IPSASB®

STAFF QUESTIONS AND ANSWERS

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ACCOUNTING FOR CONTINGENCIES AND FINANCIAL GUARANTEES

How do IPSAS deal with contingencies and financial guarantees?

Insight into how International Public Sector Accounting Standards™ (IPSAS™) reflect the accounting consequences of contingencies and financial guarantees.

Effective public financial management requires transparency and a strong understanding of the economic reality of an entity. In response to the COVID-19 pandemic, many governments and public sector entities were innovative in how they provided interventions to deliver support, including using what are called contingencies in the System of National Accounts (SNA 2008) and the Government Finance Statistics Manual (GFSM 2014) that include transactions such as loan guarantees which have specific guidance in IPSAS. The use of contingencies and loan guarantees to intervene and provide support may be seen as "costless" because of the lack of initial cash outflows. However, such interventions introduce significant financial risks that should be appropriately reported.

To provide a complete and more transparent picture of an entity's economic position and a better understanding of its risks, the accounting for contingencies and loan guarantees under IPSAS often occurs at the inception of these items. This is because these items can introduce significant financial risks which need to be considered to understand the true financial position of the entity.

This Q&A highlights issues which may be encountered when accounting for contingencies and loan guarantees. While not exhaustive, it identifies several IPSAS which may be applicable in order to capture the economic consequences of the different types of transactions. It does not reference any specific transaction, nor is it intended to be used as application or implementation guidance. The terms and conditions of specific transactions can be highly complex and wide-ranging.

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Q1. ***What are the different types of contingencies and financial guarantees addressed by IPSAS?***

Under IPSAS, contingencies in SNA 2008 and GFSM 2014, are treated as contingent liabilities and provisions, and financial guarantees and are addressed by the following standards:

- **IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*:** Contingent liabilities and provisions are accounted for under IPSAS 19 and is discussed in more detail in Question 2 below; and
- **IPSAS 41, *Financial Instruments*:** Financial guarantees fall within the scope of IPSAS 41. The accounting for financial guarantees is discussed in Questions 3 and 4 below.

Q2. ***How are contingent liabilities accounted for under IPSAS 19?***

A contingent liability is defined as:

- A possible obligation that arises from past events, whose existence will be confirmed by the one or more uncertain future events that are not wholly within the control of the reporting entity; or
- A present obligation that arises from past events but is not recognized because it is not probable that an outflow of resources will be required, or the amount of the obligation cannot be reliably measured.

Under IPSAS 19, contingent liabilities are not recognized but are required to be disclosed in the notes of the financial statements. In addition, IPSAS 19 provides guidance for provisions, which are recognized liabilities of uncertain timing or amount.

The relationship between contingent liabilities and provisions is as follows:

- For all potential outflows where the probability of outflow is remote, no accounting or disclosures are required.
- If the potential outflow arises from a possible obligation—that is, the past event which gives rise to the obligation has not occurred yet—and the probability of outflow is not remote, the potential outflow is a contingent liability and is disclosed in the notes to the financial statements.
- If the potential outflow arises from a present obligation—that is, the past obligating event has already occurred—but the outflow is not probable or the amount of the outflow cannot be reliably measured, the potential outflow is also considered a contingent liability that should be disclosed.
- In cases where there is a present obligation, the probability of outflow is likely, and the amount of the outflow can be reliably estimated, the potential outflow is a provision that is recognized as a liability in the financial statements.

Q3. ***How are financial guarantees accounted for under the IPSAS?***

A financial guarantee is defined in IPSAS 41 as a contract that requires 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.

The accounting for financial guarantees depends on whether the transaction arises from an exchange or non-exchange transaction:

- For financial guarantees originating from an exchange transaction—that is, a transaction where an entity receives consideration (i.e., a fee) in exchange for the issuance of the guarantee—the financial guarantee is initially recognized upon issuance and measured at the amount of consideration received; and
- For financial guarantees arising from a non-exchange transaction, the financial guarantee is recognized upon issuance and measured at fair value. To determine fair value, an entity considers whether there are quoted prices available in an active market for a directly equivalent financial guarantee. Where there is no active market for a directly equivalent contract, the entity considers whether a valuation technique can provide a reliable measure of fair value. If no reliable measure of fair value can be determined, an entity is required to measure the financial guarantee contract at the amount of the loss allowance which reflects the potential outflows from the contract.

For guarantees arising from both exchange and non-exchange transactions, the guarantee is subsequently measured at the higher of:

- The estimate of a loss allowance reflecting potential outflows from the guarantee; and
- The initially recognized amount less any amounts recognized as revenue in accordance with the principles in IPSAS 47, *Revenue*.[1] That is, the fee is amortized into revenue over the life of the guarantee.

If a financial guarantee is called, the financial liability representing the guarantee is adjusted to the amount that the guarantor is required to pay. Due to the measurement requirements noted above, there may be situations where the estimated loss allowance has already been adjusted prior to the formal notice of calling upon the guarantee. The guarantor continues to account for the financial liability in accordance with the terms of the guarantee contract (for example, if the contract requires immediate payment, the financial liability is presented as a current liability). If the guarantor and the lender decide to renegotiate the terms of the payment, the guidance on derecognition of financial liabilities is applied to determine if the renegotiation resulted in a modification or an extinguish followed by the issuance of new debt.

In addition, IPSAS 30, *Financial Instruments: Disclosures*, requires the disclosure of information relating to the exposure to credit and liquidity risks arising from financial guarantees, including the maximum amount that the entity could have to pay if the guarantee is called.

Q4. How is the loss allowance for a financial guarantee measured?

The expected credit loss model is meant to reflect an entity's true economic position by ensuring that it recognizes an appropriate estimate of its credit losses. Generally, an allowance for expected credit losses is initially estimated based on the 12-month expected credit losses arising from the financial guarantee contract. If the credit risk associated with the guaranteed instrument has significantly increased, the loss allowance is required to be measured using the lifetime expected credit losses of the guarantee. To determine if a significant increase in credit risk has occurred, the entity considers changes in the probability of default occurring over the term of the guarantee.

When a financial guarantee relates to an instrument that is already credit-impaired upon the initial recognition of the guarantee, the loss allowance is estimated using the lifetime expected credit losses.

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1 If an entity has not yet adopted IPSAS 47, the revenue recognition principles in IPSAS 9, *Revenue from Exchange Transactions*, are applied.

This scenario may be applicable to financial guarantees that were issued to support entities that are in financial distress.

The above measurement requirements are meant to reflect the economic risks of issuing a financial guarantee. As a guarantee becomes more and more likely to be called, the estimated loss allowance and the corresponding liability will increase towards the maximum amount that the guarantor is liable to pay upon a default in accordance with the terms of the guarantee.

Q5. ***Are there any differences between IPSAS and International Financial Reporting Standards (IFRS) that should be considered when determining the accounting treatments of contingencies?***

In general no, as many IPSAS draw upon existing IFRS where these are relevant and are developed using IPSASB's *Process for Reviewing and Modifying IASB Documents*[2]. However, the IPSAS suite of standards also includes wholly public sector-specific guidance on transactions, including the accounting for financial guarantee contracts arising from non-exchange transactions, as discussed in Q3.

Q6. ***Are IPSAS requirements consistent with government finance statistical guidelines for accounting for contingencies (e.g., SNA 2008, GFSM 2014 or ESA 2010[3])?***

It depends on the facts and circumstances of the transactions and the nature of the contingencies. Key similarities and differences are as follows:

- IPSAS 19 requires the recognition of provisions whereas statistical guidelines do not recognize provisions, except for standardized guarantees where a financial liability is recognized.
- Both IPSAS 19 and statistical guidelines require the disclosure of contingent liabilities.
- IPSAS 41 provides a single accounting model for financial guarantees (see answers to Q3 and Q4). Whereas statistical guidelines provide a dual accounting model depending on whether it is a one-off guarantee or a standardized guarantee.
- IPSAS 41 requires all financial guarantees to be recognized at inception. Similarly, under statistical guidelines, standardized guarantees are recognized at inception, whereas one-off guarantees of entities that are not in financial distress are only recognized when the guarantee is called.

Looking Forward

As governments continue to innovate and move away from direct funding when providing support, these programs may have a novel impact on the financial position of public sector entities. The financial risks that various support schemes have on public sector entities means more than ever that transparent accounting is needed to ensure that entities and their users are aware of such risks and that they are appropriately managed and considered in the management of an entity's finances. The IPSASB staff will continue to monitor the situation and update this document as necessary.

This publication does not constitute an authoritative pronouncement of the IPSASB, nor does it intend to amend, or override the requirements of existing IPSAS or provide further implementation guidance. This publication is not meant to be exhaustive and is not a substitute for reading the relevant IPSAS.

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2 https://www.ipsasb.org/publications/process-reviewing-and-modifying-iasb-documents

3 The *Manual on Government Deficit and Debt – Implementation of ESA 2010* also provides extensive and more detailed guidance on this topic.

Key Contacts

Ross Smith, IPSASB Program and Technical Director (rosssmith@ipsasb.org)

Edwin Ng, IPSASB Principal (edwinng@ipsasb.org)

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