can be subject to significant revision if new information becomes available.

Where some or all of the expenditure required to settle a provision is expected to be recovered from a third party the recoverable amount is treated as an asset. The net provision expense after deducting expected recoveries from third parties is recognised in the statement of revenue and expenditure.

Nuclear Decommissioning Authority's (NDA's) nuclear decommissioning provision forms the bulk of the overall government provision for nuclear decommissioning and represents the best estimate of the costs of decommissioning plant and equipment on their designated nuclear licenced sites to return them to pre-agreed end states in accordance with the Authority's published strategy. NDA's programme of work will extend beyond 2120. The estimate is necessarily based on assumptions regarding processes and methods likely to be used to discharge the obligations, reflecting a combination of latest available technical knowledge, requirements of the existing regulatory regime, government policy and commercial agreements. Given the very long timescale involved and the complexity of the plants and material being handled, considerable uncertainty remains in the estimates of future costs, particularly in later years. The estimate is updated to reflect changed circumstances and more recent knowledge and changed assumptions; as a result, material adjustments could be made to the carrying amount of the nuclear decommissioning provision and related assets and liabilities in the future.

²⁶ See UK Whole of Government Accounts year ended 31 March 2016, Note 22, p.86, HM Treasury

The clinical negligence provision requires the directors of the NHS Litigation Authority to make judgements, estimates and assumptions to value the liability. The estimates and associated assumptions are based on historical experience and other factors that are considered to be relevant. They are reviewed annually by the NHS Litigation Authority, supported by its actuaries the Government Actuary's Department. Known reported claims are individually valued using likely costs to resolve the claim and probability factors to take account of the potential of a successful defence. Whilst incurred but not reported claims are valued using actuarial models to predict likely values. Due to the long-term nature of the liabilities and the assumptions on which the estimate of the provision is based, some uncertainty about the value of the liability remains.²⁷

Other provisions included a wide range of provisions across all parts of the public sector. These included provisions in relation to: injury benefits, medical costs, criminal injuries compensation, legal costs, compulsory purchases, concessionary fuel allowance to ex-miners, mine water treatment, public safety and subsidence, subsidence pumping stations and tip management, claims in respect of structural damage and diminution of value of properties affected by transport schemes, and compensation payments for termination of employment.²⁸

4.4.1.2 Contingent liabilities

Contingent liabilities and contingent assets are not recognised as liabilities or assets in the statement of financial position, but are disclosed in the notes to the accounts. A contingent liability is a possible obligation arising either from past events whose existence will be confirmed only by uncertain future events, or a present obligation arising from past events which is not recognised because either an outflow of economic benefit is not probable or the amount of the obligation cannot be reliably measured. A contingent asset is a possible asset whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the control of the entity. Where the time value of money is material, the contingent liabilities and assets are stated at discounted amounts.

Contingent liabilities disclosed under IAS 37 by the UK government in note 29 of its WGA include both quantifiable contingent liabilities for a total of GBP 104.3 billion and non-quantifiable contingent liabilities.

²⁷ See UK Whole of Government Accounts year ended 31 March 2016, Note 2. Critical accounting estimates and judgements, p.63, HM Treasury

²⁸ See UK Whole of Government Accounts year ended 31 March 2016, Note 22, p.88, HM Treasury

Figure 9: Quantifiable contingent liabilities

	2015-16 £bn	2014-15 £bn
Export guarantees and insurance policies	11.6	13.4
Clinical negligence	26.7	14.0
Taxes subject to challenge	49.1	35.6
Transport infrastructure projects	7.6	6.4
Other	9.3	7
Total quantifiable contingent liabilities	104.3	76.4

The most significant amounts are explained as follows:

- **Taxes subject to challenge:** HM Revenue and Customs (HMRC) is engaged in a number of legal and other disputes which can result in claims by taxpayers against HMRC. This covers a range of cases, including corporate tax and VAT.
- **Clinical negligence:** the Department of Health is the actual or potential defendant in a number of actions regarding alleged clinical negligence. In some cases, costs have been provided for or otherwise charged to the Department's accounts. In other cases, there is a large degree of uncertainty as to the department's liability and amounts involved.
- **Export guarantees and insurance policies:** the Export Credit Guarantee Department supported exports and investments through issuing and renewing guarantees and insurance policies. It issues guarantees and insurance against loss for, or on behalf of, exporters of goods and services and overseas investors from the UK, and supports the provision of fixed-rate export finance.

Furthermore, information is also provided about non-quantifiable contingent liabilities, including legal claims, contingent liabilities for reinsurance arising from acts of terrorism, civil nuclear liabilities, financial assistance scheme, contingent liability in relation to the Channel tunnel and Transport for London and service life insurance.

In addition to the contingent liabilities reported in note 29, government departments disclose contingent liabilities where the risk of crystallisation is remote. These remote contingent liabilities are not required to be disclosed under accounting standards, but are reported here on the basis that guarantees, indemnities and letters of comfort expose the taxpayer to financial risk.

Remote contingent liabilities that are quantifiable are disclosed separately from non-quantifiable contingent liabilities.

Figure 10: Quantifiable remote contingent liabilities

	1 April 2015 Total restated £bn	Increase in year £bn	Liabilities crystallised in year £bn	Obligation expired in year £bn	31 March 2016 Total £bn
Guarantees	60.9	8.3	-	(0.4)	68.8
Indemnities	14.9	1.8	-	(0.2)	16.5
Letters of comfort	-	-	-	-	-
Total	75.8	10.1	-	(0.6)	85.3

Guarantees include (a) callable capital to the European Investment Bank (EIB) as each Member State may be called upon to pay its share of the balance of the subscribed capital should the bank have to meet its obligations, (b) contingent liabilities in respect of callable capital on investments in international financial institutions, (c) the UK's maximum liability from current outstanding loans to EU Member States and third countries for which the risk is ultimately borne by the EU budget. Loans are issued under the following initiatives: the European Financial Stabilisation Mechanism (EFSM); the Balance of Payments Facility; and the Guarantee Fund to Third Countries, etc.

Indemnities for example include the Government Indemnity Scheme, which indemnifies lenders to museums, galleries and other institutions when mounting exhibitions or taking long-term loans for study or display.

Information about non-quantifiable remote contingent liabilities is also disclosed in relation to regional development banks and funds, National Health Service, nuclear matters, guarantee to protect British Telecom's pension liabilities and fire and rescue service.

4.4.1.3 Financial guarantees

Financial guarantees are initially recorded at the value of any fees the UK government receives to compensate for the risk it has taken on, with the valuation of the guarantee subsequently adjusted if this income is judged to be insufficient to cover the liability.²⁹

In order to stimulate parts of the economy and address market failures, the UK government has made increasing use of guarantee schemes in recent years, which could generate additional liabilities in the future. Under the terms of these schemes, the UK government guarantees to reimburse a lender for any losses from non-payment of debt it has issued. For example, on the Help to Buy mortgage guarantee scheme, the UK government agrees to cover a proportion of losses that mortgage lenders may incur on high loan-to-value mortgages.³⁰

Financial guarantees are reported by the UK government within other financial liabilities, recorded in note 21 of the WGA (GBP 0.4 billion at 31 March 2016).

²⁹ See UK National Audit Office (NAO), Evaluating the government balance sheet: provisions, contingent liabilities and guarantees, 30 June 2016, p.6

³⁰ See UK National Audit Office (NAO), Evaluating the government balance sheet: provisions, contingent liabilities and guarantees, 30 June 2016, p.6

4.5 Austria

4.5.1 Provisions, contingent liabilities and contingent assets

The accounting policies of the Austrian central government in relation to provisions and contingent liabilities are based on IPSAS 19 and are included in the Federal Budget Regulation (in § 79 for provisions and § 56, 78 and 81 for contingent liabilities).

According to these rules, provisions must be set up if the event triggering the obligation occurs, and the amount of the obligation can be estimated reliably. Short-term provisions are measured at the estimated settlement amount.

No specific rules are foreseen in respect of contingent assets.

The amounts of provisions reported in the balance sheet of the Austrian government at 31 December 2016 are summarised below (in million EUR).

Figure 11: Provisions reported in the Austrian central government balance sheet

Long-term provisions	
Provisions for reclamation of contaminated sites	28.9
Provisions for the disposal of nuclear waste	203.0
Other provisions	476.7
Short-term provisions	
Provisions for litigation	529.5
Other provisions	2,396.4

4.5.2 Financial guarantees

Financial guarantees that are financial liabilities (see table under 4.5.1 above) are treated in accordance with the IPSAS standards relating to financial instruments (IPSAS 28, 29 and 30). Other financial guarantees are disclosed in the notes (see table below). The accounting policies of the Austrian central government applicable to financial guarantees are included in the Federal Organic Budget Law (in § 82).

The financial guarantee liabilities reported in the balance sheet of the Austrian government at 31 December 2016 amount to 2,753 million EUR. The detail is as follows (in million EUR).

Figure 12: Financial guarantee liabilities reported in the Austrian central government balance sheet

Financial guarantees	
Stabilisation of the financial market	1,330
Austrian export financing guarantees act	922
Austrian export guarantees act	378
Other	123

The amounts disclosed as financial guarantees in the notes to the accounts of the Austrian government at 31 December 2016 are summarised below (in million EUR).

Figure 13: Financial guarantees disclosed in the Austrian central government financial statements

Financial guarantees	
Federal Finances Act	29,856.6
Export promotion	25,705.6
Stabilisation of the financial market	16,512.9
Stabilisation of balance of payments	9,726.1
Secondary coins	4,629.4
Eurofima	2,074.8
Business development	1,198.4
Nuclear liability act	134.0
Oil and stockholding company	85.8
European Investment Bank	73.4
Electricity industry - energy bonds	0.1

4.5.3 Implementation challenges

The Austrian government recently made the move to accrual-based standards based on IPSAS³¹. It is therefore interesting to understand what the main implementation challenges were and how these have been addressed.

According to the Ministry of Finance, the main challenges are linked to the major efforts to be done to take stock of all information which is needed to inventorise all provisions, contingent liabilities and contingent assets at the opening balance sheet first and at each closing date thereafter. Huge efforts have been made in that respect.

In addition, the reliability of the data obtained may be a challenge as well.

In order to simplify preparation of the opening balance sheet, materiality thresholds were considered for the booking of accruals for outstanding invoices with an expected value of EUR 50,000 or more, and for other long-term provisions with an expected value of EUR 100,000 or more.

Furthermore, some liabilities have not been estimated individually but groupings of items presenting similar characteristics in terms of risks have been made and a provision has been calculated for this group of items taken together.

³¹ Austria's federal budget reform took place in two stages following unanimous decisions in the parliament in 2007 and 2009. In the first stage (2009-2012), the Medium-Term Expenditure Framework Act (BFRG [Bundesfinanzrahmengesetz]) puts a clear focus on ex ante expenditure controls. Accrual budgeting and accounting as well as performance budgeting were introduced in the second reform stage with the passage of the Federal Organic Budget Act 2013 (BHG 2013 [Bundshaushaltsgesetz]). The total implementation period covered five years and the new integrated budgeting and accounting system was fully operational by 2013. For further details see PwC, Collection of information [...], 1 August 2014, pp.27-28.

The unit of accounts has thus been in those cases the population of items presenting a similar risk profile. Such cases include:

- Provisions for guarantees based on the Austrian Export Financing Guarantees Act ('Ausfuhrfinanzierungsförderungsgesetz'), combined by currency;
- Provisions for guarantees based on the 'Ausfuhrförderungsgesetz', combined by product;
- Provisions based on the Austrian SME Promotion Act ('KMU-Förderungsgesetz').

On an ongoing basis, preparation of the year-end financial statements do not involve particular difficulties according to the Ministry of Finance. Preparation of the disclosures is automated. The following table is prepared to reconcile and analyse the changes in provisions between beginning and end of the year.

Figure 14: Changes in provisions schedule template (as disclosed by the Austrian central government)

	Carrying amount at 31/12/n-1	Allocation (+)		Decrease (-)		Interest expense (+)	Carrying amount at 31/12/n
		New	Increase	Utilisation	Reversal		
Categories of short-term provisions - A - B - ...							
Categories of long-term provisions - ...							
Total							

4.6 Country comparison

Figure 15: Government practices relating to provisions, contingent liabilities and contingent assets as well as financial guarantees compared (UK and Austria)

	United Kingdom	Austria
<i>Scope and definition</i>	IAS 37.	Federal Organic Budget Law based on IPSAS 19 for provisions and on IPSAS 28, 29 and 30 for financial instruments.
<i>Recognition</i>	In line with IAS 37 (for provisions) and IAS 32 and IAS 39 (for financial guarantees).	In line with IPSAS 19 (for provisions) and IPSAS 28 and IPSAS 29 (for financial guarantees).
<i>Measurement</i>	Same as above.	Same as above.
<i>Presentation</i>	Same as above.	Same as above.
<i>Disclosures</i>	In line with IAS 37 (for provisions) and IFRS 7 (for financial guarantees).	In line with IPSAS 19 (for provisions) and IPSAS 30 (for financial guarantees).

Both the UK and the Austrian government follow the principles included in international financial reporting standards for the recognition and measurement of provisions and financial guarantees, i.e. IFRS (as adapted for the public sector) in the UK and IPSAS in Austria.

Some challenges inherent to the setting up and subsequent measurement of provisions and financial guarantees inevitably arise (such as the need to regularly update the estimates based on the latest relevant information available). The UK government provides extensive disclosure about the nature of provisions, contingent liabilities and guarantees and the related sources of estimation uncertainty.

In Austria, the challenges linked to the data collection upon first-time implementation were overcome by a combination of one-time implementation efforts and a pragmatic approach taken in respect of the preparation of the opening balance sheet (use of materiality threshold, collective assessment of liabilities following proper determination of the units of account).

5 Difficulties/issues when accounting for provisions and financial guarantees

Based on the input gathered from Member States and disclosed in chapter 2 ‘Background of the issue’ and the additional analyses performed in the context of this issue paper, the following areas are identified as involving the main difficulties/issues when accounting for provisions, contingent liabilities and contingent assets on the one hand, and financial guarantees on the other hand:

- Data availability, especially at first-time adoption, which is seen as an implementation or application issue.
- Inherently difficult measurement, which is an issue of a more conceptual nature.
- Presentation and disclosure of provisions, contingencies and financial guarantees.

5.1 Data availability, especially at first-time adoption

IPSAS 19 ‘Provisions, contingent assets and contingent liabilities’ might prove to be difficult to apply in practice.

Setting up a complete inventory of existing provisions and financial guarantees may constitute a particular challenge for entities which transition from a cash-based environment to the accrual basis of accounting as data may be unavailable and the records may be incomplete. This is especially valid considering the differences in terms of recognition between ESA 2010 and international financial reporting standards such as IPSAS and IFRS.

The existence of significant present obligations needs to be identified and a reliable estimate of the costs to be incurred needs to be made. This may for example be difficult for long-term obligations such as environmental obligations. Similar difficulties arise for the collection of information needed to account for financial guarantees in accordance with international standards.

Procedures for collecting information from non-financial staff (e.g. in-house or external lawyer) in respect of provisions, contingent liabilities and contingent assets, as well as financial guarantees must be set up. Collected data needs to be communicated to the accounting and financial staff in a timely manner in order to prepare IPSAS compliant information.

5.2 Inherently difficult measurement

International accounting standards set clear requirements for the measurement of provisions and contingent liabilities. The best estimate of the expenditure required to settle the present obligation at the reporting date should be used, taking into account the risks and uncertainties that inevitably surround many events and circumstances in reaching that best estimate. When measurement relates to a large population of items, an expected value method of estimation should be used. Where the effect of the time value of money is material, the provision should be measured on a net present

value basis, using an appropriate discount rate. This issue is further discussed in a separate issue paper.³²

Measuring long-term provisions is inherently difficult and reflects the uncertainty over the government's overall exposure to financial risk. The uncertainty around the size, probability and timing of these liabilities makes measuring them particularly challenging. The longer the timeline for the expected cash outflows, the more difficult the estimates as the greater the likelihood is that circumstances arise that impact the initial estimates. In addition, some estimates are based on significant assumptions, complex modelling techniques and management judgement. In some instances, uncertainty about future technological developments could have a major impact on costs and timescales.

For example, challenges around estimation of nuclear decommissioning costs have been highlighted by the National Audit Office in the UK. *“The main challenges for the government in resolving its nuclear legacy are understanding the cost drivers and reducing uncertainties around the nature, scale and timing of the liabilities - which extend far into the future - as far as possible.”*³³ On the same topic, the European Court of Auditors has analysed the situation in Lithuania, Bulgaria and Slovakia and recommended that *“The Commission should work together with all relevant Member States so that all future costs associated with nuclear decommissioning and the final disposal of spent fuel are accounted for properly, in a transparent manner, consistent with relevant accounting standards.”*³⁴

Financial guarantees should initially be measured at their fair value, and thereafter amortised following the principles in the revenue recognition standard for exchange transactions or measured at the amount determined under IPSAS 19 (or under the new expected credit loss model imposed by IPSAS 41), whichever the higher.

In practice, determining the fair value of a financial guarantee in a public sector environment may also be problematic in the absence of relevant market data. Complex valuation models may need to be developed in order to properly capture the economic substance of such guarantees.

Financial guarantees may include one-off interventions to support private or public sector entities that may incur financial difficulties or to facilitate access to funding and/or to certain markets by them. They can also be granted as part of a wider financial guarantee program aimed e.g. at boosting SMEs or a certain sector of the economy, or to support exports by corporates wanting to expand their activities. The substance of each guarantee or guarantee program needs to be considered in the valuation technique or financial model that is developed.

³² See PwC, EPSAS issue paper on applying discount rates under the future EPSAS, EPSAS Working Group, Luxembourg, 7-8 May 2018, 44 pages.

³³ See UK National Audit Office (NAO), “Evaluating the government balance sheet: provisions, contingent liabilities and guarantees”, 30 June 2016, p.8.

³⁴ See ECA special report “EU nuclear decommissioning assistance programmes in Lithuania, Bulgaria and Slovakia: some progress made since 2011, but critical challenges ahead”, 2016, 88 pages.

5.3 *Presentation and disclosure of provisions, contingencies and financial guarantees*

IPSAS rules do not provide any detailed guidance on the presentation of provisions, contingent liabilities and contingent assets, and financial guarantees. Information to be disclosed in the notes in relation to provisions and contingent liabilities should be given by class, but no specific guidance is provided on the categories that should be determined.

ESA 2010 do not prescribe rules for provisions. However ESA 2010 distinguishes between two types of financial guarantees: one-off guarantees and standardised guarantees.

The absence of detailed guidelines on the topic may lead to diversity in practice and a lack of comparability in EPSAS financial statements.

6 Discussion of matters relevant for a European harmonisation

In our opinion, the main topics that are worth being discussed at a European level in the context of the EPSAS standard setting, that are relevant for a European harmonisation and may help enhance comparability of the reporting between EU Member States, relate to:

- The approach to measure provisions, contingencies and financial guarantees.
- The need for a consistent presentation of provisions, contingent liabilities and contingent assets on the one hand, and financial guarantees on the other hand.

In contrast, the necessity to put in place adequate administrative processes, including a reliable tracking system of the events that trigger recognition of provisions, contingencies and financial guarantees, and processes that enable to generate information which is reliable enough to be used in the measurement of such items, does not, in our view, need to be discussed in the context of the EPSAS standard-setting process. Indeed, the challenge for governments is of an organisational nature.

6.1 Member States' approach to measuring liabilities and related risks as well as related implementation guidance

Implementing best practices with regard to measuring liabilities and related risks should facilitate the assessment of provisions and financial guarantees and provide better insight into the financial risks associated with these items. Appropriate disclosures by Member States will be facilitated by the setting up of reliable processes.

Member States may wish to discuss the opportunity to develop specific EPSAS guidance for the measurement of certain categories of provisions, contingencies or financial guarantees to facilitate implementation and ensure a greater level of consistency in application. This would in particular be helpful for governments that make the move to EPSAS from a cash-based environment and may not have developed a thinking yet about those topics.

Topics for discussion might include:

- *Methodology used to estimate long-term obligations or to develop models to measure financial guarantees.*

Some variation in the levels of sophistication in the analytical models used to estimate provisions, contingent liabilities and financial guarantee contracts across government is to be expected, given the differing nature of liabilities and financial risks posed. Having to estimate far into the future presents a particular challenge for departments and other bodies as the dataset is often incomplete and more assumptions are needed. Developing guidance and sharing best practices with regard to the use of models for measuring provisions ('best estimate') and financial guarantee contracts may help achieving the objectives of harmonisation at EU level.

In order to make this possible, the usefulness of performing a survey of the major types of provisions, contingencies and financial guarantees granted by EU Member States could be

discussed. Best practices might then be identified and shared with the Member States. Based on the outcome of the survey, measurement guidance might also be developed where appropriate.

- *Selection of an appropriate discount rate.*

The value of provisions reported in the accounts may be significantly affected by the discount rate used. On a legal claim provision, for example, the value may be discounted over just a few years whereas environmental provisions may need to be discounted over a very long period of time. Ordinarily each year the value of the provision increases as it becomes one year closer to being paid out, offset by the value of the expenditure incurred against the provision. Providing additional guidance with regard to the discount rate relevant for EU central governments may lead to better consistency in terms of figures reported by central governments. The selection of an appropriate discount rate is further discussed in a separate issue paper.³⁵

- *Interpretation of some IPSAS concepts.*

Providing additional guidance to Member States when it comes to specific notions not specifically addressed by international standards may lead to better harmonisation and transparency for the readers of the accounts. For example, the lack of guidance on remote contingent liabilities may limit transparency and increase the potential for inconsistency in reporting. For example, under IPSAS and IFRS, there is no specific indicator as to when a contingent liability should be classified as remote, which may lead to a diversity of practices in treating contingent liabilities.

6.2 Presentation and disclosure of provisions, contingencies and financial guarantees

The need for a consistent presentation of the provisions may be discussed in order to enhance comparability of the reporting between EU Member States.

Both internationally recognised accounting frameworks (IPSAS and IFRS) require provisions to be presented on a separate line item on the statement of financial position. Further subclassification is generally given in the notes by class in a way that is appropriate to the circumstances of the reporting public sector entity.

Various subclassifications may be used, for example based on those types of provisions that are most frequently encountered in practice. Member States can also discuss the opportunity to group provisions and liabilities arising from financial guarantees for disclosure purposes. When talking of financial guarantees, the classification used in the ESA 2010 reporting between one-off guarantees and standardised guarantees might be retained.

³⁵ See PwC, EPSAS issue paper on applying discount rates under the future EPSAS, EPSAS Working Group, Luxembourg, 7-8 May 2018, 44 pages.

Typical groups of such liabilities may for example include:

- Provisions for environmental obligations (decommissioning, site restoration, etc.).
- Provisions for litigation.
- One-off guarantees.
- Standardised guarantees.
- Other provisions.

As an illustrative example, the UK National Audit Office proposes to group into four broad categories government provisions, contingent liabilities and financial guarantees with similar profiles and challenges³⁶:

- Liabilities arising from the government's long-term energy policies (e.g. provisions related to the costs of nuclear decommissioning).
- Legal challenges to the government (e.g. provisions relating to legal claims as a result of the government's activities).
- Liabilities arising from market interventions (e.g. guarantee schemes to support key sectors of the economy).
- Government's role as an insurer of last resort (e.g. guarantee schemes with regard to infrastructure projects).

In addition, Member States may also wish to determine typical classes of contingent liabilities to ensure greater consistency in the presentation of disclosures.

³⁶ See UK National Audit Office (NAO), Evaluating the government balance sheet: provisions, contingent liabilities and guarantees, 30 June 2016, p.32

7 PwC's recommendations on the way forward

We present below our recommendations in the same order as the topics proposed for discussion for a European harmonisation under Chapter 6.

7.1 *Member States' approach to measuring liabilities and related risks as well as related implementation guidance*

Provisions and financial guarantee contracts may involve amounts which are highly significant and high levels of risks for Member States.

It is in our view crucial to consider both materiality and relevance of the information to be provided, i.e. information should be provided if it is important for a proper understanding of the government's liabilities and related risks.

When material transactions are concluded that involve major risks for governments, these should be reflected in financial statements in a transparent way. Financial statements should properly depict the substance of the (sometimes complex) arrangements, the financial risks that are taken by governments when they enter into significant and risky transactions, including in relation to financial guarantees. Similarly, when a government is exposed to major risks and/or has incurred major (long-term) obligations in relation to its activities, these should be reflected in the financial statements too, either through recognition on the balance sheet or by way of disclosure.

Given the materiality of the amounts and the complexity of the topics involved, we believe that developing EPSAS guidance on some selected topics (possible examples are suggested in 6.1) may be useful to help governments apply the new requirements. It would in addition help enhancing consistency in the measurement of liabilities and contingencies.

Finally, we share below some thoughts that may help in achieving a good balance between the relevance of the information which is provided in EPSAS financial statements and the cost of its preparation:

- Accounting for financial guarantees is a technical area. In practice, smaller entities are not expected to enter into complex transactions or might, depending on the governance in place, be prohibited from doing so. The required expertise may often be developed at central level and be in the hands of a limited number of staff, therefore limiting the total cost.

The same reasoning applies to the estimate of long-term provisions: when significant estimates requiring technical expertise need to be made, these are supposed to be made by some individuals having the required level of expertise. The process to estimate provisions, contingencies and financial guarantees should however be supported by robust processes concerning the collection of the data needed for making the estimations.

- In relation to financial guarantees, a simplified methodology or model that provides a good approximation of fair value can be considered, keeping in mind materiality considerations. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's

length transaction, its measurement is even simpler: its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.

Similarly, the use of materiality thresholds may help in capturing those items that are significant without engaging undue costs or efforts. However, when assessing provisions for risks that involve a large population of individually small items, materiality should be considered at the aggregate level. As the EPSAS project also aims to embed good accounting and public finance management practices in the whole general government sector, keeping track and reporting smaller amounts of liabilities and contingencies may also help enhance internal control and financial discipline.

7.2 Presentation and disclosure of provisions, contingencies and financial guarantees

In order to achieve consistency in the presentation and disclosure of the provisions across EU governments, we recommend to define a subclassification for provisions, contingent liabilities and financial guarantees which reflects the major types of liabilities and contingencies that governments most usually have. In addition, further tailoring should still be possible to reflect the particular circumstances of each government.