Demystifying Sovereign Contingent Liabilities

Faculty Advisor:
Prof. Thomas Byrne

Authors:
Alison Aman
Clemens Graf von Luckner
Mohammad Shadan Khan
James Kobus
Jiayi Li
Masamichi Narasaki
Wanran Zhu

Capstone Client

EXECUTIVE SUMMARY

Contingent liabilities are not direct obligations and are thus rarely reported on sovereign balance sheets, even under best-practice accounting standards. Although contingent liabilities are sometimes included in the footnotes to sovereign financial statements, disclosure is often not transparent. It can therefore prove difficult to identify sovereign contingent liability exposure in advance. The IMF has noted that countries with stronger institutions are better able to control and reduce risks to contingent liability crystallization. Yet, even in such countries contingent liabilities have had a major toll on public finances, notably during the 2008 global financial crisis. The ongoing coronavirus pandemic is exerting even greater pressure in an exceptionally short amount of time on advanced and emerging market sovereigns alike, threatening another spike in contingent liability crystallization.

These dynamics can create a variety of problems for stakeholders. Policymakers may find themselves in weaker-than-expected fiscal positions if they rely on budget projections that did not factor in contingent liability exposure. Lenders and investors utilizing sovereign balance sheets to perform financial analyses may underestimate the true indebtedness of the sovereign entity they are assessing. When an undisclosed contingent liability ultimately crystallizes and is disclosed to investors, sovereign entities may face increased borrowing costs at precisely the time they need to raise funds. Sovereign exposure to contingent liabilities also tends to rise during periods of crisis, adding further stress to a government's budget.

After discussing the importance of contingent liabilities, this report outlines the two prominent public sector financial reporting standards, International Public Sector Accounting Standards (IPSAS) and Government Finance Statistics (GFS). From here, it profiles eight specific types of sovereign contingent liabilities - explicit government guarantees, ECA financing, implicit government guarantees, PPPs, hedging derivatives, environmental & natural disaster liabilities, intragovernmental loans, and social benefits - and delineates how each is reported under both frameworks.

Next, the report outlines a proprietary database created for this report, compiling the accounting standards utilized, dates of transition, credit ratings, sovereign debt costs, and other macroeconomic data across 51 countries and six continents. A variety of statistical analyses are included examining the relationships between accounting transparency and sovereign borrowing standing.

The paper then profiles three deep-dive country case studies focused on the United Kingdom, Malaysia, and South Africa. The UK case study demonstrates that even countries considered to be in the top echelon of financial reporting do not report most contingent liabilities on balance sheet. The Malaysia case study explores the risks public-private partnerships (PPPs) present for sovereign balance sheets. The South Africa case study concludes that fiscal transparency only serves to improve a government's borrowing position when the increased transparency does not lead to the uncovering of large contingent liabilities that before had not been made transparently available.

The paper concludes with key takeaways for issuing governments, including:

- Greater fiscal transparency improves sovereign borrowing position
- Accrual accounting is more transparent than cash accounting, enhancing credit quality under certain circumstances
- Transparency is beneficial but underlying contingent liability exposure must also be addressed; providing transparent financial reports is resource-intensive
- Developing an international enforcement ecosystem would be beneficial

Key takeaways for lenders and investors, including:

- Assessing contingent liability exposure is essential for sovereign debt analysis
- Take notice of the accounting framework a sovereign issuer is using
- Appreciate the degree of discretion that goes into sovereign liability disclosure

SIPA

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Acknowledgements

The Columbia SIPA Capstone team would like to extend our gratitude to our mentors, interviewees, participants, and advisors who made our research possible.

The team would like to extend a special thanks to **Thomas Byrne**, Adjunct Professor of International and Public Affairs, Columbia SIPA, whose advising and feedback guided us throughout this research project.

Suzanne Hollmann, Saleha Awal, and the rest of the Columbia SIPA Capstone Program for their logistical support.

Christian de Guzman, **Dietmar Hornung**, and **Lucie Villa** for their insights and perspective on the role of contingent liabilities in sovereign credit analysis.

Glossary of Terms

1MDB - 1Malaysia Development Berhad
ASB - Accounting Standard Board of South Africa
ASEAN - Association of Southeast Asian Nations
BIS - Bank for International Settlements
BNM - Bank Negara Malaysia
COA - Chart Of Accounts
DMC - Debt Management Committee
DOSM - Department of Statistics Malaysia
ECA - Export credit agency
EFSM - European Financial Stabilisation Mechanism
e-GDDS - Enhanced General Data Dissemination System
EIB - European Investment Bank
ESA - European System of Accounts
ETP - Economic Transformation Program
FDI - Foreign Direct Investment
FRTS - Fiscal Reporting Transparency Score
FTC - Fiscal Transparency Code
GAAP - Generally Accepted Accounting Principles
GDP - Gross Domestic Product
GDRM - Government Debt and Risk Management
GFS - Government Finance Statistics
GFSM - Government Finance Statistics Manual
GGS - General Government Sector
GLC - Government-linked Companies
IFRS - International Financial Reporting Standards
IMF - International Monetary Fund
IPP - Independent Power Producers
IPSAS - International Public Sector Accounting Standards
IPSASB - International Public Sector Accounting Standards Board
MOF - Ministry of Finance
MPSAS - Malaysia Public Sector Accounting Standards
NAO - National Accounting Office
NEP - New Economic Policy
NFPC - Nonfinancial Public Corporations
ONS - Office of National Statistics
PFC - Public Financial Corporations
PNFC - Public Non-Financial Corporation
PPE - Plant, Property and Equipment
PPP - Public–Private Partnership
PSND - Public Sector Net Debt
RAF - Road Accident Fund
RBI - Reserve Bank of India
RCAP - Regulatory Consistency Assessment Program
SARB - South African Reserve Bank
SCA - Service Concession Agreement
SDDS - Special Data Dissemination Standard
SDG - Sustainable Development Goals
SNA - System of National Accounts
SOE - State Owned Enterprises
SPV - Special Purpose Vehicle
WGA - Whole of Government Accounts

SECTION I: BACKGROUND

What Are Contingent Liabilities?

The IMF defines Contingent liabilities of the sovereign as obligations that do not arise unless particular discrete events occur in the future.[1] This means that the potential obligation and the amount of future payment are uncertain. In contrast, direct liabilities are those whose settlement date is fixed when the nominal obligation is incurred by the sovereign, namely Treasury bills or bonds. The terms "crystallization" or "realization" are often used once the assumption of the obligation by the sovereign is established.

Contingent liabilities can be classified as either "explicit" or "implicit" contingent liabilities. Explicit contingent liabilities are those that arise from legal or contractual agreements. These are typically structured via government guarantee contracts. Implicit contingent liabilities in contrast arise out of public expectation or political pressure. The textbook example of this comes in the form of government bailouts. The United States (US) government for example was not contractually obligated to guarantee the liabilities of Fannie Mae and Freddie Mac - two quasi-government entities that have an effective monopoly on the US secondary mortgage market. Yet, the immense scale of these two entities' operations meant that the failure of these organizations would have represented a systematic risk to the US economy and financial system. So, as the US mortgage market deteriorated starting in 2007, the US government stepped in and placed the entities into conservatorship.[2]

Figure 1: Explicit vs. Implicit Contingent Liabilities

Explicit Contingent Liabilities	**Implicit** Contingent Liabilities
• Arise from legal or contractual agreements • Scope and nature of the liability are clearly defined • Examples: legal government guarantees, PPP arrangements, certain environmental liabilities	• Not legally or contractually defined but rather arise out of public expectation or political pressure • Scope and nature of the liability are uncertain • Example: government "bailouts"

Source: compiled across a variety of reports, these have become widespread industry classifications.

1 Bova, Elva, et al. *IMF Working Paper: The Fiscal Costs of Contingent Liabilities: A New Dataset*. IMF, Jan. 2016, www.imf.org/external/pubs/ft/wp/2016/wp1614.pdf

2 *The Rescue of Fannie Mae and Freddie Mac*. Federal Reserve Bank of New York, Mar. 2015, www.newyorkfed.org/medialibrary/media/research/staff_reports/sr719.pdf

Why Do Contingent Liabilities Matter?

Contingent liabilities in many cases turn out to be true economic debts for sovereign entities, yet they are typically not reported on sovereign balance sheets. While not all contingent liabilities will be realized, some of them certainly will on a probability-weighted basis. This means that the expected value of the contingent liabilities is real and in many cases large, and yet disclosure is often not highly transparent.

These dynamics can create a variety of problems for stakeholders. Policymakers may find themselves in weaker-than-expected fiscal positions if they rely on budget projections that did not factor in contingent exposure. Lenders and investors utilizing sovereign balance sheets to perform financial analyses may underestimate the true indebtedness of the sovereign entity they are assessing. When an undisclosed contingent liability ultimately crystallizes and is disclosed to investors, sovereign entities may face increased borrowing costs at precisely the time they need to raise funds.

These are not just theoretical possibilities. Looking at a dataset from 80 advanced and emerging economies, a 2014 IMF paper identified 230 contingent liability realizations in advanced and emerging economies from 1990-2014. The average fiscal cost of these events was a meaningful six percent of GDP, with costs as high as 40 percent for major financial sector bailouts.[3]

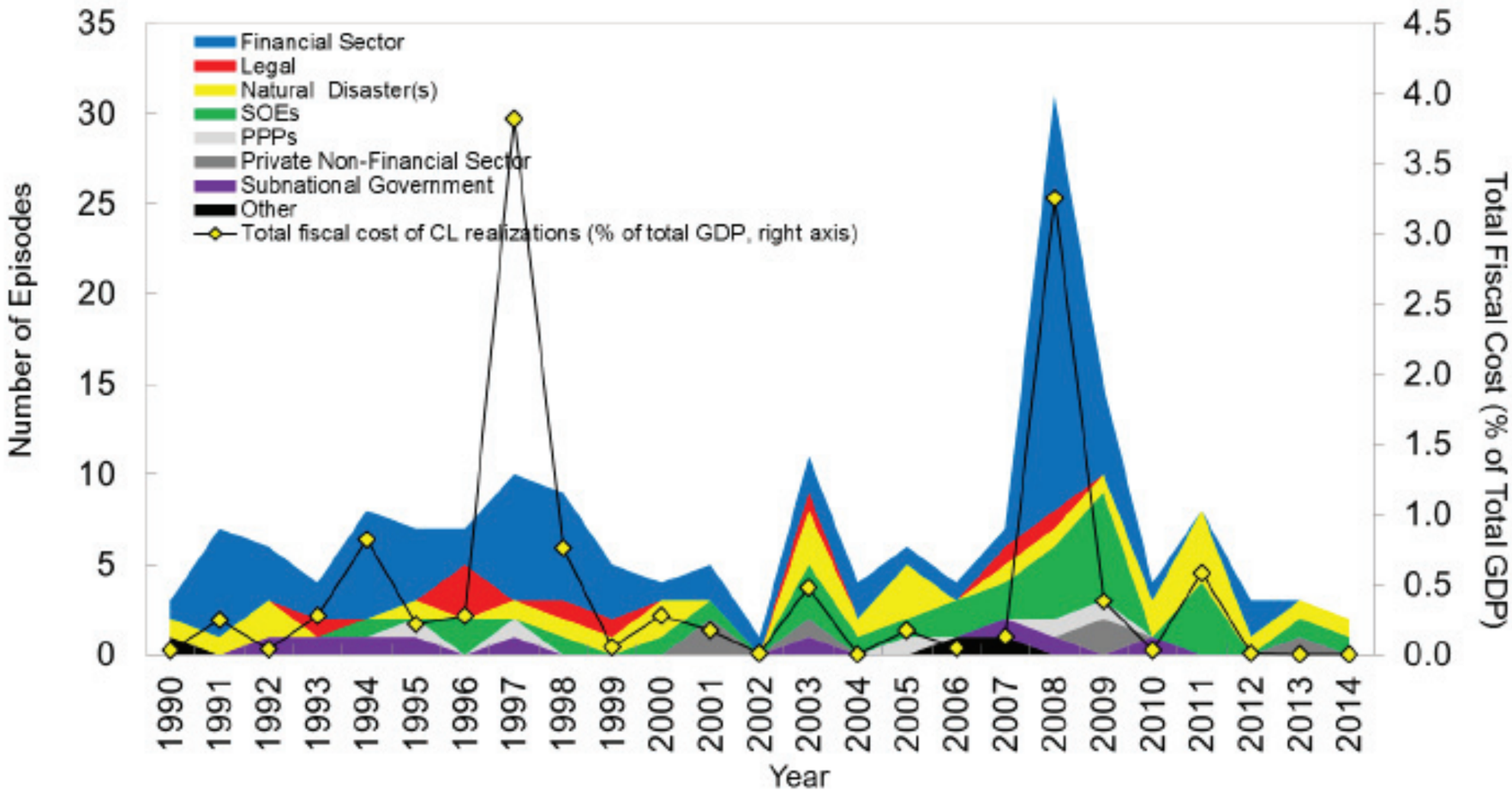
Table 1: Realized Fiscal Liabilities Across 80 Countries, 1990-2014

Type of Contingent Liabilities	Number of Episodes	Number of Episodes with Identified Fiscal Costs	Avg. Fiscal Costs (% GDP)	Maximum Fiscal Costs (% of GDP)
Financial Sector	91	82	9.7	56.8
Legal	9	9	7.9	15.3
Subnational Government SOEs	13	9	3.7	12
SOEs	32	31	3	15.1
Natural Disaster(s)	65	29	1.6	6
Private Non-Financial Sector	7	6	1.7	4.5
PPPs	8	5	1.2	2
Other	5	3	1.4	2.5
Total	230	174	6.1	56.8

Source: IMF, footnote 1

3 Bova, Elva, et al. *IMF Working Paper: The Fiscal Costs of Contingent Liabilities: A New Dataset*. IMF, Jan. 2016, www.imf.org/external/pubs/ft/wp/2016/wp1614.pdf

Figure 2: Contingent Liability Realizations by Year and Type



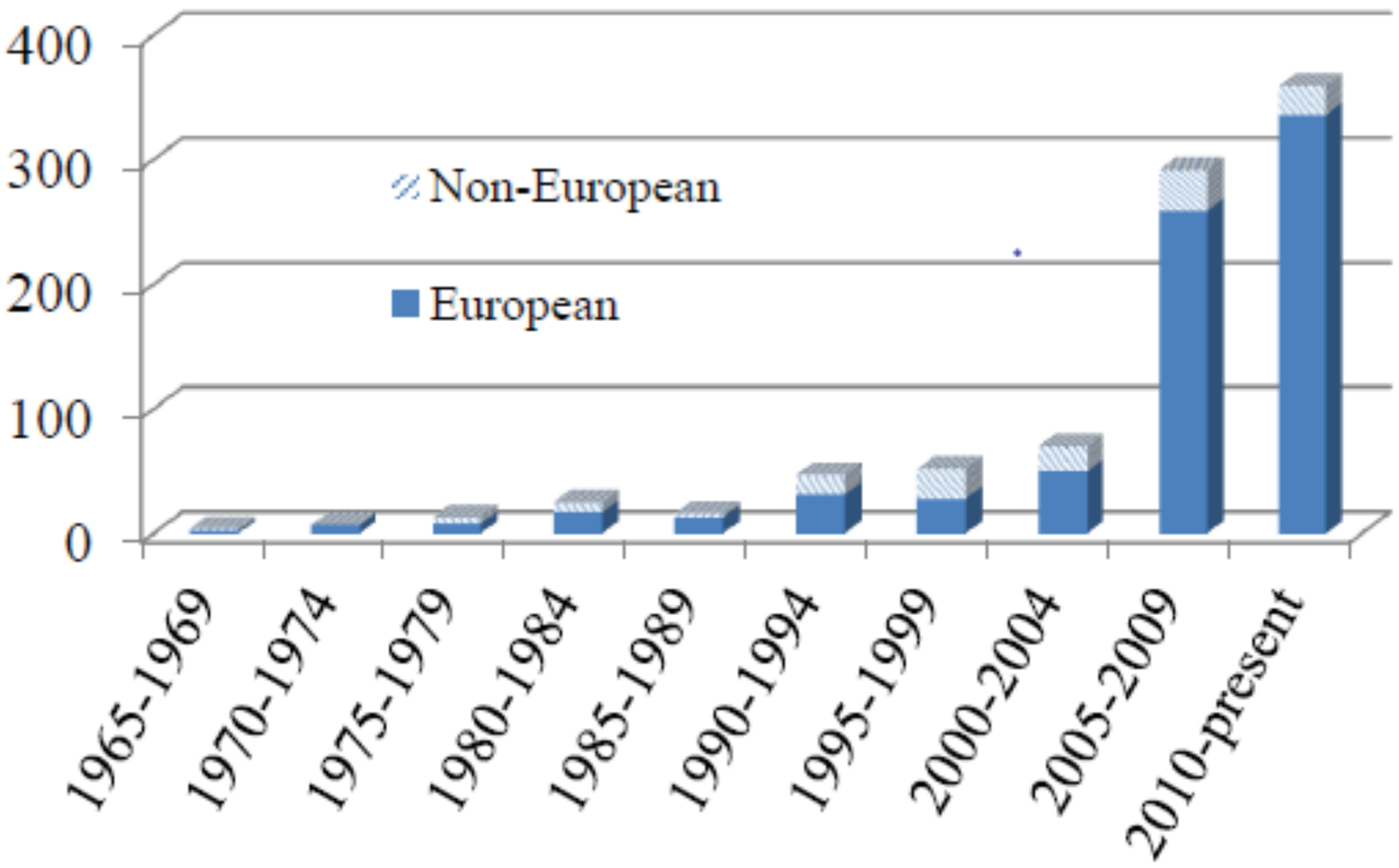
Source: IMF, footnote 1

More recently, the Republic of Congo in 2015 failed to disclose ~$1 billion in commodity advances that required repayment. The IMF, upon finding out about the arrangement, restated the country's estimated debt-to-GDP ratio from 77% to 117%.[4] In July 2016, Moody's downgraded Mozambique to Caa3 after the disclosure of $1 billion of previously unreported state-owned-enterprise debt that carried sovereign guarantees.[5]

Despite examples such as these, contingent liabilities and specifically government guarantees have been utilized with increasing frequency in the wake of the 2008 global financial crisis and the European debt crisis.[6] One potential explanation for this phenomenon is that governments are intentionally utilizing such instruments as a way of borrowing against the sovereign's credit strength without having to increase balance sheet liabilities. Whenever a sovereign entity wants to financially facilitate an enterprise or project that is not consolidated under the federal government or general government sector reporting, it has two options: 1) borrow funds directly and then re-lend to the enterprise / project or 2) wrap a sovereign guarantee around the issuing entity. The first option puts the debt directly on the sovereign balance sheet while the second does not.[7]

4 Lucie Villa et al, *Risks from Financial Misreporting Vary, Disclosure Has Major Credit Implications*. Moody's Investor Service, 21 Mar. 2019.
5 Ibid
6 Bucheit, Lee, and G. Mitu Gulati. *The Gathering Storm: Contingent Liabilities in a Sovereign Debt Restructuring*. 21 Aug. 2013, https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5814&context=faculty_scholarship
7 Buchheit, Lee, and G. Mitu Gulati. "Restructuring a Sovereign Debtor's Contingent Liabilities." *SSRN*, 27 Dec. 2012, papers.ssrn.com/sol3/papers.cfm?abstract_id=2194099

Figure 3: Number of Bonds with Sovereign Guarantees, Jan 1, 1965 - July 1, 2013 (n=885)



Source: Footnote 6

These dynamics raise important questions for sovereign borrowers, policymakers, and investors alike. How are the major categories of contingent liabilities treated under the prominent public reporting standards? What are the relationships between the choice of accounting standard, transparency, and sovereign debt costs? Are sovereign issuers better off being transparent about their contingent liability exposure, even though many of the liabilities will never crystallize? What lessons can be gleaned from countries that have transitioned to more transparent reporting standards? The remaining sections of this report will explore these questions, among others.

SECTION 2: OVERVIEW OF PUBLIC-SECTOR FINANCIAL REPORTING STANDARDS

Before diving into specific categories of sovereign liabilities, this section will first provide an overview of the two major public-sector financial reporting frameworks: International Public Sector Accounting Standards (IPSAS) and Government Finance Statistics (GFS). These reporting standards make it possible for investors and policy makers to compare financial stocks and flows across countries. The frameworks also outline how sovereign liabilities, including contingent liabilities, should be disclosed. By understanding these guidelines, investors and policymakers can better understand the level of transparency that is entailed when a country adopts one of these frameworks.

International Public Sector Accounting Standards (IPSAS)

International Public Sector Accounting Standards (IPSAS) are a set of accounting standards issued by the International Public Sector Accounting Standards Board (IPSASB) for use by public sector entities around the world in the preparation of financial statements.

IPSAS is designed to apply to public sector entities that meet all of the following three criteria: 1) are responsible for the delivery of services to benefit the public and/or to redistribute income and wealth; 2) mainly finance their activities, directly or indirectly, utilizing taxes and/or transfers from other levels of government, social contributions, debt or fees; and 3) do not have a primary objective to make profits. Therefore, IPSAS is usually applicable to national governments, regional (e.g., state, provincial, territorial) governments, local (e.g., city, town) governments and related governmental entities (e.g., agencies, boards and commissions). IPSAS standards are also widely used by intergovernmental organizations or institutions and do not apply to government business enterprises.[8]

In the 2019 edition, IPSAS contains 42 standards based on accrual accounting systems and one standard for cash-based accounting.

IPSAS is prepared based on its private-sector equivalent, the International Financial Reporting Standards (IFRS). IPSAS adapts IFRS to the public sector context and tries to maintain the accounting treatment and original text of the IFRS unless there is a significant public sector issue that warrants a departure. One key difference between the two is that IPSAS 24 requires a public sector entity to present the comparison between budgeted amounts and the actual amounts that arise from executing the said

8 IPSASB, Preface of International Public Sector Accounting Standards, p14, https://www.ifac.org/system/files/publications/files/IPSASB-HandBook-2019_Volume-1_Locked_0.pdf

budget, which helps to demonstrate how well the public sector entity manages public funds and provides services. There is no equivalent standard under IFRS. Another major difference is in the area of income taxes. Public sector entities are assumed to be generally exempt from income taxes and consequently IFRS 12 Income Taxes doesn't have an equivalent in IPSAS.[9]

The objective of IPSAS is to improve the quality and comparability of financial information reported by public sector entities around the world, leading to better informed assessments of the resource allocation decisions made by governments, and thereby increasing transparency and accountability of governments.[10] Governments or national standard-setters have the right to establish accounting standards and guidelines for financial reporting in their jurisdictions.[11] Therefore, several country governments are developing a set of country-specific standards based on IPSAS, e.g. Vietnam.

Though several countries have fully adopted the IPSAS, there are more countries that are in transition or haven't adopted it. One reason is that it usually takes several years to transfer from a cash-based accounting standard to an accrual-based one. The other problem is the key requirement to produce consolidated financial statements for all controlled entities, including ministries and departments, and business entities, which is a time-consuming and resource-intensive process, to be discussed later in this report.

Under IPSAS, Contingent liability arises when: a) there is a possible obligation to be confirmed by a future event that is outside the control of the entity; b) present obligation may, but probably will not, require an outflow of resources embodying economic benefits or service potential; and c) A sufficiently reliable estimate of the amount of a present obligation cannot be made.[12]

Government Finance Statistics (GFS)

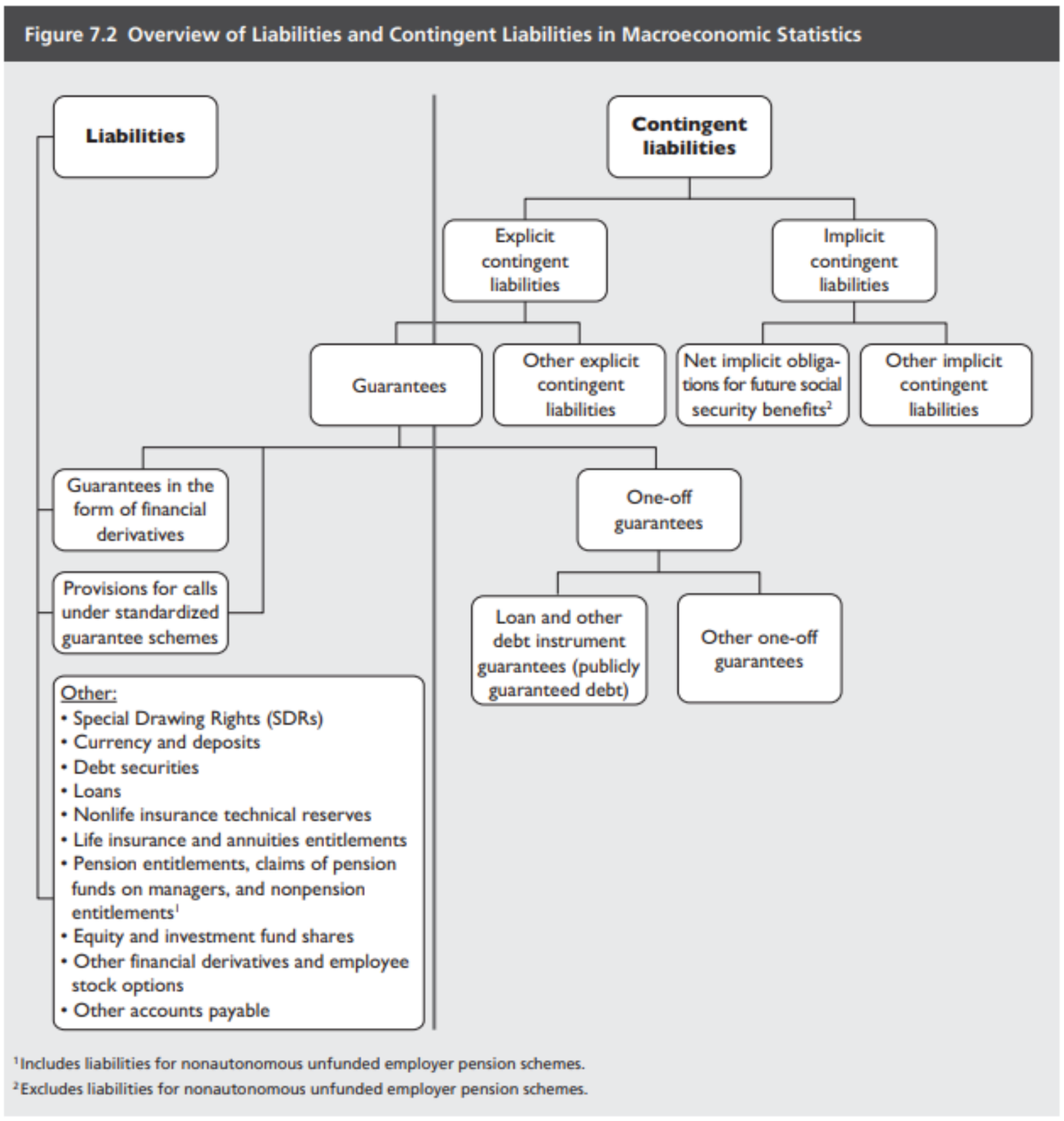
The Government Finance Statistics (GFS) were developed by the International Monetary Fund (IMF) and serve as one of three core components of the System of National Accounts (SNA). The other two components of the SNA are the External Sector Statistics and the Monetary and Financial Statistics standards. The GFS serves as a comprehensive conceptual and reporting macroeconomic statistical framework that is designed to facilitate sound fiscal analysis and policy making for central governments. It covers both fiscal and debt statistics for the public sector and its sub-sectors.

GFS addresses contingent liabilities in section 7.251 of the Government Finance Statistics Manual (GFSM 2014), mainly focusing on the treatment of explicit contingent liabilities in the form of government guarantees or implicit contingent liabilities in the form of social security benefits. Figure 4 is a flowchart

9 IPSAS vs. IFRS: How do they differ?, http://www.sgv.ph/ipsas-vs-ifrs-how-do-they-differ-by-lloyd-kenneth-s-chua-june-2-2014/
10 https://en.wikipedia.org/wiki/International_Public_Sector_Accounting_Standards
11 IPSASB, Preface of International Public Sector Accounting Standards, p16, https://www.ifac.org/system/files/publications/files/IPSASB-HandBook-2019_Volume-1_Locked_0.pdf
12 IPSAS19 - Provisions, Contingent Liabilities and Contingent Assets, https://www.ifac.org/system/files/publications/files/A11-IPSAS_19.pdf

representing the decisions accounting professionals should go through in determining how to categorize a contingent liability under GFS. The GFS defines an explicit contingent liability as one that requires a legal obligation. If no legal obligation is specified, it is categorized as an implicit liability and then further categorized as either a *net implicit obligation of Future Social Security Benefits* or *Other*. For explicit contingent liabilities there are also two categories - *Guarantees* and *Explicit contingent liabilities not elsewhere classified*. Categories to the left of the vertical line generally wind up being reported on the balance sheet; categories to the right of the line, where most contingent liabilities are located, escape balance sheet disclosure.

Figure 4: Overview of Liabilities and Contingent Liabilities Under GFS



Source: Government Finance Statistics Manual 2014, pg 211

The GFS assigns a record memorandum item number to each category (6M61 -6M7) of contingent liability which then can be included on the Balance Sheet. For additional information, a *Summary Statement of Explicit Contingent Liabilities and Net Implicit Obligations for Future Social Benefits* is included with the Balance Sheet. It contains more details on the obligations disclosed in the statement.

Figure 5: Summary Statement of Explicit Contingent Liabilities and Net Implicit Obligations for Future Social Security Benefits

Table 4.6 Summary Statement of Explicit Contingent Liabilities and Net Implicit Obligations for Future Social Security Benefits

6M6	**Total explicit contingent liabilities**
6M61	Publicly guaranteed debt[1]
6M62	Other one-off guarantees[2]
6M63	Explicit contingent liabilities not elsewhere classified
	Legal claims
	Indemnities
	Uncalled share capital
	...
6M7	**Net implicit obligations for future social security benefits**
	Present value of implicit obligations for future social security benefits
	Minus: Present value of future contributions to social security schemes

[1]It is recommended that details of publicly guaranteed debt (i.e., loan and other debt instrument guarantees) are shown by maturity and type of debt instrument, at nominal values.

[2]For example, credit guarantees and other similar contingent liabilities (such as lines of credit and loan commitments), contingent "credit availability" guarantees, and contingent credit facilities.

Source: Government Finance Statistics Manual 2014, pg 77

Table 2: IPSAS Comparison with GFSM

	IPSAS	GFSM
Authority	International Accounting Standard Board (IPSASB)	International Monetary Fund (IMF)
Objective	Financial Reporting: Evaluate financial performance and position	Macroeconomic Statistics: Evaluate economic impact
Private Sector Equivalent	IFRS	N/A
Recognition Criteria	Past events with probable outflows are recognized (economic event has taken place; the amount can be reliably measured; future outflows are probable) • counterparty asymmetry • contingent liabilities disclosed in the footnote	Economic events recognized (when economic value is created, transformed, exchanged, transferred, or extinguished) • symmetry for both parties of each transaction • provisions for unrecognized items are included in the GFS memorandum
Valuation Method	Fair value, historical cost, and other bases	Current market prices
Contingent Liability	Arises when: • There is a possible obligation to be confirmed by a future event that is outside the control of the entity; • A present obligation may, but probably will not, require an outflow of resources embodying economic benefits or service potential; • A sufficiently reliable estimate of the amount of a present obligation cannot be made.	Arises when: • GFS reports most contingent liabilities under an appendix called “Summary Statement of Contingent Liabilities” rather than on the balance sheet • Guarantees structured as financial instruments are a key exception • A distinction is made between explicit and implicit contingent liabilities

A Quick Note on Cash vs. Accrual

Although cash accounting is permitted under both IPSAS and GFS, IPSASB and the IMF recommend the transition from cash to accrual accounting. Some of the general advantages that make accrual superior to cash accounting for private companies also matter for sovereigns: for instance, recording all payments to one counterparty and one good/service at once, rather than dividing them up over different accounting periods significantly increases oversight and organizability.

Cash based accounting also ignores non-cash expenses such as depreciation and amortization. There are however some additional aspects that render accrual accounting a major advancement for sovereigns – especially those who have not yet gained the confidence of financial markets in the accuracy of their balance sheet related publications. By nature, sovereigns represent large entities, which means often enough that contracts the sovereigns engage in come with very large payments. Accumulating some arrears on payables can lead to a sovereign balance sheet that looks significantly more sustainable than if it included the obligations from “unpaid bills”. Under accrual accounting standards, where payments are accounted for when they are certain to arise, not when they actually occur, the balance sheet more accurately reflects the economic debts owed by the sovereign.

Applying a cash accounting method does not mean a sovereign is hiding its arrears, which is essentially equal to hiding outstanding debt obligations, but the sovereign technically could. Interestingly, there are some developed countries such as Germany and Japan that still apply cash accounting. However, because the countries have achieved the confidence of the market to forego possible arrear accumulation in the short run, moving from cash to accrual would have a less significant impact on transparency and investor perceptions. For emerging economies however, that generally encounter more skeptical investors when publishing their budgets and financial statistics, transitioning to accrual accounting can significantly increase perceived transparency. Mainly because it removes one aspect from investors’ perceived risk matrix: the possibility of existing accumulated arrears finding their way on the balance sheet and significantly impacting the sovereign’s debt sustainability. Cases where this happened in recent times include Gabon in 2017 (with arrears worth 6% of GDP) or the Bahamas in 2017 (equally with arrears worth 6% of GDP)[13] – both cases led to a deterioration in sovereign ratings, indicative of the impact on perceived default risk, but also investor confidence.

[13] Lucie Villa et al, *Risks from Financial Misreporting Vary, Disclosure Has Major Credit Implications*. Moody's Investor Service, 21 Mar. 2019.

SECTION 3: EXAMINING EIGHT CATEGORIES OF SOVEREIGN CONTINGENT LIABILITIES

(1) Explicit Government Guarantees

Overview of Explicit Government Guarantees

In a broad sense, an explicit government guarantee is an agreement under which a government body assumes the responsibility of payment by the primary borrower of a loan or execution of an obligation in case of a default. Government guarantees can be divided into either explicit guarantees or implicit guarantees.

An explicit guarantee often requires a legal obligation to the government guarantor, which is autonomous and separately enforceable. It may also be expanded by legislation in cases such as public-private partnership (PPP), state-owned companies (ex. export credit agencies (ECA)), and deposit insurance schemes.

For explicit government guarantees, a distinction is made between standardized guarantees and one-off guarantees. Standardized guarantees are characterized by routinized transactions and issued to a large number of beneficiaries with standard terms and conditions. One-off guarantees are, on the other hand, non-standardized and have idiosyncratic characters. The reason why this distinction is important is that standardized guarantees are recognized as liabilities whereas one-off guarantees are categorized as contingent liabilities in GFS[14].

Explicit Government Guarantees Under IPSAS[15]

Under IPSAS19, guarantee obligations can either be recognized as provisions (liabilities) or disclosed as contingent liabilities. The standard specifies that a provision (liability) should be recognized in the financial

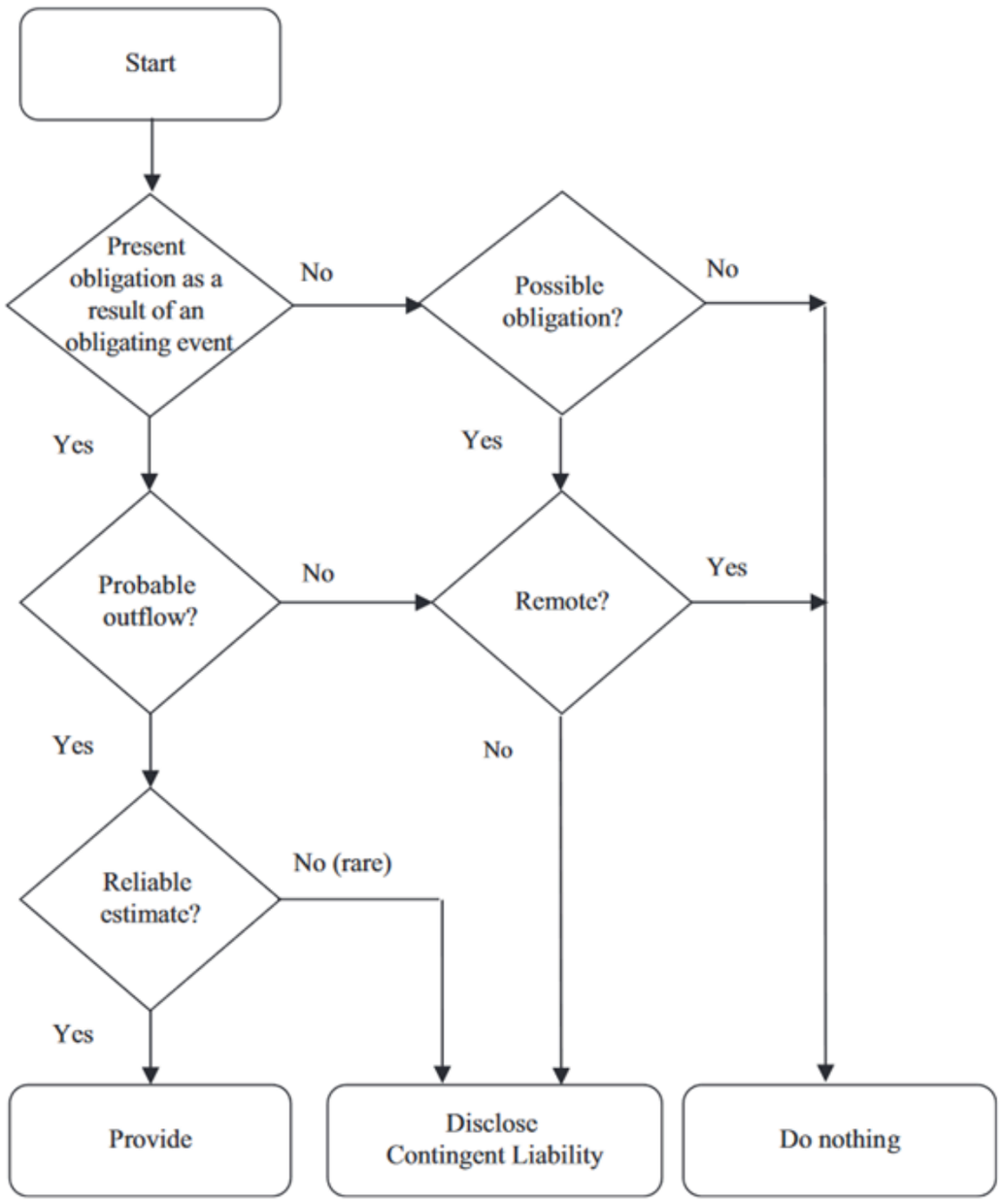
[14] International Monetary Fund. "Government Finance Statistics Manual 2014." *IMF*, 2014, www.imf.org/external/Pubs/FT/GFS/Manual/2014/gfsfinal.pdf.
[15] IPSASB. "2019 Handbook of International Public Sector Accounting Pronouncements." *IFAC*, 27 Feb. 2020, www.ipsasb.org/publications/2019-handbook-international-public-sector-accounting-pronouncements.

statement if there is more than a fifty percent probability that a guarantee will require future payments, and the amount of payments can be reasonably calculated.

The amount recognized as a provision should be the best estimate of the payments required to satisfy the obligation at the reporting date in terms of present value. The rules require that provisions should be reassessed at the end of each year to reflect the new best estimates.

An obligation that does not result in recognition requires declaration as a contingent liability unless the future obligations are so vague or doubtful that it would be inaccurate to report on them.

Figure 6: Flowchart of Recognition Under IPSAS



Source: IPSAS 19

Explicit Government Guarantees Under GFS[16]

GFSM2014 mandates that provisions for standardized guarantee arrangements are classified as a liability and included in public sector debt. In comparison, publicly guaranteed debt and other one-off guarantees are disclosed at nominal value as a memorandum item on a government's balance sheet.

16 International Monetary Fund. "Government Finance Statistics Manual 2014." *IMF*, 2014, www.imf.org/external/Pubs/FT/GFS/Manual/2014/gfsfinal.pdf.

Takeaways: Explicit Government Guarantees

As can be seen, IPSAS and GFS make a similar distinction but name the categories differently. One-Off-Guarantees under GFS are equal to Financial Guarantees under IPSAS, when the former are not recognized as insurance contracts. Meanwhile *standardized guarantees* under GFS are roughly equal to insurance contracts under IPSAS.

In both cases, guarantees only find their way onto sovereign balance sheets when payment is determined to be probable by the reporting entity. If the likelihood of payment is estimated to be under 50%, then disclosure is only required in the notes to the financial statements. If the probability of crystallization is deemed to be "remote," then no disclosure is required at all. As one can imagine, there is a significant deal of subjectivity and judgement inherent in estimating the probability of contingent liability realization. Users of sovereign financial statements should be aware of this dynamic when assessing the indebtedness of a sovereign entity.

(2) Export Credit Agency (ECA) Financing

Overview of ECA Financing

Export Credit Agencies (ECA) are created to promote exports, by means of providing the financing to pay for these exports to potential purchasing counterparties. ECAs also provide the exporter (=seller; =creditor) with a guarantee that the importer (= buyer; =debtor) will pay. Some ECA activities can thus be considered a sub-classification of explicit government guarantees.

In some cases, for example in China (Chinasure and ExIm) the ECAs are owned by the Chinese Sovereign Wealth Fund. In other cases there are directly state-owned financing entities. Regardless, the guarantees the agencies offer are always part of the Consolidated General Government Balance Sheet. As generally, these agencies generally issue many insurances and guarantees, the profits they make cover the losses from potential counterparty defaults. In some particular instances however, one-off guarantees can be huge in size, and the law of large numbers thus no longer applies, which is why the guarantee becomes a contingent liability to the sovereign.

The difference between a contingent and non-contingent liability is thus mainly a function of the guarantee's size, as well as the measurability of risk.

ECA Financing Under IPSAS

Under IPSAS, ECA-related obligations fall under guarantee and insurance schemes, and are not mentioned as an individual category within the reporting standards but are referred to as Financial Guarantees.

Financial Guarantees issued by a sovereign can be treated as an insurance contract unless there does not (yet) exist an obligation, because the former depends on the whether the guarantee being called. In this instance, a sovereign applying IPSAS reporting standards would not recognize the liability in its statement of financial positions, but must disclose it as an explicit contingent liability.

In contrast the financial guarantee can be reported as an on-balance-sheet insurance contract, when the risks and insured amount are well-identified, unambiguously measurable and confined to occur within a specified period[17].

ECA Financing Under GFS

GFS explicitly discusses ECAs, however just like under IPSAS, they are viewed as one of many kinds of guarantees a sovereign can grant to other market participants. GFS thereby strictly differentiates between one-off-guarantees and standardised guarantee schemes (p.202 of GFS)[18].

In the latter, the government insures a large number of creditors for their counterparty risks. These guarantee schemes operate similar to insurance companies, which derive their long-term financial stability from the law of large numbers and the statistical independence of individual defaults. The obligations arising from the standardised guarantees are thus non-contingent, and the ESA will be treated on the balance sheet like a sufficiently funded state-owned insurance company. With a large number of insurance contracts issued, the government should have fairly expectable returns from insuring the exports, hence removing any contingency.

In contrast, one-off-guarantees issued by an ECA are contracts, where the guarantee and the conditions under which it can be called are so particular that it is not possible to calculate the degree of risk associated with the debt with any degree of accuracy. An example for this are governments that issue individual guarantees of a very large size and thus the insurance scheme (which issues many small contracts) is no longer applicable. One-off guarantees are considered explicit contingent liabilities by the GFS.

They are contingent, as guarantors usually cannot reliably estimate the risk of guarantees being called by the insured. As a result, in most cases, one-off guarantees are considered a contingent liability (unless and until such guarantees are called and become non-contingent).

Takeaways: ECA Financing

GFS and IPSAS thus make a similar distinction but give different names to the respective categories. GFS' One-Off-Guarantees are equal to Financial Guarantees under IPSAS, when the former are not recognized as insurance contracts. Meanwhile *standardized guarantees* (GFS) are roughly equal to

17 IPSAS19 - Provisions, Contingent Liabilities and Contingent Assets, https://www.ifac.org/system/files/publications/files/A11-IPSAS_19.pdf

18 IMF, IMF. "Government finance statistics manual 2014." *Washington, DC: International Monetary Fund* (2014).

insurance contracts (IPSAS). ECA related obligations, as shown above, can thus only be standard liabilities or explicit contingent liabilities, and unlike other one-off-guarantee schemes (as for example the guarantee that implicitly secure the solvency of banks that are too big to fail) never give rise to implicit contingent liabilities.

(3) Implicit Government Guarantees

Overview of Implicit Government Guarantees

As mentioned, implicit government guarantees do not involve contractual government credit protection but rather arise out of public expectation, political pressure, or close affiliation with a government entity. By their very nature, implicit guarantees are generally not disclosed within sovereign financial reporting. In doing so, a government would be acknowledging the existence of the guarantee, at which point it would cease to be implicit.

Implicit Government Guarantees Under IPSAS

There does not appear to be a clear guidance on the implicit guarantees in IPSAS, which is unsurprising given the context discussed above. An obligation that does not result in recognition requires declaration as a contingent liability unless the future obligations are so vague or doubtful that it would be inaccurate to report on them.

Implicit Government Guarantees Under GFS

One potential implicit liability is mentioned under GFS. It is recommended that the net obligations for future social security benefits be included in the balance sheet as a separate memorandum items. Other potential implicit contingent liabilities such as bank bailouts or disaster relief funding are not mentioned in GFS.

Takeaways: Implicit Government Guarantees

By their nature, implicit contingent liabilities are generally not disclosed under public-sector financial reporting standards. Although there is a guideline on potential government social security assurances under GFS, there is a great deal of ambiguity and therefore broad discretion remains with governments. Nonetheless, implicit contingent liabilities are real, and policymakers, investors, and analysts should think carefully about systemic risk and potential government exposure. The IMF study mentioned earlier in this report found that implicit contingent liabilities have been among the most frequent and costly for sovereign

entities. More specifically, the study found that financial sector bailouts constituted nearly 40% of all identified crystallizations and on average the fiscal costs amounted to a staggering ~10% of GDP.[19]

(4) Public-Private Partnerships (PPPs)

Overview of PPPs

Public-Private Partnership (PPP) financing is a project finance structure which has gained prominence over the past couple of decades. It's a form of blended finance in which a separate legal entity usually called special purpose vehicle (SPV) is created for execution and running the project. There are various prominent models of execution which are prevalent across the globe such as design, build, operate, and transfer schemes (DBOT); build, own, and transfer schemes (BOTs); or build, own, operate, and transfer schemes (BOOTs). *There can be many variations in PPP contracts regarding aspects such as the disposition of the assets at the end of the contract, the required operation and maintenance of the assets during the contract, and the price, quality, and volume of services produced.*

The core underlying principles stay the same. Government grants the right to develop/upgrade a public good/resource such as road, port etc. The private developer develops the project, runs the project as per agreed terms and transfers the asset at the end of the contractual period. As might be evident, despite their utility in attracting private sector expertise and finance, PPPs have gained criticism across the world as an instrument of masking actual government liabilities as governments may have to step in if a PPP project does not progress/perform as per the expectations.

PPPs Under IPSAS

IPSAS discusses PPP treatment primarily under IPSAS 32[20] – Service Concession Agreements (SCA): Grantor. The common features include that the grantor is a public sector entity; operator use the service concession asset to provide public service on behalf of the grantor; operator is compensated for the service; operator is obliged to hand over the service concession asset to the grantor. The key aspect under IPSAS is that the grantor should have the control. The grantor controls or regulates services specifications (recipients, price etc.) and controls through ownership, beneficial entitlement or otherwise—any significant residual interest in the asset at the end of the term of the arrangement.

The asset gets recorded on the balance sheet of the grantor depending upon the way the grantor compensates the operator:

19 Bova, E., Ruiz-Arranz, M., Toscani, F., & Ture, H. E. (2016). The Fiscal Costs of Contingent Liabilities: A New Dataset. *IMF Working Papers*, 16(14), 1. doi: 10.5089/9781498303606.001

20 "IPSAS 32—SERVICE CONCESSION ARRANGEMENTS: GRANTOR". *Ifac.Org*, 2011, http://www.ifac.org/system/files/publications/files/B5-IPSAS_32.pdf.

a) Financial liability model: The grantor compensates the operator for the construction, development, acquisition, or upgrade of a service concession asset by making a predetermined series of payments or shortfalls. The grantor initially recognizes a financial liability at fair value and reduces the liability in the following years by periodic payments to the private party. The financial liability is recorded in accordance with relevant IPSAS standards in IPSAS 28, 29 and 30[21].

b) Grant of a right to the operator model: The grantor compensates the operator for the construction, development, acquisition, or upgrade of a service concession asset and related services by granting the operator the right to earn revenue from third-party users of the service concession asset or another revenue-generating asset.

c) A combination of the two: the grantor pays partly by incurring a financial liability and partly by the grant of a right to the operator

A brief comparison of treatment is as follows:

Table 3: Comparison of two PPP recording model under IPSAS

Financial Liability Model		Right to the Operator (Unearned Revenue) Model	
Balance Sheet	**Income Statement**	**Balance Sheet**	**Income Statement**
Asset	Depreciation	Asset	Depreciation
Financial Liability	Interest	Unearned Revenue	Revenue Earned
	Cost of Services		

Source: IMF[22]

In addition to the above, guarantees and commitments for the SCA that do not meet the requirements in IPSAS 28 (*Financial Instruments: Presentation*)[23] and IPSAS 29 (*Financial Instruments: Recognition and Measurement*)[24] relating to financial guarantee contracts or are not insurance contracts are accounted for in accordance with IPSAS 19 (*Provisions, Contingent Liabilities and. Contingent Assets*)[25]. Similarly, Contingent assets or liabilities that may arise from disputes over the terms of the SCA are accounted for in accordance with IPSAS 19.

As regards disclosures, grantors are advised to disclose all aspects of the SCA i.e. description of the arrangement. Significant terms of the arrangement that may affect the amount, timing, and certainty of future cash flows, all the rights and obligations etc. These disclosures are provided either separately for

21 *2018 Handbook Of International Public Sector Accounting Pronouncements*. 2018, https://www.ipsasb.org/publications/2018-handbook-international-public-sector-accounting-pronouncements-15.
22Carruthers, Ian. "IPSASB: Current Guidelines In Ipsass For Recording Ppps". *Imf.Org*, 2017, https://www.imf.org/external/pubs/ft/gfs/gfsac/meetings/2017/pdf/Carruthers4.2.pdf. Accessed 7 May 2020.
23 (2018 Handbook Of International Public Sector Accounting Pronouncements)
24 (2018 Handbook Of International Public Sector Accounting Pronouncements)
25 (2018 Handbook Of International Public Sector Accounting Pronouncements)

each SCA or in aggregate for SCA involving services of a similar nature (e.g., toll collections, telecommunications or water treatment services)[26].

PPPs Under GFS

GFS discusses PPP treatment under the section A 4.58 – A 4.65 in GFS Manual 2014[27]. PPP accounting under GFS depends primarily on Ownership assessment and it follows the "Risk-Reward" Majority Criterion. "Majority" should be assessed from an economic point of view. A single risk and reward may imply the "majority" in some cases, while in other cases, a number of separate risks and rewards combined may do so. The risks identified with acquiring the asset are (a) Extent of government controls the design, quality, size, and maintenance of the assets And; (b) Construction risk. Post completion, risk associated with operating the assets are Risk associated with operating the asset are (a) Supply risk; (b) Demand risk; (c) Residual value and obsolescence risk and; (d) Availability risk.

A sample road concession risk matrix to do such assessment is as below:

Table 4: Sample road concession matrix to assess risk allocation

RISK CATEGORY	DESCRIPTION	BASIC RISK ALLOCATION		
		Public	Shared	Private
LAND AVAILABILITY, ACCESS AND SITE RISK	The risk associated with selecting land suitable for the project; providing it with good title and free of encumbrances; addressing indigenous rights; obtaining necessary planning approvals; providing access to the site; site security; and site and existing asset condition.	•		
SOCIAL RISK	The risk associated with the project impact on the marine environment, adjacent properties and people; resettlement; indigenous land rights; and industrial action.	•		
ENVIRONMENTAL RISK	The risk associated with pre-existing conditions; obtaining consents; compliance with laws; conditions caused by the project; external events; climate change; and marine environment events (e.g. algae blooms).		•	•
DESIGN RISK	The risk that the project design is not suitable for the purpose required; approval of design; and changes.			•

26 (Paragraph 31-33, "IPSAS 32—SERVICE CONCESSION ARRANGEMENTS: GRANTOR")
27 "IMF's Government Finance Statistics Manual 2014". Imf.Org, 2014, https://www.imf.org/external/np/sta/gfsm/.

CONSTRUCTION RISK	The risk of construction costs exceeding modelled costs; completion delays; project management; interface; quality standards compliance; health and safety; defects; intellectual property rights compliance; and industrial action.			•
VARIATIONS RISK	The risk of changes requested by either party to the service which affect construction or operation.		•	
OPERATING RISK	The risk of events affecting performance or increasing costs beyond modelled costs; performance standards and price; availability of resources (other than power, where not combined power and desalination); intellectual property rights compliance; health and safety; compliance with maintenance standards; and industrial action.		•	•
DEMAND RISK	The risk that demand for potable water is not sufficient to utilize the full production capacity of the project.	•		
FINANCIAL MARKETS RISK	The risk of inflation; exchange rate fluctuation; interest rate fluctuation; unavailability of insurance; and refinancing.		•	
STRATEGIC / PARTNERING RISK	The risk of the Private Partner and/or its sub-contractors not being the right choice to deliver the project; Contracting Authority intervention in the project; ownership changes; and disputes.		•	
DISRUPTIVE TECHNOLOGY RISK	The risk that a new emerging technology unexpectedly displaces an established technology, or the risk of obsolescence of equipment or materials used.		•	
FORCE MAJEURE RISK	The risk that unexpected events occur that are beyond the control of the parties and delay or prevent performance.		•	
MAGARISK	The risk of actions within the public sector's responsibility having an adverse effect on the project or the Private Partner.	•		
CHANGE IN LAW RISK	The risk of changes in law affecting performance of the project or the Private Partner's costs.	•		
EARLY TERMINATION RISK	The risk of a project being terminated before its natural expiry on various grounds; the financial consequences of such termination; and the strength of the Contracting Authority's payment covenant.		•	
CONDITION AT HANDBACK RISK	The risk of deterioration of the project assets/land during the life of the PPP and the risk that the			•

	project assets/land are not in the contractually required condition at the time of hand back to the Contracting Authority.			

Source: Global Infrastructure Hub[28]

Based on who is deemed the owner of the PPP asset during the contract period, following treatment is advised:

a) Government is considered as an economic owner: Government does not make any explicit payment at the beginning of the contract, a transaction (i.e. imputed financial lease or Loan that equals the market value of the asset at acquisition) must be imputed to cover the acquisition of the asset(s). From the actual payments, a portion of each payment represents the repayment of the loan and the remainder could represent an expense for use of goods or services, subsidies, etc., in accordance with the contract.

b) Private party is considered as an economic owner: The government obtains legal and economic ownership of the assets at the end of the contract without any significant payment. Over the contract period, government gradually builds up a financial claim (e.g., other accounts receivable) and the private corporation gradually accrues a corresponding liability (e.g., other accounts payable), such that both values are equal to the residual value of the assets at the end of the contract period. At the end of the contract period, the reverse entry for these transactions are made and the asset is transferred to the government with little to no payment and liability is extinguished. Another comparatively less popular approach is capital transfer approach. Government records revenue in the form of a capital transfer that finances the acquisition of the asset and the private unit records an expense in the form of a capital transfer payable to the government, financed by the disposal of the asset.

Takeaways: PPPs

Table 5: Comparison of IPSAS and GFS for recording PPP

IPSAS 32	GFSM 2014
Recognition based on control	Recognition based on risk and rewards
Specified accounting where grantor does not make payments (unearned revenue)	Imputed transaction where grantor does not make payments (examples given include imputed financial leases and imputed loans)
No specific guidance if grantor does not control the asset (apply other IPSASs instead of IPSAS 32)	Provides guidance where operator has economic ownership (two options: recognize revenue and accumulate receivable over life of arrangement; or recognize revenue on final transfer)

[28] Hub, Global. "Risk Allocation Tool". *Ppp-Risk.Gihub.Org*, 2019, https://ppp-risk.gihub.org/.

Grantor regulates price as part of control of asset	Grantor usually (but not always) regulates price

Source: IMF[29]

When do PPPs end up on the balance sheet?

Under IPSAS, the two control criteria as discussed above is sacrosanct. Since the government usually controls the terms of service of the contract, under IPSAS, most PPPs are expected to end up on the Government Balance Sheet. For various contingent obligations that may arise, they should be recorded on the books as "provisions" if they are assessed to be probable (no numerical threshold prescribed but generally accepted as having a probability >50%) and a reliable estimate outflow can be made. If these conditions are not met, a contingent liability is identified. This discussion is relevant for various financing, performance contingent clauses which could potentially and substantially increase or materialise the 'contingent' liability of the government depending upon financing, performance etc outcome.

Under GFS, while the criterions are similar in nature, one major deviation is that it takes a majority risk/reward (*economic owner*) approach compared to the control approach in IPSAS. This could mean that materiality of even one risk/reward condition (assessed as per the sample matrix given above) is enough to make one party recognize the asset on the balance sheet.

To conclude, IPSAS 32 and GFSM 2014 will result in different PPP classifications in very few instances and those should be regarded as exceptions than expectations.

(5) Hedging Derivatives

Overview of Hedging Derivatives

Hedging derivatives are financial instruments that aim to reduce or eliminate a variety of risks associated with another transaction or obligation. Because the underlying value of these instruments is sensitive to fluctuating prices and asset values, the potential liability is dependent on future events and can thus be considered contingent. Sovereigns widely utilize currency forwards or options and foreign exchange swaps to stabilize the exchange rate, defending a fixed exchange rate regime, or maintaining an exchange rate band. Nations that derive a meaningful portion of government revenue from commodities or natural resources may use derivative instruments to hedge the prices of their commodity exports (or in some cases, imports). Other hedging derivatives include futures contracts, repurchase agreements, credit default swaps, etc.

29 (Carruthers)

Hedging Derivatives Under IPSAS

IPSAS does advise sovereigns to recognize hedging derivatives in financial disclosures, and it has defined that only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items on the consolidated financial statements.

According to IPSAS hedge accounting rules, a hedging transaction is established if all the following criteria are met (otherwise, the transaction will be considered as contingent and thus will be included in the relevant footnote section):[30]

1) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge
2) It is expected to be highly effective
3) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect surplus or deficit
4) Effectiveness of the hedge can be reliably measured
5) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting period for with the hedge was designated

There are three defined types of hedges under IPSAS, with different rules to recognize their profit/loss/change in value:[31]

1) Fair value hedges: recognized in surplus or deficit
2) Cash flow hedges: effective hedge recognized in net assets/equity, ineffective portion recognized in surplus or deficit
3) Hedge of net investment: effective hedge recognized in net assets/equity, ineffective portion recognized in surplus or deficit

Hedging Derivatives Under GFS

GFS never considers financial derivatives/options/forward-type contract/credit derivatives contingent liabilities. They are however always reported, as the counterparty is clearly defined, and the potential gains and losses should be assessable. The GFSM includes only a very limited amount of information on how exactly to calculate the value of the derivative on the Balance Sheet.

Takeaways: Hedging Derivatives

IPSAS and GFS treat hedging derivatives in a different manner. According to the IPSAS handbook, only instruments that involve a party external to the reporting entity can be designated as hedging instruments;

[30] IPSAS 29 - Disclosure of Financial Information about the General Government Sector, https://www.ifac.org/system/files/publications/files/B2-IPSAS_29.pdf
[31] IPSAS 29 - Disclosure of Financial Information about the General Government Sector, https://www.ifac.org/system/files/publications/files/B2-IPSAS_29.pdf

transactions within the economic entity are eliminated upon consolidation. Whether a hedging instrument is considered contingent or not depends on its measurability and effectiveness. However, GFS never considers financial derivatives/options/forward-type contract/credit derivatives as contingent liabilities.

(6) Environmental & Natural Disaster Liabilities

Overview of Environmental & Natural Disaster Liabilities

Environmental contingent liabilities can be classified into two broad categories - liabilities resulting from human activities that damage the environment and natural disasters that cause hazards to humans. Human activities may include the storage and disposal of hazardous waste, training sites such as military firing ranges, and industry activities such as mining, and illegal dumping. Examples of costs associated with human activities include both contamination and cleanup. When a potential problem is suspected, inspections and surveys must be conducted to ascertain the scope of the damage. If there is a human element of damage, the sovereign may have to pay restitution to those affected in the form of legal settlements. Moreover, federal agencies often assist with the response and recovery from natural disasters such as earthquakes, floods, hurricanes, and wildfires. For both human damage and natural disasters, reporting systems and infrastructure need to be in place to help request assistance. Cleanup costs include reconstruction and renovation, acquisition of technology that may be required, and long-term monitoring.

Environmental & Natural Disaster Liabilities Under IPSAS

Environmental liabilities are recognized under IPSAS as contingent liabilities only if there is no present obligation, but the possibility an obligation will materialize is greater than 50%. If a present obligation does exist, but a reliable estimate of cost cannot be ascertained, then it would also be listed as a contingent liability and appear in a footnote in the financial statements. Once the environmental liability becomes an actual obligation, then it would be recorded as a provision on the Balance Sheet under IPSAS. Natural disasters, by their nature, cannot be assessed in advance so are not disclosed under IPSAS or GFS.

Environmental & Natural Disaster Liabilities Under GFS

The Government Finance Statistics Manual (GFSM) does not specifically address environmental liabilities within its framework so one must follow the logic laid out in the GFSM 2014 to categorize environmental liabilities. The value of the contingent liability would be included as a record memorandum item number on the Balance Sheet, and any additional information would be contained in the *Summary Statement of Explicit Contingent Liabilities and Net Implicit Obligations for Future Social Benefits*.

In order to determine which record memorandum item number to categorize it under, the first step is to determine if it is an explicit or implicit contingent liability. An explicit liability would be one in which the sovereign has a legal obligation to bear financial responsibility or if the government has made a policy or

statement that assumes financial responsibility. In the case of government-acknowledged responsibility, this may be interpreted as a form of guarantee and could be classified under line item *6M61 - Publicly Guaranteed Debt*. A legal obligation can take the form of a law, a contract, or a court ordered civil suit determined by a judge and could be categorized under record memorandum item number *6M63 - Explicit Contingent Liabilities Not Elsewhere Classified*. The GFSM 2014 only recognizes one category of implicit contingent liabilities and that is related to future social security benefits, so any implicit environmental contingent liabilities would not be recognized under GFS.

Takeaways: Environmental & Natural Disaster Liabilities

In general, costs incurred as a result of environmental compliance regulations and operation and maintenance costs are not considered contingent liabilities. However, as the world turns its attention to combating climate change, one grey area is how to address future potential environmental compliance costs that may arise from changes in policy. Another concern about including environmental liabilities is that disclosure may prejudice the outcome of a contingency. If the government estimates that they may be responsible for environmental contamination of a nuclear site, if contamination occurs, that may be used against them in a legal settlement.

Natural disasters, similarly, can be a significant driver of sovereign contingent liabilities, though due to their unpredictable nature they are rarely disclosed under financial reporting frameworks. As indicated in the IMF study cited earlier in this report, natural disasters constituted nearly 30% of all major contingent liability realizations between 1990-2014, with an average fiscal cost of ~1.6% of GDP.[32] Although there is considerable nuance in the literature, many studies forecast that natural disasters such as hurricanes, flooding, and wildfires will occur with increasing frequency as a result of climate change.[33] Key stakeholders should thus pay close attention to this classification of contingent liabilities.

(7) Intragovernmental Loans

Overview of Intragovernmental Loans

Intragovernmental loans refer to funds lent from one government entity to another. When the entities on both sides of a transaction are consolidated under a sovereign entity's financial statements, the debt cancels out and has no impact on the balance sheet or debt ratios. The funds represent an asset for one

[32] Bova, E., Ruiz-Arranz, M., Toscani, F., & Ture, H. E. (2016). The Fiscal Costs of Contingent Liabilities: A New Dataset. IMF Working Papers, 16(14), 1. doi: 10.5089/9781498303606.001. Retrieved fromhttps://www.imf.org/external/pubs/ft/wp/2016/wp1614.pdf

[33] Seneviratne, S.I., N. Nicholls, D. Easterling, C.M. Goodess, S. Kanae, J., et al (2012). Changes in climate extremes and their impacts on the natural physical environment. Managing the Risks of Extreme Events and Disasters to Advance Climate Change Adaptation: A Special Report of Working Groups I and II of the Intergovernmental Panel on Climate Change (IPCC). Cambridge University Press, Cambridge, UK, and New York, NY, USA, pp. 109-230. Retrieved from https://www.ipcc.ch/site/assets/uploads /2018/03/SREX-Chap3_FINAL-1.pdf;

entity and a liability for the other. However, not all government affiliated entities are typically consolidated for sovereign financial reporting purposes. In these cases, intragovernmental loans can have implications for sovereign financial analysis and can become contingent if a state-owned enterprise (SOE) or other similar entity is not able to repay.

Intragovernmental Loans Under IPSAS

Under IPSAS, governments may elect to report at the central, federal, or general government sector (GGS) levels. The general government sector is the widest of these definitions. GGS is typically defined to include not-for-profit entities undertaking nonmarket activities such as state and / or regional governments. However GGS excludes Public Financial Corporations (PFCs) such as government controlled banks and central banks and Public Non-Financial Corporations (PNFCs) such as government controlled utilities.[34] This means that even under the widest categorization, many state-owned enterprises (SOEs) are likely to not be consolidated.

Under IPSAS, "control" is the criteria evaluated to determine whether or not an affiliated entity is to be consolidated.[35] In some countries, then, state or regional governments are controlled by the federal government and therefore need to be consolidated. Intragovernmental loans in these cases are eliminated and have no overall effect on sovereign financial statements. In others, regional governments are not deemed to be controlled by the federal sovereign and therefore not included under the sovereign's financial statements. Governments can elect to break-out their financial statements into segment-level information, but this is not required. Still, only units that are controlled would be included in this segment-level reporting. Loans between government entities that are not all consolidated are listed on the balance sheet.

Intragovernmental Loans Under GFS

Governments generally consolidate the whole GGS under GFS policies, whether or not control has been established. [36] This means that Public Financial Corporates (PFCs) and Public Non-Financial Corporations (PNFCs) are not included under GFS financial data, however state and regional level data typically are. The same accounting treatment is applied for intragovernmental debt between consolidated entities; namely, it is eliminated.

Takeaways: Intragovernmental Loans

Intragovernmental loans, when transacted between consolidated sub-entities, are not contingent liabilities. Still, analysts should be careful to adjust for these when assessing indebtedness. The US government, for example, provides two separate categories of debt: "Gross Debt" and "Debt Held by the Public." US government gross debt currently stands at ~$23.5 trillion while debt held by the public stands

34 IPSAS 22 - Disclosure of Financial Information about the General Government Sector, https://www.ifac.org/system/files/publications/files/A11-IPSAS-22.pdf
35 IPSAS 35 - Consolidated Financial Information, https://www.ifac.org/system/files/publications/files/B8-IPSAS_35.pdf
36 *Government Finance Statistics Manual 2014*. IMF, 2014, www.imf.org/external/Pubs/FT/GFS/Manual/2014/gfsfinal.pdf

at ~$17.5 trillion.[37] In this case the lower, ~$17.5 trillion figure is the relevant direct obligation to market participants and investors. This is because the ~$6 trillion difference between the two figures is intragovernmental debt, not issued to market investors and is almost entirely held in social security and similar trust funds.[38] The Congressional statutory debt limit, however, includes such trust fund debt.

However, when loans are transacted between government entities and the recipient is not consolidated (e.g. a loan to an SOE), then a contingent liability could arise just like with any other bad debt. Users of financial statements should thus remain cognizant about what level of government a sovereign entity is reporting at. As we have seen, many SOEs are not consolidated onto sovereign balance sheets even under the more expansive general government sector categorization. If investors suspect that a central or federal government may in fact backstop the liabilities of an SOE, or that an SOE may not repay money received from the central government, then adjustments to account for this SOE debt should be made when estimating a sovereign's indebtedness.

(8) Social Benefits

Overview of Social Benefits

The concept of social benefits covers a wide range of areas ranging from government employee benefits, grants to public sector entities, and public services such as education and healthcare. and differs a lot depending on the accounting and statistical standards (Figure 7). Here, we will outline each classification under IPSAS and GFS.

Social Benefits Under IPSAS

1. Social Benefits[39]

IPSAS19 defines social benefits as cash transfers such as state pensions, unemployment benefits and income support. An entity shall recognize a liability for a social benefit program when: (a) the entity has a current obligation for the outflow of money arising from a past event; and (b) the current obligation can be evaluated in a manner that achieves the qualitative attributes and takes into account information limitations.

There may be uncertainty associated with the measurement of the liability. Uncertainty over resource outflows does not preclude a liability from being recognized unless the degree of uncertainty is too high.

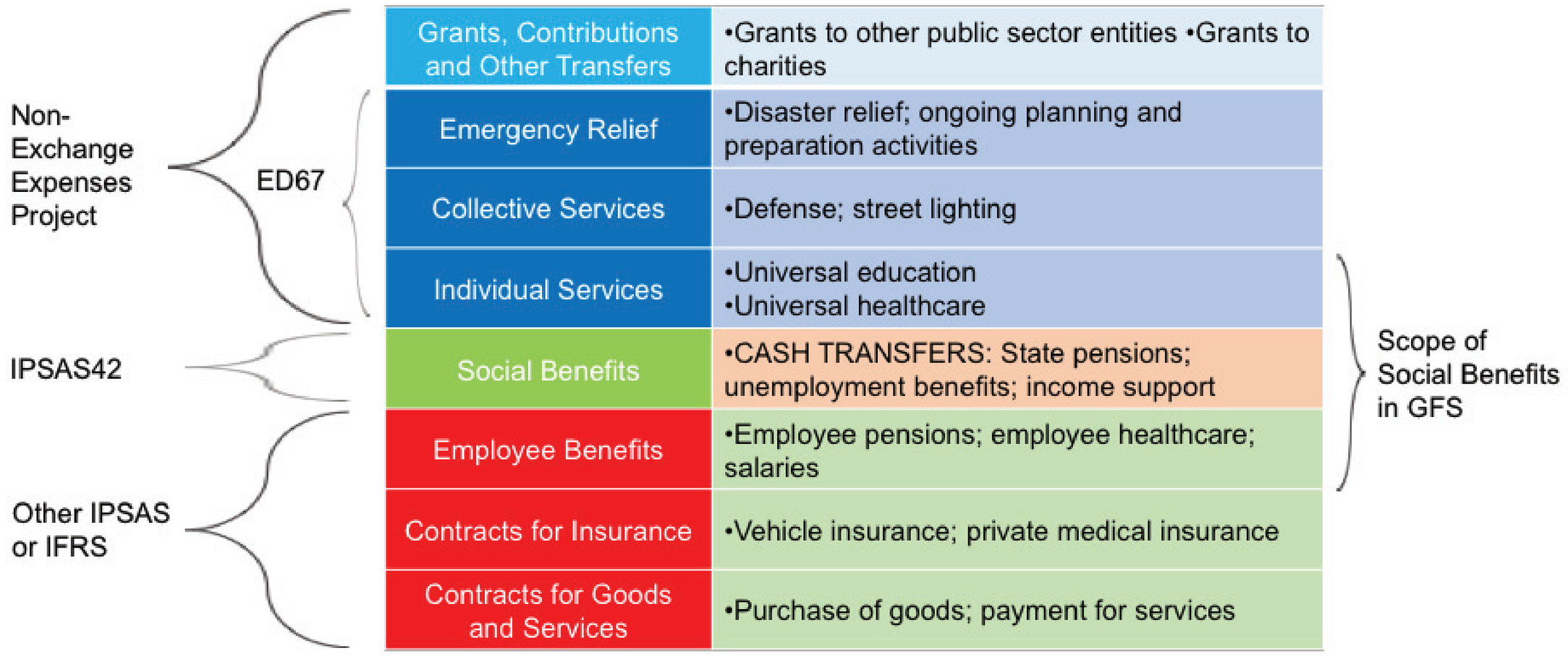
37 "The Daily History of the Debt Results." *Debt to the Penny (Daily History Search Application)*, TreasuryDirect.gov, 23 Mar. 2020, www.treasurydirect.gov/NP/debt/search?startMonth=03&startDay=23&startYear=2020&endMonth=&endDay=&endYear=

38 "Q&A: Gross Debt Versus Debt Held by the Public." *Committee for a Responsible Federal Budget*, 27 Sept. 2017, www.crfb.org/papers/qa-gross-debt-versus-debt-held-public

39 IPSASB. "IPSAS 19—PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS." *IFAC*, 18 Feb. 2020, www.ifac.org/system/files/publications/files/A11-IPSAS_19.pdf.

If the degree of ambiguity does not preclude a liability from being recognized, it is taken into consideration when calculating the liability.

Figure 7: Classifications of Social Benefits under IPSAS and GFS



Source: IPSASB[40]

2. Individual Services[41][42]

Individual services are goods and services offered by a public sector agency to individuals and/or families, aimed at meeting the needs of society as a whole.

Such obligations do not become current obligations until the people have access to the programs. No provision is recognized with the purpose of delivering individual services before accessing the services to individuals and/or households.

3. Employee Benefits[43]

Post-employment benefit arrangements such as pensions and health care are classified as either defined contribution arrangements or defined benefit plans. IPSAS39 stipulates that defined contributions are recognized either as liabilities or expenses, whereas defined benefits are recognized as liabilities.

[40]IPSASB. "IPSAS® 42 Summary—Social Benefits." *IFAC*, Jan. 2019, www.ifac.org/system/files/publications/files/IPSAS-42-Social-Benefits-At-a-Glance.pdf.

[41] IPSASB. "IPSAS 19—PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS." *IFAC*, 18 Feb. 2020, www.ifac.org/system/files/publications/files/A11-IPSAS_19.pdf.

[42] IPSASB. "IPSAS 23—REVENUE FROM NON-EXCHANGE TRANSACTIONS (TAXES AND TRANSFERS)." *IFAC*, 18 Feb. 2020, www.ifac.org/system/files/publications/files/A11-IPSAS_23.pdf.

[43] IPSASB. "IPSAS 39—EMPLOYEE BENEFITS." *IFAC*, 18 Feb. 2020, www.ifac.org/system/files/publications/files/B12-IPSAS_39.pdf.

Social Benefits Under GFS[44]

1. Social Security

The link between benefits and contributions is not considered sufficiently strong to give rise to a financial claim. There is uncertainty about the amount of future payment for these social benefits. There are no liabilities related to possible future claims on social security programs. An expense is only reported when the benefits are due to be paid.

2. Social Assistance

No liability for potential social assistance compensation payments should be reported on the government's balance sheet. Other accounts payable would be recognized only in circumstances where, at the end of a reporting period, a benefit occurred but remained unpaid.

3. Employment-related Social Insurance

They are deemed to be part of the governments' virtual or implied contracts. Hence, when the social contributions become payable, they give rise to necessary government expenses.

Takeaways: Social Benefits

The concept of social benefits covers a wide range of areas such as social assistance, social security and employment-related social insurance. As a result, the classification and treatment of these categories vary between IPSAS and GFS. With varying recognitions, most social benefit programs are not recognized as direct liabilities on the government's balance sheet. Given the sheer size of the social benefit programs in every country and political mandates for such programs, not reporting these contingent liabilities on the government balance sheet means that debt ratios systematically understate the true indebtedness of governments that provide social benefit programs but do not have such programs fully funded and are capable of meeting future obligations.

44 International Monetary Fund. "Government Finance Statistics Manual 2014." *IMF*, 2014, www.imf.org/external/Pubs/FT/GFS/Manual/2014/gfsfinal.pdf.

SECTION 4: SOVEREIGN ACCOUNTING DATABASE

Summary of Database and Data Analysis

The database profiled in this section was created proprietarily for this report and covers 51 countries across six continents. The database outlines the international accounting standards and statistical standards that each country follows, as well as when the country adopted or transitioned to the framework. The database further includes macroeconomic data, sovereign ratings, and sovereign debt costs for each country in order to explore potential statistical relationships with accounting transparency. Table 6 below outlines the countries included in the database and Table 7 outlines the variables included. Later in the section statistical analyses are outlined.

Table 6: Countries and Regions Included in Sovereign Accounting Database

Region	Country
North America	United States, Canada, Mexico
Latin America	Chile, Brazil, Argentina, Colombia, Venezuela
Europe	United Kingdom, Germany, France, Italy, Netherlands, Spain, Greece, Portugal, Denmark
Asia Pacific	China, Singapore, India, Vietnam, Mongolia, Thailand, Japan, Korea, Indonesia, Philippines, Malaysia, Australia, New Zealand
Russia + CIS	Republic of Armenia, Azerbaijan, Kazakhstan, Kyrgyz Republic, Russia, Uzbekistan
Middle East and North Africa	Israel, Lebanon, Saudi Arabia, Turkey, United Arab Emirates, Iraq, Jordan
Africa	Algeria, Botswana, Egypt, Morocco, Nigeria, South Africa, Tunisia, Zambia

Table 7: Variables Included in Sovereign Accounting Database

Public Sector Accounting	Standard Applied: IPSAS/Other/NA
	Accounting Method: Cash/Accrual/NA
Public Sector Financial Statistics	Standard Applied: GFS 2014/Other
	Dissemination Standards: SDDS Plus/SDDS/e-GDDS
Sovereign Rating	S&P

	Moody's
Composition of Financial Statements	Central Government
	General Government
	Public Sector
Economic Data	General Government Debt
	GDP
	Central Government Debt/GDP
	General Government Debt/GDP
	Non-Resident Holding of General Government Debt
	Fiscal Deficit/Surplus
Quantitative Analysis	Average 5-year CDS
	Average 5-year UST
	Estimated Yield

Descriptive Statistics

Table 8: Descriptive Statistics

Reporting Standard / Practice	% of Countries in Compliance (including full and in transition)	% of Countries not in Compliance	% of Countries in Full Compliance	% of Countries in Transition
IPSAS	65%	35%	14%	51%
GFS	75%	25%	38%	37%
Accrual Accounting	69%	31%	38%	31%
Report data to IMF	85%	15%	-	-
SDDS Plus	24%	-	-	-
SDDS	37%	-	-	-
e-GDDS	39%	-	-	-

Figure 8: IPSAS Adoption

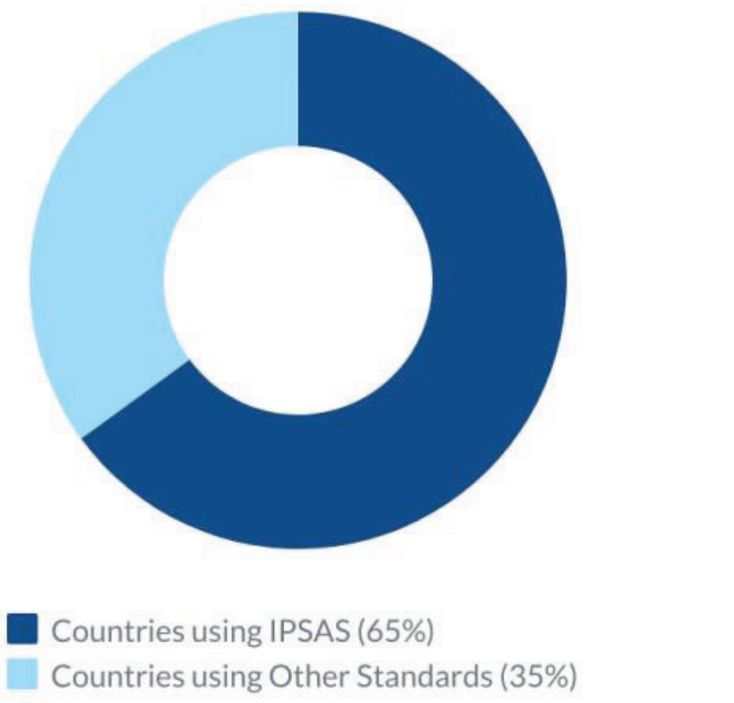


Figure 9: Accrual Accounting

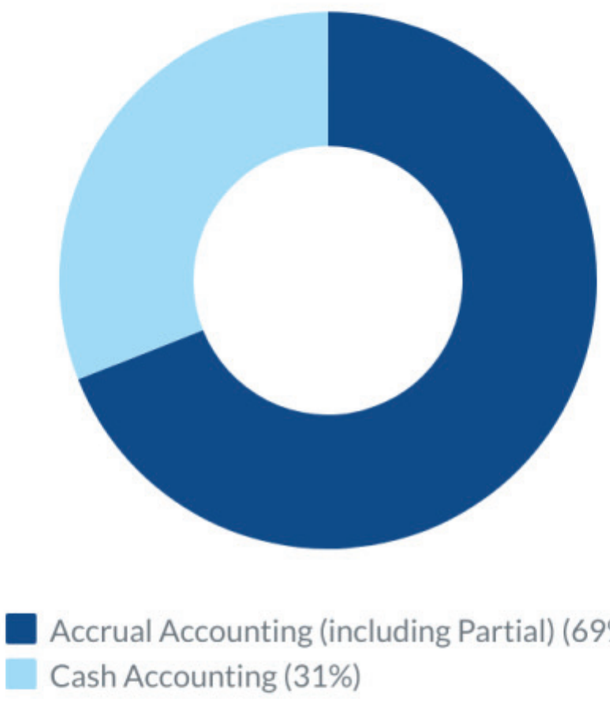


Figure 10: GFS Compliance

Figure 11: Report Data to IMF

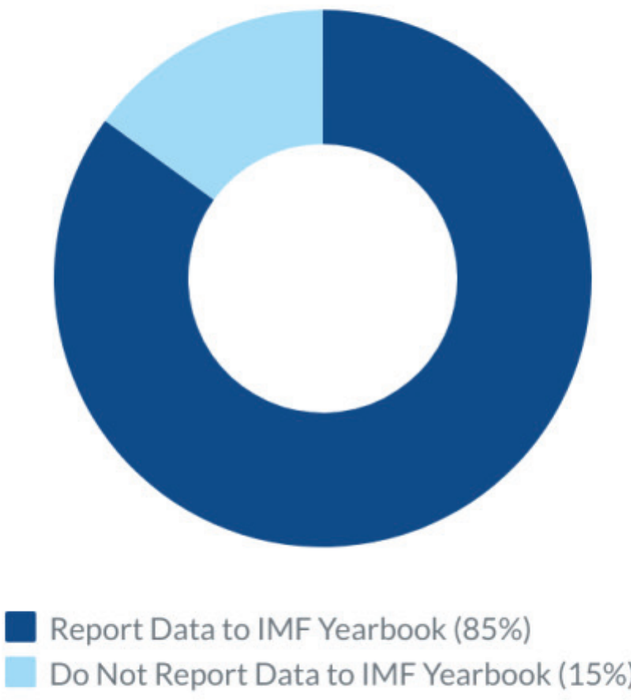


Figure 12: Dissemination Standard

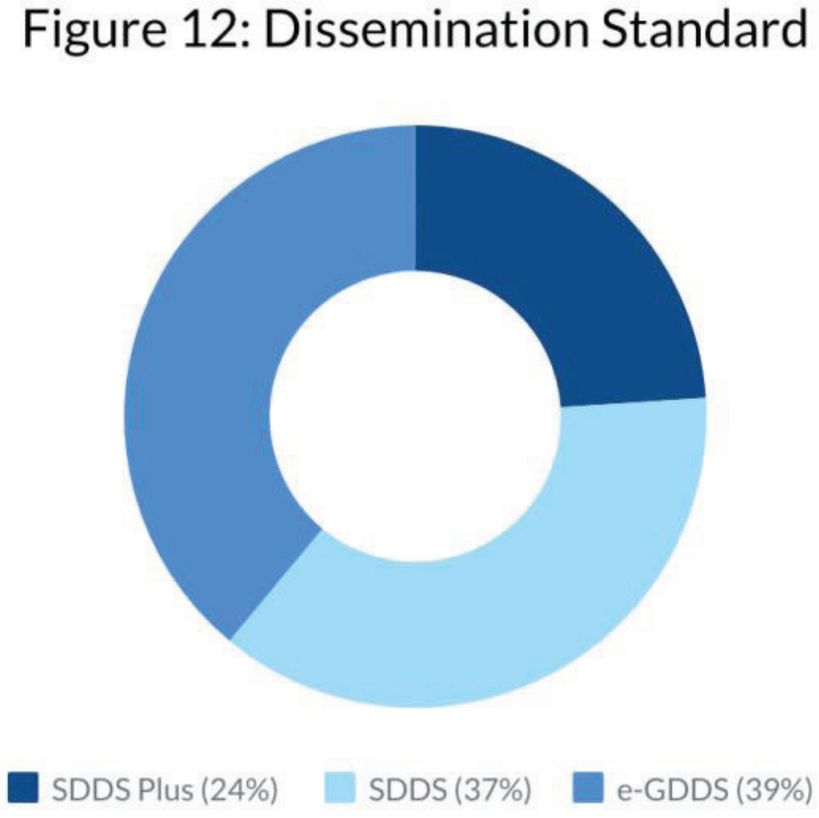
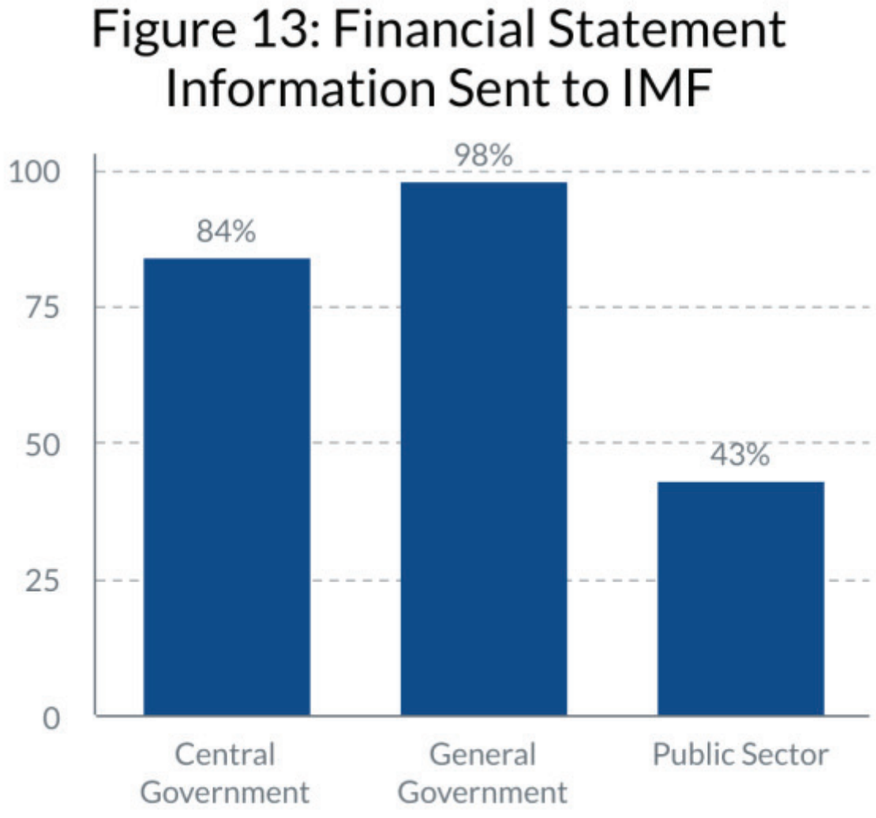


Figure 13: Financial Statement Information Sent to IMF



SIPA

Capstone Fiscal Reporting Transparency Score (CFRTS) - Exploring Relationships Between Accounting Transparency and Sovereign Debt Costs

To assess the relationship between the fiscal transparency as measured by the selected indicators/variables in the novel dataset and sovereign ratings or borrowing cost, we aggregated our variables into one single transparency score. We made these hypotheses:

1. A country currently transitioning to a new standard, which has not yet achieved full implementation should score better than a country that has not yet launched the transition, but worse than a country that has achieved full implementation.
2. Having fully implemented the IPSAS accounting standard has significantly more weight in an aggregate transparency score, than whether a country reports their financial data to the IMF.

To account for these hypotheses, we create a weighting matrix, informed by a) the "Gold Standards" we identified ex ante (New Zealand, UK e.g.) and our qualitative analysis developed in the first part of this report.[45] The factors that positively impact a country's Capstone Fiscal Reporting Transparency Score (we shall refer to as CFRTS in the following) are ordered as a function of their weight (from highest to lowest): (A) the implementation of IPSAS (full/partial/not compliant), (B) the implementation of GFS Standards (full/partial/not compliant), (C) application of accrual accounting rather than cash accounting (full accrual/partially accrual/cash), (D) the applied Dissemination standard (SDDS Plus; SDDS; e-GDDS) and (E) whether or not a country submits its fiscal data to the GFS (compliant/not compliant). Scaling the weighted average score from these categories to 100, allows the derivation of the Capstone Fiscal Reporting Transparency Score (CFRTS). Plotting the CFRTS on the x-axis, the following scatterplot graphs provide insights into possible motivations for sovereigns to achieve more transparency.

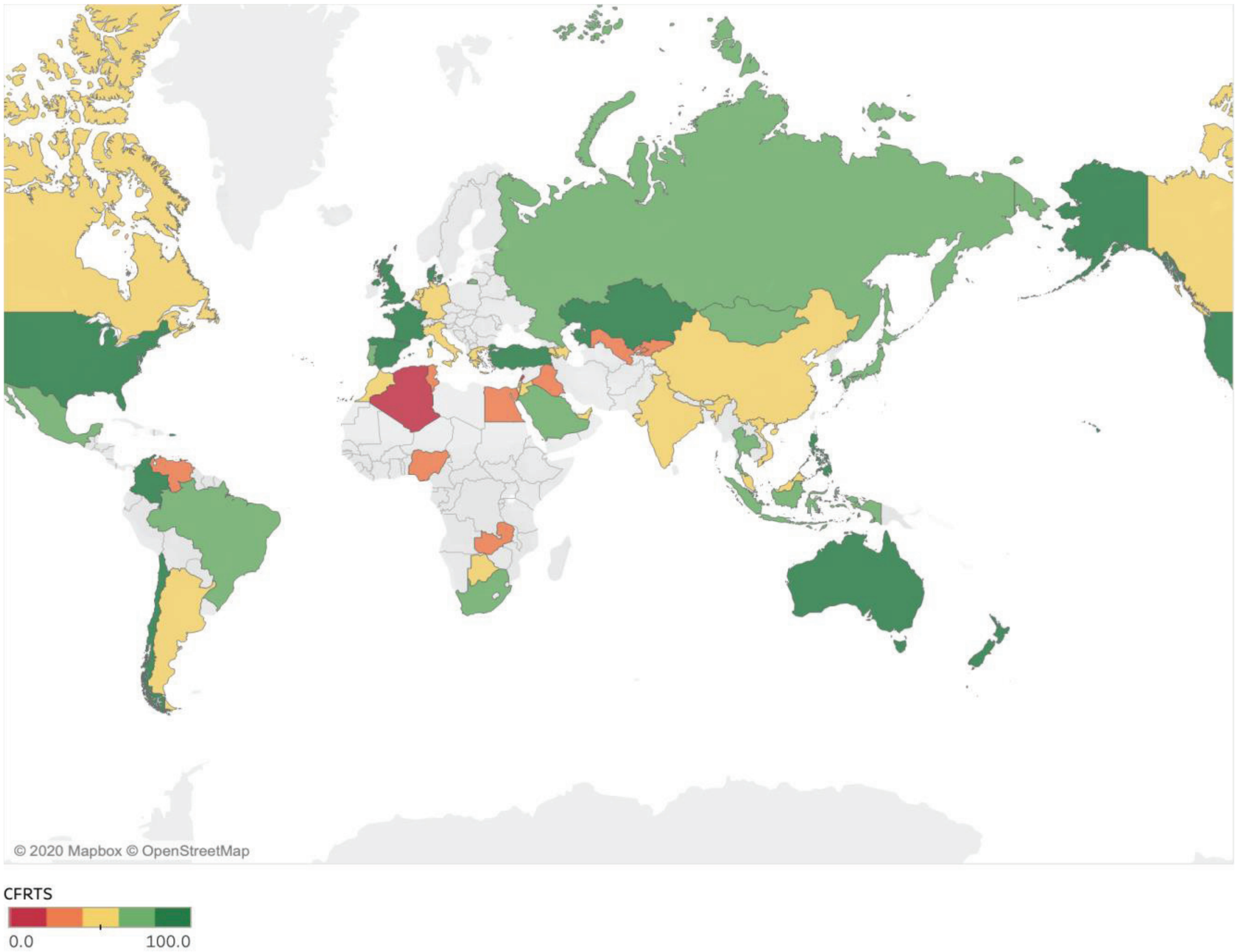
[45] It would technically be possible to define the weights by means of an OLS regression of ratings on all the variables. The reason we explicitly refrain from this methodology is that there exist evident and strong multi correlations between the variables, which will lead to potentially very biased OLS coefficient estimates. For instance, countries that apply GFS always also submit data the IMF; and countries moving from their idiosyncratic reporting standard to IPSAS often combine this launching a transition to accrual accounting as well.

Table 9: Capstone Fiscal Reporting Transparency Score

Country		Country	
Chile	100.0	China	55.9
New Zealand	94.1	Greece	55.9
Spain	94.1	Malaysia	55.9
Australia	82.4	Vietnam	55.9
Colombia	82.4	Germany	52.9
Denmark	82.4	India	52.9
France	82.4	Netherlands	52.9
Kazakhstan	82.4	Canada	47.1
Philippines	82.4	Azerbaijan	44.1
Turkey	82.4	Botswana	41.2
UK	82.4	Italy	41.2
US	82.4	Jordan	41.2
Brazil	79.4	Singapore	41.2
Portugal	79.4	UAE	41.2
Indonesia	70.6	Tunisia	38.2
Japan	70.6	Uzbekistan	32.4
Mongolia	70.6	Egypt	29.4
South Korea	70.6	Iraq	29.4
Mexico	67.6	Kyrgyz Republic	29.4
Russia	67.6	Nigeria	29.4
Saudi Arabia	67.6	Venezuela	29.4
South Africa	67.6	Zambia	29.4
Thailand	67.6	Lebanon	11.8
Israel	58.8	Algeria	0.0
Morocco	58.8		
Argentina	55.9		
Armenia	55.9		

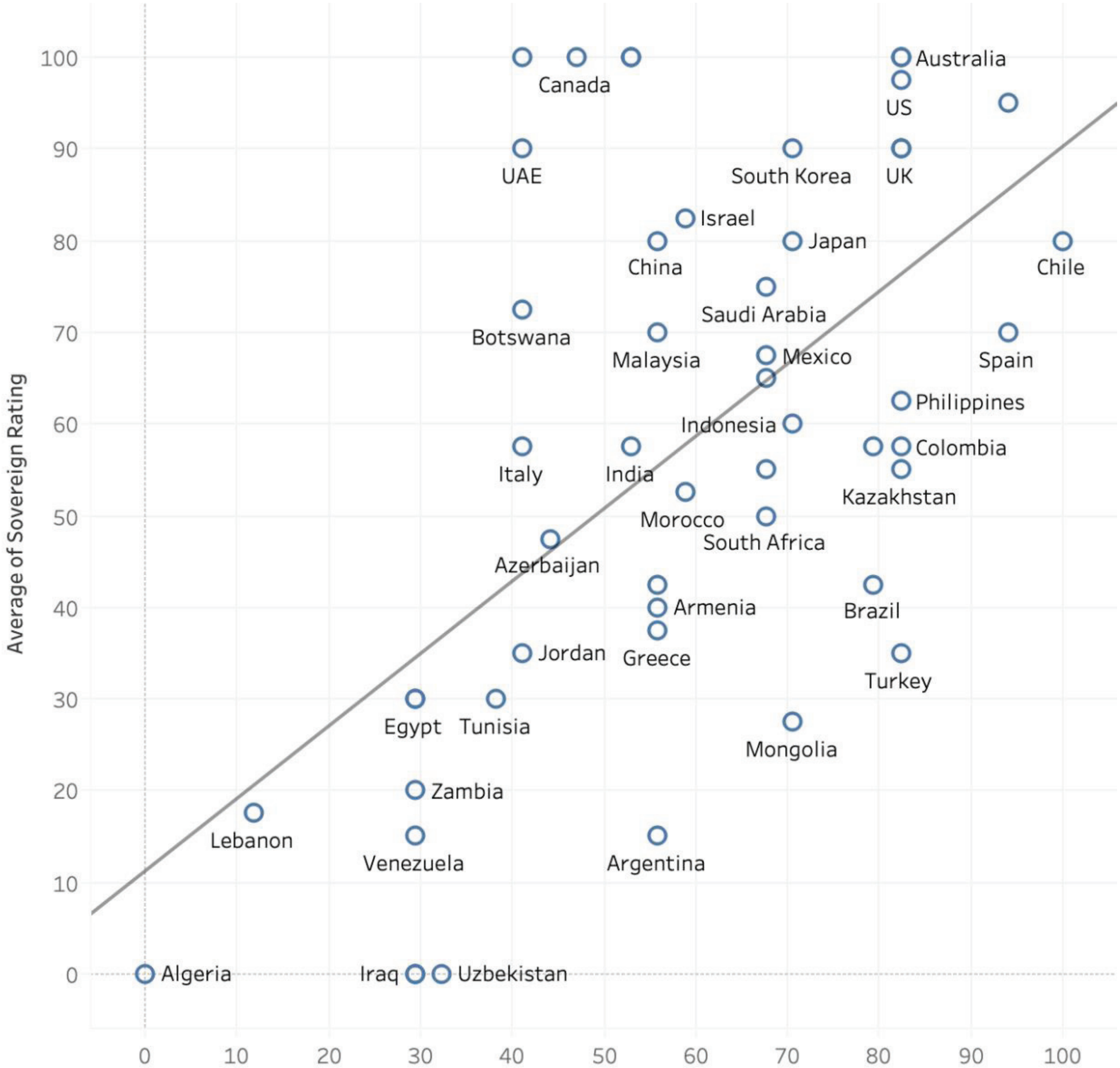
CFRTS

Figure 14: Geographic Distribution of the CFRTS



As presented in the world map, the transparency of sovereign fiscal reporting differs not only across, but also within regions. The only region that has rather poor transparency levels across the board seems to be the Middle East and North Africa, with only Saudi Arabia reaching a transparency score above 60.

Figure 15: Higher Transparency Correlates with Better Sovereign Credit Rating



As can be observed from Figure 15, there exists a strong correlation between a higher transparency score and sovereign ratings. The direction of possible causal effects is likely to be defined by more transparency being equal to stronger institutions, thus enhancing sovereign credit quality. The example of Moody's Sovereign Rating methodology underlines this argument, since transparency – especially on questions related to governance and contingent liabilities – is accounted for within three broad rating factors, namely Institutional and Governance Strength, Fiscal Strength and Susceptibility to Crisis. Nonetheless, the degree of scattering also indicates that high transparency alone does not always lead to a better credit quality and a higher rating. Cases like that of South Africa indeed indicate that when greater transparency provides insight into prior hidden liabilities of the sovereign, greater transparency

can actually lower sovereign credit quality and ratings. However, without transparency the downside susceptibility to event risk would likely be higher.

Some level of reverse causality may also be at play - e.g. countries with higher per capita income and stronger institutions may be more likely to have the resources and political will to compile transparent financial reports, which can be time-consuming and resource-intensive. In addition, the existence of a deep debt capital market base in the domestic market with institutional investors provides an incentive to governments to develop transparent fiscal accounts. We believe this factor indirectly influences South Africa's relatively high transparency score.

Figure 16: Greater Transparency is Further Associated with Lower Borrowing Costs

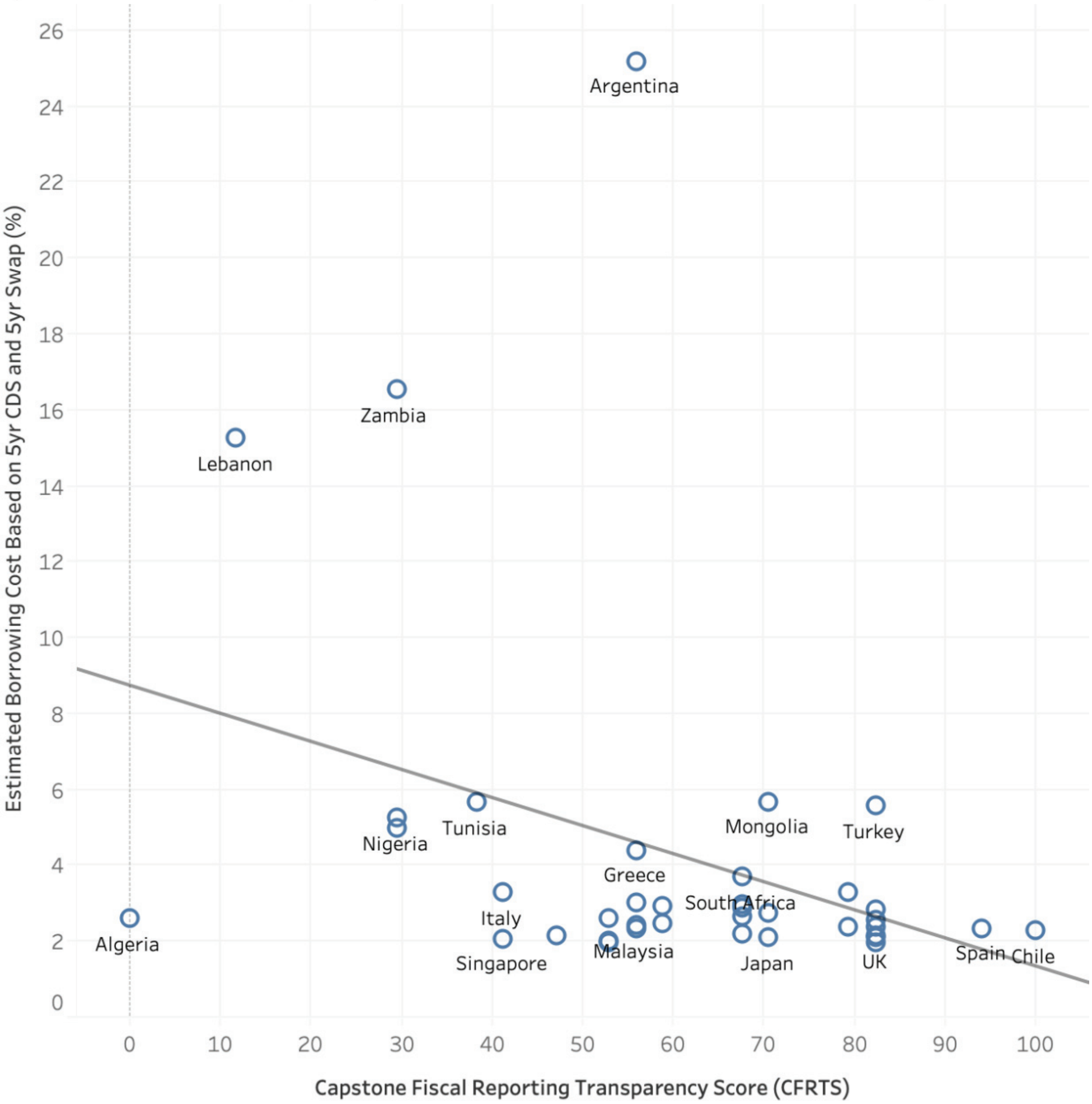


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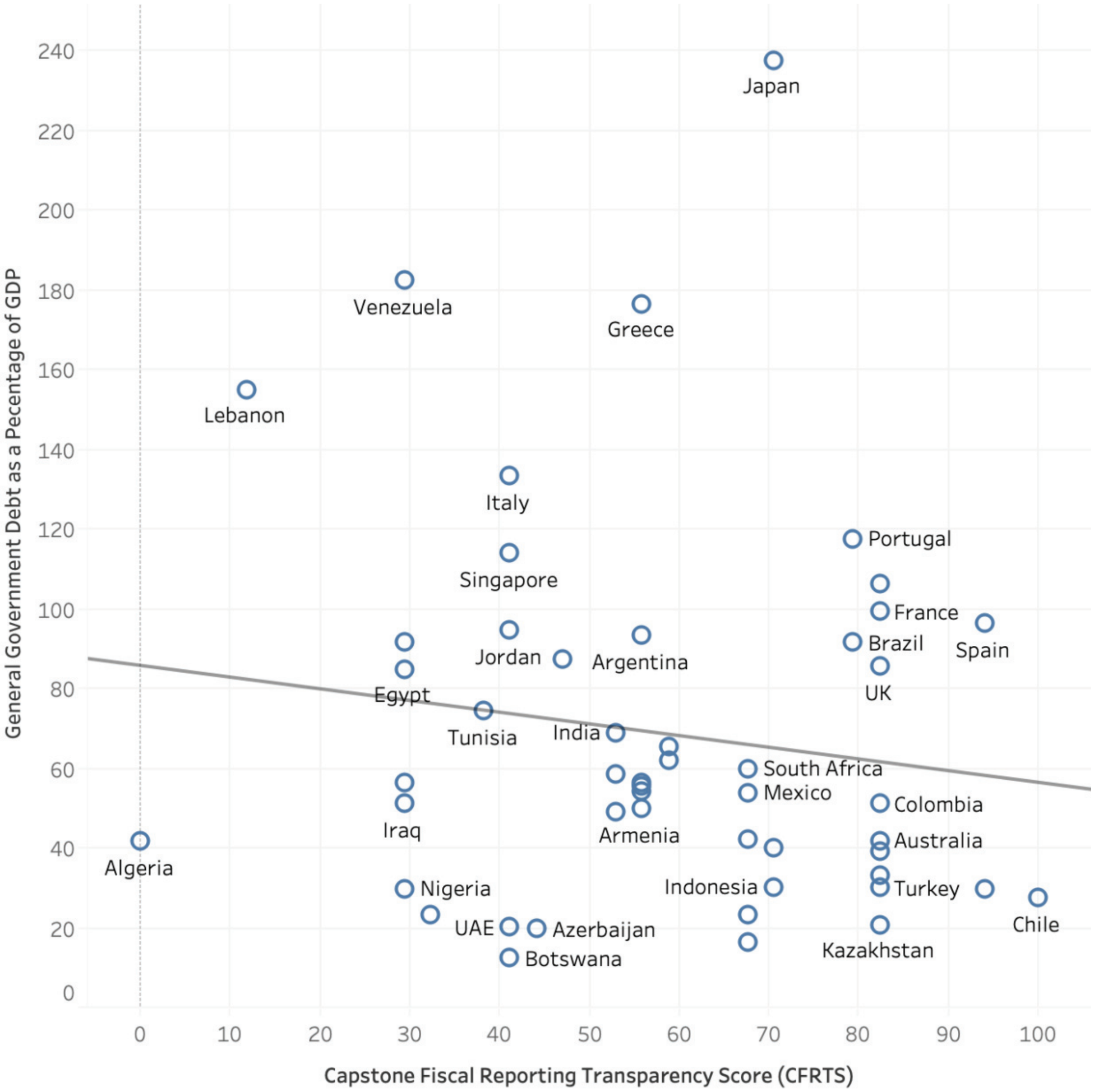
Figure 17: Accounting Transparency Has Little Correlation with General Government Debt-to-GDP Ratios



The correlation between transparency scores and general government debt is weakly negative, which is interesting for two reasons:

1. As increased levels of transparency make it harder to hide sovereign liabilities, the debt to GDP ratios of untransparent sovereigns are more likely to be underestimating contingent liabilities. Thus the actual underlying correlation is likely more negative than presented here.
2. This finding in turn is fascinating, as the reason for this finding could be twofold: Either (A) sovereigns with very high levels of debt to GDP also have more hidden debt to GDP and are thus

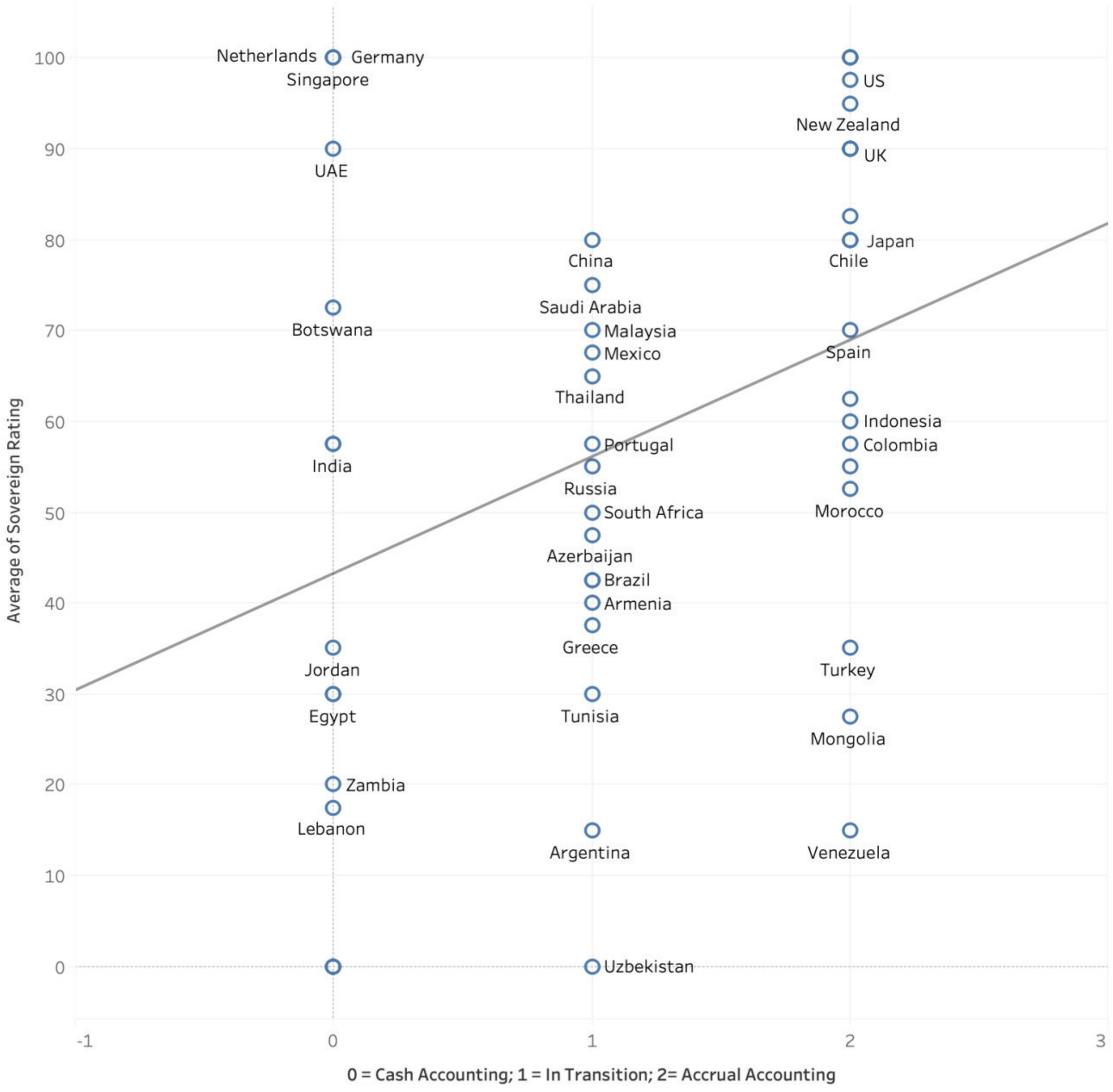
less inclined to improve their transparency. The Lebanese case, where before 2019 even the Ministry of Finance itself was unable to produce but vague estimates of total sovereign debt, could serve as empirical evidence for such a dynamic. Or (B) high levels of transparency make it impossible to keep parts of added leverage opaque ex ante and thus countries that are more transparent are less inclined to rely on debt financing, because they have exposed themselves to stricter oversight because of their increased transparency.

Figure 18: Countries that Rely More on Foreign Investors are More Transparent

Unlike absolute levels of general government debt, the share of government debt that is held by foreign investors is positively correlated with increased transparency. Whilst but a correlation, this finding hints at a possible dynamic of fiscal transparency being a facilitating factor for improved access to international capital markets. In other words, sovereigns seeking to finance their deficits by borrowing from

international capital markets have greater incentives to improve their transparency, as more sophisticated foreign investors reward transparency with lower sovereign spreads. Sovereigns less dependent on foreign financing likely face less incentives to improve their transparency and comparability with other sovereigns from a macroeconomic perspective.

Figure 19: Accrual Accounting is Associated with Higher Credit Ratings, Aside from a few highly Trustworthy Sovereigns



As has been discussed in the section on accrual vs. cash accounting, the difference matters in particular, when sovereigns are in arrears on non-debt obligations, which can remain opaque under cash accounting

standards. This is reflected in sovereign ratings (Lebanon, Egypt, Zambia). However, applying cash accounting is not per se an impediment to high sovereign ratings. When a sovereign has developed a track record of fiscal prudence, or responsibility as a safe haven for investors in times of elevated risk (Germany, Singapore, Japan, UAE), it can achieve high sovereign ratings despite applying cash accounting. Establishing such a track record however is rare and likely to take much longer than transitioning to accrual accounting, which is why countries when aiming to move up the rating scale are likely incentivized to implement accrual accounting.

Regression Analysis

To better investigate the correlation between variables, we have selected a number of representative measures and performed three regression analyses:

Variables:

- Credit Rating Score: in order to convert the Moody's and S&P ratings into numerical values, we have assigned scores to each notch, ranging from 5 to 100, and applied the average credit rating score to perform the regression
- Transparency Score: the score that we have assigned according to the disclosure matrix
- Cost of Borrowing: the 5-year estimated yield[46]

Table 10: Regression Results 1

	(1) Cost of Borrowing (USD Yield)	(2) Cost of Borrowing (USD Yield)	(3) Cost of Borrowing (USD Yield)
Credit Rating	-0.0957***	-0.109***	
	(0.0218)	(0.0199)	
Transparency Score	-0.0414		-0.0734**
	(0.0285)		(0.0283)
Constant	12.79***	11.04***	8.635***
	(1.793)	(1.352)	(1.848)
Observations	44	44	45
Adjusted R^2	0.421	0.406	0.115

Standard errors in parentheses

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

[46] In order to derive a comparable variable that reflects the sovereign's yield spread, we rely on 5-year CDS data applying the no-arbitrage-assumption. When this assumption holds, an investor cannot derive a profit from selling her long position in the sovereign bond and instead sell the CDS whilst investing the principal at the risk-free rate. In case of default, both the CDS seller and the bond investor would lose $(1 - RecoveryRate) * Principal$. For no arbitrage opportunity to arise, the CDS must thus be equal to the sovereign spread (yield on the sovereign bond minus the risk-free rate). For a proxy of the sovereign spread we thus calculate: $5 - Year\ CDS + Risk\ Free\ Rate$ Where for the risk-free rate, we apply the average of the US 5-year treasury yield between February 2019 and February 2020 and for the 5-Year CDS-measure we turn to the average of each country's 5-year CDS between Feb/2019 and Feb/2020 to smoothen out potential spikes. In sum, our yield thus measures the return a US investor would expect when investing in a USD-denominated sovereign bonds and is perfectly comparable across countries.

Table 11: Regression Results 2

	(1) Credit Rating
Transparency Score	0.573***
	(0.178)
Constant	26.80**
	(11.68)
Observations	45
Adjusted R^2	0.176

Standard errors in parentheses

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Table 10 - Regression (1):

$$\beta_1 * Transparency\ Score + \beta_2 * Credit\ Rating\ Score = Cost\ of\ Borrowing$$

Our first regression aims to explore the broad relationship between transparency score and borrowing costs. Country credit ratings were used as a comprehensive control variable to capture a variety of other factors relevant to a country's cost of borrowing (e.g. debt levels, institutional strength, growth outlook, etc.). From the result, we can conclude that having a one percentage point higher transparency score is associated with approximately 4 basis points (one hundredth of a percent) lower yield. The confidence level of this coefficient's statistical significance remains just below 90%. However, as there likely exists a degree of multicollinearity between credit ratings (that take into account transparency factors), the standard errors are likely inflated relative to the coefficient. Meanwhile, having a better credit rating is unsurprisingly associated with a lower cost of borrowing, statistically significant at robust levels. In addition, the adjusted R-square implied that around 42% of the variability can be explained by these two variables alone.

Table 11 - Regression (1):

$$\beta_1 * Transparency\ Score = Credit\ Rating$$

In order to investigate the validity of our multicollinearity hypothesis concerning regression 1, we performed a second regression of credit rating on the transparency score. The result shows that there is indeed a strong positive relationship between the two, with a p-value below 0.01 that renders the correlation statistically significant at a 99% confidence level. This correlation suggests that these two measures are very much correlated, which confirms the hypothesis of multicollinearity within the first regression.

Table 10 - Regression (2):

$$\beta_1 * Credit\ Rating\ Score = Cost\ of\ Borrowing$$

From the output above, we confirm that credit rating scores are negatively correlated with cost of borrowing, with a p-value of approximately zero. Also, the R-square suggested that approximately 40.6%

of the variability can be explained by this regression model. Compared to the R-square of 42% in regression (1), we can conclude that our transparency score has taken into account some variables that are missing in the credit rating, which led to an increase of R-square and improvement if incorporated into the regression model. However, one should keep in mind that our data analysis does have some drawbacks, for instance, omitted variable bias and differing interpretations of causation channels.

SECTION 5: SOVEREIGN ACCOUNTING CASE STUDIES

Country Case Study #1: United Kingdom (UK)

The Gold Standard of Fiscal Transparency

According to the IMF, the UK is "at the forefront of fiscal reporting practices worldwide" having met 42 out of 48 Fiscal Transparency Code (FTC) principles, with a record 23 being met at an "advanced" level.[47] The country, along with others such as Australia and New Zealand, is often considered the "gold standard" of sovereign financial reporting.

The UK consolidates over 8,000 public sector entities including central government departments, non-departmental public bodies, independent government agencies, local and regional governments, hospitals, and public corporations in its Whole of Government Accounts (WGA) reporting framework.[48] WGA thus presents what can be considered full government financial statements, including estimates for physical assets and not just financial assets. The UK also provides a list of entities that are left out due to judgement (very few around 20) and minor entities which are not included on the basis of materiality (max £20 mn in Gross expenditure, PPE or Net Assets).

The WGA are prepared using a fully accrual-based EU adopted International Financial Reporting Standards (IFRS) framework that has been adapted for the public sector by the UK authorities. In implementation the government also draws heavily on IPSAS. This effectively means that the IPSAS framework serves as a second form of accounting guidance that can be applied in circumstances when IFRS does not specifically address a public sector issue. The WGA reports are easily accessible and the most recent report for the 2017/2018 fiscal year stood at 244 pages.

UK Reporting Under GFS

Annual UK GFS data is reported for publication in the Government Finance Statistics Yearbook. Fiscal data for the IMF Article IV consultation missions covers public sector operations across the general government and public sector boundaries which is in line with European System of Accounts (ESA) 2010 / Government Finance Statistics Manual (GFSM) 2014. The UK publishes detailed information on public

47 International Monetary Fund, 2016. "United Kingdom; Fiscal Transparency Evaluation," IMF Staff Country Reports 16/351, International Monetary Fund.
48 "Whole Of Government Accounts, 2017 To 2018". *GOV.UK*, 2020, https://www.gov.uk/government/publications/whole-of-government-accounts-2017-to-2018.

sector finances for the entire public sector on a monthly basis and the GFS data is being compiled on an accrual basis. The UK participates in the Eurostat GFS convergence project with the IMF and thus, GFS data for general government, including government balance sheet data, are submitted in line with GFSM 2014 presentation on a quarterly and annual basis. In addition, since June 2019, the Office of National Statistics (ONS) has presented a balance sheet, statement of operations and statement of other economic flows for the public sector compliant with the GFSM 2014 presentation. The main areas of difference between ESA/GFS reporting and WGA accounts are as follows:

Table 12: Comparison of WGA and ESA / GFS Accounting

Area	WGA Treatment	ESA Treatment
PFI/PPP	Most PFI assets and liabilities are recognised on the balance sheet after assessing control of the assets. PFI payments are apportioned between repaying debt, paying interest and paying for services	Most PFI assets and liabilities are not recognised on the balance sheet after assessing risks and rewards. Payments under PFI contracts are recognised as a current expense in-year for off balance sheet schemes and a capital expense in-year for on balance sheet schemes.
Revaluation and impairment of assets	Assets are revalued as set out in note 1 of the accounts. Assets are assessed annually for impairment compared to their carrying value	Assets are recognised at cost less depreciation and are not revalued. Only impairments caused by obsolescence or accidental damage are recognised
Public sector pensions	Recognises expenditure when rights accrue to employees, even though payment is not due.	Recognises expenditure as it is paid to retirees. The future liability for current employees is not recognised
Provisions	Recognises expenditure when it becomes probable that a payment will be needed as a result of past events.	Recognises provisions only when they are settled (i.e. there are actual payments). Amounts expected to be paid out in future as a result of past events are not recognised.
Effects of discounting future liabilities	Future cash flows are discounted to estimate the value of the liability. Changes to the cash flows and discount rate are recognized in-year	Not included
UK Asset Resolution (UKAR)	Includes both the liabilities and the assets.	Includes UKAR's own debts to the private sector and exclude their non-liquid financial and other assets

Source: WGA Accounts, 2017-18[49]

[49]("Whole Of Government Accounts, 2017 To 2018")

Table 13: A Reconciliation of Net Public Sector Debt Between WGA and ESA/GFS

	Balance sheet levels at end March (£ billion) 2017-18	2016-17	2015-16
Public sector net debt (National Account) - PSND	1,779	1,727	1,603
Remove items included in National Accounts but not in WGA			
Housing Associations	-	-70	-67
Add net liabilities included in WGA but not in PSND			
Net public service pensions liability	1,865	1,835	1,425
Provisions	422	322	306
Working capital (creditors and debtors)	-40	-39	-27
Add assets netted off in WGA net liabilities but not in PSND			
Tangible and intangible fixed assets	-1,264	-1,221	-1,169
Equity (including equity in public sector banks)	-52	-51	-50
Adjust for items measured differently			
Differences in the measurement of net debt for UK Asset Resolution (UKAR)	-10	-24	30
Capital liabilities for PFI contracts	33	33	33
Gilts held by the Asset Purchase Facility	-200	-127	-50
Gilts issued	54	51	38
Other	-22	-15	-26
WGA net liabilities	2,565	2,421	1,986

Source: WGA Accounts, 2017-18[50]

The difference in the above table is primarily due to two particularly large and partially offsetting items:

- **Public service pensions:** PSND only includes liabilities arising from past cash payments. The WGA debt measure includes an estimate of the net present value of future cash payments arising from past employment.[51]
- **Inclusion of the public sector's tangible and intangible fixed assets:** These asset items not included in PSND offsets a large part of these additional liabilities under WGA. Similarly, the treatment of change in asset values is different. WGA values change every year to reflect market value whereas, under PSND, changes in market prices are not included until assets are sold and a profit or loss is realised.

50 ("Whole Of Government Accounts, 2017 To 2018")

51 "Forecast Evaluation Report". *Obr.Uk*, 2018, https://obr.uk/docs/dlm_uploads/Forecast-Evaluation-Report-2018_Web_Accessible.pdf.

Contingent Liability Reporting Under WGA

The UK's disclosure of contingent liabilities is robust. However, it is noteworthy that even the "gold standard" of sovereign accounting reports the majority of contingent liabilities is off its balance sheet. This is due to the nature of IPSAS accounting, which generally does not encourage liabilities to be included unless the probability of payment is estimated at over 50%.

Still, the UK is extremely transparent about the amount and nature of its potential contingent liability exposure in the footnotes to its financial statements. Table 14 below displays all of the non-remote contingent liabilities disclosed in the footnotes of the UK WGA reports.The largest potential exposure is "Clinical negligence claims" which largely stem from lawsuits against The Department of Health and Social Care. Notably, £78.4 billion has already been recognised as a provision and another £46.1 billion has been listed as contingent. Guarantees and insurance policies provided by UK Export Finance make up the second largest category at £11.9 billion. The Crossrail public-private-partnership is also singled out as a £5.1 billion contingent exposure. The WGA disclosure also lists a number of liabilities deemed likely enough to include but that it was not able to quantify, including civil nuclear-related liabilities, pension scheme deficits, and other London transportation projects.

Table 14: UK Quantifiable Non-Remote Liabilities by Type

	2017-18 £bn	2016-17 £bn
Export guarantees and insurance policies	11.9	12.8
Clinical negligence	47.3	365
Taxes subject to challenge	6.0	18.7
Transport infrastructure projects	8.0	8.3
Other	10.5	7.7
Total quantifiable contingent liabilities	83.7	84

Source: Note 29, 2017/2018 WGA[52]

Under IPSAS contingent liabilities estimated to be remote are not required to be disclosed, even in the footnotes. Impressively, the UK government discloses these anyway, going a step beyond what is required under IPSAS. The largest remote contingent liability listed is the potential £31 billion of callable capital to the European Investment Bank (EIB). Other remote contingent liabilities listed include loans under the European Financial Stabilisation Mechanism (EFSM), rail contracts, and indemnity provided to museums and galleries.

52 ("Whole Of Government Accounts, 2017 To 2018")

Table 15: UK Quantifiable Remote Contingent Liabilities by Type

	1 April 2017 (restated) (£bn)	Increase in year (£bn)	Liabilities crystallized in year (£bn)	Obligations expired in year (£bn)	31 March 2018 (£bn)
Guarantees	72.6	1.8	-	(5.0)	69.4
Indemnities	14.4	13.7	-	-	28.1
Letter of Comfort	11.4	-	-	-	11.4
Total quantifiable contingent liabilities	98.4	15.5	-	(5.0)	108.9

Source: Note 30, 2017/2018 WGA[53]

Lastly, the UK government notes that it has "entered into a number of contingent liabilities where the size of the liability could either not be determined with reasonable certainty or to quantify it would jeopardise the outcome of any legal proceedings."[54]

Case Study: Hinkley Point C - A Notable Contingent Liability

Hinkley Point C (HPC) is a project to construct a 3,200 MW nuclear power station in Somerset, England. EDF, the french power and utility company largely owned by the French government, is the developer and economic owner of the project. To date, the project is several billion pounds over-budget and is now expected to cost between £21.5bn and £22.5bn.[55] Originally slated to be operational in 2017, EDF is now targeting 2025 and recently warned of another possible 15 month delay. Staffing reductions and other complications from the COVID 19 pandemic could cause even further delays.[56]

In order to incentivize construction of the plant, the UK government signed a fixed-price output agreement with the owners of the plant. The agreement is structured as a "contract for difference," meaning that the government will compensate the power plant if wholesale electricity prices are below the stated contract price (and vice-versa). This means that, in the event that wholesale power prices trend below the stated contract price, the plant will be owed large payments in order to honor the contract.

53 ("Whole Of Government Accounts, 2017 To 2018")
54 Pg. 68: ("Whole Of Government Accounts, 2017 To 2018")
55 Cholteeva, Yoana. "Hinkley Point C Nuclear Project To Run Up To £2.9Bn Over Budget". *Power Technology | Energy News And Market Analysis*, 2019, https://www.power-technology.com/news/hinkley-point-c-nuclear-project-to-run-up-to-2-9bn-over-budget.
56 Cooke, Yasmin. "EDF May Consider Further Reduction To Hinkley Point Workforce". *Somersetlive*, 2020, https://www.somersetlive.co.uk/news/health/coronavirus-edf-consider-further-reduction-4007686.

The price guaranteed in the contract is reported to be fixed at £92.5 per MWh (linked to inflation) over 35 years.[57] Figure 20 below estimates the annual payment owed to Hinkley Point C based on current market prices, which are currently about half the price that the government has guaranteed to the plant.

Figure 20: Payment to Hinkley Point C Power Plant Estimated at Over £1 billion Annually

Power Plant Capacity (MW)	3,200
Capacity Factor	90%
Annual Power Plant Generation (MWh)	25,228,800
Contract Price - 2012 Nominal (£ per MWh)	92.50
Annual Inflation	1%
Contract Price - 2019 (£ per MWh)	99.17
Avg. GB 2019 Market Price (£ per MWh)	43.74
Avg. Price Difference (£ per MWh)	55.43
Estimated Annual Payment to Power Plant (£)	1,398,495,962

Source: capstone team calculations; power prices taken as the 2019 month-ahead average as reported on the UK Office of Gas and Electricity Markets (OFGEM) website[58]

Over the course of the 35 year contract, it is clear that the potential government subsidy payments to the Hinkley Point C reactor could be substantial. Yet, this potential liability is not on the UK's balance sheet, or even included in the contingent liability footnote tables. Instead, the exposure is listed in the Financial Instruments footnote, where despite being excluded from the balance sheet, the country concedes that the payments could be quite large. The following language was included in the fiscal year 2017/2018 WGA report - at £36.6 billion the estimated exposure from this contract would be the second largest contingent liability disclosed by the government:

> *The government entered into the Hinkley Point Contract for Difference on 29 September 2016. The fair value of the CfD liability is valued at £36.6 billion (2016-17: £28.8 billion). This valuation required an estimate of wholesale electricity prices to 2060, but there is significant estimation uncertainty with electricity prices past 2040. Due to this uncertainty, the CfD for Hinkley Point C is not recognised on the Statement of Financial Position*[59]

Ultimately, the annual payment may be socialized across electric utility customers in the UK, rather than being paid directly by the UK government. However, there is no guarantee the entire amount will be "passed-through" and in any case the potential UK government exposure to Hinkley Point C does not stop there.

[57] "Hinkley Point C". *GOV.UK*, 2016, https://www.gov.uk/government/collections/hinkley-point-c.
[58] "Electricity Prices: Day-Ahead Baseload Contracts – Monthly Average (GB)". *Ofgem*, 2019, https://www.ofgem.gov.uk/data-portal/electricity-prices-day-ahead-baseload-contracts-monthly-average-gb.
[59] Pg. 13, ("Whole Of Government Accounts, 2017 To 2018")

On top of the price guarantee, the UK government has also explicitly guaranteed £2 bn of the project's construction costs and the entirety of the debt that has been raised to finance the > £20 billion project.[60] [61] Moreover, given that the massive project is expected to generate nearly ~10% of the nation's electricity, there are concerns that the government may need to backstop the project entirely should it become financially unviable. Nuclear power plants have a poor construction track record. Of the two new nuclear reactors being constructed in the United States, the Vogtle plant expansion in Georgia is five years behind schedule and over $14 billion over budget.[62] The other, the VC Summer plant in South Carolina, was abandoned altogether after 10 years of planning and construction and a staggering $9 billion spent - all on a project that will never generate electricity.[63] Should the Hinkley Point C project run into similar challenges, there is a concern that the UK government could end up footing some of the bill.

Takeaways

- **Contingent Liabilities Escape Balance Sheet Disclosure Even For Countries at the Forefront of Financial Reporting**

The United Kingdom is considered the "gold standard" of sovereign financial reporting for good reason. The country is highly transparent with respect to its sovereign contingent liabilities and in some cases - e.g. disclosing even remote contingent liabilities - even goes above and beyond IPSAS standards. And yet, the majority of these contingent liabilities are disclosed in footnotes rather than on the country's balance sheet.

In total, the UK in its WGA footnotes discloses ~£84 billions of non-remote contingent liabilities and ~£109 billions of remote contingent liabilities. These are in addition to the ~£37 billion Hinkley Point contract exposure and a number of other unquantifiable contingent liabilities that are not included in these totals. Users of the UK's financial statements, in order to get a more accurate picture of the country's indebtedness, would thus need to adjust the country's ~£1,347 of government borrowings to include a probability-adjusted estimate of the country's ~£230 billions of potential contingent liability exposure.

60 Gauke, David. *UK Guarantee for Hinkley Point C: Written Statement - HCWS216*. Parliament.uk, 25 Oct. 2016, www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2016-10-25/HCWS216/

61 *Commission Decision on the Aid Measure Which the United Kingdom Is Planning to Implement for Support of the Hinkley Point C Nuclear Power Station*. European Commission, 8 Oct. 2010, ec.europa.eu/competition/state_aid/cases/251157/251157_1615983_2292_4.pdf

62 "Plant Vogtle Expansion in the Spotlight: Billion$ More at Risk - SACE: Southern Alliance for Clean Energy." *SACE | Southern Alliance for Clean Energy*, 8 Nov. 2019, cleanenergy.org/blog/plant-vogtle-expansion-in-the-spotlight-billion-more-at-risk/

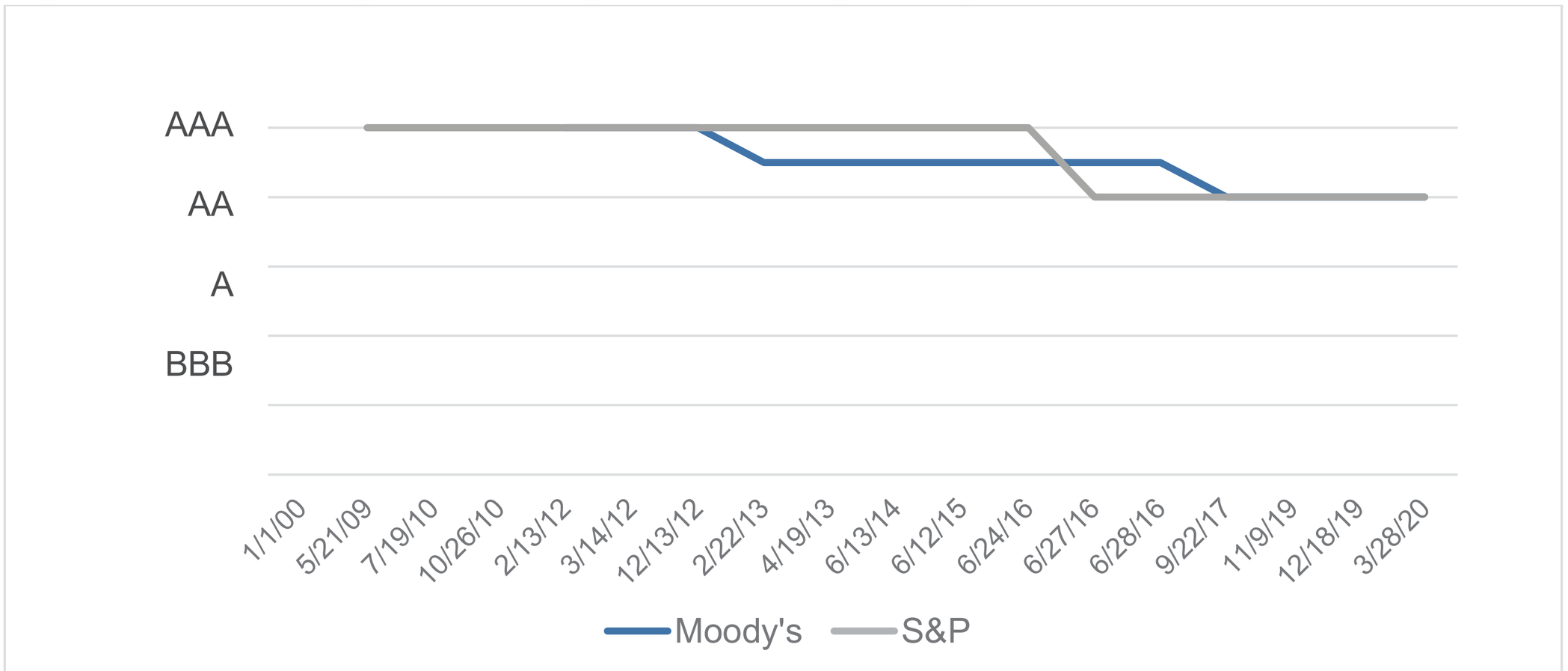
63 Plumer, Brad. *U.S. Nuclear Comeback Stalls as Two Reactors Are Abandoned*. The New York Times, 1 Aug. 2017, www.nytimes.com/2017/07/31/climate/nuclear-power-project-canceled-in-south-carolina.html

- **Transparency is an Important, But Insufficient Element of Sovereign Creditworthiness**

The prominent credit rating agencies typically include institutional strength as a factor in their sovereign rating frameworks, a metric which is meant to capture in part the transparency of sovereign disclosure.[64] This means that, all else equal, greater transparency should enhance an issuer's credit rating.

And yet, despite its strong disclosure, the majority of contingent liabilities are not included on the country's balance sheet due to the IPSAS probability framework. Moreover, the country has been experiencing a gradual deterioration in its fiscal position. The country lost its Moody's AAA rating in 2013 and was downgraded again in 2017 in the wake of the Brexit referendum.[65] In November 2019 Moody's again put the country on negative watch as Brexit uncertainty lingered and a "no-deal" scenario began to look more plausible.[66] Figure 21 below shows how Moody's sovereign credit rating has deteriorated broadly across the three major credit rating agencies.

Figure 21: United Kingdom Sovereign Credit Rating History



Source: World Government Bonds

64 https://www.spratings.com/documents/20184/774196/How+We+Rate+Sovereigns+2019/a574456b-4ee9-2f51-0a95-21823713cf38; Moody's Rating Methodology: 27 November 2018.Sovereing Bond Ratings

65 "Moody's Downgrades Outlook On UK's Rating On Brexit Paralysis". *CNBC*, 2019, https://www.cnbc.com/2019/11/08/moodys-downgrades-outlook-on-uks-rating-on-brexit-paralysis.html.

66 "Moody'S Lowers UK Credit Outlook To Negative On Brexit 'Paralysis'". *Ft.Com*, 2019, https://www.ft.com/content/1e5d9686-0274-11ea-b7bc-f3fa4e77dd47.

- **Best-in-Class Financial Reporting Practices are Time-Consuming & Resource-Intensive**

In 1998, the UK Treasury and National Audit Office recommended the publication of whole of government accounts and set out timelines for a full set of audited accounts to be made available for 2005–06.[67] The UK government did not meet this deadline, and instead it first reported under the WGA framework for its 2009/2010 fiscal year. It is perhaps unsurprising that a program of this scale and complexity - consolidating over 8,000 different government departments and agencies - would run into difficulties. In the early stages, the WGA project reportedly experienced challenges with data collection and reconciling accounts on such a large scale across the entire general government sector.[68] The UK's experiences highlight the robust institutional accounting and auditing systems needed to successfully implement transparency at the level the WGA program aspires. Given the arduous nature of putting up systems, reconciliation and instilling the fiscal discipline, the entire exercise requires a significant political buy-in as well.

Difficulties continue to this day, particularly with respect to time lag. As shown in Table 16 below, the lag between the submission to the National Accounting Office (NAO) and the WGA publication has for the last six publications averaged over 15 months. These delays can significantly limit the usefulness of the disclosures, as much of the information is outdated by the time it is available for investors and other stakeholders to digest. Due to these delays, many stakeholders rely on the more timely Public Sector Finance (PSF) statistics. There is a trade-off, however, as the PSF coverage of stocks and flows falls short of WGA's on a number of material issues that could be relevant for policy or investment decisions (e.g. transactions, holdings and valuation of fixed and equity assets, cost of employment associated with pension entitlements, procurement of public assets via PPP arrangements).

Table 16: Lag Between NAO Submission and WGA Publication

FY	Submission NAO	WGA Publication	Lag (wrt FY)
2009/10	Dec 17, 2010	Nov 24, 2011	19m
2010/11	Feb 29, 2012	Oct 31, 2012	18m
2011/12	Feb 1, 2013	July 17, 2013	16m
2012/13	Jan 22, 2014	Jun 10, 2014	15m
2013/14	Dec 19, 2014	May 26, 2015	12m
2014/15	Jan 18, 2016	May 26, 2016	14m

Source: IMF[69]

67 Chow, Danny et al. "New Development: In Pursuit Of WGA—Research Findings From The UK". *Public Money & Management*, vol 29, no. 4, 2009, pp. 257-260. *Informa UK Limited*, doi:10.1080/09540960903035049.

68 Chow, Danny, et al. *Reporting on the UK's WGA Experiment*. Public Money & Management, 29 May 2009, www.researchgate.net/profile/Jodie_Moll/publication/228426393_Reporting_on_the_UK's_WGA_Experiment/links/0fcfd5093e56a81db5000000.pdf

69 (IMF *United Kingdom; Fiscal Transparency Evaluation*)

Country Case Study #2: Malaysia

Introduction - A World Leader in the Use of Public-Private Partnerships for Development

On March 28th, 2016 the World Bank Group recognized Malaysia's commitment to sustainable development and further cemented its status as a regional and international leader in this area when it opened the first Global Knowledge and Research Hub in Kuala Lumpur. According to a press release, "The Hub serves as a global platform to share and operationalize Malaysia's development expertise for developing country programs (WBG or otherwise), and create innovative policy research on national, regional, and global issues."[70]

One of the areas that Malaysia is particularly strong in is in the use of public-private partnerships (PPPs) for economic development. Having only just been founded as a modern nation in 1963, it has made remarkable progress transforming itself from a colony of the British empire to a developed nation in less than sixty years. Much of that success is owed to the collaboration between the private and public sector, which began in the 1980's, long before it was common practice in the rest of the developing world. Given their success in fostering economic growth, the governance process of PPPs, transparency in the procurement process and disclosure of the terms of the arrangements, remains a work in progress.

This case study will discuss Malaysia's current accounting framework, its transition from cash to accrual accounting, and how it records contingent liabilities on the balance sheet. It will look at how Malaysia has used PPP's to ease pressure on the federal government's budget, while continuing to meet the needs of the country; risks associated with PPP structures and how these risks can become contingent liabilities for the government; and some steps Malaysia has taken already to improved its regulatory framework to prevent the crystallization of contingent liabilities from PPPs.

Accounting Framework

As recently as the financial statements ending on 31 December 2018, Malaysia is still using a modified cash-based accounting framework based on IPSAS 2006 standards. However, the country is in the process of transitioning both the government's financial accounting standards and its macroeconomic statistics standards to an accrual basis. As part of the transition, it has developed a national accrual-based standard, called the Malaysia Public Sector Accounting Standards (MPSAS), which are heavily modeled off the 2011 and June 2013 International Public Sector Accounting Standards (IPSAS). The MPSAS is intended to cover the public sector, except Government Business Enterprises (GBEs), which use the Malaysian Financial Reporting Standards (MFRS) based on the International Financial Reporting Standards (IFRS), the private sector's equivalent of IPSAS.

70 "The World Bank Group Global Knowledge and Research Hub in Malaysia." *World Bank*, www.worldbank.org/en/country/malaysia/brief/global-knowledge-and-research-hub.

The transition to better financial management and transparency began fifteen years ago when the federal government adopted a cash basis IPSASs from the year ending December 31, 2005.[71] In 2011, the government announced it would be transitioning to the accrual based MPSAS. The decision to transition was primarily prompted by the need for greater accountability and better performance of government-controlled corporations.[72] Published in 2013, the government set an ambitious target implementation date of 2015 for the federal level to fully implement MPSAS, and 2016 for the state governments with a no later date of 2017. Although those dates have passed without the process being completed, much progress has been realized. The IMF suggests that Malaysia will be using accrual-based accounting principles for its 2021 financial statements.[73]

There are four main challenges cited by the government for the delay in implementation: policies and standards needed to be established, relevant laws and regulations had to be identified and amended, new information technology systems had to be acquired, and change management and training programs had to be implemented for an estimated 70,000 personnel.[74] Many government servants have had limited knowledge and have been unwilling to participate in the transition. In addition, the procurement process for accounting systems and software applications has been insufficient, supposedly because national procurement policies based on racial preferences, known as Bumiputra laws, establish quotas for the number of projects that must be awarded to the indigenous Malay people and there weren't enough qualified vendors to fulfil these quotas.

Malaysia Macroeconomic Statistics Reporting Under GFS

As of 2019, Malaysia has employed accrual-based GFS for the budgetary central government sector only. In order to apply accrual-based GFS to extrabudgetary central government, subnational, and nonfinancial public corporations (NFPC), processes of data collection need to be refined, namely the surveys that collect the metrics need to be redesigned. The IMF has assessed that state governments pose limited fiscal risk because states can only borrow from the federal government level, with the exception of the states of Sarawak and Sabah which remain autonomous in regards to raising their own debt. The emphasis for the revised surveys is on NFPC's and extra budgetary central government. With IMF assistance, the Ministry of Finance (MOF) and Department of Statistics Malaysia (DOSM) have developed an automated process to convert chart of accounts (COA) to Government Finance Statistics (GFS) formatting for data from 2018 onward. Although it has nearly completed the transition to accrual-based GFS, the government does not intend to disseminate these metrics until the first publication of

71 IPSASB. "IPSAS ADOPTION EXPERIENCE A Closer Look At: Malaysia." *IFAC*, Nov. 2013, p.1. www.ifac.org/system/files/uploads/IPSASB/A-Closer-Look-At-Malaysia-2013.pdf.
72 ShawallizaYusof, Nur, and Hartini Jaafar. "The Implementation of Accrual-Based Accounting in Malaysian Public Sector: Opportunities and Challenges." *International Business Education Journal*, vol. 11, no. 1, 31 Dec. 2018, pp. 49–62.
73 International Monetary Fund. Statistics Dept. "Malaysia : Technical Assistance Report-Government Finance Statistics Mission." *IMF*, 13 Aug. 2019, p.6. https://www.imf.org/en/Publications/CR/Issues/2019/08/13/Malaysia-Technical-Assistance-Report-Government-Finance-Statistics-Mission-48583.
74 IPSASB. "IPSAS ADOPTION EXPERIENCE A Closer Look At: Malaysia." *IFAC*, Nov. 2013, p.1. www.ifac.org/system/files/uploads/IPSASB/A-Closer-Look-At-Malaysia-2013.pdf.

accrual based financial statements, which is expected to be in 2021. Until that time, it will use the accrual-based GFS figures internally.[75]

Contingent Liability Reporting Under Malaysian Public Sector Accounting Standards

As noted earlier, Malaysia's national accounting standards, MPSAS 2014, are heavily influenced by IPSAS (2011 & 2013). The Accountant General "has to a very large extent, maintained the accounting treatment and original text of the IPSASs unless there is a significant public sector issue and local legislation which warrant a departure."[76] As such, the chapter organization is the same, with MPSAS chapters corresponding to IPSAS chapters covering the same topic. The main difference between MPSAS and IPSAS is in regards to Government Business Enterprises (GBEs). In MPSAS, GBEs apply approved accounting standards issued by MASB, whereas in IPSAS GBEs apply IFRS standards issued by IASB.[77] Given that Malaysia has not yet transitioned to MPSAS and is still operating on a modified cash basis IPSAS, a comparison between the two standards is warranted. Cash Basis IPSAS standards were first issued in October 2002, and later modified in December 2006 and 2007.[78] Conducting a comparison between the presentation and disclosure of contingent liabilities under chapters 19 and32 of cash basis IPSAS 2006 and accrual basis MPSAS 2014 reveals no difference in the treatment of contingent liabilities.

The majority of Malaysia's contingent liability risk is attributed to statutory guarantees on loans issued to SOE's and PPP's, which are covered under MPSAS 19 - *Provisions, contingent liabilities, and contingent assets*. The treatment of other aspects of PPPs depends on the business model of the arrangement. The primary business models for PPPs that are used in Malaysia are either the Build-Lease-Maintenance-Transfer (BLMT) or the Build-Operate-Transfer (BOT) model.[79] Figure 22 shows which chapters of MPSAS pertain to different business models of PPPs .

75 International Monetary Fund. Statistics Dept. "Malaysia : Technical Assistance Report-Government Finance Statistics Mission." *IMF*, 13 Aug. 2019, p.6. https://www.imf.org/en/Publications/CR/Issues/2019/08/13/Malaysia-Technical-Assistance-Report-Government-Finance-Statistics-Mission-48583.

76 Accountant General's Department, Government of Malaysia. "Preface to Malaysian Public Sector Accounting Standards." *Malaysian Public Sector Accounting Standards*, Mar. 2013, p.4. https://www2.anm.gov.my/PublishingImages/SitePages/Malaysia%20Public%20Sector%20Accounting%20Standard/Preface%20MPSAS%20final_Final_v.1.2_15.03.2016.pdf.

77 Accountant General's Department, Government of Malaysia. "MPSAS 19 Provisions, Contingent Liabilities And Contingent Assets." *Malaysian Public Sector Accounting Standards*, Feb. 2014, p.43. https://www2.anm.gov.my/PublishingImages/SitePages/Malaysia%20Public%20Sector%20Accounting%20Standard/MPSAS%2019%20Provisions,%20Contingent%20Liabilities%20and%20Contingent%20Assets_v1.2_18.09.15.pdf.

78 IPSASB. "IPSAS® Summary – Financial Reporting under the Cash Basis of Accounting (the Cash Basis IPSAS)" *IFAC*, Nov. 2017, www.ifac.org/system/files/publications/files/Cash-Basis-At-a-Glance_0.pdf.

79 Lim, Mark, and Faez Abdul Razak. "Overview of the Malaysian PPP Framework." *In-House Community*, 19 Jan. 2016, www.inhousecommunity.com/article/overview-of-the-malaysian-ppp-framework/.

Figure 22: Relevant MPSAS chapters per PPP business model

IG4. Shaded text shows arrangements within the scope of MPSAS 32.

Category	Lessee	Service provider			Owner	
Typical arrangement types	Lease (e.g., operator leases asset from grantor)	Service and/or maintenance contract (specific tasks e.g., debt collection, facility management)	Rehabilitate-operate-transfer	Build-operate-transfer	Build-own-operate	100% Divestment/ Privatization/ Corporation
Asset ownership	Grantor				Operator	
Capital investment	Grantor		Operator			
Demand risk	Shared	Grantor	Grantor and/or Operator		Operator	
Typical duration	8–20 years	1–5 years	25–30 years			Indefinite (or may be limited by binding arrangement or license)
Residual interest	Grantor				Operator	
Relevant MPSASs	MPSAS 13	MPSAS 1	This MPSAS/MPSAS 17/ MPSAS 31		MPSAS 17/MPSAS 31 (derecognition) MPSAS 9 (revenue recognition)	

Source: MPSAS 32: Service Concession Arrangements[80]

PPPs that follow the Build-Operate-Transfer (BOT) business model are considered to be service concession arrangements and are mainly governed by the tenets of MPSAS 32 - *Service Concession Arrangement Pertaining to a Grantor*. Regardless of the business model, most contingent liabilities arising from PPPs fall into the following categories: asset or liability arising from a dispute over the terms of service concession agreement, financial guarantees, performance guarantees, or insurance contract guarantees. Where the guarantee is an insurance contract, the grantor can elect to apply the relevant international or national accounting standard dealing with insurance contracts. See MPSAS 28, paragraphs AG3–AG9 for further guidance.[81]

[80] Accountant General's Department, Government of Malaysia. "MPSAS 32 Service Concession Arrangements: Grantor." *Malaysian Public Sector Accounting Standards*, Mar. 2016, p.24, https://www2.anm.gov.my/PublishingImages/SitePages/Malaysia Public Sector Accounting Standard/MPSAS 32 Service Concession Arrangements-Grantor_Final_21-03-2016_v1.2.pdf

[81] Ibid, p.19.

A financial guarantee arising from a service concession arrangement is considered a guarantee, security, or indemnity related to the debt incurred by the operator to finance construction, development, acquisition, or upgrade of a service concession asset. A performance guarantee is a guarantee of minimum revenue streams, including compensation for short-falls. These types of contingent liabilities may be dealt with under MPSAS 28 - *Financial Instruments: Presentation*, MPSAS 29 - *Financial Instruments: Recognition and Measurement*, and MPSAS 30 - *Financial Instruments: Disclosure*.[82] If the contingency is regarding an asset or liability arising from a dispute over the terms of service concession agreement, is not a financial guarantee contract, or is not an insurance contract it is accounted for according to MPSAS 19.

As with IPSAS 19, under MPSAS 19 a liability is considered to be contingent if 1) a possible obligation may arise based on the occurrence or non-occurrence of one or more uncertain events or 2) a present obligation that is known to exist, but has a low probability an outflow of resources will occur and/or the amount of the obligation cannot be measured. If an entity shares an obligation with another party, the obligation that is to be met by the joint party is treated as a contingent liability.[83] In order for a contingent liability to be disclosed, the probability of occurrence must not be remote. Disclosures of contingent liabilities should include a brief description of the nature of the contingent liabilities, and where practical, an estimate of the financial effect, and indication of the uncertainties of the amount or timing of the outflow.[84]

Contingent liabilities in form of Statutory Guarantees will appear in the notes of the government's financial statements as well as an addendum under the section titled "Statement of Memorandum Account - Statutory Guarantees." Table 17 below is an example of this attachment from Malaysia's 2018 Financial Statements.[85] Most of the statutory guarantees that are disclosed in the financial statements under MPSAS 19 pertain to loans taken out by SOEs. However, many SOEs have subsidiaries that were created as special purpose vehicles in PPP arrangements, so it may be difficult to distinguish between the two. In the event that an underlying entity defaults on a loan that the government has guaranteed, the Statutory Guarantee will be converted to a Guarantee. This constitutes the crystallization of a contingent liability and will be recorded in the notes under "Financial Commitment" as well as in the "Statement of Memorandum Account of Liability - Guarantees Commitment."

[82] Ibid, p.19.
[83] Accountant General's Department, Government of Malaysia. "MPSAS 19 Provisions, Contingent Liabilities And Contingent Assets." *Malaysian Public Sector Accounting Standards*, Feb. 2014, p.13. https://www2.anm.gov.my/PublishingImages/SitePages/Malaysia%20Public%20Sector%20Accounting%20Standard/MPSAS%2019%20Provisions,%20Contingent%20Liabilities%20and%20Contingent%20Assets_v1.2_18.09.15.pdf.
[84] Ibid, p.24.
[85] Accountant General of Malaysia. "Federal Government Financial Statement 2011." *Accountant General's Department, Government of Malaysia*, 24 Sep. 2012. http://www.anm.gov.my/index.php/en/arkib-ag/terbitan/penyata-kewangan-kerajaan-persekutuan/book/100-senarai-ahli-mbj/1?page=3

Table 17: Malaysia Statement of Memorandum Account - Statutory Guarantees

Statement of Memorandum Account - Statutory Guarantees
as at 31 December 2018

Agency	*Domestic*	*External*	*Total*	
			2018	*2017*
	RM	*RM*	*RM*	*RM*
CONTRIBUTORS / DEPOSITORS GUARANTEES				
Bank Simpanan Nasional	26,769,058,725.10	–	26,769,058,725.10	24,883,249,896.07
Kumpulan Wang Simpanan Pekerja	839,642,920,247.23	–	839,642,920,247.23	768,508,566,754.71
Lembaga Tabung Haji	74,499,889,879.76	–	74,499,889,879.76	70,210,891,459.33
Perbadanan Tabung Pendidikan Tinggi Nasional - SSPN-*i*	3,682,902,756.00	–	3,682,902,756.00	2,797,018,580.00
TOTAL CONTRIBUTORS / DEPOSITORS GUARANTEES	944,594,771,608.09	–	944,594,771,608.09	866,399,726,690.11
LOAN GUARANTEES				
Statutory Bodies				
Lembaga Kemajuan Tanah Persekutuan (FELDA)	4,000,000,872.60	–	4,000,000,872.60	4,100,000,872.60
Lembaga Pembiayaan Perumahan Sektor Awam (LPPSA)	17,750,000,000.00	–	17,750,000,000.00	11,500,000,000.00
Perbadanan Kemajuan Negeri Pahang	120,000,000.00	–	120,000,000.00	120,000,000.00
Perbadanan PR1MA Malaysia (PR1MA)	5,000,000,000.00	–	5,000,000,000.00	3,717,500,000.00
Perbadanan Tabung Pendidikan Tinggi Nasional	37,700,000,000.00	–	37,700,000,000.00	40,200,000,000.00
Total Statutory Bodies	64,570,000,872.60	–	64,570,000,872.60	59,637,500,872.60
Companies				
1Malaysia Development Berhad	5,000,000,000.00	–	5,000,000,000.00	5,000,000,000.00
Asset Global Network Sdn. Bhd.	455,220,000.00	–	455,220,000.00	556,380,000.00
Bank Pembangunan Malaysia Berhad (BPMB)	6,350,000,000.00	–	6,350,000,000.00	6,400,000,000.00
Bank Perusahaan Kecil & Sederhana Malaysia Bhd (SME Bank)	2,600,000,000.00	–	2,600,000,000.00	2,600,000,000.00
Danainfra Nasional Berhad	52,740,000,000.00	–	52,740,000,000.00	42,180,000,000.00
Govco Holdings Berhad	7,300,000,000.00	–	7,300,000,000.00	8,800,000,000.00
Jambatan Kedua Sdn. Bhd.	4,600,000,000.00	1,151,122,500.00	5,751,122,500.00	6,317,729,700.00
Johor Corporation (JCorp)	2,600,000,000.00	–	2,600,000,000.00	2,600,000,000.00
K.L. International Airport Berhad (KLIA)	–	94,377,547.10	94,377,547.10	180,723,597.79
Khazanah Nasional Berhad	15,000,000,000.00	–	15,000,000,000.00	17,000,000,000.00
Malaysia Debt Ventures Sdn. Bhd.	930,000,000.00	–	930,000,000.00	900,000,000.00
Malaysia Rail-Link Sdn. Bhd.	5,300,000,000.00	13,562,350,408.20	18,862,350,408.20	14,492,744,886.90
MKD Kencana Sdn. Bhd.	3,500,000,000.00	–	3,500,000,000.00	1,000,000,000.00
Pelabuhan Tanjung Pelepas Sdn. Bhd.	1,995,000,000.00	–	1,995,000,000.00	1,840,000,000.00
Penerbangan Malaysia Berhad (PMB)	468,547,290.07	–	468,547,290.07	530,146,652.81
Pengurusan Air SPV Berhad (PASB)	13,310,000,000.00	–	13,310,000,000.00	13,110,000,000.00
Prasarana Malaysia Berhad	31,414,000,000.00	–	31,414,000,000.00	26,614,000,000.00
Projek Lebuhraya Usahasama Berhad (PLUS)	11,000,000,000.00	–	11,000,000,000.00	11,000,000,000.00
Sabah Electricity Sdn. Bhd. (SESB)	–	–	–	1,728,409.94
Sarawak Hidro Sdn. Bhd. (SHSB)	1,000,000,000.00	–	1,000,000,000.00	1,000,000,000.00
Senai Airport Terminal Service Sdn Bhd	330,000,000.00	–	330,000,000.00	330,000,000.00
Sentuhan Budiman	800,000,000.00	–	800,000,000.00	800,000,000.00
SRC International Sdn. Bhd.	3,600,000,000.00	–	3,600,000,000.00	3,900,000,000.00
Suria Strategic Resources Sdn. Bhd. (SSER)	1,036,205,224.00	6,889,059,143.51	7,925,264,367.51	2,940,476,380.85
Syarikat Perumahan negara Berhad (SPNB)	530,300,000.00	–	530,300,000.00	–
Tenaga Nasional Berhad (TNB)	–	2,546,897,521.57	2,546,897,521.57	2,554,639,389.80
TRX City Sdn. Bhd.	485,398,523.01	–	485,398,523.01	594,653,421.76
Turus Pesawat Sdn. Bhd.	5,310,000,000.00	–	5,310,000,000.00	5,310,000,000.00
Total Companies	177,654,671,037.08	24,243,807,120.38	201,898,478,157.46	178,553,222,439.85
TOTAL LOAN GUARANTEES	242,224,671,909.68	24,243,807,120.38	266,468,479,030.06	238,190,723,312.45
TOTAL GUARANTEES	1,186,819,443,517.77	24,243,807,120.38	1,211,063,250,638.15	1,104,590,450,002.56

Source: Government of Malaysia 2018 Financial Statements[86]

[86] Accountant General of Malaysia. "Federal Government Financial Statement 2018." *Accountant General's Department, Government of Malaysia*, 3 Oct. 2019, p.359. http://www.anm.gov.my/index.php/en/arkib-

When it comes to the disclosure of liabilities arising from PPPs, paragraphs 31-33 of chapter 32 of MPSAS 2014 and cash basis IPSAS 2006, direct that disclosure of service concession arrangements should be made within the notes of the financial section. Information to be disclosed should be robust including a description of the arrangement, significant terms of the arrangement that may affect the amount, timing, and certainty of future cash flows and the nature and extent of various rights and obligations granted. These disclosures should be provided either individually for each concession arrangement or in aggregate for each class of service concession arrangement (telecommunications, toll roads, water and water treatment)[87].

In the notes to Malaysia's financial statements there is a section called "Memorandum of Liabilities" that show a portion of the government's liabilities including Federal Debt and Other Liabilities that are not reported in the Statement of Financial Position. Starting 2018, the components of this memorandum consist of Federal Debt, Private Finance Initiative Liabilities, Financial Commitments and Other Liabilities.[88] Private Finance Initiative Liabilities, are another name for PPPs, so one can look here to see the size of the governments' PPP commitments. Figure 23 shows the notes regarding Private Finance Initiative Liabilities from the 2018 Financial Statements.

It is clear to see from this example that at the federal level Malaysia aggregates the disclosures regarding PPP liabilities not in accordance with the standards set forth in chapter 32. Instead only providing details of each PPPs service concession arrangement it opts to instead disclose a total aggregate number for PPP liabilities. According to the OECD and IMF data, PPPs consist of 12% of Malaysia's GDP.[89] So to not have transparency on the underlying service concession arrangements (SCAs) of this amount of liabilities is concerning. Without knowing what is in the SCA of each PPP, investors cannot anticipate or hold the government accountable for potential contingent liabilities. Malaysia's federal financial statements do not list any contingent liabilities associated with PPP's, other than potential statutory guarantees. It is possible that details of SCAs exist on the financial statements of lower level agencies, but it is unclear where those details may be found.

ag/terbitan/penyata-kewangan-kerajaan-persekutuan/book/155-2018-financial-statement/7-federal-government-financial-statement.

87 Accountant General's Department, Government of Malaysia. "MPSAS 32 Service Concession Arrangements: Grantor." *Malaysian Public Sector Accounting Standards*, Mar. 2016, pp.8-9. https://www2.anm.gov.my/PublishingImages/SitePages/Malaysia%20Public%20Sector%20Accounting%20Standard/MPSAS%2032%20Service%20Concession%20Arrangements-Grantor_Final_21-03-2016_v1.2.pdf.

88 Accountant General of Malaysia. "Federal Government Financial Statement 2018." *Accountant General's Department, Government of Malaysia*, 3 Oct. 2019, p.359. http://www.anm.gov.my/index.php/en/arkib-ag/terbitan/penyata-kewangan-kerajaan-persekutuan/book/155-2018-financial-statement/7-federal-government-financial-statement.

89 OECD. "OECD Economic Surveys: Malaysia 2019." *OECD Publishing*, July 2019, www.oecd.org/economy/surveys/Malaysia-2019-OECD-economic-survey-overview.pdf.

Figure 23: Private Finance Initiative Liabilities from 2018 Federal Financial Statements

(b) Private Finance Initiative Liabilities

Private Finance Initiative Liabilities are Federal Government's obligations to make repayments for financing raised on public projects funded through Private Finance Initiative Trust Account.

Private Finance Initiative Liabilities as at 31 December 2018 are as follows:

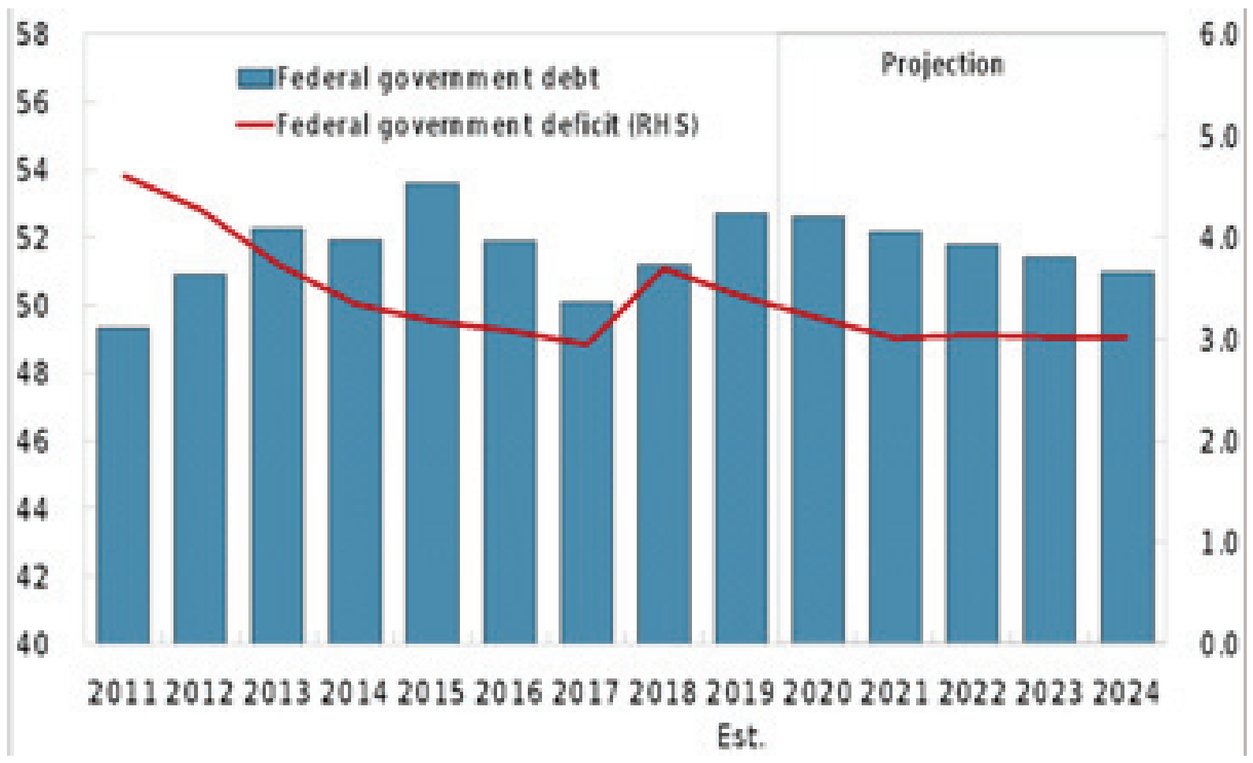
	2018 RM	*2017 RM*
PRIVATE FINANCE INITIATIVE LIABILITIES	**36,416,442,980**	**35,462,452,983**
Private Finance Initiative	14,833,406,915	16,483,406,914
Private Finance Special Development Activities	21,583,036,065	18,979,046,069

Source: Malaysia 2018 Federal Government Financial Statements[90]

Debt/Fiscal Trends 2009-2019

Analyzing the financial statements from 2009 – 2018, we see a few important trends in Malaysia's debt statistics. First, Figure 24 illustrates the percentage of national debt to gross domestic product (GDP) is declining, even though public debt levels are rising.

Figure 24: Medium-Term Fiscal Outlook
(in percent of GDP)



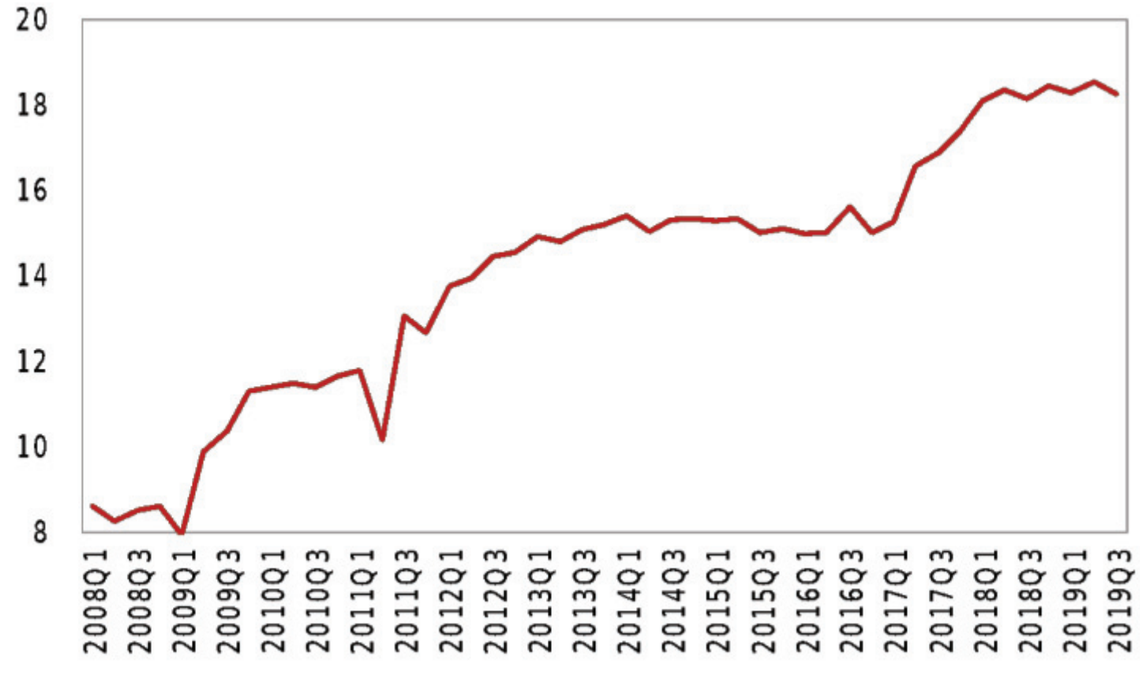
Source: IMF[91]

Second, total statutory guarantees as a share of GDP have risen.

90 Accountant General of Malaysia. "Federal Government Financial Statement 2018." *Accountant General's Department, Government of Malaysia*, 3 Oct. 2019, p.361. http://www.anm.gov.my/index.php/en/arkib-ag/terbitan/penyata-kewangan-kerajaan-persekutuan/book/155-2018-financial-statement/7-federal-government-financial-statement.

91 International Monetary Fund. "Malaysia : 2020 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Malaysia." *IMF*, 28 Feb. 2020, www.imf.org/en/Publications/CR/Issues/2020/02/27/Malaysia-2020-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-49105.

Figure 25: Federal Government Loan Guarantees
(in percentage of 4-quarter rolling GDP)



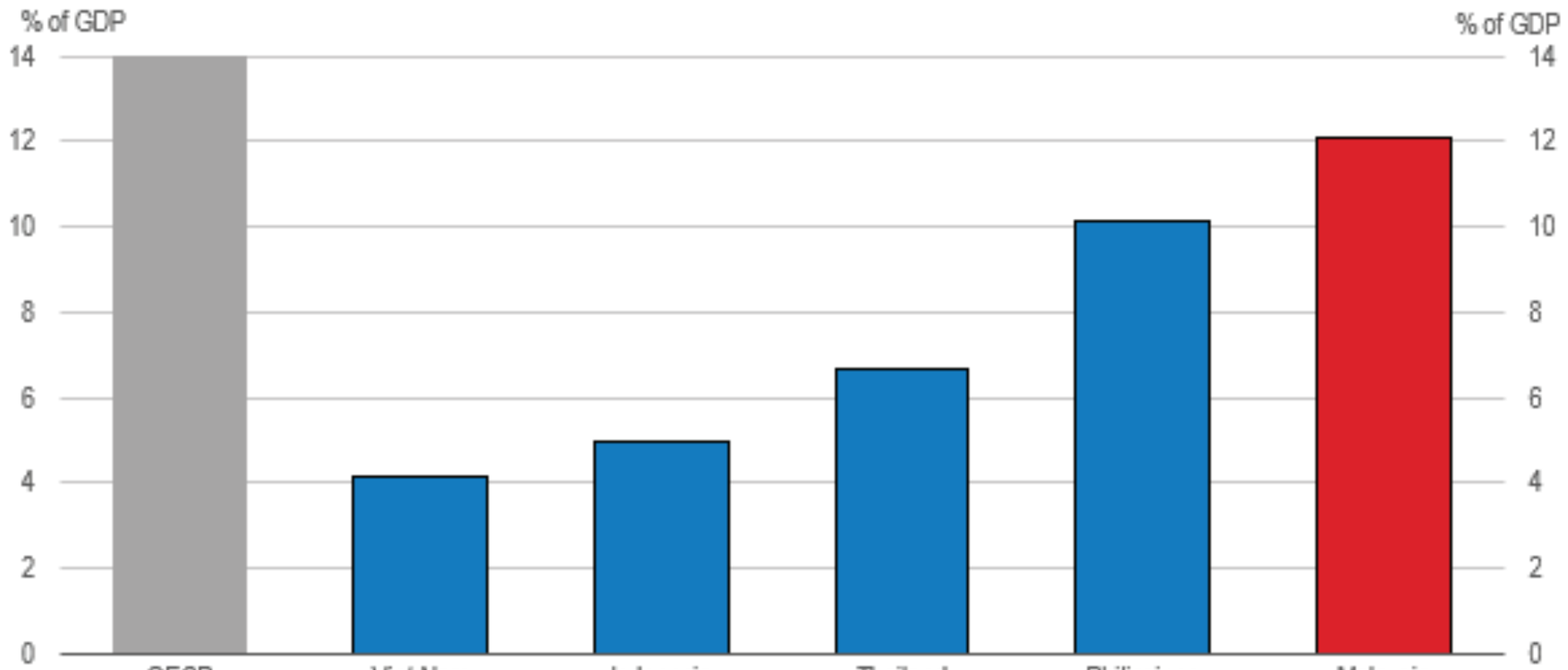
Source: IMF[92]

The majority of Malaysia's statutory guarantees are to Government Business Enterprises (GBEs), also known as State Owned Enterprises (SOE). Most SOE's in Malaysia are seen to be extremely healthy and well run due to the government's reform initiatives aimed at helping strengthen management and allowing for better use of capital and other resources. These reforms can be traced back to 2004, when the Malaysian government launched a Transformation Programme for Government-linked Companies (GLCs) for the 2005-15, which targeted public listed SOEs. The program introduced key performance indicators (KPIs) and made several changes in board composition and a number of GLCs' management.

In May 2019, the Malaysian government established the Debt Management Committee (DMC). The committee is chaired by the Finance Minister and composed of minister and secretary level representatives of relevant government agencies. The committee was formed to assure that bond issuing, and government sector total borrowing would be carried out in an appropriate manner as well as to hammer our strategies to reduce the burden of government's debts and liabilities. In July 2019, Prime Minister Mahrtir suggested putting a limit on government guarantees in July 2019, but it has not happened yet until now. A third trend is a rise in long-term fiscal commitments from public-private partnerships. The IMF estimates these commitments account for a total of 12% of GDP in 2015 (see Figure 26).

92 Ibid.

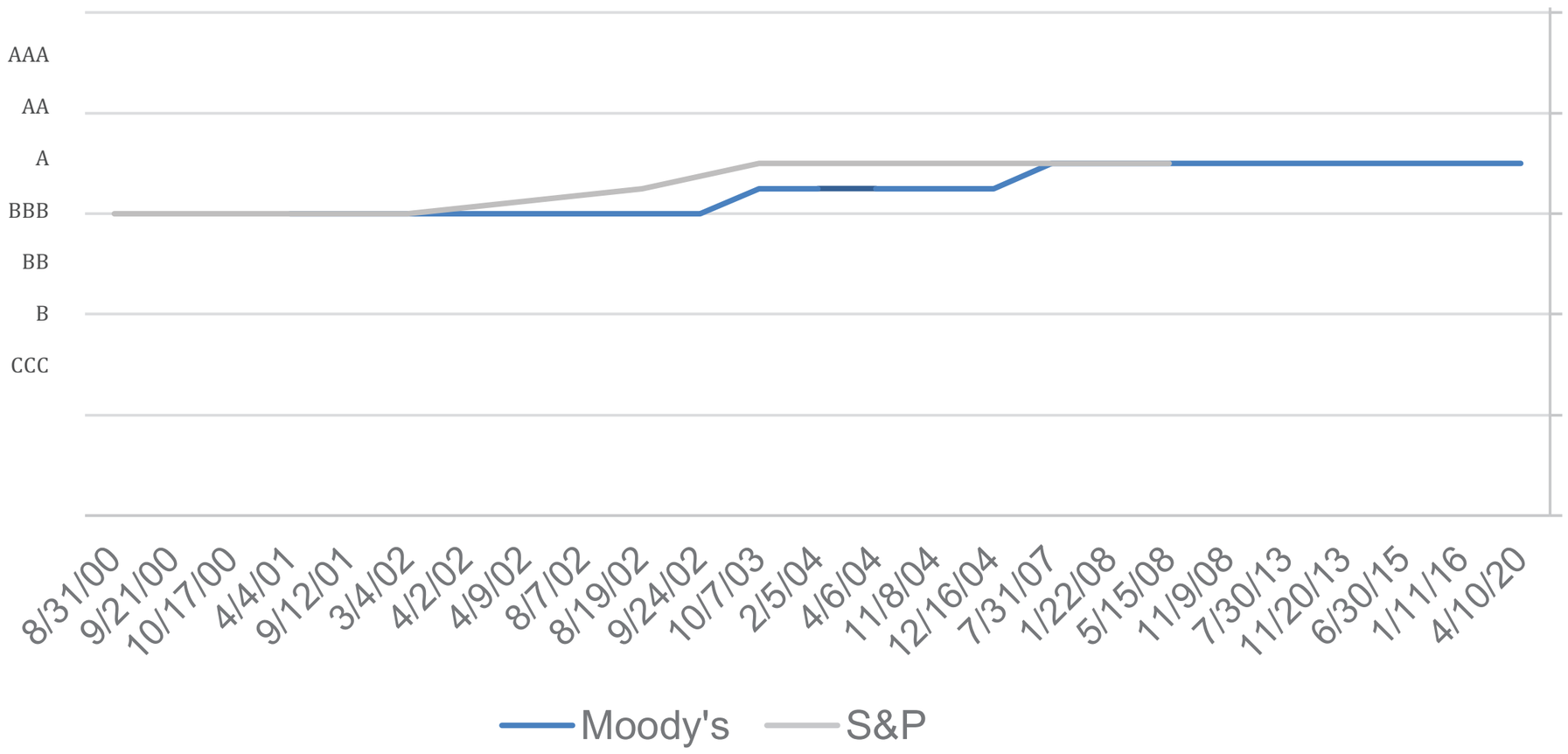
Figure 26: Malaysia's Capital Stock of PPPs



Source: OECD 2019 Economic Survey: Malaysia[93]

Malaysia Credit Rating History

Figure 27: Malaysia Credit Rating History



Source: World Government Bonds[94]

93 OECD. "OECD Economic Surveys: Malaysia 2019." *OECD Publishing*, July 2019, www.oecd.org/economy/surveys/Malaysia-2019-OECD-economic-survey-overview.pdf.
94 "Malaysia Credit Rating." World Government Bonds, www.worldgovernmentbonds.com/credit-rating /malaysia/.

Credit ratings of Malaysia have been quite stable in the decade though the Malaysia government has been transitioning accounting standards from cash to accrual and carried out several reforms including launching the Transformation Programme for SOEs and establishing the DMC. In the meantime, however, Malaysia has been plagued by the notorious political scandal regarding 1MDB, and thereby incurring a huge amount of liabilities on the balance sheet. Given the fact that several factors drive credit ratings, it is hard to conclude whether the measures Malaysia has taken so far were effective on the ratings.

Government Interests, Policy, and Regulation

To date, Malaysia has implemented over 500 public-private partnerships since 1983 across a variety of sectors to include transportation, information and communication technology, power, water and sanitation, and health. In 2009, the Privatisation and Private Finance Initiative Unit, later renamed the Public Private Partnership – UKAS, was created under the Prime Minister's department. According to the Public Private Partnership – UKAS, Malaysia has 72 active PPPs listed on its website.[95] Relative to this large number of initiatives, Malaysia has very few contingent liabilities arising from these partnerships, which leads us to question if the government's policies are effective in reducing the likelihood that contingent liabilities will crystallize.

The main benefit to the government of using a PPP comes in the form of reduced upfront capital expenditure costs. In the Financial Liability model, also called the service payment model in Malaysia[96], the private partner finances the cost of the investment upfront, and the government makes a series of payments over the life of the investment. Given that Malaysia mandates that its federal government debt not exceed 55% of GDP, this model can help ease strain on the government's annual budget by dispersing payments over a number of years.[97] This allows the sovereign to initiate multiple projects at once, increasing the rate of development, which hopefully contributes to an accelerated rate of economic growth. In the Grant of a right to the operator model, known as the stand-alone model in Malaysia,[98] the government doesn't incur a debt or exchange money with the private party, instead opting to forgo the revenue stream generated by the project. This method further simplifies the budget process and does not impact the size of the government's debt.

The primary business models for PPPs that are used in Malaysia are either the Build-Lease-Maintenance-Transfer (BLMT) or the Build-Operate-Transfer (BOT) model.[99] The main difference between the two models is in a BLMT model the government leases the project from the contractor and in a BOT the contractor is reimbursed through revenue generation, usually to the government rather than to consumers. In Malaysia, the BLMT is used for constructing and maintaining hospitals, universities and

95 *http://www.ukas.gov.my/en/mypartnerships/ppp/main-projects?start=2*
96 Lim, Mark, and Faez Abdul Razak. "Overview of the Malaysian PPP Framework." *In-House Community*, 19 Jan. 2016, www.inhousecommunity.com/article/overview-of-the-malaysian-ppp-framework/.
97 OECD. "OECD Economic Surveys: Malaysia 2019." *OECD Publishing*, July 2019, p.29, www.oecd.org/economy/surveys/Malaysia-2019-OECD-economic-survey-overview.pdf.
98 Lim, Mark, and Faez Abdul Razak. "Overview of the Malaysian PPP Framework." *In-House Community*, 19 Jan. 2016, www.inhousecommunity.com/article/overview-of-the-malaysian-ppp-framework/.
99 Ibid.

hostels, while the BOT is utilized for developing roads and highways[100]. There were 100 PPP projects involving outstanding government commitment of RM135.1 billion at the end of June 2018, and most of these commitments come from BLMT, which amounts to 48 projects[101].

Although there is still room for improvement, much has been done to minimize the occurrence and impact of contingent liabilities arising from PPPs. First, the government has improved the transparency of the procurement process. It has prioritized improving the transparency of PPP contracts by updating the existing regulatory structure and adopting guidelines that mandate open tenders and implement auctions on government land to prevent undervaluation.[102] Second, the government has developed a fund in the budget specifically for public-private partnerships, called the Facilitation Fund. The Fund aims to encourage private sector projects by providing government support for basic infrastructures such as highways, bridges and utilities, and it is expected to rationalize the government expenditure in these projects and increase private sector participation in the economy[103]. Thirdly, the government has increased regulation during the implementation of the project to ensure initiatives meet key performance indicators (KPIs) and have good corporate governance. In each project, the UKAS, the relevant ministries and the SPV form a project management committee (PMC), which consists of members from both the government and the SPV, for monitoring and reviewing the facilities and service quality based on KPIs.[104]

*MyGov*Net: An Information and Communication Technology (ICT) PPP*

MyGov*Net is an initiative whose purpose is to provide the users of Malaysia's federal public agencies an online network infrastructure where they can access services with a single login and password. The project connects more than 10,000 unique agencies. The network has built-in connectivity to the Internet gateway provider, enabling electronic communications between Government-to-Government, Government-to-Business and Government-to-Citizens networks.[105] GITN Sdn. Berhad (GSB) is the official network provider for this government integrated telecommunications network providing infrastructure, hardware, and software, as well as serving as the central manager of the service.[106] GSB is a special purpose vehicle created in 1996 for the implementation of the applications of a government plan called the Multimedia Super Corridor (MSC) which began in 1998[107] and MyGov*Net is a project within that plan. GITN Sdn. Berhad (GSB) is a wholly owned subsidiary of Telekom Malaysia Berhad, ™

[100] Usman Ahmad, Usman Ahmad, et al. "MALAYSIAN PUBLIC PRIVATE PARTNERSHIP." *Academy of Accounting and Financial Studies Journal*, vol. 22, no. Special Issue, 2018, https://www.abacademies.org/articles/Malaysian-Public-Private-Partnership-1528-2635-22-SI-155.pdf.

[101] Ministry of Finance Malaysia. "Fiscal Outlook and Federal Government Revenue Estimates 2020." *Ministry of Finance Malaysia*, 11 Oct. 2019, https://www1.treasury.gov.my/index.php/en/fiscal-economy/fiscal-outlook-and-federal-government-revenue-estimates-2020.html.

[102] OECD. "OECD Economic Surveys: Malaysia 2019." *OECD Publishing*, July 2019, p.29, www.oecd.org/economy/surveys/Malaysia-2019-OECD-economic-survey-overview.pdf.

[103] "Facilitation Fund." *Official Portal of Public Private Partnership Unit (UKAS) Malaysia*, www.ukas.gov.my/en/faq?view=topic&id=7.

[104] Ahmad, Usman, et al. "Malaysian Public–Private Partnerships: Risk Management in Build, Lease, Maintain and Transfer Projects." *Cogent Business & Management*, vol. 5, no. 1, 20 Nov. 2018, doi:10.1080/23311975.2018.1550147.

[105] Government Integrated Telecommunications Network. (2020). Network Provider for MyGov*Net. Retrieve from www.gitn.com.my/.

[106] Ibid

[107] Ibid

itself a state-owned enterprise of the Malaysian government. MyGov*Net is governed by the Government Integrated Network Service Concession Agreement.[108] However, since Malaysia is not adhering to IPSAS 32 regarding the disclosure of the terms of service concession arrangements (SCA) that govern this PPP, assessing the specific contingent liabilities and performance associated with it is not fully possible. Given GITN provides all the infrastructure and operation for the project, this is likely a BOT business model, with revenues being collected directly from the government.

Takeaways

- **The process of transitioning to accrual accounting has improved the strength of Malaysia's institutions.**

Although Malaysia has yet to complete its transition from modified cash to accrual accounting, it is reaping the benefits of greater institutional strength derived from the transition process through policy development, IT infrastructure development that has improved communication and efficiency of public operations, and reduction in corruption through the collection of more transparent data. The technical task of transitioning the government's public sector accounting framework is no small feat. One of the main challenges in the transition is regarding data availability and completeness both in terms of the quality of reporting criteria and the system of delivery. The IMF noted in a technical assistance visit to Malaysia in 2019 that the current existing survey used to collect data from statutory bodies, local governments, and nonfinancial public corporations needed to be redesigned to accommodate the needs of GFS reporting. To collect this information the country has implemented IT infrastructure to increase communication between government agencies.

- **The government is not adhering to disclosure standards regarding Service Concession Arrangements (SCA) as per IPSAS.**

Malaysia has developed a national accrual basis accounting framework, called Malaysia Public Sector Accounting Standards (MPSAS), which is heavily modeled off IPSAS 2013. It is set to implement these standards for its financial statements ending on 31 December 2021. In the meantime, it is using modified cash basis IPSAS 2006 standards. Comparing the most relevant chapters for contingent liabilities of public-private partnerships (PPPs) and state-owned enterprises (SOEs), chapters 19 and 32, of both the cash based IPSAS standards and the accrual based MPSAS we found no difference between how contingent liabilities will be defined, measured, or disclosed. Malaysia currently does not comply with the rigor set forth in its o MPSAS and the cash basis IPSAS standards requiring disclosure of the service concession arrangement (SCA) terms that govern many PPPs. This lack of disclosure remains a serious impediment to obtaining transparency surrounding the implementation of PPPs. As the use of PPPs increases, the potential risks associated with contingent liabilities from these arrangements also grows. The degree to which a sovereign actually adheres to these standards may matter more than whether they follow a cash basis or accrual basis approach.

[108] "MyGov * Net.Global - Network Service Transformation For Malaysian Representative Offices Overseas." *MyGOV - The Government of Malaysia's Official Portal*, www.malaysia.gov.my/portal/content/30575.

- **Effective regulation can reduce the likelihood of contingent liability crystallization.**

Most of the Malaysian SOEs are appraised for being healthy and well run owing to the government's reform initiatives aimed at helping strengthen management and allowing for better use of capital and other resources. Also, the government has been trying to improve debt management by establishing the inter-government committee (DMC) and to reduce the fiscal burden.

With respect to PPPs, Malaysia had not incurred a serious loss recently and it could be attributed to the several measures the Malaysian government has taken to minimize the occurrence and impact of contingent liabilities. The government has improved the transparency of the PPP contracts by updating the existing regulatory structure and adopting new guidelines. Also, the government has developed the Facilitation Fund in the budget specifically for public-private partnerships to encourage private participants in public projects and to rationalize the government expenditure. Finally, the government has increased monitoring and evaluation methods of PPP projects to ensure initiatives meet key performance indicators (KPIs) and have good corporate governance.

Country Case Study #3: South Africa

Introduction

South Africa represents a particularly curious case study. According to the Open Budget Index; Global Integrity Report and our own analysis, South Africa ranks among the most transparent nations in the world when it comes to the reporting of its budget and thus also contingent liabilities. Nonetheless, its sovereign spreads remain comparatively high, and its credit rating leaves significant upside whitespace. Does the South Africa case thus serve as evidence for the argument that transparency does not directly impact sovereign ratings/borrowing cost? Not necessarily. As the empirical analysis suggests, more transparency is likely to impact sovereign ratings/borrowing cost positively. Instead however, the South African case provides a compelling example to show that fiscal transparency only serves to improve credit ratings when the increased transparency does not lead to uncovering large contingent liabilities that before had not been as transparently made available.

Moreover, the South Africa case illustrates the significant discretion that countries have to maneuver within IPSAS, specifically when it comes to contingent liabilities and estimates of their likelihood of crystallization. Indeed, South Africa's bailout of Eskom in 2019 clearly did not come as a surprise. Yet, in the 2019 budget (that also includes a whole discussion section on how Eskom's debt could be handled), Eskom is still listed as a contingent liability, rather than a certain payable.

Overview of South Africa's Sovereign Financial Situation

By looking at the latest 2019 IMF Article IV, we can see that the economic performance of South Africa remains subdued, and risks are materializing given the structural impediments to growth. The stagnation can be ascribed to weak private investment and productivity growth, which hindered the rise of per-capita income and led to huge inequality.

GDP growth has continued a declining trend since 2011, with just 0.8% annual real GDP growth in 2018. Unemployment kept rising from 27.5% in 2018 to 29.1% in 2019, with the youth (aged 15-34 years old) accounting for 63.4% of the total unemployed. Inflation is estimated to have moderated in 2019 to below the midpoint of the inflation target range, aided by one-off factors. Fiscal deficits have been persistently large due to continued high expenditure amid weakening revenue performance and state-owned enterprise (SOE) bailouts. In addition, the current account deficit is largely financed by non-FDI inflows. With increasing interest payments to nonresident investors, the external current account deficit has widened to 3.5% of GDP with a projection of reaching 6.5% of GDP in FY2020. Moreover, the debt position is projected to exceed 60% of GDP in FY 2020. Domestic borrowings are expected to finance most of the current account deficit.

Potential risks related to SOEs are substantial, which may lead to a surge of sovereign debt positions and contingent liabilities due to bailouts. Concerns toward the local electricity company Eskom are especially considerable, while banks are still sound albeit with some tolerable vulnerabilities. The South African Reserve Bank (SARB) has shown its credibility and strong performance through fairly anchored

inflation expectations at the targeted level of 3% to 6% in the context of the flexible exchange rate regime, despite that the ability to boost economic growth through monetary policy has been largely restrained due to structural impediments.

Public Accounting Framework

South Africa started its transition from modified cash to accrual accounting under IPSAS in 2009, and it is still under transitioning. Currently, the country has made comprehensive disclosures to the IMF regarding its financial positions, including central government, general government, and public sector. Also, it is completely in compliance under the GFS 2014 methodology for economic statistics reporting.

IPSAS

The Accounting Standard Board (ASB) is the entity responsible for adopting public sector accounting standards in South Africa. Established in 1999 as outlined in the Public Finance Management Act of South Africa, the ASB started considering standards based on international best practices.

The ASB has adopted accrual IPSAS since around 2008 and 2009 which are referred to as the Generally Recognized Accounting Practice (see chart below).[109] The transition is targeting completion in 2015. However, in practice most government departments are still applying a modified cash basis of accounting while the National Treasury is developing a roadmap to implement accrual accounting in all departments. In the process of migration to the international standard, South Africa is mainly facing the challenges of capacity building, technical issues in initial application, and consolidation.

Table 18: Status of Accounting Framework Implementation in South Africa

Level of Government	Previous Accounting Standard	IPSAS Application Timeline
National and provincial ministries	Modified cash	Pending
National and provincial agencies	Local GAAP (based on IFRSs)	1 April 2008
Central revenue authority	Cash	1 April 2012, with five-year transition
Parliament and legislatures	Modified cash	1 April 2010 & 2015, with three-year transition
Municipalities – Big cities	Accrual, fund based	1 July 2008
Municipalities – All other	Fund based	1 July 2009, with three-year transition

Source: ASB

[109] Swart, Erna. *Adoption of IPSASs Issues for Consideration Arising from South African Experience*. 2018, www.asb.co.za/wp-content/uploads/2019/04/Adoption-of-IPSAS-Ghana-Roundtable-SA-.pdf.

Government Finance Statistics (GFS)

In 2000, the National Treasury started to disclose national government debt not only on a gross, but also on a net basis in its annual Budget Review to replace the previous three-years rolling budget system,[110] which brings additional discipline, consistency and transparency to the country's fiscal process.

As far as reporting on fiscal activities including public-sector debt is concerned, there exists a long-standing relationship between the South African Reserve Bank, the National Treasury, and Statistics South Africa reinforced through various memoranda of understanding for sharing financial and non-financial economic data in various formats. National Treasury supplies the Reserve Bank with national government debt data on a monthly basis. The Bank compiles the debt statistics for the national government on a monthly basis and releases the data via the Reserve Bank's internet site. The information is also sent to the International Monetary Fund (IMF) and Bank for International Settlements (BIS). Annually, the National Treasury publishes debt statistics in its Budget Review. There is also a chapter in the Budget Review on asset and liability management where the national government debt is described in detail.

South Africa discloses the financial statement of its central government, general government and public sector to the IMF annually. The disclosure of general government debt is common among countries. However, only around 30 countries make disclosure on their public sector balance sheet, and South Africa is one of them.

Major Contingent Liabilities Facing the Country

In recent years, the South African government has issued guarantees continuously to state-owned enterprises (SOEs) in order to mitigate their cost of borrowing, and the Treasury Department has made significant efforts to quantify these hidden liabilities. Within the National Treasury, the Asset and Liability Management division has devoted itself to transition the previous qualitative monitoring system towards a more sector-specific system for better assessing and measuring purposes. It classified the existing SOEs with a credit scorecard and a traffic light system: green represents good shape, amber for warning signal and red for alarm. The system has enabled the government to visualize each SOEs' default risk and estimate the probability for any specific contingent liability to materialize. The risk analysis highlighted risk drivers and helped inform government actions to address these risks, including strategic adaptations, governance changes, and financial support. At the same time, as one of the first countries joining the Government Debt and Risk Management (GDRM) Program, South Africa has partnered with the World Bank to further improve their methodology for cost/risk assessment and management for government guarantees and on-lending practices.

Admittedly, while the increasing level of contingent liabilities remains to be one of the country's major problems, its sovereign financial disclosures can be considered reasonably strong with proper disclosures on all its contingent liabilities, including guarantees to state-owned companies, independent

[110] Van den Heever, Johan, and Michael Adams. "IFC Bulletin No 391Improving Public Sector Debt Statistics in South Africa." *IFC Bulletin No 39*, BIS, 2015, www.bis.org/ifc/publ/ifcb39zj.pdf.

power producers, public-private partnership, as well as provisions for multilateral institutions and other contingent liabilities. The following table summarizes the amount of government guarantee and estimated exposure made for each public institution as of 2019.

Table 19: South Africa Government Guarantee Exposure

	2016/17		2017/18		2018/19	
R billion	**Guarantee**	**Exposure[2]**	**Guarantee**	**Exposure[2]**	**Guarantee**	**Exposure[2]**
Public institutions	**475.7**	**290.4**	**469.8**	**321.3**	**483.1**	**372.4**
of which:						
Eskom	*350.0*	*202.8*	*350.0*	*244.7*	*350.0*	*294.7*
SANRAL	*38.9*	*29.4*	*38.9*	*30.4*	*38.9*	*30.3*
Trans-Caledon Tunnel Authority	*25.6*	*20.9*	*25.7*	*18.9*	*43.0*	*14.9*
South African Airways	*19.1*	*17.8*	*19.1*	*11.1*	*19.1*	*17.3*
Land and Agricultural Bank of South Africa	*11.1*	*3.8*	*9.6*	*3.8*	*9.6*	*2.5*
Development Bank of Southern Africa	*12.5*	*4.1*	*12.2*	*4.1*	*11.4*	*4.4*
South African Post Office	*4.4*	*4.0*	*4.2*	*0.4*	–	–
Transnet	*3.5*	*3.8*	*3.5*	*3.8*	*3.5*	*3.8*
Denel	*1.9*	*1.9*	*2.4*	*2.4*	*3.4*	*3.4*
South African Express	*1.1*	*0.8*	*1.1*	*0.9*	*1.2*	*0.2*
Industrial Development Corporation	*0.4*	*0.2*	*0.4*	*0.1*	*0.5*	*0.2*
South African Reserve Bank	*3.0*	–	–	–	*0.3*	–
Independent power producers	**200.2**	**125.8**	**200.2**	**122.2**	**200.2**	**146.9**
Public-private partnerships[3]	**10.0**	**10.0**	**10.0**	**9.6**	**10.1**	**10.1**

Source: National Treasury[111]

The major contingent liabilities South Africa is exposed to include:[112]

a) The liabilities of the nine largest SOEs: Denel, the Development Bank of South Africa, Eskom, Landbank, the South African Post Office, the South African National Road Agency, Telkom South Africa, Transnet and South African Airlines;

b) Government guaranteed power purchase agreements between Eskom, the state-owned electric utility, and independent power producers (IPPs);

d) Guarantees to Public-Private Partnerships;

e) The Road Accident Fund (RAF);

f) Subnational debt from district, local and provincial governments.;

g) Other contingent liabilities[113] include the provisions for multilateral institutions, commitment to the Export Credit Insurance Corporation of South Africa, and post-retirement medical assistance to government employees.

[111] National Treasury Republic of South Africa, *Medium Term Budget Policy Statement 2019*., 2019, www.treasury.gov.za/documents/mtbps/2019/mtbps/FullMTBPS.pdf.

[112] National Treasury, National Budget 2019, Chapter 7: Government Debt and Contingent Liabilities, p.86, http://www.treasury.gov.za/documents/National%20Budget/2019/review/Chapter%207.pdf

[113] National Treasury, National Budget 2019, Chapter 7: Government Debt and Contingent Liabilities, p.87, http://www.treasury.gov.za/documents/National%20Budget/2019/review/Chapter%207.pdf

Case Study: Eskom

In South Africa, Eskom, a fully state-owned electric utility and monopolist, represented 73% of the total government guarantee exposure in 2019.[114] The government explicitly guarantees various long-term debt instruments of Eskom, including foreign currency loans and bonds, as well as domestic bonds. In addition to credit guarantees to Eskom, the government provides payment guarantees to independent power producers (IPPs) as they contract with Eskom through power purchase agreements.[115] The government is guaranteeing two types of risks. Firstly, under these payment guarantees, the National Treasury is obliged to purchase power from IPPs if Eskom is unable to honor its obligations from the power purchase agreements. Secondly, if a project were terminated early, the government may be required to pay project sponsors. In order to closely monitor the risk arising from the contingent liabilities, the National Treasury of South Africa established a dedicated Credit Risk Directorate under the Asset and Liability Management Division, with the support and technical assistance from the World Bank Group.

The National Treasury developed a two-step risk management method. First, a credit rating methodology based on an energy sector-specific scorecard was developed. The energy sector scorecard includes business risk indicators and financial risk indicators. Industry prospects, corporate governance, and market position are rating subfactors to assess business risks. Profitability, debt capacity, efficiency, cash flow adequacy, and liquidity ratios are used to assess financial risk. Aggregating scores across risk factors, Eskom's credit quality is rated on an internal scale from 1 (extremely low risk) to 9 (imminent default or in default). Risk assessments are reported to South Africa's high-level Fiscal Liabilities Committee which advises the Minister of Finance on the issuance of new guarantees and exposure to other contingent liabilities.[116]

Second, a scenario analysis methodology to assess Eskom's ability to service debt from cash flows and cash reserves, aiming to offer insights into Eskom's financial health and its ability to service debt obligations if certain scenarios materialize.[117] The inputs of the model include macroeconomic and industry specific variables as well as Eskom's corporate plan. The National Treasury constructs four to five scenarios: one consistent with Eskom's corporate plan; one consistent with the macroeconomic model used for budgeting; and two to three downside scenarios where specific risks materialize.

[114] Calculated based on table 7.9 on the previous page
[115] Bachmair, Fritz Florian, Cigdem Aslan, and Mkhulu Maseko. *Managing South Africa's Exposure to Eskom: How to Evaluate the Credit Risk from the Sovereign Guarantees?*. The World Bank, 2019.
[116] Bachmair, Fritz Florian, Cigdem Aslan, and Mkhulu Maseko. *Managing South Africa's Exposure to Eskom: How to Evaluate the Credit Risk from the Sovereign Guarantees?*. The World Bank, 2019.
[117] Bachmair, Fritz Florian, Cigdem Aslan, and Mkhulu Maseko. *Managing South Africa's Exposure to Eskom: How to Evaluate the Credit Risk from the Sovereign Guarantees?*. The World Bank, 2019.

Figure 28: Factors in the Energy Scorecard in South Africa

Business risk indicators	Financial risk indicators
• **Industry Prospects** ○ Operating Environment ○ Regulatory Framework • **Corporate Governance** ○ Adherence to applicable legislation ○ Management Quality • **Market Position** ○ Diversification ○ Size (capacity)	• **Profitability** ○ Operating margin ○ Net profit margin ○ Revenue growth • **Debt capacity** ○ Debt to assets ratio ○ Debt to equity ratio ○ Interest cover ratio • **Efficiency** ○ Cost to income ratio • **Cash flow adequacy** ○ Funds from operations to total debt ratio • **Liquidity** ○ Cash ratio ○ Quick ratio ○ Current ratio

Source: National Treasury of South Africa

Over the past several years, Eskom has barely managed to grow its revenue enough to cover most of its operational expenses through increasing prices. However, price hikes generate many arrears from consumers and municipalities, which makes the profitability of the company very volatile and it even dropped below zero in 2017. This makes it unable to keep up with its debt repayments. In 2019, Eskom's total liabilities amounted to R605 billion, of which R450 billion is attributed to debt securities and borrowings, an increase of almost 15 times from 2005.[118] Besides struggling to serve its ballooning debt, the corruption scandal and mismanagement of its executives also directly contributed to its financial mess.

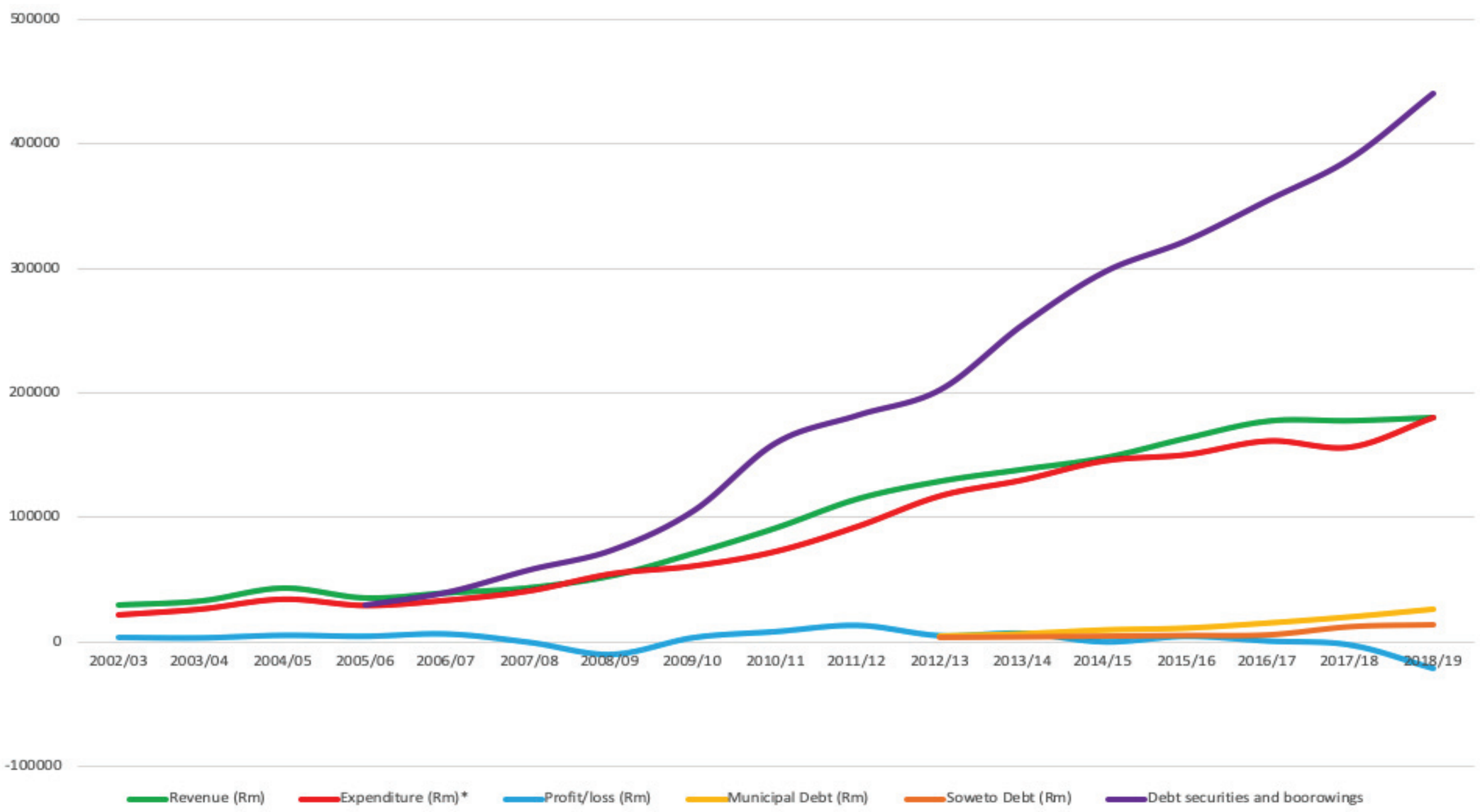
Due to the operational struggle and huge debt burden, Eskom unleashed two nationwide blackouts in 2019. Since Eskom supplies about 95% of the nation's electricity, the government has said it's too big and essential to fail. Consequently, the government decided to bailout the firm, with the condition that Eskom can only use the bailout package to service debt and not for operational costs. Eskom will receive 138 bn Rand in bailouts with the possibility for extra funds and continued support if the relief plans are not effective, according to the medium-term budget policy statement by the minister of finance.[119] The

[118] Writer, Staff. "Eskom's 20 Year Road to Financial Crisis in a Nutshell." *BusinessTech*, 30 July 2019, businesstech.co.za/news/finance/332227/eskoms-20-year-road-to-financial-crisis-in-a-nutshell/.
[119] *Medium Term Budget Policy Statement 2019*. National Treasury Republic of SouthAfrica, 2019, www.treasury.gov.za/documents/mtbps/2019/mtbps/FullMTBPS.pdf.

government is also considering splitting Eskom into three distinct nationally owned entities to handle generation, distribution and transmission affairs respectively.

The bailout of Eskom led to a downgrade of South Africa's sovereign debt by Moody's from Baa3 to Ba1 in March 2020,[120] leaving South Africa without an investment-grade credit rating for the first time in 25 years. S&P also acknowledged the sizable contingent liability tied to Eskom and moved South Africa's outlook from stable to negative[121].

Figure 29: Eskom's Financial Situation 2002-2019



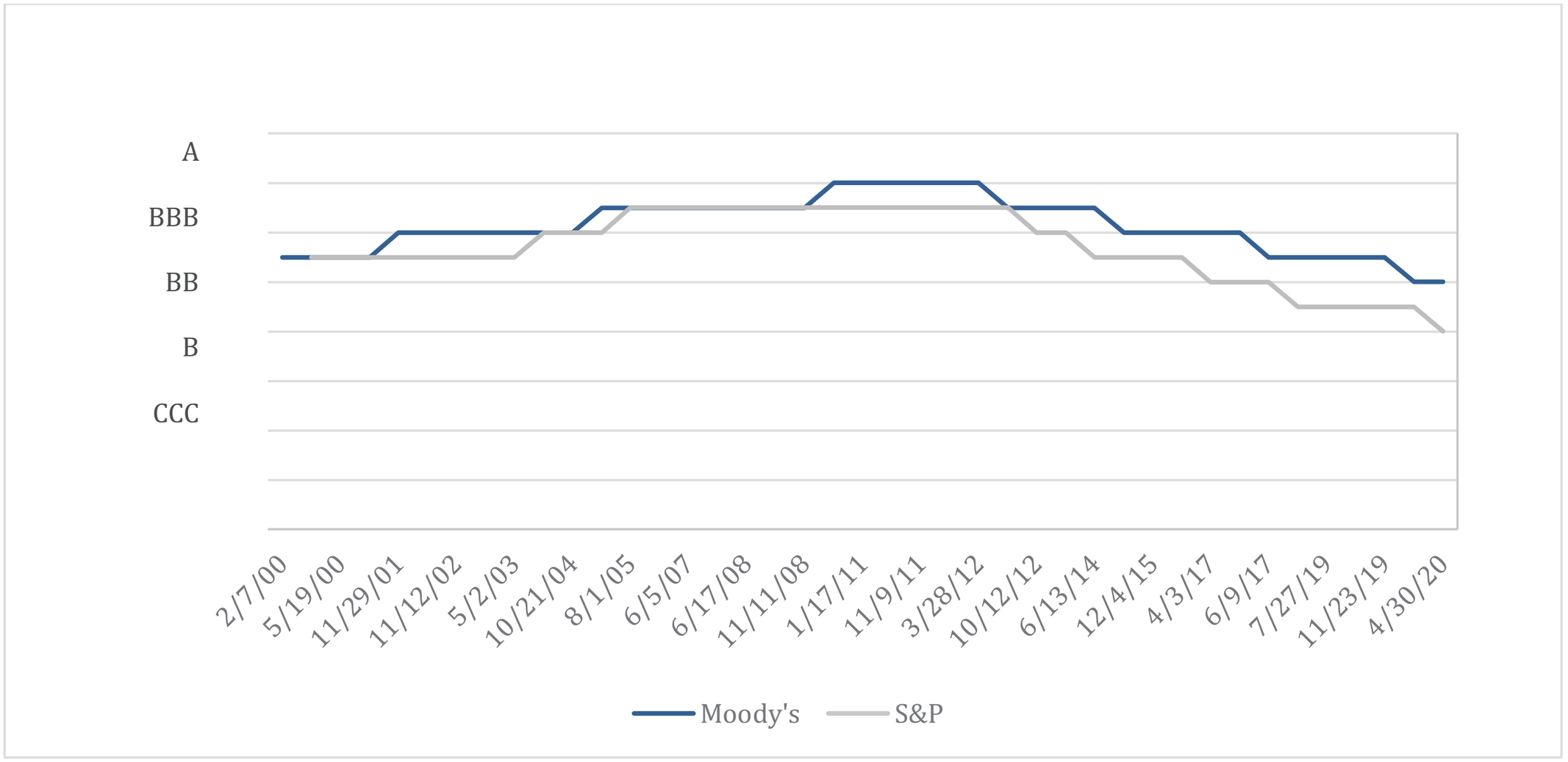
Source: Business Tech

In terms of next steps, the Ministry of Finance has identified Eskom as the biggest economic risk and made a plan to no longer provide equity to Eskom but in the form of loans. To reduce contingent liability, debt relief will only be considered for Eskom after it shows progress in improving cash flow management and operations, setting up the three units with new boards and CEOs with the necessary skills, and ensuring they are run within their means.

120 Moody's, Government Of South Africa – Ba1 Negative: Annual Credit Analysis, https://www.moodys.com/research/Moodys-downgrades-South-Africas-ratings-to-Ba1-maintains-negative-outlook--PR_420630

121 "S&P Changes SA's Outlook to Negative, Warns of Growing Debt Burden." *Fin24*, 23 Nov. 2019, www.fin24.com/Economy/sp-changes-sas-outlook-to-negative-warns-of-growing-debt-burden-20191123.

Figure 30: Credit Rating History over this period



Source: World Government Bonds

Takeaways

- South Africa has a good data disclosure in terms of adoption of IPSAS and compliance to GFS. It also does well in internal risk assessment of government guarantees.
- The case of Eskom demonstrated that the materialization of contingent liability will have a negative impact on credit rating.
- Rating agencies might notice the risk of large-scale contingent liabilities, but usually tend to take a cautionary method in terms of its credit implications before the contingent liabilities actually materialize. Thus, the South African case provides a compelling example to show that fiscal transparency only serves to improve credit ratings when the increased transparency does not lead to uncovering large contingent liabilities that before had not been as transparently made available.
- Moreover, the South Africa case illustrates the significant discretion that countries have to maneuver within IPSAS, specifically when it comes to contingent liabilities and estimates of their likelihood of crystallization. Indeed, South Africa's bailout of Eskom in 2019 clearly did not come as a surprise. Yet, in the 2019 budget, Eskom is still listed as a contingent liability, rather than a certain payable.
- Good internal risk assessment is not enough for South Africa on the current stage, the government should take steps to reform its structure of government guarantee and improve the efficiency and debt-repaying capacity of large SOEs.

SECTION 6: KEY TAKEAWAYS

Takeaways for Issuing Governments

Transparency Improves Sovereign Ratings

The statistical analyses outlined in Section 4 of this report demonstrate that international capital markets reward fiscal transparency: a one unit increase in the proprietary capstone financial reporting transparency score (CFRTS) is associated with a ~4bps decline in sovereign debt spreads. Moreover, transparency, as reported in the transparency score (CFRTS) statistically explains around 17% of credit ratings, whereby moving from least to most transparent is statistically associated with a relative improvement in the sovereign's credit rating equal to moving from Ba3 to Aaa. These results are likely influenced by the fact that sovereign rating agencies directly include an assessment of the fiscal transparency in their rating matrix. In Moody's methodology for instance, improvements in fiscal transparency directly impact the Fiscal Strength and Susceptibility to Crisis Factors. However, even when controlling for the credit rating, transparency still retains some explanatory power over the cost of borrowing, indicating the relevance of transparency to investors. Sophisticated investors are likely to additionally reward transparency, because it reduces risks of the rise of unrecorded/hidden liabilities that could impact the sovereign's solvency and thus increase repayment risks.

Accrual Accounting is More Transparent than Cash Accounting, Enhancing Credit Quality Under Certain Circumstances

Ceteris Paribus, accrual accounting is considered more transparent than cash accounting. Yet, it is surprising that many sophisticated countries continue to use cash accounting. Implementing a reform to move from cash to accrual accounting is likely to be seen as a reform toward more transparency. However, this will likely only lead to improvements of sovereign rating and spreads, when the market has significant doubts about the credibility/accuracy of the sovereign's budgets and financial accounts. When investors have reasons to believe that the sovereign aims to hide liabilities through accumulating arrears on obligations (which is possible under cash accounting only), they might demand increased sovereign spreads. The evident way to reduce the sovereign spreads is thus to strictly implement accrual accounting standards that remove the risks perceived by investors. In turn, when investors have high confidence in the accuracy of a sovereign's budget and financial statistics, they will not demand increased spreads because of the potential risks of hidden arrears. Thus, for sovereigns which are endowed with the markets' confidence, moving from cash to accrual would not bring about any benefits in terms of reduced sovereign spreads.

This explains why there remain highly sophisticated and highly transparent nations that still apply cash accounting methods, such as Singapore, Japan or Germany.

Transparency is Helpful But Underlying Contingent Liability Exposure Must Also Be Addressed

Transparency is important for achieving low borrowing costs, as demonstrated in the first takeaway. It is also helpful for credit ratings, given that fiscal transparency is usually captured by a factor called institutional strength in the sovereign rating framework of the prominent credit rating agencies. Data transparency, especially the information on fiscal account and debt, moreover, indicates a country's capacity and willingness to mobilize resources to meet debt payment obligations. It also helps to mitigate the risk of policymakers having an inaccurate image of the government's financial health.[122] Policymakers for instance may find themselves in weaker-than-expected fiscal positions if they rely on budget projections that did not factor in contingent exposure.

However, transparency alone is insufficient. The UK is often considered as the "gold standard" of sovereign financial reports. However, the country has been experiencing a gradual deterioration in its fiscal position and credit rating, given the amid uncertainty of Brexit. South Africa, though not a "gold standard" of fiscal data disclosure, has made continuous effort to catch up with the global best practices in the past two decades. According to Moody's, South Africa ranked third place on fiscal transparency among emerging markets.[123] However, in 2019, the country has to bailout its debt-laden SOE Eskom, which led to a downgrade of South Africa's sovereign debt by Moody's from Baa3 to Ba1 in March 2020, leaving South Africa without an investment-grade credit rating for the first time in 25 years.

Rating agencies might notice the risk of large-scale contingent liabilities, but usually tend to take a "through the cycle" method in terms of its credit implications before the contingent liabilities actually materialize. However, once the contingent liabilities materialize, it often has a materially negative impact on the sovereign's credit rating. Consequently, transparency alone is not enough, and the country governments should take steps to reform the structure of government guarantee programs and improve the efficiency and debt-repaying capacity of large SOEs. Overall, fiscal transparency only serves to improve credit ratings and borrowing costs when the increased transparency does not lead to uncovering large contingent liabilities that before had not been made transparently available.

122 Lucie Villa et al, *Risks from Financial Misreporting Vary, Disclosure Has Major Credit Implications*. Moody's Investor Service, 21 Mar. 2019.
123 Ibid.

Providing Transparent Financial Reports is Resource-Intensive

While increasing transparency of financial reporting appears to bring benefits for sovereign credit ratings and borrowing costs, compiling such reports is a resource-intensive endeavour. While many countries have had national account systems reporting (such as GFS) processes in place for considerable periods of time, newer IPSAS-based standards often require additional institutional capabilities.

The UK experience shows us that even those countries considered to be at the forefront of fiscal accounting practices can have difficulties with implementation. The initial release of the UK government's whole of government accounts (WGA) report was delayed by several years. Even recently, the lag between the submission to the National Accounting Office and the WGA publication has for the last six publications averaged over 15 months. It is perhaps unsurprising that a program of this scale and complexity - consolidating over 8,000 different government departments and agencies - would run into difficulties. In the early stages, the WGA project reportedly experienced challenges with data collection and reconciling accounts on such a large scale across the entire general government sector.[124]

More recently, Malaysia has also run into challenges as it transitions to a more sophisticated public sector reporting framework. There have been four main challenges cited by the government for the delay in implementation: policies and standards needed to be established, relevant laws and regulations had to be identified and amended, new information technology systems had to be acquired, and change management and training programs had to be implemented for an estimated 70,000 personnel.[125]

These challenges highlight the robust institutional accounting and auditing systems needed to successfully implement highly transparent financial reporting frameworks. New technologies and fully automated IT systems will hopefully allow for smoother transitions in the future, but there will likely always be a cost tradeoff involved in increasing transparency. Given the arduous nature of putting up systems, reconciliation and instilling the fiscal discipline, the entire exercise requires a significant political buy-in as well. Governments will have to assess whether the borrowing and credit benefits of providing transparent public-sector financial reports outweigh the costs and resources required for implementation.

[124] Chow, Danny, et al. *Reporting on the UK's WGA Experiment*. Public Money & Management, 29 May 2009, www.researchgate.net/profile/Jodie_Moll/publication/228426393_Reporting_on_the_UK's_WGA_Experiment/links/0fcfd5093e56a81db5000000.pdf

[125] IPSASB. (November 2013). A Closer Look At Malaysia: IPSAS Adoption Experience. Pg 1. Retrieved from https://www.ifac.org/system/files/uploads/IPSASB/A-Closer-Look-At-Malaysia-2013.pdf

Developing an International Enforcement Ecosystem Would be Beneficial

During the course of our research and in our discussion with different rating agencies and leading experts, we could see distinct advantages of adopting and committing to global public-sector accounting standards in a more transparent fashion. However, what stands out clearly is the lack of an expert body/ecosystem to educate stakeholders of such adherence. Almost always countries adopt their own version of IPSAS, which though broadly in sync, involves some variation. There are also some subjective elements in standard such as probability assessment of contingent liabilities which defines if they will end up as provisions or footnotes on the balance sheet. It's clear that these issues have significant monetary ramifications for the country, and they might be inclined to take a less prudent but more favorable view for themselves. Other than investors themselves, the only bodies which report on these dynamics to some extent are the credit rating agencies, though we found out during research that their assessment of accounting standards adherence is not very in-depth. Hence, there is a void which presents the opportunity to be filled.

If we look globally, we can find a similar case in the development of the Regulatory Consistency Assessment Program (RCAP)[126] done by Bank for International Settlements (BIS). Basel standards, just like IPSAS, are self-adopting standards. Post global financial crisis, it was felt that countries, even though they claim to have adopted BASEL standards, varied greatly in their adoption which gave rise to regulatory arbitrage opportunities. Hence, RCAP as a program was adopted in 2012 where a group of cross-jurisdictional and cross-risk experts studied in-depth a country's standards and gave their assessment on compliance of the country's banking regulations compared with BASEL standards. To date, assessment of 28 countries[127] covering 90% of global banking assets has been conducted and the assessments are publicly available.

A similar dialogue could be initiated to assess a country's compliance with IPSAS. The International Public Sector Accounting Standards Board (IPSASB) given their core positioning, might be an ideal organisation to take up such an endeavor. Countries will likely opt for such evaluation because the existence of such a setup, just like RCAP, will function as a self-differentiation mechanism. Ergo, countries who/wish to signal transparent accounting standards will opt for such assessment.

[126] "Implementation Of The Basel Standards". *Bis.Org*, 2020, https://www.bis.org/bcbs/implementation.htm?m=3%7C14%7C656%7C80.
[127] "RCAP On Consistency: Jurisdictional Assessments". *Bis.Org*, 2020, https://www.bis.org/bcbs/implementation/rcap_jurisdictional.htm.

Takeaways for Lenders and Investors

Assessing Contingent Liability Exposure is Essential for Sovereign Debt Analysis

As mentioned earlier in this report, a 2014 IMF paper identified 230 contingent liability realizations across 80 advanced and emerging economies from 1990-2014. The average fiscal cost of these events was a meaningful six percent of GDP, with costs as high as 40 percent for major financial sector bailouts.[128] Clearly, contingent liability exposure can be material to a sovereign's financial profile, yet under most accounting frameworks contingent liabilities are not included on sovereign balance sheets. We found that even a "gold standard" country like the UK, which is highly transparent with respect to its sovereign contingent liabilities, discloses the majority of the contingent liabilities in footnotes rather than on the country's balance sheet. Lenders and investors utilizing sovereign balance sheets to perform financial analyses may therefore systematically underestimate the true indebtedness of the sovereign entity they are assessing.

In order to assess the true economic picture of a sovereign entity, lenders and investors need to carefully examine footnote disclosures regarding contingent liabilities and make pro-forma balance sheet adjustments as necessary. Headline debt-to-gdp metrics in many cases do not paint an accurate picture. Moreover, investors ought to think carefully about contingent liability exposure that may be excluded from the footnotes, either because the obligation is implicit or because the sovereign has determined the likelihood of crystallization to be remote.

Take Notice of the Accounting Framework a Sovereign Issuer is Using

Generally speaking, accrual accounting addresses fiscal positions more comprehensively compared to cash accounting. However, empirical analysis showed that in order to have a better credit rating and lower borrowing cost, adopting accrual accounting is not indispensable, as justified by the example of Singapore, which still implements the cash accounting basis. As also suggested by our data analysis, even if we can see that transparency is positively correlated with credit rating, it is worth noting that association doesn't imply causation. As suggested in the South Africa cash study, even if the sovereign has developed comprehensive disclosure frameworks, it is also possible for it to have a low credit rating due to the inability to solve the underlying problem. There are still many confounding factors that were left out from our regression analysis, and omitted variables and reverse causality problems still exist in our context.

[128] Bova, Elva, et al. *IMF Working Paper: The Fiscal Costs of Contingent Liabilities: A New Dataset*. IMF, Jan. 2016, www.imf.org/external/pubs/ft/wp/2016/wp1614.pdf.

It is essential for investors to maintain critical thinking when looking at sovereign financial statements and evaluating investment opportunities, as nondisclosure of liabilities does not imply its absence, and higher transparency does not guarantee a better credit worthiness.

Appreciate the Degree of Discretion that Goes into Sovereign Liability Disclosure

Under IPSAS, a contingent liability is included as a provision on the balance sheet if the probability of crystallization is estimated to be above 50%. If the likelihood is considered “remote,” then the contingent liability does not even need to be disclosed in the footnotes. Similar probability judgments are made under GFS. Moreover, if an exposure is deemed to be unquantifiable, it will also likely escape balance sheet disclosure.

Given that these sorts of probabilities generally cannot be estimated with precision, a significant amount of discretion and judgment is involved on the part of the sovereign and their auditor.
If analysts, rating agencies, reporters, and international institutions assess debt-metrics (e.g. debt-to-GDP ratios) based on reported balance sheet data, sovereign entities may have an incentive to downplay their probability estimates and thus understate their liability exposure.

SECTION 7: CONCLUSION

Contingent liabilities are not direct obligations and thus such liabilities are rarely reported on sovereign balance sheets. Identifying in advance what might be a contingent liability is difficult, and disclosure is not transparent in most cases, even when best-practice accounting standards are used. The IMF has noted that countries with stronger institutions are better able to control and reduce risks to contingent liability crystallization. Yet, the fact is that even in such countries contingent liabilities have had a major toll on public finances, notably from the 2008 global financial crisis. The ongoing coronavirus pandemic is exerting even greater pressure in an exceptionally short time on advanced and emerging market sovereigns alike, threatening another surge in contingent liability crystallization.

These dynamics can create a variety of problems for stakeholders. Policymakers may find themselves in weaker-than-expected fiscal positions if they rely on budget projections that did not factor in contingent liability exposure. Lenders and investors utilizing sovereign balance sheets to perform financial analyses may underestimate the true indebtedness of the sovereign entity they are assessing. When an undisclosed contingent liability ultimately crystallizes and is disclosed to investors, sovereign entities may face increased borrowing costs at precisely the time they need to raise funds. Even worse, sovereign exposure to contingent liabilities rises during periods of crisis, adding further stress to a government's budget.

After discussing the importance of contingent liabilities, this report outlined the two prominent public sector financial reporting standards, International Public Sector Accounting Standards (IPSAS) and Government Finance Statistics (GFS). From here, it profiled eight specific types of sovereign contingent liabilities - explicit government guarantees, ECA financing, implicit government guarantees, PPPs, hedging derivatives, environmental & natural disaster liabilities, intragovernmental loans, and social benefits - and delineated how each is reported under both frameworks.

Next, the report detailed a proprietary database created for this report, compiling the accounting standards utilized, dates of transition, credit ratings, sovereign debt costs, and other macroeconomic data across 51 countries and six continents. A variety of statistical analyses were included examining the relationships between accounting transparency and sovereign borrowing standing.

The paper then profiled three deep-dive country case studies focused on the United Kingdom, Malaysia, and South Africa. The UK case study demonstrated that even countries considered to be in the top echelon of financial reporting do not report most contingent liabilities on balance sheet. The Malaysia case study explored the risks public-private partnerships (PPPs) present for sovereign balance sheets. The South Africa case study concluded that fiscal transparency only serves to improve a government's borrowing position when the increased transparency does not lead to the uncovering of large contingent liabilities that before had not been made transparently available.

SECTION 7: CONCLUSION

The paper concluded with key takeaways for issuing governments, including:

- Greater fiscal transparency improves sovereign borrowing standing
- Accrual accounting is more transparent than cash accounting, enhancing credit quality under certain circumstances
- Transparency is beneficial but underlying contingent liability exposure must also be addressed; providing transparent financial reports is resource-intensive
- Developing an international enforcement ecosystem would be beneficial

Key takeaways for lenders and investors included:

- Assessing contingent liability exposure is essential for sovereign debt analysis
- Take notice of the accounting framework a sovereign issuer is using
- Appreciate the degree of discretion that goes into sovereign liability disclosure