INTOSAI PUBLIC DEBT COMMITTEE – MOSCOW 2004

UK NATIONAL AUDIT OFFICE

Contingent Public Debt

Introduction

1. At the Mexico City meeting of the Public Debt Committee in 2003 it was agreed that the UK National Audit Office would begin a study looking at contingent debt in INTOSAI member countries. The results of this work would be presented for consideration by the Public Debt Committee in Moscow 2004.

Previous work by the Public Debt Committee

2. The Public Debt Committee has already done significant work in the area of contingent debt and the UK National Audit Office has taken full account of this when considering this study. The main areas of work that have taken place previously are as follows:

   - Guidance on the Reporting of Public Debt – published by the Public Debt Committee in May 2000 (http://www.intosaipdc.org.mx). This included – (i) results of a survey of SAIs on levels, type and role of the SAI in the audit of contingent debt (ii) examples of different types of contingencies reported by SAIs (iii) examples of disclosure of actual and contingent liabilities in the UK and Portugal. A summary of the relevant aspects of this paper is provided at Annex A.

   - Fiscal Exposures: Implications for Debt Management and the Role of SAIs – published by the Public Debt Committee in February 2003 (http://www.intosaipdc.org.mx/). Contingent debt is an important element of the wider subject of fiscal exposure and this report raises key issues that are relevant to any consideration of contingent debt. These are summarised at Annex B.

   - an informal working group of the USA, Sweden and the UK has discussed issues around fiscal exposure and contingent debt and exchanged various papers.

The current study

3. Given the extent of work undertaken previously by the Public Debt Committee, we considered whether further benefits would accrue from additional coverage of this area. We concluded that a comprehensive study of contingent debt in INTOSAI member countries had the potential to achieve the following positive outcomes:

   - a dedicated study on contingent debt would provide more focussed attention to the issues and how they might be addressed. Previous consideration of contingent debt has been included within documents covering a range of related issues;

   - the study would provide an opportunity to track the progress made by countries since the previous survey. It would provide a useful insight into whether the risks around contingent debt are being actively addressed;

   - the study could form the basis of specific Public Debt Committee guidance on contingent debt;

   - the study could contribute to the public debt audit training materials being developed by the Public Debt Committee and IDI.

4. Any study in this area would need to be underpinned by up to date information on contingent debt and how it is handled in different countries. We concluded that such information would best be obtained through a follow-up questionnaire to INTOSAI member states on the latest position and practices regarding contingent debt. A draft questionnaire is provided at Annex C. In preparing the draft questionnaire we aimed to:

   - develop the 8 questions used in the original questionnaire to provide comprehensive coverage of the subject – the draft questionnaire has 21 questions;

   - keep the questions as simple as possible and easy to understand;

   - provide respondent countries with the scope to describe particular issues of relevance to them.

   As part of this work we revisited UK arrangements for contingent debt. These are summarised, by way of background information, at Annex D.

Conclusion

5. We would welcome Committee Members' thoughts and comments both on the questionnaire and on the study in general. In particular, how should the study progress from here and what will the eventual outputs be?

Annex A

Guidance on the reporting of public debt – May 2000

1. Relevant extracts from the above report by the Public Debt Committee have been reproduced below.

Main results of survey of SAIs on levels, type and role of the SAI in the audit of contingent debt

Background

Because of the lack of information the Public Debt Committee decided to institute its own survey on contingent public debt.

The main objectives of the survey were to:

- raise awareness of the topic among SAIs;
- gather better information about the different forms of public debt liabilities, and
- gain an understanding about the different ways SAIs understand their roles and how their governments control liabilities of this sort.

The methodology adopted consisted in preparing a preliminary questionnaire which was tested by a small number of SAIs. After this a full survey document was produced based on the experiences of our initial trial. A full questionnaire was then sent out to 41 INTOSAI members.

Countries from all continents were invited in order to have a representative sample of its diverse membership of around 160 SAIs. The majority of selected SAIs responded the questionnaire.

Main survey outcomes

The questionnaire sent to a total of 41 SAIs represents approximately 25% of total INTOSAI membership. 30 replies were received representing 18% of the INTOSAI universe and 71% of the SAIs invited to participate in the survey.

The questionnaire contained the following eight questions:

- Question 1: Do you use any definition of contingent liabilities?
- Question 2: Have you ever identified any kind of contingent liabilities incurred by your government or by other public bodies you audit? If the answer is yes please describe them.
- Question 3: What are the most common sources of contingent liabilities?
- Question 4: In your country, are there any bookkeeping actions or reports on contingent liabilities?
- Question 5: Can you provide information on contingent liabilities in terms of their estimate significance?
- Question 6: Has the Federal Government assumed any liabilities from lower levels of Government?
- Question 7: Which is the bookkeeping or report method adopted regarding contingent liabilities?
- Question 8: Are you encouraging audit programs on contingent liabilities?

Responses from individual countries were grouped according to continent (Africa, America, Asia, Europe and Oceania) with the following distribution:

Continent	**Responses received**
Africa	1
America	8
Asia	7
Europe	12
Oceania	2
TOTAL	30

Most SAIs (67%) use a definition of contingent liabilities but this is not necessarily their own. In some countries, definitions are given by law or statute. On the other hand, other countries adopt General Accepted Accounting Practice (GAAP) or international definitions as their reference. Some SAIs use their own definition.

There is a general consensus in defining a contingent liability as a potential debt established by a current or previous government commitment which may crystallise if certain predefined future events take place.

Although the majority of countries do have policies concerning contingent liabilities, it has not been possible so far to establish any pattern or make general comments on these.

Nearly three quarters (72%) of SAIs state that they have identified some kinds of contingent liabilities while auditing. Guarantees represent the most frequent liability identified and the most important source of contingent liabilities. The following table shows a summary of the most common contingent liabilities identified.

Identified liabilities	**Frequency**	**%**
Guarantees	17	38.7
Legal Litigations	4	9.2
Uncalled Capitals	1	2.3
Compensations/Indemnities	6	13.6
Insurances	6	13.6
Aids for damage	2	4.5
Pensions	2	4.5
General Commitments	6	13.6
TOTAL	44	100.0

Note: Due to the wide range of types, several contingents have been grouped as general commitments: bonds to cover deficits, international agreements, state restructuring, environmental liabilities, tax reforms, loans to students guarantees, guarantees for exports, price fixing support of basic foods.

An overwhelming majority of SAIs (almost 84%) state that their respective countries have bookkeeping methods or reports on contingent liabilities. All European countries that participated in the survey responded positively to this question. The most common way of recording or reporting contingent liabilities is through financial statements (more than half of consulted SAIs). Almost 20% of SAIs are issuing reports covering contingent debt. Administrative reporting is also employed as a way of Contingent Liabilities disclosure. In only two responses, are reports covered by some form of budget law.

The main government departments involved in this area are, not surprisingly, the Ministry of Finance or the General Accounting Departments. They are often involved in compiling additional information on contingent liabilities.

Estimates have been produced by respondents of the level of contingent liabilities in terms of Gross Domestic Product (GDP) or Public Expenditure (PE). As a broad average, Contingent Liabilities may represent around 10% of GDP and nearly 47% of PE. Unfortunately, it is not possible to deduce further information due to the lack of more accurate information available at this stage of the survey.

On the acceptance of liabilities from lower levels of Government, only 40% of the countries stated that Federal Governments assumed liabilities from provinces and municipalities (local authorities). Instances were also provided where contingent liabilities are accepted on behalf of public enterprises, health and education services.

The majority of SAIs (50%) report at least an intention of encouraging audit programs on contingent liabilities. Most information would be required from respondents to establish if specific projects or programs on Contingent Liabilities were being undertaken.

Preliminary conclusions

The following general conclusions can be suggested at this stage of the survey:

- contingent liabilities are generally understood as potential debts which will arise if pre-defined events occur;
- contingent liabilities are mainly identified and incurred as government guarantees;
- Financial Statements are the most common channel of reporting contingent liabilities;
- contingent liabilities are significant sources of potential public debt in terms of Gross Domestic Product or Public Expenditure;
- Federal Governments are not assuming automatically contingencies arising from lower levels of government;
- SAIs are generally encouraging audit programs on contingent liabilities.

Examples of the different types of contingency reported by SAIs

Type of liability identified	**Example given**
Guarantees	✔ Guarantees to meet borrowing and lending costs of the European Community in relation to the budget (UK) ✔ Increasing claims against the constituted Fund guaranteeing saving protection in case of bankruptcies – FOBAPROA – (Mexico)
Legal Litigations	✔ Liability or third party claims in excess of the operator's liability in the event of a nuclear accident in the UK (UK) ✔ Litigation against the Government by owners of nationalised companies to be indemnified for the losses incurred during the period of public management (Portugal) ✔ Litigation against the Government due to aboriginal land claims (Canada) ✔ Claims on significant tax refunds (Canada) ✔ Litigation against the Government filed by pension beneficiaries due to law changes caused by the fiscal crisis (Argentina).
Uncalled Capitals	✔ Callable capital subscription to the Asian Development Bank, Inter-American Bank, and to the European Investment Bank (UK)
Compensations/ Indemnities	✔ Indemnities provided to ship owners against third party claims arising from the dumping of radioactive waste at sea (UK) ✔ Indemnity to a truck terminal due to the abolition of internal European frontiers that reduced the expected earnings of the company (Portugal)

	✔ Indemnities stemming from allegations of negligence for infections transmitted through blood and blood products (Canada) ✔ Agreement to compensate Government suppliers through Treasury Bonds on account of pending unsettled demands and debts (Argentina) ✔ Indemnities provided to former prisoners under the military regime, according to the duration of imprisonment (Argentina)
Insurances	✔ Insurance for public sector schools that are unable to obtain commercial insurance cover (UK).
Aids for damage	✔ Provision of funds in the case of an emergency to the European Union (UK).
Pensions	✔ Agreement to meet any deficiency in respect of the ability of certain pension schemes to fund payments to their members (UK) ✔ Agreement to compensate pensioners through Treasury Bonds due to settlements arising from pending debt recognition (Argentina)
General Commitments	✔ Potential liability under the European Patent Convention (UK) ✔ Help to credit card debtors (Mexico) ✔ Cover for liabilities arising from the restructuring of the Army National Bank (Mexico).

Comment: the examples given indicate the wide variety of commitments entered into and how these are sometimes identified as contingent liabilities. Liabilities can result from, for example, public policies to support different social or economic sectors or if there are changes in economic or social conditions which will lead to governmental assistance and support.

Annex B

Fiscal Exposures: Implications for Debt Management and the Role of SAIs – February 2003: summary of key issues

1. Relevant extracts from the above report by the Public Debt Committee have been reproduced below to provide a summary of key issues relating to contingent debt.

   - ***What is meant by fiscal exposure and contingent debt?*** - fiscal exposure provides an umbrella for considering the wide range of responsibilities, programs and activities undertaken by national governments that may draw on future resources". Contingent debt is a key element that falls within this umbrella and represents potential claims on central government that "arise from uncertain events that will be resolved in the future.

   - ***The significance of fiscal exposure and contingent debt*** - to help avoid fiscal instability and unexpected changes in financing needs, policy choices should be based on a complete picture of a country's fiscal health, including a comprehensive understanding of potential draws on future budgetary resources. A comprehensive approach to debt management includes ensuring oversight of and the timely provision for contingencies, and effective risk management.

   - ***Identifying and classifying fiscal*** exposures – the Public Debt Committee report recognised the challenges inherent in identifying and assessing fiscal exposures and, drawing on the work of Hana Polackova-Brixi of the World Bank, provided a framework to assist with this process. The framework considered – (i) the nature of the commitment i.e. whether an exposure was explicit or implicit and (ii) the certainty of the event creating the exposure – whether the claim stemmed from an event that had already occurred or was contingent on some future event. The table below shows that contingent debt can be either explicit (recognised by law or contract) or implicit (based on expectations about the role of government). The table provides examples of each type of contingent debt.

Liabilities	**Direct** – claim based on current events or continuation of current policy	**Contingent** – claim contingent on a future event
Explicit – government liability is recognised by law or contract	• foreign and domestic sovereign borrowing • employee benefits payable	• guarantees for non-sovereign borrowing • insurance programmes (for bank deposits, crops, floods, war risk)
Implicit – expectations for spending stemming from potential “moral” or “social” claims based on current policies and/or public perceptions about the role of government	• future recurrent cost of public investment projects • future public pensions (as opposed to civil service pensions) if not required by law • future health care if not required by law	• default of a sub-national government or public or private entity on non-guaranteed debt • cleanup of the liabilities of privatised industries • bank failure (beyond coverage provided by insurance programme) • investment failure of a non-guaranteed pension fund, employment fund or social security fund • default of the central bank on its obligations (foreign exchange contracts, currency defence, balance of payments stability)

- ***Assessing the expected costs of fiscal exposures*** – valuing the expected costs of exposures – including contingent debt – rather than just reporting the maximum amount, provides policy makers with a better indication of the level of losses a government needs to anticipate. The determination of an appropriate value for fiscal exposures is not straightforward and is likely to involve judgements and estimates. This is particularly true for contingent debt where the likelihood of the debt crystallising needs to be taken into account. Sophisticated techniques based on financial derivatives have been applied to some government guarantees. This is equivalent to the government selling a put option to a lender, which gives the lender the right to put the loan on the government. Some countries have begun work to assess comprehensively the risk of government insurance programmes. Broadly, the risk assumed by the government can be regarded as the difference between actual premiums paid by the insured and the premiums necessary to fully cover the losses inherent in the coverage provided. This difference between the full risk premium and the actual premium charged represents the government's subsidy cost.

- ***Reporting of fiscal exposures*** –

    i. reporting contingent debt in financial statements - an increasing number of countries are preparing accrual based financial statements. Contingent liabilities are recognised on the balance sheet through a provision for expected losses only when it is deemed that the amount of the loss is probable and can be reasonably estimated. Some contingencies, which do not meet these criteria, are not recognised directly in the body of the financial statements but rather, are disclosed in the notes to the statements. These disclosures generally include contingencies if the future confirming event is more than remote, but less than probable.

    ii. financial disclosure of contingencies – some countries have taken steps to improve the disclosure of contingencies and other commitments. The IMF's "Code of Practices on Fiscal Transparency" provides that statements should be published with the annual budget giving a description of the nature and fiscal significance of contingent liabilities.

    iii. implicit claims - the extent to which implicit claims should be reported is a subject of debate. Some argue that transparency of all exposures is an important and necessary step toward understanding and mitigating risk. Conversely, others argue that the public disclosure of implicit exposures could greatly increase moral hazard. For example, while the IMF "Code" strongly promotes disclosure, it recommends the exclusion of implicit guarantees, such as the possibility that a government may in the future bail out a public enterprise or private sector bank, from disclosure in statements on contingent liabilities.

- ***Budgeting of fiscal exposures*** – some countries have taken steps, such as the use of accrual estimates, to increase the recognition of the expected costs of fiscal exposures directly in the budget. Budgeting for the potential costs of fiscal exposures represents a trade off between the opportunity cost associated with forgoing using these resources to increase spending (or to cut taxes) and the benefits of promoting fiscal stability and government credibility by more directly recognising the potential costs of these exposures. For example, some countries provide in the budget, as a separate item, annual amounts to cover any urgent or unforeseen expenditures, including contingent liabilities. In general, criteria are established which must be met before obtaining these funds. For example, the Hungarian government created multiple reserve funds, such as a deposit insurance fund, a guarantee fund for pensions and a state guarantee fund. Other countries established reserve funds to meet major contingencies such as a major natural disaster. Canada created a "contingency reserve" within the annual budget. The reserve covered risks arising from unavoidable inaccuracies in the models used to translate economic assumptions into budget forecasts and risks arising from completely unpredictable events such as earthquakes. It was not a source of funding for new government initiatives. If the funds were not needed they were used to pay off public debt. The government determined the amount of the contingency reserve after consultation with private sector economists.

- ***"Best practices" for dealing with fiscal risk*** – this is a developing area that encompasses contingent debt. Various approaches are being taken forward by different countries that fall generally into the following categories:

  i. improved transparency – for example the preparation of a "Polackova" matrix and the publication of supplementary information on fiscal exposures. While not providing any form of direct control, these actions would serve to identify and heighten awareness of fiscal exposures and perhaps encourage these issues to be addressed.

  ii. establishment of direct control mechanisms – some countries have taken steps to limit government exposure. For example, Canada introduced controls so that any new loan or guarantee programme must be approved by the Minister of Finance and authorised by Parliament.

  iii. development of risk management systems - establishing risk focussed processes can help governments better understand fiscal exposures and prevent them from unknowingly accepting risks that may jeopardise future budgets. For example, in March 1995, the government of the Philippines issued a consultative document aimed at better management of its contingent liabilities. The policy called for the unbundling of risks to better distinguish between core guarantees that were viewed as appropriate for government support and those that were viewed as temporary. The policy recommended withdrawing certain guarantees and limiting others to 80 percent of total project costs to increase risk sharing.

- ***Possible roles for the SAI*** - SAI's can improve a nation's long-term fiscal health by taking an active role in ensuring the proper understanding and monitoring of fiscal exposures and their implications for debt management. Possible roles that a SAI might fulfil with respect to fiscal exposures are set out in the table below.

Fiscal exposures – possible roles for SAIs
1. Audit and help improve understanding of exposures reported in financial reports.
2. Encourage sound reporting practice for fiscal exposures
3. Assist the development of a single portfolio for a country's fiscal exposures
4. Encourage the use of frameworks to help improve understanding of the scope and nature of a country's exposures
5. Assess the expected costs and risks associated with specific fiscal exposures
6. Utilise tools, such as simulations, to illustrate and increase understanding of the country's long-term fiscal outlook
7. Encourage best practice for dealing with risk – risk assessment, risk mitigation and risk management

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Annex C

INTOSAI Public Debt Committee

Questionnaire to INTOSAI Member States on contingent debt

Introduction

This questionnaire has been prepared by the Public Debt Committee of the International Organisation of Supreme Audit Institutions. The aim of the Public Debt Committee is – "to publish guidelines and other informational materials to be used by Supreme Audit Institutions (SAIs) to encourage the proper reporting and sound public debt management".

At its 2003 meeting in Mexico City, the Public Debt Committee concluded that there was a need to take forward its previous work on contingent debt to update its understanding of the particular issues and approaches applicable in individual INTOSAI Member States and to consider developments in different countries since its previous survey in 2000.

This questionnaire has been prepared in response to this need and will form the basis of………………………………

If you have any queries about the questionnaire please contact………………

Thank you for completing this questionnaire. Please send completed responses to…………………..

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Respondent Details

Country: ____

Organisation: ____

Name of respondent: ____________________________________

Position: ____

Contact Details: ____

Date of completion: _____________________________________

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SECTION 1: what is contingent debt?

Question 1: what do you understand by the term “contingent debt”?

Please provide a brief description/definition: ____________________________________
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SECTION 2: identification and classification of contingent debt

Question 2: are procedures in place to identify and classify contingent debt?

A	Yes	☐
B	No	☐

If “Yes” please go to Question 3
If “No” please go to Question 4

Question 3: does your country use the “Polackova matrix” to identify and classify liabilities?

A	Yes	☐
B	No	☐

If “Yes” please indicate the types of contingent debt that reside within the matrix i.e. (i) explicit contingent debt (ii) implicit contingent debt. For example, guarantees to third parties, legal litigations, letters of comfort, uncalled capitals, compensations/indemnities, insurance programmes, aids for damage, pensions, general commitments______________
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If "No" please describe how contingent liabilities are identified and classified and provide a brief description of the types of contingent liabilities present________________

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SECTION 3: assessing the expected costs of contingent debt

Question 4: does your country calculate the expected costs of contingent debt?

A	Yes	☐
B	No	☐

If "Yes" - (i) please describe, for the different types of contingent debt identified above, the methods used to assess expected costs (ii) what is the expected cost of the main types of contingent debt? (iii) please express contingent debt as a percentage (a) of annual government expenditure (b) Gross Domestic Product______________________________

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Question 5: does contingent debt score against total public debt?

A Yes
B No

If "Yes" what percentage of total public debt is represented by contingent debt?_________

SECTION 4: reporting of contingent debt

Question 6: are disclosures relating to contingent debt required in government financial statements and/or other publications (for example, public debt report, fiscal policy statement)?

A Yes
B No

If "Yes" please describe the disclosure requirements_______________________________

Question 7: are contingent debts reported to the legislature?

A	Yes	☐
B	No	☐

If "Yes" please describe the reporting requirements________________________________

Question 8: is the reporting of explicit contingent debt (recognised by law or contract) different from implicit contingent debt (expectations based on moral or social perceptions about the role of government)?

A	Yes	☐
B	No	☐

If "Yes" please describe the reporting requirements________________________________

SECTION 5: budgeting for contingent debt

Question 9: is the expected cost of contingent debt recognised in the government's budget?

A Yes

B No

If "Yes" please describe the budgetary process for contingent debt____________________

SECTION 6: control mechanisms and risk management

Question 10: are control mechanisms and/or risk management systems in place to limit/manage contingent debt?

A Yes

B No

If "Yes" please go to Question 11

If "No please go to Question 15

Question 11: are procedures in place governing the actions of individual departments/agencies when entering into potential liabilities?

A Yes
B No

If "Yes" please describe the procedures that individual bodies should follow____________

Question 12: do individual departments/agencies actively manage the risks associated with contingent debt?

A Yes
B No

If "Yes" please describe the main risk management techniques used (e.g. transferring risk to private risk/insurance markets, risk sharing provisions, contingency reserves, financial hedging through derivative instruments)____________

Question 13: is there centralised risk management of aggregate contingent debt?

A Yes ☐
B No ☐

If "Yes" please describe the main risk management techniques used (e.g. transferring risk to private risk/insurance markets, risk sharing provisions, contingency reserves, financial hedging through derivative instruments)____

Question 14: is there a specific entity with primary responsibility for the risk management of contingent debt (e.g. Ministry of Finance/Treasury, Debt Management Office, Central Bank)

A Yes ☐
B No ☐

If "Yes" please state the entity responsible_______________________________________

If "No" please confirm either (i) there is no central risk management of contingent debt or (ii) central risk management is undertaken by variety of individual bodies – in this scenario please identify the bodies concerned and their specific roles within the risk management process____

SECTION 7: the audit of contingent debt

Question 15: does the SAI for your country have responsibilities for the oversight and/or audit of contingent liabilities?

A	Yes	☐
B	No	☐

If "Yes" go to Question 16
If "No" go to Question 20

Question 16: does the SAI undertake financial audit on contingent liability figures disclosed as part of financial statements/reports (e.g. accounts for individual government bodies, consolidated government accounts, specific reports prepared to provide information on fiscal exposures)

A	Yes	☐
B	No	☐

If "Yes" please describe the financial audit responsibilities of the SAI________________
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Question 17: does the SAI undertake performance audit on issues related to contingent debt? (e.g. identification, costing and risk management)

A	Yes	☐
B	No	☐

If "Yes" please describe the performance audit responsibilities of the SAI and provide examples of work that the SAI has completed in this area___________________________

Question 18: are there significant issues arising out of the SAI's work on contingent debt? (e.g. completeness and /or valuation of contingent liabilities, estimation of probability of contingency occurring, legality/propriety of contingencies, transparency of government's position)

A	Yes	☐
B	No	☐

If "Yes" please describe the significant issues arising_______________________________

Question 19: does the SAI report separately each year on its work in relation to fiscal exposures and in particular, contingent debt?

A Yes
B No

If "Yes" please describe the reporting arrangements________________________________

Question 20: is there scope to enhance the SAI's role in relation to contingent debt? e.g. (i) encourage sound reporting practices for fiscal exposures (ii) encourage the use of frameworks to help improve understanding of the scope and nature of the country's exposures (iii) assess the expected costs and risks associated with specific fiscal exposures (iv) encourage best practice for dealing with risk

If "Yes" please describe the priority areas that your SAI would seek to address__________

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SECTION 8: key strengths and weaknesses

Question 21: please identify the three most significant strengths and three most significant weaknesses that apply to your country's handling of contingent debt.

Strengths

1.

2.

3.

Weaknesses

1.

2.

3.

Annex D

Contingent liabilities in the UK

Introduction

1. In preparing the draft questionnaire at Annex C, we considered arrangements for the handling of contingent liabilities in the UK. These are summarised below.

General approach

2. Contingent or actual liabilities may arise as a result of a specific guarantee, indemnity, letter or statement of comfort. While a letter or statement of comfort might not necessarily give rise to a legal obligation, it might nevertheless impose a moral obligation on the government. In some circumstances, even if there is no written undertaking of any type, liabilities might arise – for example, because an activity carries an inherent risk of losses or claims form third parties.

3. Ministers are free to give guarantees and indemnities and to issue letters or to make general statements of comfort. However, Parliament is not bound in advance to authorise funds needed to honour any liabilities arsing unless the liability has been charged by statute directly on the Consolidated Fund (the government's "current account" at the Bank of England). Legislation authorising liabilities should set out arrangements for notifying Parliament of any guarantees or indemnities given and these arrangements should be followed by government departments. Where the relevant Act does not specify reporting requirements, departments should follow the general reporting requirements described later in this paper.

4. Departments should consider carefully the justification for accepting non-statutory liabilities. As a general rule, departments should only accept such liabilities where:

   - the need is urgent and unlikely to be repeated; and

   - the department concludes that it would be in the national interest to act without statutory authority.

   Where there is a continuing policy requirement to accept particular types of liability, for example, guarantees of borrowing by third parties, departments should ensure they obtain specific statutory powers before entering into such liabilities. Departments are required to consult with the Treasury before seeking such powers.

5. Departments should carry out a careful appraisal of the risks before contingent or actual liabilities are accepted. In all cases, steps should be taken to restrict the total

liability to a minimum, for example by specifying the duration, the extent and the conditions attached to guarantees.

6. Departments should consider:

   - whether some form of commitment fee, payable by the beneficiary of the guarantee or indemnity would be appropriate; or

   - whether a charge should be established in the form of a deferred payment that could be reduced if the beneficiary was able to dispense with the guarantee, or any part of it, earlier than agreed.

   Departments should not, however, accept a liability simply in consideration of a payment. Such fees should only be used to limit the cost to the Exchequer of a guarantee or indemnity which is justified on other grounds.

7. Guarantees and indemnities should normally exclude any liabilities arising from negligence on the part of the indemnified body or its contractors, agents or employees. For example, if a department uses premises or facilities belonging to an outside body, it may be appropriate to indemnify the body against damage to its buildings or equipment or personal injuries to its staff arising from government use. In such a case the department should exclude any damage or injury attributable to negligence on the part of the indemnified body or of its agents from the scope of the indemnity.

Letters of comfort and statements of support

8. There is no simple or accepted definition of a letter of comfort. In the private sector the phrase typically refers to a letter issued by a parent company to a creditor of a subsidiary or associated company to give reassurance that the parent company is aware of financial obligations being assumed by the subsidiary or associate. In certain cases an indication may be given or implied as to the parent company's likely reaction should a subsidiary or associate subsequently fall into financial difficulties. But the essence of the letter of comfort is that it is intended to give some reassurance to the creditor without the parent company being legally bound, in all cases, to stand behind the subsidiary's obligations.

9. Departments should approach any request for a letter of comfort with a strong disposition to reject it. While letters of comfort are not generally legally binding, they may lead to a moral obligation: a public sector body, which is ultimately dependent on government credit, is unlikely to be able to issue such a document without effectively committing government credit and having to meet the obligation if it should materialise. Moreover, the existence of a letter of comfort could lead to threats of legal action, which might have implications for government credit. Proposals to issue a letter of comfort should therefore be exceptional and should be cleared in advance with the Treasury.

10. Oral statements which could be interpreted in a similar way to a letter of comfort (for example, a statement of general support for an outside body) should also be generally avoided.

Disclosure of contingent liabilities

11. The UK moved to a system of resource accounting and budgeting in accordance with the requirements of the Government Resources and Accounts Act 2000. Resource accounting was introduced for the financial year 2001-02 with resource budgeting following in 2002-03. Consequently, Government departments and bodies are required to disclose contingent liabilities in accordance with financial reporting standards – in this case "FRS12 - Provisions, Contingent Liabilities and Contingent Assets".

12. The Resource Accounting Manual (RAM) provides guidance to government departments on the preparation of their resource accounts. Chapter 4.3 of the RAM sets out the requirements in relation to provisions and contingencies.

13. In accordance with FRS12, government departments only recognise provisions within their financial statements when:

- an entity has a present obligation (legal or constructive) as a result of a past event;
- it is probable that a transfer of economic benefits will be required to settle the obligation;
- a reliable estimate can be made of the amount of the obligation;
- the estimated amount is material to the accounts.

14. For possible material contingent liabilities, departments need to disclose a brief description of the nature of the contingent liability and, where practical:

- an estimate of its financial effects;
- an indication of the uncertainties relating to the amount or timing of any outflow;
- the possibility of any reimbursement.

15. No disclosure in the accounts is necessary for remote contingent liabilities.

Reporting contingent liabilities to Parliament

16. Government Accounting is a comprehensive guide to central government bodies about financial and accountability issues. Chapter 26 of Government Accounting sets out arrangements for reporting contingent liabilities to Parliament. When reporting contingent liabilities to Parliament, a distinction is made between amounts greater than £100,000 and whether the liability is of a statutory nature. Non-statutory contingent liabilities and provisions are reported if they are:

- more than £100 000; and
- outside normal course of business for the department concerned or outside normal commercial business dealings; or
- represent significant back-end costs

17. In such cases, the government department should lay a Minute before Parliament explaining the reasons for the liability but should not enter into the liability until 14 days after the Minute has been laid. This "negative resolution" provides Parliament with the opportunity to question or, if possible, reject the department's plans to enter into the liability.

18. Statutory liabilities must be reported as follows:

- the department must make a "Statement" to both Houses of Parliament immediately the liability is incurred. The statute authorising the liability should set out the reporting requirements. However, if this is not the case then a statutory liability should be reported if it is above £100 000;

19. Central government statutory and non-statutory contingent liabilities are summarised in separately published "Supplementary Statements to the Consolidated Fund and National Loans Fund Accounts". The tables include all the cases notified under paragraphs 12-14 above, excluding a small number of cases where there are considerations of national security, or commercial confidentiality, or where public knowledge of a guarantee could prompt claims from third parties. Such cases are reported to Parliament through the Chairman of the Public Accounts Committee. The NAO is notified of such liabilities via a letter received annually from the Public Accounts Committee. Some examples of contingent liabilities disclosed in the Supplementary Statements are provided in the table below.

Examples of UK contingent liabilities - 31 March 2003	
Nature	**Amount £m**
1. Ministry of Defence – waste management, decommissioning and dismantling costs associated with the MOD's nuclear activities on certain MOD operated sites and sites currently operated by: Atomic Weapons Establishment Management Ltd, British Nuclear Fuels Limited, Nuclear Industries Radioactive Waste Executive, Rolls Royce & Associates and UK Atomic Energy Authority	21,946
2. Export Credits Guarantees Department – credit insurance guarantees, including tender to contract cover, also guarantees given to minimise loss, refinancing sovereign debt or reduce interest support costs	19,108
3. Department of Health – an indemnity to water undertakers in respect of costs, damages and expenses not otherwise covered by insurance arising from claims or proceedings on the grounds of alleged harm to health arising solely from fluoridation.	Unquantifiable
4. Home Office – Crown as insurers of the last resort in respect of contracts to design, construct, manage and finance new prisons.	Unquantifiable
5. Department for International Development – European Bank for Reconstruction and Development callable capital	867
6. Department for Trade and Industry – as part of a financing package to Royal Mail Group, the Department has agreed to buy 2 bond issued by the company, one of £200 million and one of £300 million.	500
7. Department for Trade and Industry – indemnities given to the UK Atomic Energy Authority by the Secretary of State to cover certain indemnities given by UKAEA to carriers and British Nuclear Fuels against certain claims for damage caused by nuclear matter in the course of carriage	Unquantifiable
8. Department for Transport – Channel Tunnel Rail Link: government guaranteed bonds	3,750

20. The Treasury plans to introduce "Central Government Accounts" for the financial year 2003-04. These consolidated financial statements for central government will include disclosures relating to contingent liabilities and replace the information provided in the Supplementary Statements to the Consolidated Fund and National Loans Fund described above. Central Government Accounts will include a compilation of contingent liabilities disclosed in departmental resource accounts and through Parliamentary reporting procedures. Aggregate figures will be provided where the amounts are quantifiable, broken down to an appropriate level of detail. A narrative summary will be provided for non-quantifiable contingent liabilities.

21. A summary of the reporting requirements under the Resource Accounting Manual and Government Accounting is provided in the table below.

Reporting requirements		
	Resource Accounting Manual	**Government Accounting**
Amounts	A narrative description and, where possible, an estimate of the amount of the contingent liability is disclosed. Where the contingent liability is unquantifiable, disclosure is restricted to a narrative description	Only contingent liabilities above £100k are reported to Parliament
Cash v discounted	Future cash flows associated with provisions and contingent liabilities should be discounted	A forecast of possible cash outflows is required
Coverage	Provisions and contingent liabilities relating to all aspects of departments' activities are covered by disclosure requirements	Departments are only required to report those provisions and contingent liabilities that are outside the department's normal course of business
Contingent v accrual	Disclosure requirements differ depending on whether the liability is actual or contingent	No distinction is made between actual and contingent liabilities for reporting purposes

Remote Contingent Liabilities	Remote contingent liabilities are not required to be disclosed in financial statements	Remote contingent liabilities should be reported to Parliament if the general qualifying conditions are met

22. The process for determining the nature of disclosures required can be summarised as a decision tree as shown below.

The decision tree for contingent liabilities