ISSN 1977-0375

eurostat
Methodologies and Working papers

Manual on Government Deficit and Debt

Implementation of ESA95

2010 edition

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Cataloguing data can be found at the end of this publication

Luxembourg: Publications Office of the European Union, 2010

ISBN 978-92-79-13835-5
ISSN 1977-0375
Doi:10.2785/34596
Cat. No. KS-RA-09-017-EN-N

Theme: Economy and finance
Collection: Methodologies and working papers

PREFACE

The excessive deficit procedure, defined by the Maastricht Treaty (Article 104) and in force in the European Union since 1994, has been an important challenge for statisticians. Eurostat has endeavoured to guarantee a proper application of the conceptual reference framework, the European System of Accounts (ESA), in order to obtain reliable and comparable statistics. The criteria for statistical evaluation have been made transparent, and consensus has emerged as to their pertinence.

From February 2000 onwards, the ESA95 is the conceptual reference framework for these data, which is legally binding in the European Union. The aim of the present manual is to aid the application of ESA95 for calculating Government Deficit and Debt data. It provides the appropriate answers to most of the statistical issues raised in the European Union during recent years regarding government financial statistics.

It is the result of a collective work of reflection, conceptual and textual elaboration made by a group of experts, co-ordinated by Eurostat, representing EU Member States, the Commission (the Directorate General for Economic and Financial Affairs) and the European Central Bank. It was discussed and approved by the working parties on national and financial accounts. The contribution of European statisticians and national accountants has been vital. We are most grateful to them.

Having received the approval of the Committee of Financial, Monetary and Balance of Payments Statistics (CMFB), this manual is an indispensable complement to ESA95 and SNA2008. It is of great use to statisticians and specialists of public finance not only in the European Union but also beyond, and in particular for the countries which are candidates for accession.

This third edition is an important update of the manual. It includes new chapters on recording of EU grants, public-private partnerships, return of bank notes, securitisations and dividends; and further developments of existing chapters such as capital injections, government guarantees and swaps. These were developed following Eurostat Decisions.

These additions and changes were prepared by an Editorial Committee having met nine times within a three years time frame (2007-2009), chaired by Luca Ascoli (Head of Unit "Statistics for Excessive Deficit Procedure I" in Eurostat), supported by John Verrinder, and with Philippe de Rougemont and Jean-Pierre Dupuis assuming the secretariat of the project, assisted by Gitte Renno (all Eurostat). Other Eurostat statisticians, Denis Besnard, Viera Karol'ová, Ágota Krénusz, Gabe de Vries, Kurt Wass and Marcin Woronowicz, were involved in the drafting work. ECB officials (Remigio Echeverria, Julia Catz and Henri Maurer) and experts from EU Member States were active participants in this Editorial Committee, notably E. Bablina, J. Branco, S. Brodersen, U. Burgtorf, M. Kellaway, J. Golland, M. Lucey, J. Magniez, P. Menezes, C. Modart, P. Schuerman, and G. Semeraro.

22 September 2010

François LEQUILLER

Director

INTRODUCTION: SCOPE AND DEFINITIONS

The Excessive Deficit Procedure (EDP)

The Maastricht Treaty, which foresaw the creation of the Euro, organised the way that multilateral fiscal surveillance would be conducted within the European Union. This surveillance is based on the EDP which sets out schedules and deadlines for the Council, following reports from and on the basis of opinions by the Commission and the Economic and Financial Committee, on how to judge whether an excessive deficit exists in a Member State.

The Treaty obliges Member States to comply with budgetary discipline by respecting two criteria: a deficit to GDP ratio and a debt to GDP ratio not exceeding reference values of 3% and 60% respectively, as defined in the Protocol on the EDP annexed to the Treaty.

Council Regulation 479/2009, as amended by Council Regulation 679/2010, requires that Member States report EDP-related data to Eurostat twice per year at end-March and end-September. The data are reported in harmonised tables (see Annex 2). These tables are designed specifically to provide a consistent framework, with a link to national budgetary aggregates and between the deficit and changes in the debt. They should be fully consistent with GFS data supplied through the ESA95 Transmission Programme.

The latest EDP Notification Tables for each Member State, for all biannual reports since September 2005, and a brief explanation of their contents, can be found here. Further information on Government Finance Statistics is here

Statistical Methodology

These reference values for Deficit and Debt are based on concepts defined in the European System of Accounts (ESA95). The government deficit is the net lending / net borrowing of general government as defined in ESA95 adjusted for the treatment of interest relating to swaps. The government debt is defined as the total consolidated gross debt at nominal value in the following categories of government liabilities (defined in ESA95): currency and deposits, securities other than shares excluding financial derivatives, and loans.

ESA95 is derived from, and almost entirely consistent with the worldwide manual for national accounts (SNA93). ESA95 is a legislative text which can be found here in a user-friendly form. Since ESA95 is a conceptual framework, it has been necessary for Eurostat to supplement it with additional guidance in the form of this ESA95 Manual on Government Debt and Deficit, Eurostat Decisions, and bilateral advice to Member States.

Eurostat's decisions and advice take account of the views of national experts. Eurostat, statisticians from the Member States and other interested parties meet several times per year in the National Accounts Working Group and Financial Accounts Working Group to discuss methodological and practical issues relating to national accounts. The Committee on Monetary, Financial and Balance of Payments Statistics (CMFB) is a high-level advisory group composed of officials from National Statistical Offices and Central Banks. It provides opinions to help Eurostat clarify the interpretation of ESA95 for the purpose of compiling Government Deficit and Debt statistics. The guidance in this manual is influenced by those committees.

Key concepts for measuring Government Deficit and Debt

ESA95 is a system for producing economic statistics. As such, it records the economic reality of transactions rather than their legal form. This can involve looking through

complex financial operations to understand who bears the financial risks and who has control over the rewards, irrespective of how the contracts have been constructed. In the context of measuring Government Deficit and Debt, this search for the economic reality affects such matters as the following.

- The classification of units: is a unit inside or outside the Government sector? The Government Deficit and Debt is primarily affected by units classified to the Government sector. This is determined by considering whether or not a unit is public (performs a government function, or controlled by another public unit), and by whether it is market (financed by its own sales) or non-market. Market institutional units are not in the Government sector.
- The timing of transactions: ESA95 records transactions when the economic activity takes place, rather than when the cash is paid if different. Such differences might be large, and therefore significant for the deficit, in the case of some taxes and the purchase of capital assets.
- The nature of a transaction: non-financial transactions such as consumption, wages and salary, subsidies and grants to cover losses directly affect the deficit, whereas others do not such as the acquisition of financial assets or the repayment of debts.

Structure of the manual

The following terms are used when referring to text within the manual, based on the hierarchical structure shown in the table of contents on the next page.

I. Part

I.1 Chapter

I.1.1 Section

I.1.1.1 Sub-section

Each of the eight parts starts with an overview and ends with keywords and references. The links to legal texts are shown in Annex 1. An index can be found at the end of the manual.

Contents

I

Delimitation of the general government sector

Part I Delimitation of the general government sector

I.1 Overview

1. Government Deficit and Debt statistics report on the activity of the General Government sector (S.13) as defined in national accounts. This sector is defined in ESA95 as all institutional units that are non-market producers whose output is intended for individual and collective consumption, and mainly financed by compulsory payments made by units belonging to other sectors, and/or all institutional units principally engaged in the redistribution of national income and wealth.
2. Non-market producers are units that do not obtain most of their income from the sale of goods and services, and so the definition excludes government-owned trading businesses (often referred to as public corporations). The public sector is usually defined as general government plus public corporations.
3. The general government sector is divided into four sub-sectors:
   a) central government (S.1311): this includes all administrative departments of the State and other central agencies whose competence extends normally over the whole economic territory, except for the administration of social security funds;
   b) state government (S.1312): this consists of separate institutional units exercising some of the functions of government at a level below that of central government and above that of the governmental institutional units existing at local level, except for the administration of social security funds;
   c) local government (S.1313): this includes those types of public administration whose competence extends to only a local part of the economic territory, apart from local agencies of social security funds;
   d) social security funds (S.1314): this includes all central, state and local institutional units whose principal activity is to provide social benefits and which fulfil each of the following two criteria:
      - by law or by regulation certain groups of the population are obliged to participate in the scheme or to pay contributions;
      - general government is responsible for the management of the institution in respect of the settlement or approval of the contributions and benefits independently from its role as supervisory body or employer.
4. Statistical offices frequently encounter units for which the sector classification is not obvious – for example certain types of government-financed schools and hospitals often pose problems. This chapter gives guidance on how to resolve such problems by examining whether the unit is:
   - a separate institutional unit
   - controlled by Government
   - market or non-market;

5. The classification matters because the Deficit and Debt of units classified to General Government add to General Government Deficit and Debt for EDP purposes.
6. Pension funds can pose difficulties. For example, social security funds do not include defined-contribution funded schemes for which no government guarantee exists for the risks of defaulting payments covering the majority of the participants, even where a government unit is responsible for the management of the scheme. It is not treated in the national accounts as a social security scheme in the government sector. Thus, the contributions and payments in respect of such schemes have no impact on the EDP deficit.

I.2 Criteria for classifying units to the general government sector

I.2.1 The definition of the general government sector

- The general government (S.13) sector includes all institutional units which are other non-market producers whose output is intended for individual and collective consumption, and mainly financed by compulsory payments made by units belonging to other sectors, and/or all institutional units principally engaged in the redistribution of national income and wealth. It includes:
  a. General government entities which administer and finance a group of activities, principally providing non-market goods and services, intended for the benefit of the community;
  b. non-profit institutions recognised as independent legal entities which are other non-market producers and which are controlled and mainly financed by general government;
  c. autonomous pension funds if they are obligatory by law or by regulation and if general government is responsible for the management of the institution in respect of the settlement or approval of the contributions and benefits.
- It excludes public producers organised as public corporations or, by virtue of special legislation, recognised as independent legal entities, or quasi-corporations, when any of these are classified in the non-financial or financial corporation sectors.
- In order to classify an entity inside the general government, it is necessary to determine:
  1) if it is an institutional unit
  2) if it is a public institutional unit
  3) if it is a non-market public institutional unit

  These criteria are discussed in detail below.
- The general government sector may comprise four sub-sectors, although not all apply in every country:
  a) central government (S.1311);
  b) state government (S.1312);
  c) local government (S.1313);
  d) social security funds (S.1314).

I.2.2 Concept of an institutional unit

- ESA95 2.12 sets out the rules according to which an entity can be considered as an institutional unit:

  A resident unit is regarded as constituting an institutional unit if it has decision-making autonomy in respect of its principal function, and either keeps a complete set of accounts or it would be possible and meaningful, from both an economic and legal viewpoint, to compile a complete set of accounts if they were required.

- In order to be said to have autonomy of decision in respect of its principal function, a unit must:

  a. be entitled to own goods or assets in its own right; it will therefore be able to exchange the ownership of goods or assets in transactions with other institutional units;

  b. be able to take economic decisions and engage in economic activities for which it is itself held to be directly responsible and accountable at law;

  c. be able to incur liabilities on its own behalf, to take on other obligations or further commitments and to enter into contracts.

- In order to be said to keep a complete set of accounts, a unit must keep accounting records covering all its economic and financial transactions carried out during the accounting period, as well as a balance sheet of assets and liabilities.

- The general government sector includes market entities not recognised as institutional units.

- If the entity does not keep a complete set of accounts (or it would not be possible and meaningful to compile a complete set of accounts if required) its partial accounts are to be integrated with the institutional unit's accounts.

- If the entity has no autonomy of decision in the exercise of its principal function, it should be combined with the unit that controls it.

- Units which are not individual legal entities but do keep a complete set of accounts, have a market activity, and whose economic and financial behaviour is similar to that of corporations, are deemed to have autonomy of decision and are classified as quasi-corporations in the corporations' sector outside the general government sector.

- In general the entire activity of an institutional unit is classified to one sector. The exceptions are:

  - when part of a non-market institutional unit can be recognised as a quasi-corporation (i.e. a market entities keeping a complete set of accounts and whose economic and financial behaviour is similar to that of corporations) and is classified to the corporations' sector;

  - certain types of pension funds (see sub-section I.3.2);

  - some market regulatory agencies (see section I.4);

I.2.3 Concept of public institutional unit

- A public producer is a producer that is controlled by general government. All other producers are private producers.
- Public producers are found either in the corporations' sectors (if they are market) or in the general government sector (if they are non-market or if they are not institutional units).
- Control is defined as the ability to determine the general (corporate) policy or programme of an institutional unit by appointing appropriate directors or managers, if necessary. Control may be exercised by government directly or indirectly (through a public holding corporation for example).
- Owning more than half the shares of a corporation is a sufficient, but not a necessary, condition for control. Government can also exercise control over a corporation through special legislation, decree or regulation that empowers the government to determine corporate policy or to appoint the directors.
- This definition of control is also applicable to NPIs. But in cases where the criteria set out above are not formally satisfied, or where special legislation is lacking, a more operational definition of control is necessary. The government secures the control of a unit when it influences the management of this specific unit, independently of general supervision exercised on all similar units. Public intervention in the form of general regulations applicable to all units working in the same activity should not be considered as relevant when deciding whether the government holds control over an individual unit.

Control in the example of schools

- General government controls a school if its approval is needed to create new classes, make significant investments in gross fixed capital formation, borrow or if it can prevent the school from ending its relationship with government.
- However, general government does not control the unit if it just finances the school or supervises the quality of education the school has to provide (fixing general programmes, or the maximum number of pupils per class).

I.2.4 Market/non-market rule applied to public institutional units

- When the principal function of the public institutional unit is the redistribution of national income and wealth, it is to be classified in the general government sector.
- When the principal function of the public institutional unit is financial intermediation it must be classified outside the general government sector in the financial corporations sector (S.12).
- In other cases, it is necessary to check whether the unit is market or non-market: in other words, if the unit is financed by sales of goods and services at economically significant prices then it is a market producer. Market producers are classified to the corporations' sectors (S.11 or S.12).
- The general government sector includes only public non-market institutional units, but these non-market institutional units can have market secondary local kind-of-

activity units (KAUs) not recognised as quasi-corporations, which are also included in the general government sector.

I.2.4.1 The concept of "economically significant prices"

- In both SNA93 (paragraphs 6.45 and 6.50) and ESA95 (paragraph 3.19), the distinction between market and non-market producers depends on whether or not prices charged for sales are economically significant.
- A price is said to be economically significant when it has a significant influence on the amounts the producers are willing to supply and on the amounts purchasers wish to buy.
- Conversely, a price is said to be not economically significant when it has little or no influence on how much the producer is prepared to supply and is expected to have only a marginal influence on the quantities demanded. It is thus a price that is not quantitatively significant from the point of view of either supply or demand.
- Such prices are likely to be charged in order to raise some revenue or achieve some reduction in the excess demand that may occur when services are provided completely free, but they are not intended to eliminate such excess demand.
- Market producers are producers that sell their output at economically significant prices. Non-market producers are producers that provide most of their output to others free or at prices that are not economically significant.

I.2.4.2 The 50% criterion

- In ESA95, economically significant prices are defined as prices that generate sales covering more than 50% of production costs.
- In distinguishing market and other non-market producers by means of the 50% criterion, “sales” and “production costs” are defined as follows:
  a. “sales” exclude taxes on products but include all payments made by general government or the Institutions of the European Union and granted to any kind of producer in this type of activity, i.e. all payments linked to the volume or value of output are included, but payments to cover an overall deficit are excluded.
  b. “production costs” are the sum of intermediate consumption, compensation of employees, consumption of fixed capital and other taxes on production. For this criterion other subsidies on production are not deducted. To ensure consistency of the concepts sales and production costs when applying the 50% criterion, the production costs should exclude all costs made for own-account capital formation.
- The 50% criterion should be applied by looking over a range of years: only if the criterion holds for several years or holds for the present year and is expected to hold for the near future, should it be applied strictly. Minor fluctuations in the size of sales from one year to another do not necessitate a reclassification of institutional units (and their local KAUs and output).
- The 50% criterion decides also when a government unit can be treated as a quasi-corporation (owned by the government): a quasi-corporation can be created only if it meets the 50% criterion.

- If a public unit is mainly financed by the general government according to its costs or to global budget negotiations focusing on several factors (final output, maintenance of buildings, investment in technical equipment, payment for compensation of employees…), the public institutional unit has to be classified in the general government sector because this financing does not correspond to sales. To check the nature of these payments, it could be useful to check whether general government systematically covers the unit's deficit.

I.2.4.3 Implementation of the 50% criterion

- Payments from general government to public institutional units in respect of actual services provided are to be treated as corresponding to sales in the following two cases:
  - when prices paid by the general government to public producers in respect to actual services provided are also applied to similar services (of the same quality) provided by private producers, who accept to sell services to general government on the basis of these prices. The rationale is that the existence of private producers guarantees that prices are economically significant and, hence, prices applied to services provided by public producers are also economically significant.
  - when, in the absence of private producers in the same kind of activity, the general government pays public units for actual services (rather than through coverage of costs) in order to have a significant economic influence on the supply and on the demand. For example, general government might want to give incentives to public units to develop specific services that correspond to public priorities by setting prices accordingly.
- The price received from general government is economically significant from the public producer's point of view if it is financed only according to the volume of output it provides. In this case the public producer is acting as a business subject to market forces such that some producers might have to close down if they cannot survive at those prices.
- Payments from general government to public institutional units in respect of actual services provided are <u>not</u> to be treated as corresponding to sales in the implementation of the 50% rule when prices are not economically significant, e.g. in the following two cases:
  - when prices paid by general government to public producers for actual services provided cannot be applied to similar services provided by private producers (because private producers are discriminated against in receiving such payments or do not accept to provide services on these terms), prices paid by general government to private producers are totally different from prices paid to public producers.
  - when, in the absence of private producers in the same kind of activity, a public unit is not in a position similar to a private unit because the general government would cover its remaining deficit. Therefore, the global amount of payments from the general government to the public unit is linked to its costs. In this situation, the general government decides to finance the public units in respect of actual services provided for purely administrative reasons, in order to allocate the financing, to control and to compare the costs, and to improve the internal productivity of the public units.

I.2.4.4 Application to hospitals

- There are important differences among Member States concerning the way the payments are made by the general government to public hospitals:
  i. according to their costs;
  ii. according to a negotiation (global budget) between general government and each hospital. These negotiations focus on several factors (final output, maintenance of building, investment in technical equipment, payments for compensation of employees);
  iii. according to a system of pricing applied only to public hospitals;
  iv. according to a system of pricing applied to both public and private hospitals.
- Only payments made under iv) can be considered as sales. This is because the other methods are just ways to ensure the government's payments cover each hospital's costs.

I.2.4.5 The borderline between taxes and sales of services

- In assessing whether a unit has market output it is necessary to check whether a unit's income from non-government sources should be classified as sales or as something else. For example payments for licences should be treated as sales of services only if government uses the issue of licences to organise some proper regulatory function (such as checking the competence or the qualification of the person concerned, suitability or safety of the business premises, reliability or safety of the equipment employed, quality or standard of goods and services produced), and if the payments are not out of all proportion to the cost of providing the services. The payments should be treated as taxes if either of those conditions is not satisfied. Chapter VI (Overview) provides more guidance on this.

I.3 Pension schemes

I.3.1 Background to the issue

I.3.1.1 Main definitions

1. Pension schemes provide an income after retirement from work. They can be provided through a social insurance scheme or through insurance policies and other long-term savings instruments arranged by individuals on their own initiative. In national accounts, social insurance means collectively organised protection against a list of “social risks or needs” such as, in the case of retirement pensions, the risk of not having an adequate income when old. The main flows under a social insurance scheme are “social contributions” (payments to the scheme) and “social benefits“ (payments by the scheme).

I.3.1.2 Social assistance

2. In national accounts, social insurance differs from social assistance. ESA95 says that social assistance payments "are similar in nature to social security benefits but which are not made under a social insurance scheme incorporating social contributions and social benefits" whereas social assistance benefits “are not provided in the context of a social insurance scheme". Social assistance does not require contributions from beneficiaries that are earmarked for that purpose. In addition, an insurance scheme defines in advance clear rights acquired by participants in the context of the rules set up in the scheme, whereas social assistance is adjusted to situations on the basis of rules that are subject to change by the government.

I.3.1.3 "Unfunded" pension schemes

3. There is a basic distinction between “unfunded” or “funded” schemes. Some schemes might have elements of both.

4. Unfunded schemes, frequently referred as to “Pay as you go systems”, are schemes where one unit is “responsible” for the unconditional payment of the pensions and, therefore, takes the financial risk of payment of the benefits. The managing unit may modify the rules that fix the contributions and the benefits. The accumulation of some reserves may also be observed, but there is in this case no intention to use invested assets as a major source of resources for payment of the future pensions. It is a discretionary decision from the unit managing the scheme that could decide at any time to use the reserves for something else.

I.3.1.4 Funded schemes

5. Funded schemes are arrangements where there is an accumulation of assets, mainly
financial assets, from contributions, with the explicit objective of ensuring all or a major part of payment of the future benefits from these assets (resale with possible capital gains, property income). In this case the financial risk comes mainly from uncertainty over asset performance. During a given period the benefits may not be financed exclusively from the current income generated by the assets due to the

variability of their financial performance. A funded scheme is a scheme where the assets are assumed to be sufficient to ensure the payment of all the benefits in the long-term. As a result, this "adequacy" must be considered in a dynamic way, notably for schemes that have been created recently. The participants do not own directly the assets that are collectively managed (similarly to mutual funds) but they hold an individual claim on the reserves that are accumulated.

I.3.1.5 Defined-contributions funded schemes

6. ESA95 uses the term “money purchase pension schemes” (see ESA95 7.59) for the same concept. In this case, the individual pension benefits depend on the accumulated assets. The level of the future pensions is uncertain as individual households bear the whole financial risk of the performance of assets comprising the accumulated reserves. Generally (but this is not a required condition), the participants in the scheme may have some individual choice in the orientation of the investment of their funds in one or more market segments. As a result, the same amount of contributions accumulated during the same period may give rise to different amounts of pensions. The accumulation of the assets is very similar to individual saving. Normally, participants in the scheme cannot dispose of their holdings before retirement.

I.3.1.6 Defined-benefit funded schemes

7. This is where there is an accumulation of assets but the unit responsible for management of the scheme bears the financial risk, taking the commitment to pay a promised level of benefits irrespective of the value of the accumulated assets. As a result, such schemes may show a positive (”over-funded”) or negative (“under--funded”) net worth if the market value of the assets is higher (or lower) than the present value of the promised benefits. The unit responsible for the scheme (the sponsor) has to inject money to better match the assets and obligations if the scheme becomes under-funded.

I.3.2 Treatment in national accounts

8. National accounts have drawn a line between social insurance and any other personal protection against social risks or needs (see ESA95 4.87 and 4.88). One of the following conditions has to apply for the scheme to be social insurance.

   - In order for an individual policy to be treated as part of a social insurance scheme, the scheme must be compulsory, whatever the level of this obligation (all the population, some categories of workers, branches, some firms, etc.) although experience shows that this criterion must be interpreted with some flexibility. Notably, there may be cases where there is no strict legal obligation to enter into a given scheme but where it is observed that a very large majority of the population is de facto member of the scheme because of some obvious advantages compared to other possibilities existing on markets. In addition, the expression “encouraged” is also used, which expresses that this criterion of “compulsory” is not too prescriptive.

   - The scheme must be collectively organised, meaning that the participants are submitted to general rules and cannot enter in specific negotiations about some conditions.

- The employer must pay a contribution (even if there is no actual payment in the case of "imputed contributions") on behalf of their employees. Social insurance is therefore part of the total labour cost.

I.3.2.1 Unit responsible for the management of a scheme

9. a. A government **unit** is judged to be responsible for the management and scope of a scheme if participation is imposed by law or specific regulation and the government controls the level of the main flows by setting (or approving in last resort) the rules. (Note that this role differs from the role government might have in supervising pension schemes and other financial institutions to ensure they are run according to prudent principles).

   Such schemes qualify as *"social security schemes"* (ESA95 4.88.a). The government unit managing such schemes, where clearly identifiable, is classified within the sub-sector "Social security funds".

   b. **Employers** (including government units employing civil servants) organise schemes exclusively for their own staff (or part of them in some cases) and manage directly, and are fully responsible for, all the underlying flows that are related to the rules in the framework of some specific legislation and regulation that aims to protect the pension rights of the employees.

   These schemes qualify as *"non-autonomous employer pension schemes"* (ESA95 4.88, b2). In this case, the employer acts directly as a sponsor for the scheme such that the flows, and possibly assets and liabilities, are allocated to the sector in which this employer is classified. In other words, such schemes can belong in all institutional sectors except households.

   c. **Financial institutions** manage schemes operating in a wide variety of ways including schemes that employers (including government units for civil servants) organise exclusively for their own staff. The manager, a different unit from the employer of the participants, receives the social contributions paid by the employers, and manages the flows and the accumulated assets. This is performed under a variety of control regimes established by specific regulatory bodies, employers or the participants themselves. These schemes are defined as *"autonomous private funds*" (ESA95 4.88, b1). The flows of contributions and benefits, and the corresponding assets and liabilities, are in the financial institutions' sector.

I.3.2.2 Unfunded schemes

10. If a government unit is responsible for the management and scope of an unfunded scheme, the scheme is a social security scheme or a scheme for government employees.

11. The origin of the resources used for the payment of benefits does not matter in judging the classification of such schemes. Nor does the way the participants' accumulated rights are measured (such as percentage of earnings, points, monetary accounts, etc.) and the amounts of benefits determined (such as "flat pension", percentage of earnings on a given period, period of contributions, age of retirement, etc) and adjusted during the retirement period.

12. If some financial reserves are held in the context of an unfunded scheme they are recorded as assets of the unit managing the scheme and not of the beneficiaries – see ESA95 Annex III.4

I.3.2.3 Defined contributions funded schemes

13. The financial assets (bonds shares, property…) forming the accumulated reserves of the scheme are recorded as assets of the unit managing the scheme, and the same amount is recorded in liabilities in AF.612 "net equity of households in pension funds reserves" . As a result, by definition in ESA95, the net worth of such defined contributions funds is zero and the notion of under-funded or over-funded is not relevant in this context. As there are no promised benefits, no comparison is appropriate. However it is possible to estimate the pension that would be received on the basis of the assets accumulated to date such that the sponsor (or even government as supervisory body) would take some measures to increase contributions if the level were judged too low: but this has no influence on the classification of a funded scheme.

14. In recent years, some countries have set up defined-contributions funded pension schemes where a government imposes or encourages participation, collects contributions from employers and pays pension benefits to households, fixes the level of contributions and maybe change the rules, but where it is explicitly stated that pension benefits will predominantly depend on accumulated assets. Under these conditions, it seems that all ESA95 criteria for classifying such schemes as social security schemes are not fulfilled, as government is not fixing the level of the pension benefits and it is difficult to consider that it is "financing" the scheme. As a consequence, the unit managing the scheme must be considered as a separate institutional unit not classified within the government sector and must be classified as a public financial corporation within the sub-sector S.125 "Insurance corporations and pension funds".

15. Therefore, the flows of contributions and benefits under this defined-contribution funded scheme are not recorded as government revenue or expenditure and do not have an impact on government deficit or surplus. However, redistribution may play an important role in such schemes. Contribution payments may be fixed as a share of income, whereas entitlements do not fully reflect the differences between contributions paid by different persons in a single period. In such cases, the redistribution of contributions has to be recorded within the government sector (without any effect on general government deficit or surplus), whereas the pension scheme remains a public financial corporation. The estimated amount of contributions paid by those scheme members who pay more than their increase in entitlement are shown as a social contribution paid by households to government; and the same amount is recorded as a social benefit paid by government to those households whose entitlement grows by more than their contributions.

I.3.2.4 Defined-benefit funded schemes

16. The liability of the unit managing the scheme (AF.612), and asset of households, must be valued at the "present value of the promised benefits" (ESA95 7.59).

17. If the scheme becomes under-funded and the managing unit injects funds into it, this is to be recoded as a capital transfer.

18. Even if the value of the assets is lower than 50% of the future obligations (which, obviously, could not be considered as a "predominant part"), a scheme could be treated as funded if it is obvious that the sponsor shows the intention to "re-balance" the scheme.

19. A government unit might manage a defined-benefit funded scheme. Provided that other criteria, as mentioned in ESA95 4.88a (large coverage of population, compulsory participation, control of contributions and benefits) are fulfilled, these schemes must be classified as “social security schemes”.

20. In the current ESA95, the liability vis-à-vis households for defined benefit funded schemes is not recorded in the government balance sheet. This may be seen as an inconsistency in the system (compared to a “private” defined-benefit pension fund) but, from an economic point of view, this situation is very similar to a social security fund because the government is committed to paying pensions according to rules that do not depend on the market value of the accumulated assets.

I.3.2.5 Government manages a “mixed scheme”

21. The expression "mixed schemes” (or “hybrid schemes") does not exist in current national accounts standards as their creation occurred after publication of those standards. It applies to cases where a government unit is involved simultaneously in the management of two kinds of schemes (imposed on all the population or only a part, for instance based on age criteria in cases where older workers would not have accumulated sufficient contributions in order to obtain an adequate pension from the assets). In appearance there is a single flow of contributions (a total rate is paid) and a single flow of pension benefits such that each household receives only one regular payment for a given period.

22. One scheme is unfunded and organised according to the “normal” features of a “pay-as-you go" system where the benefits (fixed according to some factors) are directly financed by the contributions collected and, if necessary, by other government resources.

23. The other scheme is a funded one that has all the features of a defined-contributions funded pension scheme: part of the contributions received from the employers is invested on markets (directly by the government unit but more frequently through specialised market units) and the individual pension benefits, for that part, will predominantly depend on the invested assets.

24. What matters here is that both corresponding flows, “in” and “out” and relating to two different sets of rules, can be identified fully. Similarly the involvement of government in each kind of scheme is very different. Under the unfunded scheme, government has taken the commitment to pay a promised level of benefits by reference to rights, determined by given rules on their calculation. Under the funded scheme, the amount of the pension depends normally on the accumulated assets and government has no general obligations towards all the participants.

25. As each scheme is run by clearly a different set of rules and more precisely, as the pension benefits are not financed in the same way, the total flows must be allocated to each corresponding scheme, and these should be treated differently in national accounts. As a result, in such situations, two different institutional units must be distinguished in national accounts, each of them referring to one identifiable scheme.

26. In this respect, the unit that is identified (resulting from the “split” for statistical purposes of the one apparent government unit) as responsible for the management of the defined-contributions funded scheme must be classified outside the general government sector.

27. Therefore, the flows of contributions made to the unit managing the defined-contributions funded scheme and the flows of benefits paid from this unit are not part of government revenue or expenditure and therefore cannot have an impact on government deficit or surplus.

I.3.2.6 Government guarantee to a funded scheme

28. Even where government is not responsible for the management of a scheme that is not classified as social security scheme, it may have a “strong interest” in the sustainability of the scheme, as part of its social protection policy. This can apply to non-government unfunded schemes, as well as government-run unfunded schemes: the accounting rules to be followed are the same. Government acts as a supervisory body closely following the performance of non-government pension schemes. Notably, it has to ensure that nobody within the population would be left without an adequate pension.

29. In this context, where government considers that the degree of uncertainty for participants in a non-government pension scheme is not acceptable, for example because of operational risks, insufficient level of accumulated reserves, market collapse, the government may grant an explicit guarantee to protect the participants. Government acts as payer of last resort to ensure that benefits reach a level considered as satisfactory.

30. The existence of a government guarantee, in conditions mentioned above, to a funded scheme that is not classified as a social security scheme, does not as such imply that the beneficiary scheme should be reclassified as a social security scheme.

31. The government guarantee must be considered as a contingent liability, not recorded in national accounts as a government liability according to the general ESA95 principles. In this respect the risk borne by government is only a potential one as it depends on the occurrence of certain specific events. As a result, neither government expenditure nor government revenue is recorded as long as the guarantee is not used.

32. Government may support a scheme for exceptional and temporary reasons, for instance a short-term shock on financial markets (such in 1987, 1994, or 2008) such that the government intervention is limited in time and amount. This does not imply reclassifying the scheme as a social security scheme, unless government takes control of the scheme and directly adjusts the levels of contributions and benefits. This means that, in a first stage, any government support, although affecting government surplus / deficit, would not have the automatic effect of reclassifying the scheme.

33. If government’s support for the scheme is not implemented for exceptional and temporary reasons but is observed frequently and assumed to be permanent, national accountants should closely examine whether government has obtained some controls over the scheme such that conditions for classifying it as a social security scheme are fulfilled (notably ESA95 2.74 and 4.88).

34. In the case of a defined-contributions funded scheme, this reclassification as a social security scheme should be implemented only when the government is effectively ensuring the payment of benefits for an amount higher from than the one paid from the assets accumulated in the fund. In this case, it becomes a defined benefit funded scheme under the responsibility of government.

I.3.3 Rationale of the treatment

I.3.3.1 Defined-contributions funded schemes managed by government

35. The level of pensions depends on accumulated assets invested on market. Therefore, government is not controlling the level of the individual pension benefits because it has no direct influence on the market performance of the assets.

36. All pension funds where the participants bear the financial risk should be treated in the same way, whatever the nature - public or private - of the unit managing the scheme, or even the obligatory or voluntary nature of the scheme. They are savings accumulated by households. Managing assets on behalf of other units is a financial intermediation activity that is not normally a function of government. When managing such schemes, government is not acting for public policy purposes but is acting in a similar way to a financial institution.

37. Classifying defined contributions funded scheme into the sub-sector S125 "insurance corporations and pensions funds" means that, although the liability relating to the future pensions is not recorded as government liability, the government securities held by the pension fund are rightly recorded in government debt. Under these conditions, the structure of the portfolio of the pension fund has no influence on the recording of Government debt.

I.3.3.2 "Mixed schemes" managed by government

38. An important aspect of such mixed schemes is the centralisation of all flows through one government unit. However, this is a technical aspect that can be justified in terms of efficiency and should not influence the sector classification.

39. What matters here is that an observed "single" flow of payments in each direction (contributions/benefits) covers transactions related to different sets of rules that require corresponding treatment in national accounts. In addition, it is important that the schemes are independent with cross-subsidy from one to the other.

I.3.4 Accounting examples

40. The classification of social contributions and social benefits as government revenue and expenditure (in the ESA95 category D.6) does not raise any specific issue. This is the same also for temporary support by government to a funded scheme that must be recorded as a capital transfer D.99 (see ESA95 4.165.i).

    ESA95 provides an example in its Annex IV.

I.4 Market regulatory agencies

I.4.1 Background to the issue

1. This section discusses the sector classification of market regulatory agencies and the treatment of their inventories.
2. These are agencies acting on behalf of the European Community (EAGGF etc.), or other units having both a market and a redistribution activity. They mainly concern agricultural products. Institutional arrangements vary between countries. Typically their activities include the purchase and storage of agricultural products; giving direct subsidies to farmers, levying charges on producers and imports; giving subsidies for exports; giving grants for capital equipment and environmental improvements.
3. The Eurostat 2005 decision on the accounting treatment of transfers between the EU budget and Member States specifies that EU transfers should have no impact on government deficit/surplus, as government is considered to act "on behalf" of the EU. The Eurostat decision focused on the recording of some ESA95 transactions, such as subsidies or investment grants. As noted above, market regulatory agencies buy and sell products, often on behalf of the EU, with an aim to stabilise prices and to maintain purchasing prices to farmers within the EU. From a national accounts point of view, general governments are not the economic owner's of these inventories. However, allocating to the EU (S.2 Rest of the world) the changes in inventories would imply recording market regulatory agencies` purchases/disposals as exports/imports with the EU institutions, which seems not a desirable or plausible national accounting solution.
4. Much of this section is derived from the Eurostat paper of 20 November 2008. The full text can be found here: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/MARKET_REGULATORY_AGENCIES.pdf

I.4.2 Treatment in national accounts

5. According to ESA95 2.21 and 2.69a, market regulatory agencies whose sole or principal activity is to buy, hold and sell agricultural and other food products are classified in the sector non-financial corporations.
6. However, market regulatory agencies, which are either exclusively or principally simple distributors of subsidies, are classified in the general government sector (sub-sector central government).
7. Market regulatory agencies may be engaged in a mixture of activities such as distributing subsidies and buying, holding and selling agricultural and other food products. In such cases, it should be examined if the agency can be divided into two distinct institutional units:
   - one institutional unit being in market intervention activities, classified in the non-financial corporations sector (S.11);

- a second institutional unit distributing subsidies, classified in the general government sector (S.13).

8. If it is not possible to distinguish two separate institutional units, the following rule should be applied to determine the "principal activity".

   - Units should be classified to the general government sector if their costs incurred in market intervention compared to the total costs are less than 80% and to the non-financial corporations' sector (S.11) if their costs incurred in market intervention compared to the total costs are more than 80%.
   - The costs incurred are measured in the same way as the value of output of non-market services, i.e. as the sum of intermediate consumption, compensation of employees, consumption of fixed capital, and other taxes on production less other subsidies on production.

9. In those circumstances where a market regulatory agency acting on behalf of the EU is classified inside general government, the creation of a unit in the corporations' sector (S.11) is recommended in order to capture the changes in agricultural inventories, and to avoid that such changes in inventories are recorded in national government accounts (as changes in government inventories, with an impact on the government deficit/surplus) or in the rest of the world accounts (as exports and imports).

10. This recording would be mainly based on the view that the EU has economic ownership of those inventories, and not the national government, and that the market regulatory agencies are in fact acting on behalf of the EU: the EU exercising control and assuming risks and rewards associated to these inventories. Such a treatment is also in line with the convention of sector classification of market regulatory agencies (in S.11) stated in ESA95.

11. The unit to be created to capture these changes in inventories is a quasi-corporation, rather than a notional unit, in order to ensure an equality of treatment with cases where market regulatory agencies are sectorised outside government. This is also appropriate because any temporary difference in value arising from changes in market value of these inventories not yet covered by subsidies is likely to be small and on average zero.

I.4.3 Rationale of the treatment

I.4.3.1 80% criteria

12. The main reasons for fixing the threshold at the high level of 80% are the following:

    - it is difficult to imagine a corporate enterprise (market producer) distributing subsidies; a significant level of costs dedicated to such an activity is an indication of the non-market character of the unit;
    - in many cases the agency forms part of, or is closely linked to, a Ministry, and its staff are civil servants;
    - in the context of the Common Agricultural Policy, the relative importance of subsidy distribution is now greater than the market intervention activity (to buy, to hold, and to sell agricultural goods);

- a treatment ensuring stability over time for the classification of market regulatory agencies is needed.

I.4.3.2 Economic ownership of the inventories

13. Given that a market regulatory agency is "acting on behalf of the EU" and does not use these inventories in its own production process, this institutional unit does not seem to be the economic owner of those inventories arising from its interventions on the market. The EU should be considered the economic owner of such inventories.

14. Nonetheless, the recording of exports/imports relationships with the EU does not seem desirable or plausible because this would entail recording export and import flows each time the agency buys or sells, inflating totals with limited analytical value. In addition, market interventions of regulatory agencies, although acting "on behalf" of the EU, are made at national level, i.e. in the national markets.

15. It is important to analyse the economic ownership of the inventories constituted by market regulatory agencies. The SNA93 does not explicitly define economic ownership; the term “economic ownership” aims at better reflecting the underlying economic reality of the transaction and where the risks and rewards of ownership lie. It seems that in the case of public interventions in the field of stocks of cereals, the Commission bears all the financial risks including all the losses derived from the intervention in the market, as the aim of the EU common agricultural policy in this field is to avoid any financial impact on the Member State resulting from market interventions. The opposite situation might also occur in the hypothetical scenario where the price goes up, the Member State repaying in full the difference to the Commission (gain on sale). In addition, the Member State is responsible for taking all necessary measures for its good conservation but, at the same time, has no control over these goods: it is obliged to buy goods; and their re-selling is only decided by the EU (Commission). In this context, the EU unquestionably has economic ownership of such inventories.

I.4.3.3 Classifying the inventories in the corporate sector:

A notional unit or a quasi corporation?

16. In national accounts, a possible solution (to avoid recording exports and imports upon each addition to or removal from inventories) would be to allocate the recording of such agricultural inventories (P.52) to the non-financial corporation sector (S.11). This would be consistent with the reasoning that general government is not the economic owner of the inventories resulting from market interventions. This approach would follow to some extent the convention stated in ESA95 (footnote of 2.21) that market regulatory agencies whose sole or principal activity is to buy, hold and sell agricultural and other food products are classified in S.11. The market regulatory agency's activity at national level – buying and selling agricultural products – reflects a market activity that should be carried out by a corporation (and not by general government).

17. The above view would imply that an artificial unit would be created to capture transactions in inventories within S.11, in those cases where the market regulatory agencies are classified inside central government (S.1311).

18. One possibility would be to recognise a notional resident unit owned by the EU. The creation of a notional resident unit seems broadly in line with the ESA95 2.15,

which explains that notional resident units, even if they keep only partial accounts and may not always enjoy autonomy of decision, are treated as institutional units, by convention. Such a notional resident unit would hold inventories and it would be regarded as transacting in those. This implies the EU being the owner of the entity in national accounts.

19. Another possibility would be to recognise a quasi-corporation in national accounts, having the same purpose as a notional resident unit mentioned above (i.e. to capture transactions in inventories in case that a market regulatory agency is classified inside central government). In some cases, this option might be seen *prima facie* to deviate from ESA95 2.13f when no complete set of accounts is formally available. However, to the extent that the EU makes up for the losses arising from the holdings of inventories, relevant and comprehensive sets of accounts must be available. This implies government being the owner of the entity in national accounts.

20. Both these treatments would avoid recording changes in acquisitions and disposals of inventories as exports/imports to the EU.

21. Summarising, two options seem to be possible, according to who is viewed as the owner of the entity that is holding the inventories, to be classified in S.11:

    Option 1) recognising a quasi-corporation, implying that the owner of the entity remains government; or

    Option 2) recognising a notional unit, implying that the owner of the entity is the rest of the world (ROW).

I.4.3.4 Net worth of general government

22. Given it is argued that the EU owns the inventories, it is important to determine whether the changes in own funds of the entity owing to gains and losses on inventories at market value (which might be large from one period to the next) would impact either general government net worth, or the rest of the world net worth, or none of them.

23. It is important to determine whether the quasi-corporation option or the notional unit option would yield different, or very different, results from the point of view of the net worth of general government. It could be assumed as a preliminary conclusion that the result would be different as far as the net worth of the EU is concerned. This is because the latter would be impacted by gains and losses on inventories in the case of the notional unit option, but not in the case of the quasi-corporation option.

24. If the agency is an entity established by government, it is likely that some equity link will exist and will appear as an asset of general government when the agency is classified outside general government. However, changes in the price of inventories should not be reflected in the equity value of the entity (i.e. should not be reflected in the price of the asset of government) because by definition those gains and losses do not accrue to government but will eventually be returned to the EU or compensated by EU subsidies. Thus, in concept, the gains and losses should, at first sight, give rise to the appearance of a kind of payable/receivable with the EU, which would keep the own funds of the agency unchanged.

25. In ESA95, *Own funds* is defined as net assets of units, excluding equity liabilities, while *Net worth* is defined as net assets of units, including equity liabilities. Thus,

Own funds minus equity liabilities of units (i.e. equity issued) equals *Net worth*. See ESA95 7.01 and 7.05. The ESA95 net worth should thus not be confused with the business accounting notion of shareholders' equity or net worth. This business accounting notion of net worth is, in fact, closer to the ESA95 notion of own funds.

26. However, in concept, the time of the appearance of the payable/receivable also results from the time of recording of the subsidy, which accounting is specifically regulated in ESA95

27. This time of recording issue of subsidies would most likely lead to an impact on the own funds of the agency. However, conceptually, this should not impact the equity value of the agency. If the agency itself were to be sold, its valuation would be independent of the value of its inventories owing to the obligation of the EU to cover losses when incurred, or of the obligation of the agency to return gains to the EU.

28. Accordingly, gains and losses on inventories must be neutral from the perspective of general government net worth in all cases (notional unit or quasi-corporation), even if they are also neutral from the perspective of the EU net worth (quasi-corporation). Thus, holding gains and losses on market regulatory agencies inventories do impact only the non-financial corporations' (S.11) net worth, pending the recognition of the subsidy associated to the receivable/payable.

29. However, this will require that the valuation of the equity in the quasi-corporation will have to correspond to the financing provided to date, rather than being equal to its own funds: thus the unit net worth would be either positive or negative, although only for short periods of time, owing to the gains and losses on inventories not yet realised or recognised, and thus not yet compensated or returned to the EU. Such deviations could nevertheless be seen as a reasonable approximation of the convention that the net worth of the quasi-corporation should be zero (ESA95 7.03).

I.4.3.5 Valuation of transactions in inventories

30. In national accounts, the transactions related to interventions in the market should be recorded in application of ESA95 4.33 and 4.35, in the context of notional or quasi-corporation units. These ESA95 paragraphs would still be applicable for the cases of notional or quasi-corporation units.

31. The transaction value on resale must include the EU subsidy. Thus, changes in inventories will tend to compensate over time. The reimbursements made by the EU correspond to the difference between purchase and resale prices, which is shown in national accounts as subsidies paid by the EU.

I.4.3.6 Accounting treatment in the financial accounts

32. The following discusses how to record in the financial accounts the links between the notional or quasi-corporation unit and the EU and/or government.

33. Under the **notional unit option** recording, some parallel might be found with SNA93 10.41, and a similar reasoning could be applied in the case of market regulatory agencies: an acquisition of equity (F.5) by the EU is to be recorded, matched by an EU borrowing (F.4) from the entity financing the market regulatory agencies (often government itself). This would imply changing the present recording in the Rest of the World financial accounts.

34. Under the **quasi-corporation option**, no entries are recorded in the Rest of the World financial accounts, as the transactions in equity on the liability side of the quasi-corporation have a counterpart entry in the accounts of government.

35. Thus, in both cases the net change in inventories that is *de facto* financed by the entity sectorised inside government (by way of borrowing from third parties or of drawing down on its liquidities) is recorded in the financial accounts of general government, instead of in the non-financial accounts as would otherwise be the case (under changes in inventories – P.52): either as transaction in equity (F.5 – quasi-corporation option) or as loans to the EU (F.4 – notional unit option).

36. A theoretical advantage of the notional unit option, over the quasi-corporation option, is that it reflects the genuine economic ownership of the EU.

37. However, a main disadvantage of the notional unit option is that this requires entries in the ROW financial accounts that do not even exist when the regulatory agency unit is classified outside general government in the first place: thus the notional resident unit option seems to introduce an apparent asymmetric treatment between those market regulatory agencies that are classified inside general government and those market regulatory agencies that are classified outside general government. This would seem to go against a homogeneous treatment across Member States.

38. In addition, the impact of the movement in the market value of inventories not yet covered by subsidies is likely to be small and temporary, and on average zero over time. In this context, the merit of imputing government lending to the EU and, simultaneously, EU financing of the inventories may be doubtful.

39. Finally, it should be reminded that strictly following a recording that portrays the change in the economic ownership would have implied recording imports and exports, which is deemed not to be particularly useful for analytical purposes (balance of payment).

40. It may be noted, however, that both options have the same impact on the government deficit and debt.

I.4.3.7 "Shell" treatment

41. When the notional unit or the quasi-corporation is seen as a "shell", for simplicity purposes, it would be conceived in national accounts as only holding inventories and undertaking transactions in those, with counterpart entries in the financial accounts: equity liability. The "shell" option would also mean that no reinvested earnings would be recorded.

42. Alternatively, these units can be conceived to be more complete entities, showing a more complete sequence of national accounts, such as generating a margin and incurring costs.

I.4.3.8 Time of recording of the subsidy

43. ESA95 4.39a indicates that the time of recording of "*subsidies which take the form of the difference between the purchase price and the selling price charged by a government*" is "*at the time the goods are bought by the agency*". But how should this be interpreted?

44. When a product is bought for 120 by the agency in period T, and resold for 100 in the following period T+1, a subsidy on product is recorded in T. In T, the output of

farmers (S14/S11) is then 120, the GDP 100, changes in inventories +100. In T+1, the output of farmers is 0, GDP is 0, final consumption is 100, and changes in inventories are -100.

45. However ESA95 4.39a specifically indicates: "*if the selling price is known at that time*", which needs to be interpreted. The resale price is *a priori* generally not known in advance. But an expected price is probably known: suppose it was 106 in the example above. Then 6 (=20-14) only is the non-expected element.

46. The reference in ESA95 above presumably intends to avoid that holding gains/losses enter the production account. Only the part that the scheme is expected to finance should contribute to output. But at the same time, in the case of agricultural market regulatory agencies, no holding gains and loss will ever be born by farmers or by the agency: all the changes in price will be eventually assumed by the EU.

47. Finally, the selling price of the goods might have fallen to 102 by end of year T. This would be the value of inventories recorded on the balance sheet at the end of period T.

48. If ESA95 4.39a also covers cases when the selling price will be known" only in the next period, then the amount to record as subsidy in T (and parallel acquisition of a receivable) by the agency is either:

    - Option (1) the actual amount observed in T+1 (20); or
    - Option (2) the expected amount observed in T (14); or
    - Option (3) an amount reflecting the market price observed as of end of the year (18).

49. In option (1), the recordings are straightforward but imply a revision in the data, when the information is gradually available (notably for quarterly data). In option (2) and (3), one issue is how to record in T+1 the difference of 6 (=20-14) or 2 (=20-18). One approach is to enter those flows in the revaluation accounts of the financial accounts (thus recording subsidies on an expected basis), which seems difficult. Another approach is to record a subsidy on production in T+1 for the remainder (that could be either positive or negative) matched by an entry in change in inventories (although this might appear artificial). In doing so an entry in the revaluation account in the non-financial assets occurs (of +4=6-(20-18) = (20-14)-(20-18) =18-14)) in T+1 in option (2) compensating the holding loss arising in T (of -4=14-18). No revaluation occurs in option (3) neither in T+1 nor in T. It should be noted that in option (3), the net worth of the quasi-corporation are always zero (see section above). In option (1) or (2), the net worth deviates from zero, for either positive or negative amounts, but for limited time spans.

I.5 Units engaged in financial activities: general issues

1. This part considers whether certain types of public units undertaking financial-type activities should be classified to general government or as public financial corporations S.12 (ESA95 2.32).
2. Units principally engaged in financial intermediation, as defined in ESA95 2.32 to 2.35, are to be classified in one of the following sub-sectors: S.121 (Central bank), S.122 (Other monetary and financial institutions), S.123 (Other financial intermediaries, except insurance corporations and pension funds) or S.125 (Insurance corporations and pension funds). It is recalled that a major feature of financial intermediaries is that they place themselves at risk by acquiring financial assets and incurring liabilities on their own account.
3. Units engaged in auxiliary financial activities, as defined in ESA95 2.39, are to be classified in the sub-sector S.124 (Financial auxiliaries).
4. In particular, in order to classify municipal credit and saving banks as financial intermediaries, it is necessary to examine if their lending or their acceptance of savings is independent of the municipality involved (ESA95 2.38).
5. The Monetary Financial Institutions (MFIs) comprise the sub-sector S.121 and S.122, and coincide with the MFIs for statistical purposes as defined by the European Central Bank in its list of MFIs in the European Union and institutions subject to the Euro system's minimum reserve system.
6. When a unit does not clearly fulfil the criteria laid down in the aforementioned ESA95 paragraphs, and therefore may be classified in the sector general government (or non-financial corporations), it is necessary to look at the 50% criterion which should be applied by looking over a range of years. Only if the criterion holds for several years or holds for the present year and is expected to hold for the near future, should it be applied strictly.
7. In applying the 50% criterion for the market/non-market test, sales would include commissions and FISIM (as defined in ESA95 3.63j).
8. The 50% criterion doesn’t apply in practice when assessing the sector classification of financial intermediaries, though it does apply for financial auxiliaries (that do not place themselves at risk).
9. Financial Supervisory Bodies are by convention considered as financial corporations, specifically as financial auxiliaries.

I.6 Special Purpose Vehicles (SPVs)

I.6.1 Background to the issue

1. Special Purpose Vehicles are legal entities that are established to undertake the economic and financial transactions associated with a single legal contract or linked set of legal contracts. The SPV is established in such a way that it is not a formal subsidiary of any other business, so that no other business can profit from it or be put at risk by it. The governing board of an SPV is usually a trust whose sole purpose is to ensure that the SPV implements the legal contract effectively. It has no authority to direct the SPV to enter into other business activity. The legal contract is usually constructed in a way that makes it very unlikely that the SPV will become insolvent or make large profits. Once the contract is completed the SPV is closed down and any remaining assets are often transferred to a charity.
2. Securitisation arrangements often use an SPV to legally separate to issuance of debt from the initial owner of the securitised assets/rights. It is the SPV which issues the securities, uses the proceeds obtained from their issuance for the purpose of taking legal ownership of the securitised assets/rights, and then services the debt thus issued.
3. SPVs are also set up for reasons other than securitisation. For example an SPV might be created to hold the bad assets of a bank in financial defeasance, or to raise debt for a PPP arrangement.

I.6.2 Treatment in national accounts

4. If the SPV has no autonomy of decision concerning the management or disposal of its assets or liabilities, the SPV is not a separate institutional unit according to national accounts criteria (as stated in ESA95 2.12) and so should be included within the sector that it serves.
5. Assuming that the SPV has been established to serve a government unit, a lack of autonomy of decision could be indicated, among other factors, by:
   - a *de facto* management of the SPV's debt by government; or
   - the absence of the right or capacity to actively manage its assets in response to market conditions, such as government having the right to approve any significant disposal; or
   - a pre-arranged contract signed by government fully determining the SPV's operations.
6. In some cases an SPV will be formally set up by an entity without public status, typically with financial institution status, to purchase and securitise government assets. In these cases, if the SPV does not have autonomy of decision, it is necessary to determine whether it should be classified within the government sector or with the entity arranging the securitisation. Generally it should be classified within government, since government is assumed to be initiating and monitoring the transaction, unless the financial institution arranging the securitisation places itself at risk and the SPV is an "SPV of substance" in the

sense that it is required to make significant decisions during the life of the securitisation and such decisions are not made by the government unit but by the arranger or other entities investing in the SPV or purchasing its securities.

7. The SPV can still lack autonomy from government even when the board of the SPV consists wholly of non-government appointees.

8. If the SPV meets the condition to be considered as a separate unit (actively managing the assets and liabilities, and bearing risk, such that there is financial intermediation), it should be classified as a financial corporation (S.12). When the risks and rewards associated with the assets are not fully transferred to the SPV, this may be proof that the SPV should be classified to the government sector.

9. If the SPV is located in the rest of the world, it remains a unit in the rest of the world but its operations are rerouted through the originating government.

10. Although SPVs are established to implement a contract, this need not imply automatically that the SPV has no autonomy of decision. It might need to appoint staff and sub-contractors, determine a Treasury management policy to meet the needs of the contract, and decide other day to day operational matters. So inevitably it is a matter of the degree of autonomy and hence the classification involves an element of judgment.

I.6.3 Rationale of the treatment

11. Concerning the sector classification of the securitisation entity (SPV), ESA95 2.55f states that they should be classified as “Other financial intermediaries” (S.123): *"In particular, the following financial corporations and quasi-corporations are classified in sub-sector S.123 unless they are MFIs:… (f) financial vehicle corporations, created to be holders of securitised assets;…*". This is assuming that such "vehicles" are financial corporations in the first place: they are institutional units and they conduct financial intermediation (or other auxiliary services).

12. To be a separate institutional unit, the criteria stated in ESA95 2.12 must be met. In order to be classified to S.123, the SPV should have autonomy of decision in respect of the management of the debt securities that it issues. Indicators of this are issuance rhythm, debt management, repayment strategy, etc. It should be clear that the SPV does not act on behalf of government. It should also have complete autonomy concerning the management and disposal of its assets. Otherwise the SPV should not be recorded as separate institutional unit.

13. Concerning recognising when an institutional unit is a financial intermediary, ESA95 2.33 states that “a financial intermediary does not simply act as an agent for these other institutional units but places itself at risk by acquiring financial assets and incurring liabilities on its own account”.

14. Concerning the classification of new financial assets resulting from a securitisation, ESA95 5.63 states that securities issued by an SPV are to be classified under AF.3 “Securities other than shares”.

I.7 Public sector holdings

I.7.1 Background to the issue

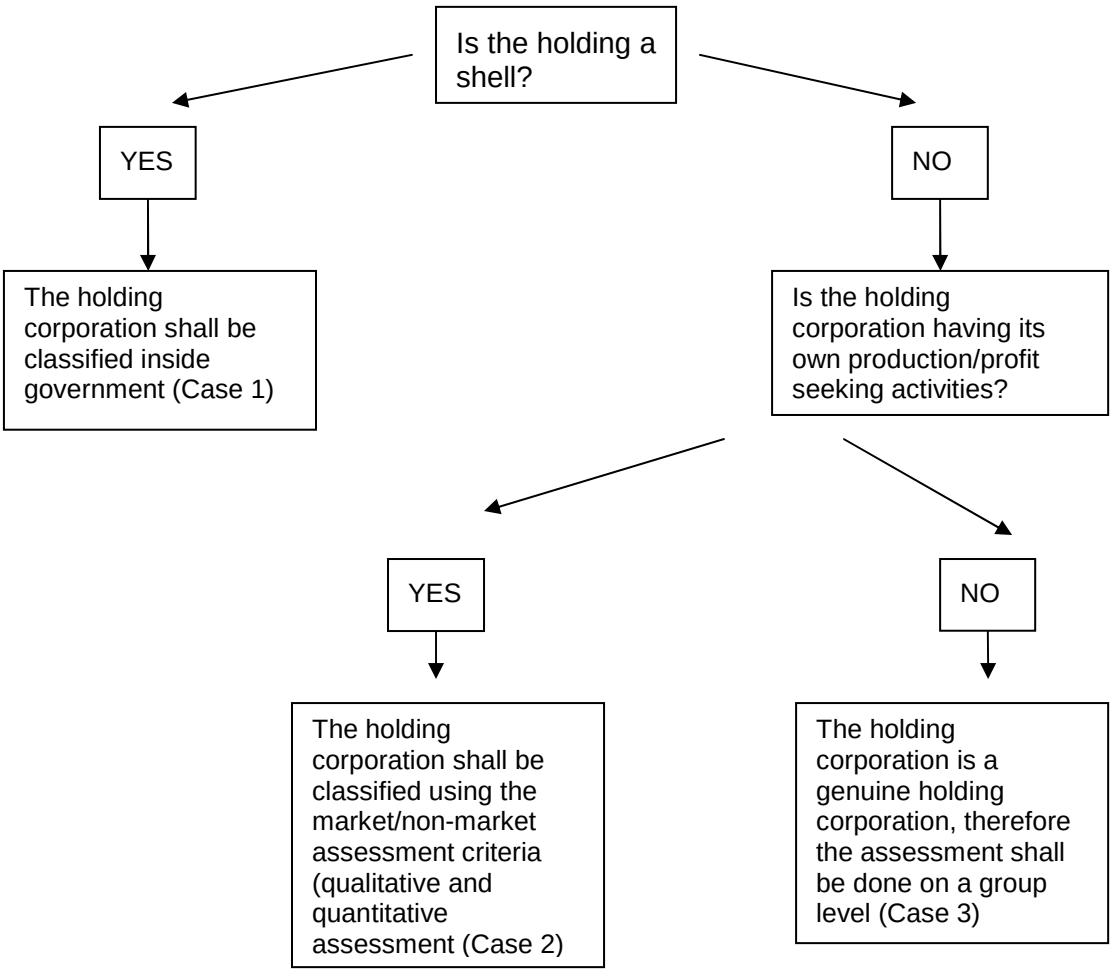
1. The issue is whether individual companies in a group of public companies can be classified to different sectors.
2. Public holding corporations commonly group public companies that are indirectly owned and controlled by government. The problem arises when part of the group – one or more subsidiaries for instance – comprise units that are non-market: should these non-market units be classified inside the general government sector, even when other entities in the group are market units?
3. Public transportation and public infrastructure units often make losses and provide typical examples of possible borderline sector classification cases.

I.7.2 Treatment in national accounts

4. ESA95 2.14 defines holding corporations as institutional units whose main function is to control and direct a group of subsidiaries.
5. Public holdings are classified in the sector S.11 (Non financial corporations) or S.12 (Financial corporations) if they control a group of corporations which are market producers, whose preponderant type of activity of the group of corporations as a whole - measured on the basis of value added - is the production of non-financial services (S.11) or is financial intermediation or auxiliary financial services (S.12).
6. Case 1: When the holding corporation is a shell or acts as a government agent (such as a privatisation agency), it should be classified inside government.
7. Case 2: When the controlling company is a "mother"/"parent" having its own production/profit seeking activities, in addition to its holding corporation activities, the classification should be made on an individual basis, using the traditional market / non-market assessment criteria .
8. Case 3: When the holding corporation is none of the above, but is a genuine holding corporation (just managing a group of subsidies), its market/non-market classification should be assessed at the group level
9. Subsidiaries, when they are institutional units, should be assessed on their own and tested individually for the market/non-market criteria for classification purposes. Non-market institutional units controlled by government are to be classified inside general government. This may imply recognising equity liabilities of general government.
10. Accounts of subsidiaries not being institutional units, such as ancillary units, should be combined with the corporation that controls them.
11. Units created in a privatisation process, to hold shares in public corporations that the government wants to dispose of, should be classified in the general government sector, because they manage assets on behalf of government, which can be considered the ultimate owner of the assets. Such units are not public holdings in ESA95 terms, as they do not really intervene (or only in a marginal way) in the management of the corporations they hold, but just act in financial markets.

12. In the case of public holdings engaged both in commercial market activities and in the management of assets to privatise some of its subsidiaries, and when it is not possible to split the holding in two separate institutional units, ESA95 1.41 should be applied: "When a unit carries out a transaction on behalf of another unit, the transaction is recorded exclusively in the accounts of the principal". Therefore, when one unit carries out transactions on behalf of another unit included in the general government sector, these transactions should be recorded in the accounts of the latter.

Decision tree: Is the holding corporation a shell (or acting on behalf of the government)?



I.7.3 Rationale of the treatment

I.7.3.1 Classification as a holding corporation

13. ESA95 defines two conditions in order for an entity to be considered as a holding corporation: it has to be an institutional unit, and it has to control and direct subsidiaries.

14. In practice, this would not be the case if such bodies were set up:

- for a restrictive purpose: for instance, to reorganise the corporations or manage their disposal;
- for a limited period of time.

I.7.3.2 Holding corporations as institutional units

15. According to ESA95 2.12: "The institutional unit is an elementary economic decision-making centre characterised by uniformity of behaviour and decision making autonomy in the exercise of its principal function. A resident unit is regarded as constituting an institutional unit if it has decision-making autonomy in respect of its principal function and either keeps a complete set of accounts or it would be possible and meaningful, from both an economic and legal viewpoint, to compile a complete set of accounts if they were required." Whenever an entity is deemed to be an institutional unit, its classification should be assessed individually. The main question in the classification of holding corporations and their subsidiaries is to judge whether this general rule prevails or whether there are, or there should be, any special rules concerning these entities.

16. ESA95 2.13c: "entities which, while keeping a complete set of accounts, have no autonomy of decision in the exercise of their principal function are combined with the units which control them" might also relate to public holding corporations if they have no autonomy of decision. In such cases, public holding corporations have to be combined with the unit that controls them, like any other unit not having autonomy of decision. In practice, for a public holding corporation to have autonomy of decision, it is necessary that the appointment of the public corporations' directors is made by the head offices themselves, and not by government. Moreover, the decisions of the disposal of the ownership of public corporations and of equity injections in some of the corporations have to be directly taken by the head offices and not by the general government itself.

17. Two issues need to be discussed in more detail, to clarify the methodological issue raised. Firstly, under what circumstances would a public holding corporation be classified inside the general government sector (assuming some of the subsidiaries are market units)? Secondly, can a subsidiary be classified inside the general government sector, even if the holding corporation and the other subsidiaries are market units?

I.7.3.3 Classification of the holding corporation

18. ESA95 2.13e gives more detailed guidance on the classification of holding corporations and their affiliates: "entities forming a part of a group of units engaged in production and keeping complete set of accounts are deemed to be institutional units even if they have partially surrendered their autonomy of decision to the central body (the holding corporation) responsible for the general direction of the

group; the holding corporation itself is deemed to be an institutional unit distinct from the units which it controls".

19. SNA95 4.36 and 4.37 also introduce the notion of holding corporations. SNA93 distinguishes two kinds of "parent corporations". The first "consists of a corporation with significant production of its own which acquires control over other corporations in order to strengthen its own position as a producer. It may, for example, acquire control of a corporation that supplies it with components, or it may acquire control of a competitor" (SNA93 4.36). The second type of parent company, called "holding company" or "holding corporation" in SNA93, is a company whose "...principal function... may be to control and direct a group of subsidiaries, without having any other significant production of its own." (SNA93 4.37). This may somehow give a more restricted notion of a holding company than ESA95 2.13e.

20. SNA93 4.38 also mentions that "each individual corporation should be treated as a separate institutional unit, whether or not it forms part of a group". This would mean that the holding corporation and each of its subsidiaries should be assessed individually when deciding the question of whether the company (the holding corporation or the subsidiary) is an institutional unit (or not), and its classification.

21. The “Treatment in national accounts” above identified three cases.

    a. In case 1, the holding corporation is classified within general government if:

        - the "shell" is not a genuine institutional unit according to the ESA95 definition, and is instead an ancillary corporation providing services to the unit that controls it.
        - while the “shell” is considered an institutional unit, it has as its principal activity typical government activities, like channelling or managing public subsidies, which implies redistributing national income and wealth. Standard government activities (e.g. taxation, distributing subsidies) performed by a market body as a secondary activity would however not lead to the unit being classified as non-market; instead the government activity can be rearranged / rerouted through the government accounts.
        - the “shell” is an institutional unit but it is acting on behalf of government, such as in the case of privatisation agencies.
        - it fails the market test.

    b. In case 2, the sectorisation of institutional units must be assessed by reference to the standard classification rules, which would in general be independent from the parent/subsidiaries relationships that the parent maintains. When a mother company has some noticeable production activity, it is likely that its management activities would not be preponderant. However, when management activities are preponderant, the classification should be determined at the group level, as in case 3.

    c. In case 3, the holding corporation should be classified based on the market/non-market criteria, when taking the group as a whole. This is because the market/non-market nature of the holding management services is difficult to establish, and can be seen as arbitrary. In particular, the revenue of the holding corporation may be in the form of dividends (that are not considered as sales for the 50% criteria) or in the form of contractual payments whose market/non-market nature would generally be problematic to determine. This sectorisation

of the holding corporation based on the consideration of the group as a whole is proposed by analogy to ESA95 2.23e (non-financial corporations) and 2.40e (financial corporations), which recommend that holding corporations are classified as financial or as non-financial corporations based on the criteria of *"the preponderant type of activity of the group of corporations as a whole"*.

I.7.3.4 Classification of subsidiaries

22. According to ESA95 2.13e and SNA93 4.38 mentioned above, subsidiaries are deemed to be institutional units, even if they partially surrender their autonomy to a central body or belong to a group.

23. SNA93 defines the notion of subsidiaries in 4.32. Beyond this, SNA93 4.38 also says: "*For certain purposes, it may be desirable to have information relating to a group of corporations as a whole. However, with the exception of ancillary corporations described in the next section, each individual corporation should be treated as a separate institutional unit, whether or not it forms part of a group. Even subsidiaries that are wholly owned by other corporations are separate legal entities that are required by law and the tax authorities to produce complete sets of accounts, including balance sheets.*

24. *Although the management of a subsidiary corporation may be subject to the control of* another corporation, it remains responsible and accountable for the conduct of its own *production activities."* Thus, SNA93 explicitly says that subsidiaries – if they are not ancillary corporations – shall be assessed individually.

25. SNA93 4.40 defines ancillary corporations, as "A subsidiary corporation, wholly owned by a parent corporation, whose productive activities are ancillary in nature: that is, are strictly confined to providing services to parent corporation or other ancillary corporations owned by the same parent corporation." According to SNA93 4.43: "Ancillary corporations are not treated as separate institutional units in the System", meaning that an ancillary corporation forms together with the parent company a single institutional unit.

26. The classification of subsidiaries is quite straightforward. If the subsidiary is an institutional unit (not an ancillary unit), then its classification has to be assessed on an individual basis. If two legally incorporated entities cannot be meaningfully considered separately, they should be treated as a single institutional unit. But, once each of the entities is deemed to be an institutional unit, the sector classification rules must strictly apply.

27. If the subsidiary is an ancillary unit, meaning that it mostly provides services to the parent corporation, then its accounts have to be consolidated with its parent. This would be applicable to cases of groups where subsidiaries do not interact with the market, but simply provide services, only or mostly, to other subsidiaries or to the holding corporation, because it is then difficult to apply the market/non-market criterion.

28. If the subsidiary of a public holding corporation is recognised as an institutional unit, and the entity is determined to be non-market, it should be classified into the general government sector, even if it is only indirectly owned or controlled by government through the public holding corporation.

29. It should be noted that if a market institutional unit conducts some non-market activities/transactions on behalf of government, these would need to be rerouted via government, in application of ESA95 1.38-1.41.

I.7.3.5 Notion of control

30. Another aspect relates to the government control: can a subsidiary that is non-market, and that is only *indirectly* controlled by government, be classified inside the general government sector? ESA95 gives some guidance on this. ESA95 2.26 says:

    "*In order to control more than half of the shareholders' voting power, an institutional unit needs not own any of the voting shares itself. A corporation C could be a subsidiary of another corporation B in which the third corporation A owns a majority of the voting shares*."

    Therefore, control can be exercised directly or indirectly, as also acknowledged in other

I.7.3.6 Equity liability of government

31. A consequence of classifying a subsidiary of a market public holding corporation as a unit in the general government sector is that a liability in equity (AF.5) would be recorded in the financial accounts of the general government sector. Such a possibility of recognising an equity liability of government – in very specific cases – has already been discussed and accepted by the Financial Accounts Working Group in 2006. An alternative recording, that may be sometimes more appropriate, would be to record a direct equity link from government to the subsidiary. In this latter case, this AF.5 amount would be deducted in the consolidated financial accounts from general government AF.5 position, on the asset side.

32. Concerning the gross or net presentation of the equity liability of the government, it might be useful to distinguish cases according to the owners of the corporation. If the public holding corporation (government) is the sole owner, both net and gross presentations might be appropriate. However, if the subsidiary is not solely owned by the public holding corporation then a gross presentation is more appropriate, in order to show the equity liability of general government to other sectors.

33. It should be noted that capital injections from government benefiting, notably via the holding, such non-market subsidiaries would not be shown as government expenditure, even if the subsidiaries were loss-making, because the transactions would be consolidated within the general government sector.

I.8 Government debt management offices

I.8.1 Background to the issue

1. The functions of Government debt management offices vary from country to country. These functions can cover a range of financial activities including: issuing securities; other forms of borrowing such as savings schemes for households; managing Government's short-term assets and liquidity; and lending to other public units. In some countries the national central bank might perform some of these activities for Government. Elsewhere they might be undertaken by part of the finance ministry.

I.8.2 Treatment in national accounts

2. When public debt management offices are separate institutional units, they should be classified in the general government sector as they act on behalf of general government.
3. They should not be classified as financial corporations as they do not provide financial intermediation. The funds borrowed by debt management offices are given to Government rather than held on the debt management office's balance sheet. The repayment of the borrowing is provided by the Government rather than from the office's own resources.

I.9 Keywords and references

Control	ESA95, 2.26 and 3.28 to 3.29
Defined-benefit pension schemes	ESA95 7.59
Economically significant price	ESA95, 3.19
Employer pension schemes	ESA95 4.88
Financial intermediation	ESA95, 2.32 to 2.38
General government sector and sub-sectors	ESA95, 2.68 to 2.74
Holding corporation	ESA95, 2.14
Institutional unit	ESA95, 2.12
Market output	ESA95, 3.17
Market regulatory organisation	ESA95, 2.21, 2.69
Market/non-market	ESA95, 3.27 to 3.45
Money purchase pension schemes	ESA95 7.59
Net equity of households in pension funds reserves	ESA95 5.110/5.113
Non-market output	ESA95, 3.23
Non-profit institution	ESA95, 3.31
Pension fund	ESA95, 2.64
Private funded social insurance schemes	ESA95 Annex III (5)
Public/private producer	ESA95, 3.28, 3.29
Quasi-corporation	ESA95, 2.13f
Social assistance	ESA954.103 / 4.105
Social insurance	ESA95 4.83 / 4.87 and Annex III (2 / 1)
Social insurance scheme	ESA95, 4.88 to 4.90
Social security fund	ESA95, 2.74
Social security schemes	ESA95 4.88
Social security schemes of government	ESA95 Annex III (4)
Transaction on behalf of another unit	ESA95, 1.41

II

Time of recording

Part II Time of recording

II.1 Overview

1. ESA95 records flows on an accrual basis when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled.
2. Thus, output is recorded when produced, not when paid for by a purchaser, and the sale of an asset is recorded when the asset changes hands, not when the corresponding payment is made. Interest is recorded in the accounting period when it accrues, regardless of whether or not it is actually paid in that period. Recording on an accrual basis applies to all flows, monetary as well as non-monetary and intra-unit as well as between units.
3. However, in some cases it is necessary to show flexibility as regards time of recording. This applies in particular to taxes and other flows concerning general government, which are often recorded on a cash basis in government accounts. It is sometimes difficult to carry out an exact transformation of these flows from cash basis to accrual basis. For practical reasons, due to the excessive deficit procedure, it was necessary to define a particular recording of taxes and social contributions payable to the government sector, so that net lending/borrowing of general government (and of counterpart sectors) shall not include amounts of taxes and social contributions unlikely to be collected. By derogation to the general principle of recording transactions, taxes and social contributions payable to the general government can either be recorded net of the part unlikely to be collected or, if this part is included, it should be neutralised in the same accounting period by a capital transfer from the general government to the relevant sectors.
4. The timing of recording of transactions has an impact on the annual Government Deficit figures; but over a long period of time the differences between accrual and cash recording is eliminated since the accrual recording simply shifts the cash transactions into a different time period. The impact of accruals recording has less impact on the Government Debt because it is measured at nominal value and accounts payable/receivable (accounting for the differences between accrual and cash) are excluded from the definition of Government Debt.
5. In some cases the difference between accrual and cash recording can affect the total amount recorded, not just the timing. This is discussed more fully in the section on taxes.
6. In determining the correct time of recording on an accruals basis there are a number of events to consider: economic, judicial and administrative. For example, economic activity can generate a liability to pay taxes but the amount of tax might only be determined some time after the economic activity; after which an invoice is sent requiring payment by some future date. The actual tax payment might be made before, on, or after that date, or not at all. National accountants need to decide which of these dates to record the tax.

II.2 Recording of taxes and social contributions

II.2.1 Background to the issue

1. Taxes and social contributions in the European Union represent at least 80% of government revenue. The manner in which they are recorded in the framework of the ESA95 given the context of the excessive deficit procedure is therefore critical: the method must be transparent and the impact on government deficit comparable.

2. The original text of chapter 4 in ESA95 was amended by the Commission Regulation 995/2001 to achieve this objective better. The amendment was made because taxes and social contributions accrued (or assessed as due) may be recorded as government resources even though a significant proportion of them might never be actually paid due to: bankruptcy of companies; lack of efficiency of the tax collecting system; or other reasons. The Regulation modified the common principles of ESA95 as concerns taxes and social contributions to ensure comparability and transparency among the Member States. The general principle is that the impact of taxes and social contributions recorded on general government net lending/borrowing shall not include amounts unlikely to be collected. Accordingly, the impact on general government net lending/borrowing of taxes and social contributions recorded in the system on an accrual basis shall be equivalent over a reasonable amount of time to the corresponding amounts actually received.

3. Article 3 of the Regulations says that taxes and social contributions recorded in the accounts may be derived from two sources: amounts evidenced by assessments and declarations or cash receipts.

   (a) If assessments and declarations are used, the amounts shall be adjusted by a coefficient reflecting assessed and declared amounts never collected. As an alternative treatment, a capital transfer to the relevant sectors could be recorded equal to the same adjustment. The coefficients shall be estimated on the basis of past experience and current expectations in respect of assessed and declared amounts never collected. They shall be specific to different types of taxes and social contributions. The determination of these coefficients shall be country-specific, the method being cleared with the Commission (Eurostat) beforehand.

   (b) If cash receipts are used, they shall be time-adjusted so that the cash is attributed when the activity took place to generate the tax liability (or when the amount of tax was determined, in the case of some income taxes). This adjustment may be based on the average time difference between the activity (or on the determination of the amount of tax) and the cash tax receipt.

II.2.2 Treatment in national accounts

4. ***Time of recording*:** this is when the activity took place which generated the tax liability or, in the case of some income taxes, when the amount of tax due is determined with certainty by the government.

5. ***Amounts to be recorded*:** this is the most delicate issue. As noted above, it is addressed by article 3 in the Council Regulation, allowing three possibilities for recording taxes and social contributions in national accounts.

6. The first two options are relevant if the amounts referred to are those evidenced by assessments or declarations as amounts due:

   a. Amounts to be recorded shall be assessed amounts adjusted by a coefficient reflecting the assessments never collected. The coefficients shall be estimated on the basis of past experience and current expectations in respect of assessed amounts never collected.

   b. Amounts assessed as due are entirely recorded as taxes and social contributions. But the discrepancy between this theoretical amount and the actual cash receipts shall be treated as a capital transfer in favour of the defaulting taxpayers.

   c. Cash amounts are recorded in the accounts: but they shall be time-adjusted so that they are attributed to the period when the activity took place to generate the liability.

II.2.3 Rationale of the treatment

7. This is the subject of the article 2 statements:

   1. The impact on the general government net borrowing/net lending of taxes and social contributions recorded in the System shall not include amounts unlikely to be collected.

      The underlying reasoning is that, when there is evidence that some of the taxes and social contributions that have been assessed will never be collected, the difference between assessments and expected collections represent a claim that has no real value and should not be recorded as government revenue.

   2. The impact on the general government net borrowing/net lending of taxes and social contributions recorded in the System on an accrual basis should be equivalent over a reasonable period of time to the corresponding amounts actually received.

II.3 Changes in the due for payment dates

II.3.1 Background to the issue

1. Sometimes Governments change the due for payment dates for taxes, subsidies, compensation of employees, social contributions and benefits.
2. The time of recording is defined in ESA95 for the different transactions. As a general rule, the system records flows on an accrual basis, that is, when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled (ESA95 1.57).
   - Wages and salaries and employers' and employees' actual social contributions are recorded in the period during which the work is done. However, ad hoc bonuses or other exceptional payments, 13th month, etc. are recorded when they are due to be paid (4.12, 4.96).
   - Taxes on production and imports are recorded when the activities, transactions or other events occur which create the liability to pay taxes (4.26).
   - Subsidies are recorded when the transaction or the event (production, sale, import, etc) which gives rise to the subsidy occurs (4.39).
   - Current taxes on income, wealth, etc. are recorded at the time when activities, transactions or other events occur which create the liabilities to pay.
   - In some cases, the liability to pay income taxes can only be determined in a later accounting period than that in which the income accrues.
   - Some flexibility is therefore needed in the time at which such taxes are recorded. Income taxes deducted at source, such as PAYE taxes and regular prepayments of income taxes, may be recorded in the periods in which they are paid and any final tax liability on income can be recorded in the period in which the liability is determined (4.82).
   - Social benefits in cash are recorded when the claims on the benefits are established (4.107).

II.3.2 Treatment in national accounts

II.3.2.1 For most distributive transactions

3. The time of recording refers to an "accrual basis": the amounts to be recorded in year (n) should then include amounts due in respect of transactions realised from 1 January (n) to 31 December (n), that is, amounts in respect of transactions realised during the 12 months of the year.

Example

4. Let us take the example of the reduction of the time lag for VAT payment granted by the State to enterprises: this time-lag is for instance reduced from 2 months to 1 month. The due for payment date for VAT is therefore brought forward by one month. The State budget on a cash basis will then record 13 months of VAT receipts during the year when this time-lag reduction takes place.

5. However, VAT recorded in the non-financial accounts under ESA95 should not include the additional cash receipts of the thirteenth month. In this case, only financial accounts are affected (flows in F.2 and F.7 - other accounts receivable).

Conclusion

6. Any change in the due for payment date, although it does affect the cash amounts in the State accounts, should not be taken into account for the calculation of taxes recorded in national accounts on accrual basis.
7. Taxes and social contributions recorded in the non-financial accounts can be derived from two sources: cash receipts or amounts evidenced by assessments and declarations.
8. If cash receipts are used, they should be time adjusted so that the cash is distributed when the activity took place to generate the tax liability (except for the cash of some taxes on income). This adjustment can be based on the average time difference between the activity and cash tax receipts.
9. Therefore, in the example given above, the cash receipts would be adjusted in order to take into consideration the reduction of the time-lag for VAT, and the additional receipts of the thirteenth month would be neutralised.
10. For most distributive transactions, any change in due for payment dates thus have no impact on the government net borrowing measured on an accrual basis according to ESA95 rules.

II.3.2.2 Exceptions

11. Exceptions to the general rule are allowed for some distributive transactions such as: ad hoc bonuses or other exceptional payments, 13th month, etc. paid by the employer to his employees; and certain income taxes, social contributions by self-employed and non-employed persons for which the liability to pay can only be determined in a later accounting period. Therefore, changes in the due for payment date (for instance forward payments) for these sorts of transactions could affect the government net borrowing.

Example

12. Corporations pay income taxes in several instalments in year (n+1) following the year (n) of reference for the income.

    It is assumed that they are required to pay in advance, at the end of year (n) the first instalment.

    When should this forward payment be recorded? In year (n) or in year (n+1)?

    The question is then: under which circumstances is the due for payment date considered to be changed?

II.3.2.3 Decision concerning the change in the due for payment date

13. Any change in the due for payment date resulting either from a law or from a change expected to be permanent, and which affects the amounts cashed by the State, has an impact on the amounts recorded in non-financial accounts and thus on the general government net borrowing.
14. On the other hand, a temporary change in the due for payment date resulting from an administrative decision, though affecting the cash amounts received by the State, should not be taken into account and therefore should not have an impact on the general government net borrowing.

II.4 Recording of interest

II.4.1 Background to the issue

1. The principle of recording interest on an accrual basis may be seen as simple and explicit in ESA95. However, the implementation needs further consideration, in order to clarify, and possibly interpret and complete the ESA95 rules.

II.4.2 Treatment in national accounts

2. General ESA accounting rules:
   - All financial instruments bearing interest are to be recorded on an accrual basis.
   - Interest is accrued on the basis of a "debtor approach".
   - Accrued interest can be calculated by simple or compound interest method.
   - Accrued interest is always reinvested under the instrument.
   - All instruments issued at a discount are treated in a similar way.
   - Arrears are kept under the instrument.
3. Implementation to specific instruments or transactions
   - Stripping has no effect on the amount of accrued interest.
   - Adjustments may be necessary in the case of instruments with floating rates and fungible issues (including savings premiums)
   - Lottery instruments are normally recorded on an accrual basis.
   - The accrual rule applies to index-linked bonds.
   - There are no specific rules in the case of short-term negotiable instruments.
   - Accrued interest may be recorded during grace periods.
   - Accrued interest on instruments denominated in foreign currencies give rise to an adjustment in the revaluation account.
   - Income of mutual funds assigned to holders is recorded on an accrual basis.
   - Early redemption of debt instruments (including exchange) may give rise to nominal holding gains.

II.4.3 Rationale of the treatment

II.4.3.1 Full coverage

4. This basic principle covers all financial instruments bearing interest.

   In the description of interest in ESA95 chapter 4, all kinds of debt instruments are mentioned. ESA95 4.44, referring to interest on deposits, loans and accounts receivable and payable, states that interest is determined “at each point of time throughout the accounting period”. ESA95 4.50, dealing with the general question of time of recording, is written in very similar terms: "interest is accruing continuously over time on the amount of principal outstanding". No exception is specified for applying the latter rule. Thus, recording interest on an accrual basis applies to any financial

instrument which generates flows of interest paid between two parties, whatever the specific features of instruments.

5. There is no rational ground for excluding some debt instruments from this analysis. National arrangements relating to interest on debt instruments cannot be a criterion for recording or not interest on an accrual basis.

II.4.3.2 "Debtor approach"

6. From a general point of view, interest can be accrued according to three possible treatments that could be respectively called:
   - “Debtor or original cost of borrowing principle”, based on the rate prevailing at the time of creation of the financial instrument, applied to the issue price (in some cases incremented by accumulated accrued interest);
   - “Acquisition principle”, based on the “historical” rate prevailing at the time the creditor records for the first time the financial instrument in the balance sheet, applied to the purchasing price;
   - “Full market approach”, based on the rate prevailing at the time of compilation, applied to the current market price of the instrument.
7. In ESA95 interest is accrued from the point of view of the debtor. ESA95 4.42 on interest specifies that it is "under the terms of the financial instrument agreed between (a debtor and a creditor)". ESA95 5.138b states that “the difference between the issue value and the redemption value is treated as interest that is accrued over the life of the security”.
8. Changes in market rates during the life of the instrument are not mentioned (Paragraph 4.46 provides similar evidence).
9. In contrast to the other two approaches emphasising the implications of price movements in financial markets linked to change in market rates, ESA95 focuses on the financial burden, the cost of borrowing, that was anticipated when the debtor raised funds through the issuance of financial instruments. Thus, in ESA95, the role of secondary markets in measuring the opportunity cost of existing as well as new borrowing is not considered in the context of recording accrued interest.
10. From a theoretical point of view, under the three approaches all the flows resulting from the contractual arrangements would be similar during the whole life of a financial instrument. But in each case, there will be a specific split between transactions (in the financial account) and other flows (in the revaluation account).
11. ESA95 specifies the treatment of nominal holding gains/losses in chapter 6 only as a change in price of assets/liabilities. Thus, ESA95 6.52 clearly indicates that accrued interest “(does) not generate holding gains” because it is “the acquisition of an asset which is added to the existing asset”.
12. Moreover, as ESA95 emphasises the creation of financial assets and liabilities, the cost of borrowing resulting from the initial agreement between the agent (s) providing funds and the beneficiary is a crucial point. It also applies to floating rate or index-linked instruments where the cost of borrowing is not known at inception but where the conditions in which the reference would be used are fully determined at the time of issuance. If the point of view of the creditor (the historical rate at purchasing time) or of the market (the present rate) were used, the cost of borrowing would be variable even for fixed rate instruments.

II.4.3.3 Method for calculating accrued interest

13. The choice for recording accrued interest is between simple interest, applied only on the principal outstanding amount, and compound interest that takes into account the amount of interest previously accrued.

14. ESA95 4.50 clearly states that when interest is "not actually paid", "the increase in the principal must also be recorded in the Financial Account as a further acquisition of that kind of financial asset by the creditor and an equal acquisition of a liability by the debtor." As a result, interest should be calculated in a compound way.

II.4.3.4 Reinvestment of accrued interest under the instrument

15. ESA95 provides some guidelines in ESA95 5.130 about the classification of reinvestment of accrued interest within the financial account. “Preferably, the counterpart financial transaction of interest accruing on financial assets (see ESA95 5.17) should be recorded as being reinvested in that financial asset. The recording of interest will, however, have to follow national practices. If the accrued interest is not recorded as being reinvested in the financial asset, it should be classified in sub-category F.79.”

16. It seems however more relevant to have a restrictive approach. If necessary, for consistency with national practices, the accruing interest could be identified in a memorandum sub-item under the “parent” instrument category.

17. For zero-coupon bonds, or short-term securities issued at a discount, recording accruing interest in the instrument category seems to be the only possible solution because, contrary to other kinds of debt securities, accrued interest linked to the discount is not identified separately from the value of principal when a transaction occurs.

18. ESA95 4.46b specifies that deep-discounted bonds have two interest components, one for the discount accrued over the life of the bond, one for the coupon regularly paid. For the former, the reinvestment should be recorded under the instrument for the same reasons as for zero coupon bonds. It would not be consistent to treat both components in different ways. The same treatment should apply to all other debt securities to ensure a comprehensive approach for securities. It is also friendlier for users of financial accounts.

19. In the case of transactions on secondary markets, the amount of accrued interest is simultaneously exchanged with the principal. It cannot be separately negotiated. The transaction must be considered as a whole. The buyer pays to the seller the amount of accrued interest.

20. Conceptually, it cannot be treated as a distributive transaction at this time. All the value of the transaction is to be recorded in the financial account, with no entry in property income.

21. This transaction has no effect on the compilation of accrued interest from the point of view of the issuer. In the accounts of the new holder, interest is accrued since the date of entry in his portfolio. Later, if the new holder has kept this asset, the actual coupon payment would be recorded only in the financial account (the non-financial account records interest accruing continuously), and can be considered as a sale back to the issuer of the accrued interest acquired when the asset was purchased plus any interest accrued since that day.

22. A further argument for recording accruing interest with the instrument is based on the difference between the change in “size” and the change in price, as developed in ESA95 6.52. Including accrued interest under the item “other accounts” would regard it

as a “timing difference between (this) transaction and the corresponding payment”. But, according to ESA95, accrued interest is not only a question of timing but represents a change in the “size” of the asset until the following payment. In a sense, the reinvestment of accrued interest cannot be seen as a transaction of a different nature than for the debt instrument.

23. ESA95 refers to possible flexibility in several paragraphs (5.121, 5.128, 5.129f and 5.130). The only justification seems to be to follow “national practice”. Comparability and aggregation of data at the European Union level require a deep harmonisation to be able to administer common policies, and so this flexibility should be reduced to a minimum.

II.4.3.5 Non-negotiable instruments

24. ESA95 7.46 states that deposits are recorded in the balance sheet as “the amounts of principal that the debtors are contractually obliged to repay to the creditors under the terms of the deposits when the deposits would be liquidated on the date the balance sheet is set up.” It adds that “the values may include accrued interest”, with a reference to ESA95 5.130.

25. ESA95 7.51 says that loans are recorded as “the amounts of principal that the debtors are contractually obliged to repay the creditors”. There is no mention of the question of accrued interest.

26. In both cases, transactors would not normally consider accrued interest as principal. For deposits, interest may be added to principal only under certain arrangements (at the end of a given period). For loans, the contract between debtor and creditor mentions explicitly a value of principal (due capital) that excludes interest. In addition payments of interest and repayments of principal are not necessarily concomitant.

27. However, as ESA95 explicitly states that accrued interest is assimilated to the acquisition of new amounts of the instrument, the reinvestment of accrued interest must analytically be considered as principal. In the case of deposits, the payment of accrued interest is, conceptually, a partial liquidation whereas payment of interest on loans is integrated in the amortisation process.

II.4.3.6 Instruments issued at a discount treated in a single way

28. Discounted bonds are mentioned in ESA95 5.138. The rule is clear that the difference between the redemption value and the issue price is treated as interest, recorded normally on an accrual basis. However, 5.138e states that "when long-term securities are issued at a discount, which is not significant, the difference between the issue value and the redemption value can be imputed at the date of issue." It seems preferable not to apply that. All bonds issued at a discount should be treated in the same way, whatever the size of the discount, for several reasons.

29. *First*, there is no definition in ESA95 of bonds “issued at a discount, which is not significant” and it is not a category recognised on the market. Any such distinction related to the size of the discount would be arbitrary and without rational economic grounds.

30. *Second*, ESA95 allows this flexible opportunity only for long-term securities. One could conclude that in any case for short-term securities the discount must always be recorded on an accrual basis. But a discount on short-term securities can be smaller than in the case of long-term securities.

31. *Third*, the original provision has no theoretical grounds and is only based on practical reasons that would depend very much on the national conditions in which the financial accounts are compiled. This could lead to different treatments. The impact on general

government deficit could be large as a large part of general government debt is issued with small discounts that could be considered as "non significant".

32. *Fourth,* government debt is often issued in the form of "fungible bonds" (also named "linear bonds") with a common nominal interest rate, coupon payment date and final maturity. Each tranche is issued at a specific issue price according to the prevailing market conditions. This price is generally different from the par value, notably because the nominal rate of the bond is expressed in round figures (for instance, only one decimal).

33. At the time of issuance, the investor pays to the debtor an accrued coupon, calculated by reference to the date of regular coupon payment. It is similar to the case of sales/purchases of debt securities on a secondary market between two holders. This coupon is included in the total amount of the issuance, recorded in the financial account. Concerning the treatment of discount or premium in the case of fungible bonds, ESA95 provides clear guidance in ESA95 5.138b. Fungible bonds may be seen as a perfect example of instruments with two interest components: one for the regularly paid nominal coupon and one for the discount/premium. Both are recorded on an accrual basis.

34. Thus, each tranche should be identified separately to estimate accrued interest from the liability side using the relevant rate of interest. This information is available in the case of issues by general government. However, there is a specific difficulty for splitting the amounts of accrued interest between holders because, after issuance, tranches are not traded separately on secondary markets nor identified as such in portfolios. It is thus necessary to allocate the accruing interest to holders according to the proportions held of the total stock of the fungible assets.

II.4.3.7 Arrears of interest recorded under the instrument

35. Arrears of interest arise when interest is not paid on its due for payment date. This should be recorded with the instrument in the same way as the reinvestment of accrued interest as discussed above.

36. ESA95 is contradictory on this matter in that in paragraph 5.17 says that arrears should be recorded in the national accounts in the category “other accounts receivable/payable” (F.79), whatever the classification of the reinvestment of accruals in the financial account. Thus, as stated in ESA95 5.17, "interest arrears do not change the total of financial assets or liabilities but possibly their classification.” It is in line with the definition of F.7 as the "counterpart transactions in case payment is due and not yet paid". Arrears for debt principal remain under the instrument item until an actual payment, a debt cancellation, or a write-off, as there is no specific category for “bad debt”.

37. However, contrary to that particular advice in ESA95, but consistent with other advice in ESA95, keeping interest arrears under the relevant instrument seems to be the logical consequence of the recommendation to record in all cases accrued interest under the instrument. As a consequence, interest arrears would be recorded in the same way as principal arrears and so kept under the instrument.

38. There is also a practical argument. For some instruments such as loans the regular payments by the debtor include both interest and principal. If the debtor defaults, the corresponding payment comprises both interest and principal, without any distinction. If penalty interest were charged, it would generally be calculated on the basis of the total amount that has not been paid in due time. The creditor and debtor would not generally regard it as two separate debts. Moreover, where reinvestment of accrued interest is classified under the same item as the principal outstanding, it would be easier to record a possible debt cancellation (with a counterpart in capital transfer) or write-off (with an

entry as other change in volume) that might occur later because that would generally apply to both principal and interest arrears.

Specific instruments or transactions

II.4.3.8 Stripped bonds

39. In ESA95, there is no explicit reference to stripping, i.e. transforming a "normal" bond into a set of zero-coupon bonds representing both future payments of interest and repayment of principal. This operation is neutral for the issuer in terms of streams of effective payments. It is generally used for improving a financial market by enlarging the number of negotiable instruments. Each strip can be traded separately on secondary markets. Stripping concerns mainly bonds issued by central government.

40. Some other features must be stressed. Stripping is operated on a voluntary basis by investors. Thus, the conversion may take place for only a minor part of the total outstanding amount of a bond. In most cases, stripping is a permanent option that can be exercised at any time but strips are fungible for the same redemption value and maturity date. As mentioned above, the sum of the strips' values are actuarially equal to the total streams of flows, including principal redemption and regular payments of interest. At the time of stripping, the total issue price of strips is equal to the present market value of principal under the original form. For the issuer, it would not be consistent to record at nominal value both strips for principal and for interest payments. There would be an artificial increase in the debt outstanding amount. Where the debt is recorded (in issuers' books and for the excessive deficit procedure) at nominal (face) value, there is no change in recording the primary debt when a bond is stripped.

41. Stripping does not change the cost of borrowing. Stripping provides no additional funding to the issuer and there is no impact on the original cost of borrowing since that is fully determined at the issuance time (for fixed rate instruments) or following rules that cannot be changed (for floating rate instruments).

42. Stripping could be analysed as the conversion of interest payments into capital repayments, regular payments of interest (non-financial transaction) being replaced by the redemption of a security (financial transaction) with a positive effect on the net borrowing/net lending of the issuer. Recording interest on an accrual basis prevents such an effect since it does not depend on the actual coupon payments.

43. Under ESA95 framework, transactions in strips (including their redemption) are recorded in the financial accounts at the transaction value. The rate of interest used for accruing interest on strips is not the rate prevailing at the time of stripping but the rate at the original issue of the bond.

44. EDP debt is recorded at nominal value, so in the case of strips, it is the stripped principal that is counted in debt not the stripped coupons. Redemption, or government purchase of stripped coupons on the market, does not change EDP debt.

II.4.3.9 Floating rates and assimilated issues (including savings premiums)

45. Floating rate debt instruments do not raise any special conceptual issues for the recording of interest. In the case of mixed bonds, where fixed and floating rates are combined, two different instruments must be considered.

46. <u>In the case of securities:</u> there is usually a link between the nature of the rate index and the frequency of interest payments. Quarterly indexed interest is normally paid every quarter with a delay of one quarter. Thus, the exact amount paid to the holders is known in advance. Interest is "pre-determined".

47. However, interest may be “post-determined”. For instance, annual interest may be indexed on an average over the previous twelve months. The exact coupon is known just a little time before the actual payment. Provisional estimates of accrued interest could differ from the actual amount and so must be corrected when the actual amount is known.

48. In regard to loans and deposits, where compilation is not conceivable on an individual basis, global information must be used, notably for deposits. Under these conditions, interest would be accrued on the basis of estimates of the most probable rate that would be effectively paid.

49. Saving premiums raise similar problems to the case of floating rates. In ESA95, this point is mentioned only for securities (5.138g), but it may concern some non-negotiable saving instruments.

50. They are paid under conditions generally regarding the length of time the instrument is held as a reward for stability. It is additional property income and not a nominal holding gain. A saving premium is treated in ESA95 as interest and must be recorded on an accrual basis. The exact total amount paid cannot be known with certainty before the end of a given period. However, in most cases, only a very small minority of holders do not get the additional remuneration, as the majority would meet the specific requirement. Thus, interest is accrued at a maximum, including the premium, with a reduction for the non-paid part. The correction would be recorded, in theory, on the whole accrual period but, if small amounts are involved, only on the last compilation period. This treatment applies to instruments with remuneration increasing proportionally to the holding time and on the assumption that holders behave rationally. If there are strong reasons to think that a significant share of holders will behave rationally (possibly on the basis of previous experience), the interest rate used for accruals should not take in account the premium. In any event, a final adjustment is always necessary as the final outcome is uncertain.

II.4.3.10 Lottery instruments

51. ESA95 5.138g mentions the case of securities with lottery payments, i.e. where interest is paid as prizes to randomly selected holders.

52. It is stated in ESA95 that lottery payments are to be treated as interest and not considered as a holding gain for the holder. Although individual holders do not know what they will receive, the issuer does know the total amount to be paid out in prizes and so the interest can be recorded using the usual rules applying to the debtor principle.

II.4.3.11 Index-linked instruments

53. Some units in general government may issue debt instruments, generally under the form of bonds that include a clause specifying that all or part of the remuneration depends on a published economic index number. It may apply only to the coupon, similarly to variable interest financial instruments. It may concern only the value of principal, the coupon being affected through the rate applied to principal. In other cases, principal and coupons might follow the same index.

54. ESA95 4.46 covers only the case of a price index. By contrast, ESA95 5.138e is more extensive, adding the price of a commodity and an exchange rate index. The list may be seen as not complete. Issuers may use other references, such as stock exchange index or the price of a specific security.

55. According to ESA, similar to SNA (11.78) and BOP 5th Manual (397), any additional payment to holders due to the evolution of the index is considered as interest, even for the up-lift on principal. It is a supplementary charge increasing the cost of borrowing.

ESA95 specifies also that the accrual rule applies to any index payment, regardless of the moment it is actually paid to creditors.

56. As a result, interest must be accrued in line with the continuous movement in the index. Any change in the index must be taken into account at each compilation date, even when it is agreed that the payment would be based on the level of the index at a certain point of time, for instance close to the final redemption date.

57. For traded instruments the market price will reflect the link to the index and in effect it reflects the accruing unpaid interest.

58. Generally, index-linked instruments include a clause for a minimum guaranteed redemption value, for instance the nominal principal amount. The recording of interest should reflect the existence of this minimum and not follow the index movement below the level at which the minimum value kicks in.

59. Where the index has significant short-term fluctuations, it could be preferable to "smooth" the recording of interest by using an average price during a period of time and not a daily one if the latter does not seem fully representative.

II.4.3.12 Short-term negotiable instruments

60. ESA95 is quite flexible on the definition of short-term instruments. This maturity is normally defined as “one year or less” but ESA95, like SNA, accepts in some cases "two years at the maximum". This flexibility has no effect on recording interest on an accrual basis.

61. Most Central Governments issue Treasury Bills – short-term bonds. Generally these instruments are similar to zero-coupon bonds. All the guidance relating to bonds issued at a discount applies to short-term bonds whatever the size of the discount. Estimates based on average maturity and average rate of interest at issuance could be used if a security-by-security approach cannot be implemented.

II.4.3.13 Instruments with grace period

62. Some debt instruments may include a grace period during which no interest is paid. This case is not mentioned in ESA95 and SNA. General government may be involved, notably for loans granted to developing countries or for public policy purposes.

63. For instruments bearing a zero rate of interest during the grace period: no interest is to be accrued, as the cost of borrowing really is zero. This statement applies even if the rate of interest applied in the following time period is adjusted so that the final yield is roughly similar to "normal" conditions over the total life of the instrument.

64. In other cases, required interest payments are postponed during the grace period to a later point in time. There is still a cost of borrowing. Interest is really due but is capitalised. In these cases the interest should be accrued over the grace period.

II.4.3.14 Accrued interest on instruments denominated in foreign currencies

65. For these financial assets and liabilities, the normal rules for accruing interest should be applied but specific attention must be given to the issue of conversion into the national currency.

66. In ESA95, nominal holding gains (or losses) are a change in the value of an asset as a result of a change in price, including exchange rate movements. ESA95 says:

    – "nominal holding gains may therefore occur not only because the price of the asset in local currency but also because the exchange rate changes." (6.58); and

    – "transactions in the financial assets in foreign currency must be converted into the national currency using the exchange rates at the time the transactions occur, while

the opening and closing balance sheet values must be concerted using the exchange rates prevailing at the dates to which the balance sheets relate."

As a consequence, nominal holding gains and losses may appear due to differences in exchange rates used for transactions and for balance sheets.

67. Where interest is denominated in foreign currency, it must be converted into the national currency by the exchange rates prevailing at the time it accrues. Ideally, interest should be accrued daily, and so using a daily exchange rate. In practice, the calculation is made over a period on the basis of the average exchange rate observed during the period (but not using a "spot" exchange rate, observed at only one specific point of time - unless foreign exchange volatility is very low). Where interest is accrued by means of a compound method, theoretically, this average should be weighted by the amounts of accrued interest at each point time during this period. However, a simple arithmetic average seems to be an acceptable proxy.

68. The actual payment of interest is a transaction in the underlying instrument and with a counterpart in “currency and deposits” and uses the exchange rate on the actual date payment is made.

69. Although the amounts of accruing interest associated with cash payments (taking into account for example both coupons and discounts/premiums) are perfectly equal in foreign currency, the amounts of accrued and paid may diverge in national currency, due to exchange volatility. So an adjustment is in all likelihood needed in the revaluation account. It results from the difference between, on the one hand, the "spot" exchange rate observed at this time (used for the conversion of outstanding amounts observed at this time) and, on the other hand, an average rate used for interest accrued during the last period or the "spot" rate observed at the end of the previous period for interest previously accrued but not paid during the last period. Conceptually, the exchange rate effect is different from the case of instruments with variable interest rate for which a correction in the amount of interest, accrued and reinvested, may be made when the exact interest rate is known. In the case of instruments denominated in foreign currencies, the adjustment is not due to an error in estimation but comes from the fact that transactions occur at different points in time.

70. Later, when the effective payment of this interest occurs, there is a new adjustment in the revaluation account due, on the one hand, to the gap between the exchange rate at this time and the rate used at the end of the last period, and, on the other hand, to the difference between the rate used for accruing since the beginning of the period and the rate at the time of payment.

71. On some occasions - as in the case of annual period of compilation for interest paid every three or six months or for discounted instruments of shorter maturity - there is no "overlapping" between the accruing period and the period of payment. In principle only one adjustment is necessary, as mentioned at the end of the last paragraph. In this case, interest is fully accrued and paid during the same period of compilation. The new claim/liability resulting from the reinvestment of accrued interest is created and extinguished during the same period. In this time-scale, the concept of accrued interest may be seen as rather theoretical. Thus, for simplification, it could be acceptable to enter directly in the property income the amount of the effective payment converted into the national currency, avoiding any adjustment.

72. These entries are fully meaningful from an economic point of view. More generally, such adjustment is frequently observed for financial instruments denominated in foreign currency for which transactions with opposite signs (as creation/extinction of a liability) of equal amounts in original currency may not be offset after conversion in national currency.

II.4.3.15 Income of mutual funds

73. Units classified within general government sector may hold shares issued by mutual funds. The income received by the mutual fund is recorded according to ESA rules, i.e. on an accrual basis for interest and "at the time they are due to be paid" (in practice close to the effective payment date) for dividends. As a reminder, holding gains or losses are not recorded as property income in the system.

74. The income assigned to shareholders is considered reinvested. It is the income received by mutual funds, after deduction of management fees, considered in the system not as a distributive transaction but as financial services. This income must be recorded on an accrual basis, in the same conditions as for other debt instruments, regardless of whether this income is distributed regularly or capitalised and so automatically included in the value of the share.

II.4.3.16 Early redemption of debt instruments (including exchange)

75. Whatever the instrument, a debtor may have the right to break the initial contract and offset his debt before the maturity date agreed at inception. In some cases, he must give notice of at least a specific period of time. The creditors are generally entitled to compensation.

Securities

76. An early redemption may take the form of repurchases on the market by the issuer. It may also be the result of an exchange of securities. The issuer calls for some specific bonds and provides in exchange a new security or a new tranche of a security previously issued.

77. The price may be determined through a competitive procedure, such as a tender. Such operations generally occur after a fall in market rates, the issuer aiming for a reduction of the interest burden, at the expense of a rise in the repayments of principal. One could nevertheless imagine the symmetrical situation and an exchange with the aim of reducing the amount of the debt.

78. A difference, sometimes called a premium, is observed between the nominal value and the effective redemption value. Where the difference is positive, it is a holding gain for the holder and a holding loss for the issuer, recorded in the respective revaluation accounts. Under ESA95, financial instruments are valued in principle at current prices, notably for debt securities. Thus, the gain/loss is equal to the difference between the value of the outstanding amount at the end of the previous period and the price of the exchange.

79. The treatment of these exchanges of bonds is very similar to transactions of bonds on secondary markets between holders of securities. It looks like a sale that is immediately followed by an automatic reinvestment in the same category of debt instrument that is part of the same transaction. Any transaction on the secondary market normally provides holding gains or losses, recorded in the system in the revaluation account.

80. In the exchange, there is equivalence between the amount bought back by the issuer and the new amount issued - with possibly a cash payment for any marginal difference in value. For bonds with regular interest payments, there is, in addition, a payment by the issuer for the accrued coupon.

81. According to ESA95, the exchange has no effect on net borrowing/net lending at the time of the exchange. Later, it is affected through new amounts of interest. The exchange is neutral from an actuarial point of view but it changes the distribution of repayments over time, between regular payments of interest and repayment(s) of principal.

Loans

82. An early redemption can also occur for loans. The debtor may be allowed to reimburse a loan before the final maturity, provided that compensation is paid. The latter cannot be considered in national accounts as a capital transfer, nor as the price of levying an option held by the borrower, nor as a service charge. The correct treatment depends on the way the compensation is calculated.

A) Compensation calculated on the amount of principal and the timing of the redemption.

83. The borrower is contractually asked to pay an additional amount for all (or part of) the time before the redemption. This additional payment should be treated as interest. However, as derogation to the accrual principle, it could be recorded only at the time of payment and not spread all over the time the loan had been in force. There would be an impact on net borrowing/net lending.

B) Compensation calculated as a fixed percentage over the remaining amount of principal.

84. This should be recorded as a holding gain (for the lender) and loss (for the borrower). The indemnity is added to the principal. It cannot be considered as interest as it takes no account of time and is similar to an early redemption of bonds. There would be no impact on net borrowing/net lending.

C) Deposits

85. For some time deposits or saving deposits, a given rate of interest may be paid only under the condition of a minimum holding period. An early liquidation, if contractually allowed, is balanced by a reduction in the rate of interest paid to the holder.

86. For recording interest on an accrual basis, the rate of interest taken into account is the maximum rate that the depositor could receive in the normal course of the contract, i.e. respecting the arrangements about maturity or notice. When it is not the case, the amount of interest accrued previously is corrected on the basis of the final rate. As this amount is in all likelihood globally very small compared to the total interest on deposits, for practical reasons, the correction for the total amount can be recorded in the latest time period only.

Accounting examples

II.4.4.1 Instrument issued at par and regular coupon/interest payments

On first of July in year 1, central government issues a bond of 1000; an annual rate of interest of 5% paid every year on that date; a maturity of 10 years; and a full redemption at that time. At end of year 1, the market price is 1045 (including 25 of accrued interest not yet paid). At end of year 2, the market price is 1075 (including 25 of accrued interest not yet paid).

YEAR 1

Non Financial account

U		R	
D.41	25 (24.3)		
		B.9	-25 (-24.3)

Financial account

ΔA		ΔL	
F22	+1000	F.332	+1025 (1024.3)
		B.9	-25 (24.3)

Revaluation account

ΔA		ΔL	
		F.332	+20

Closing balance sheet

A			
		F.332	1045 (1044.3)

YEAR 2

Opening balance sheet

A		L	
		F.332	1045 (1044.3)
			(EDP: 1000)

Non Financial account

U		R	
D.41	50		
		B.9	-50

Financial account

ΔA		ΔL	
F.22	-50	F.332	+25 -50 +25
		B.9	-50

Revaluation account

ΔA		ΔL	
		F.332	+30

Closing balance sheet

A		L	
		F.332	1075 (1074.3)
			(EDP:1000)

II.4.4.2 Instrument issued at a discount with regular coupon payments

On 01/10 in year 1, central government issues a new tranche of a bond (principal 1000, rate of interest 5%, maturity 10 years, payment date on 1st July, and redemption *in fine*). The issue price is 95% (roughly a yield of 6%). The discount of 50 is spread for 1 in the first year, 4 in the second year and 3 in the tenth year. For simplification, the bond is always quoted 100% at ends of period (Figures are rounded).

YEAR 1

Non Financial account

U			R
D.41	13.5 (12.5 +1)		
		B.9	-13.5

Financial account

ΔA			ΔL
F.22	+962.5	F.332	950+12.5+13.5
		B.9	-13.5

Closing balance sheet

A			L
		F.332	976
			(EDP: 1000)

YEAR 2

Opening balance sheet

A			L
		F.332	976

Non Financial account

U			R
D.41	54		
		B.9	-54

Financial account

ΔA			ΔL
F.22	-50	F.332	
			+4 +36.5 -50 +13.5
		B.9	-54

Closing balance sheet

A			L
		F.332	980
			(EDP: 1000)

YEAR 10

Opening balance sheet

A			L
		F.332	1022

Non Financial account

U			R
D.41	28		
		B.9	-28

Financial account

ΔA			ΔL
F.22	-1050	F.332	-1022
		B.9	-28

Closing balance sheet

A			L
		F.332	0

II.4.4.3 Instrument issued at a discount without regular coupon payments

Central government issues on 01/07 a zero-coupon bond for 3 years for 75 (nominal value is 100). The implicit interest rate is 10%. (Figures are rounded) No change in the market interest rate

YEAR 1

Non Financial account

U		R	
D.41	3		
		B.9	-3

Financial account

ΔA		ΔL	
F.22	+75	F.332	+75 +3
		B.9	-3

Closing balance sheet

A		L	
		F.332	78

YEAR 2

Opening balance sheet

A		L	
		F.332	78

Non Financial account

U		R	
D.41	8		
		B.9	-8

Financial account

ΔA		ΔL	
		F.332	+8
		B.9	-8

Closing balance sheet

A		L	
		F.332	86
			(EDP: 100)

YEAR 3

Opening balance sheet

A		L	
		F.332	86

Non financial account

U		R	
D.41	9		
		B.9	-9

Financial account

ΔA		ΔL	
		F.332	+9
		B.9	-9

YEAR 4

Opening balance sheet

A		L	
		F.332	95

Non financial account

U		R	
D.41	5		
		B.9	-5

Financial account

ΔA		ΔL	
F.22	-100	F.332	-95
		B.9	-5

Closing balance sheet

A		L
	F.332	95
		(EDP: 100)

Closing balance sheet

A		L
	F.332	0

With change in market rate

At the beginning of the following year, the rate of interest increases up to 15% for a maturity of 2 years and half (and does not change any more). The price on the market falls to 70. (Figures are rounded)

YEAR 2

Opening balance sheet

A		L
	F.332	78

Non financial account

U		R
D.41	8	
	B.9	-8

Financial account

ΔA		ΔL
	F.332	+8
	B.9	-8

Revaluation account

ΔA		ΔL
	F.332	81 –86

Closing balance sheet

A		L
	F.332	81

YEAR 3

Opening balance sheet

A		L
	F.332	81

Non financial account

U		R
D.41	9	
	B.9	-9

Financial account

ΔA		ΔL
	F.332	-9
	B.9	-9

Revaluation account

ΔA		ΔL
	F.332	93 –90

Closing balance sheet

A		L
	F.332	81 +12

YEAR 4

Opening balance sheet

A			L
		F.332	93

Non Financial account

U			R
D.41	5		
		B.9	-5

Financial account

ΔA			ΔL
F.22	-100	F.332	+5 -100
		B.9	-5

Revaluation account

ΔA			
		F.332	100 –98

Closing balance sheet

A			
		F.332	0

II.4.4.4 Strips

Central government has issued the following bond: fixed rate of 15%, principal of 1000, redemption at maturity, payment date on 1st July. At a remaining maturity of three years, it is decided to create a set of four strips.

On the basis of the original interest

As the interest rate is unchanged, the market price of the bond is equal to the nominal value. Three coupon certificates for each annual interest payment (valued respectively 99, 113, 130 on the basis of price equal to 65.8%, 75.7% and 87% for a nominal of 150) and one certificate for the final repayment of principal (valued at 658 as the price is 65.8% for a nominal of 1000) are created. The total market value of the four certificates is always equal to the nominal value. Accrued interest may be calculated on the basis of the previous form of the bond or, from the time of stripping, as the difference in the market price of the zero coupon securities (no other factors intervening), i.e. the sum of 49, 10, 9 and 7. At the end of the year, 1075 is the sum of the market values of four certificates: 707 + 106 +122 +140 or is the sum of 1000 (principal) and 75 (accrued interest on six months). This example covers clearly the case of Maastricht debt, recorded at nominal/face value and, thus, ignoring by definition any effect of stripping on the original debt. (Figures are rounded).

YEAR 1

Opening balance sheet

A			L
		F.332	1075

Non Financial account

U			R
D.41	150		
		B.9	-150

Financial account

ΔA			ΔL
F.22	-150	F.332	+150 –150
		B.9	-150

Closing balance sheet

A			L
		F.332	1075

During the second year, again, accrued interest is unchanged compared to the previous form of the bond. It is also equal to the differences in the prices of the certificates between the beginning of the year and the time of redemption for the first coupon certificate, and the end of the year for the other three (10, 106, 16, 18). At the end of the year, 1075 is the sum of the market values of three certificates (813, 122, 140) and is still equal to the sum of 1000 (nominal) and 75 (accrued interest on six months).

YEAR 2

Opening balance sheet

A			L
		F.332	1075

Non Financial account

U			R
D.41	150		
		B.9	-150

Financial account

ΔA			ΔL
F.22	-150	F.332	+150 –150
		B.9	-150

Closing balance sheet

A			L
		F.332	1075

With a change in interest rate

Stripping is implemented in new market conditions, for instance when the market rate has fallen to 10%. The current price of the bond is 1125. At this time, the values of the strips are 113, 124, 136 and 752 (on the basis of prices in percentage 75.2, 82.7 and 90.8). At the end of the year, the sum of market values of the four certificates is 1182 (790, 119 130, 143), which is also the market value of the nominal (1107), or "clean price", and accrued interest (always 75).

There would be no asymmetry in recording the asset and liability sides. But this example shows clearly that the differences in market prices cannot be used for accrued interest (the sum would be 57 for half the year, against 75 at the original rate). Thus, accrued interest must be estimated on the basis of the previous form of the bond and cannot be based on the information from the holders. The adjustment is entered in the revaluation account. The loss (the current price of the liability is higher than the "theoretical" one) is a gain in the accounts of the counterparts.

YEAR 1

Opening balance sheet

A			L
		F.332	1075

Non Financial account

U			R
D.41	150		
		B.9	-150

Financial account

ΔA			ΔL
F.22	-150	F.332	+150 –150
		B.9	-150

Revaluation account

ΔA			ΔL
		F.332	1182 – 1075

Closing balance sheet

A			L
		F.332	1182

There is no change from the previous year concerning estimation of accrued interest. 1143 is the sum of the market values of the three remaining certificates (869, 131, 143) and also the market value of principal (1068) incremented by accrued interest on six months (75). The adjustment in the revaluation account is now a gain for the issuer and is estimated only from current prices at beginning and end of the period.

YEAR 2

Opening balance sheet

A			L
		F.332	1182

Non Financial account

U			R
D.41	150		
		B.9	-150

Financial account

ΔA			ΔL
F.22	-150	F.332	+150 –150
		B.9	-150

Revaluation account

ΔA			ΔL
		F.332	1143 –1182

Closing balance sheet

A			L
		F.332	1143

II.5 Military expenditure under long-term contracts

II.5.1 Background to the issue

1. Due to the importance of military expenditure in some countries and to the frequent use of specific procurement contracts (including the use of leasing for high value equipment), and owing to the existence of borderline cases, it appeared that there were significant differences in accounting practices between EU countries as regards the time of recording of the government expenditure related to the acquisition of military equipment.
2. Military goods increasingly incorporate very sophisticated technology. This has two consequences. First, a military good, in order to be fully operational, must combine a large variety of components that are often produced by different suppliers. Second, the production process of many military goods is spread over several years. This has led to different interpretations in countries on the time of recording in national accounts of government expenditure on military goods and it was therefore imperative for Eurostat to provide clarifications also in this respect.
3. Following the work of a task force especially convened for this purpose and a CMFB consultation, Eurostat took a Decision on these issues on 9 March 2006. This chapter is based on that Decision.

II.5.2 Treatment in national accounts

II.5.2.1 Identification of military goods

4. The European system of accounts (ESA95) makes a clear distinction between some specific goods used by the military (hereafter called "military goods") and other goods.
5. ESA95 states that military goods are "*military weapons of destruction and the equipment needed to deliver them*" (ESA 3.70e). In addition, it is also specified that such equipment is used by "military forces" that have a mission of defence against foreign hostile forces.
6. The *1993 SNA* (SNA93 6.167-172 and 10.65-68) makes the same distinction and provides a list of goods to be considered as military goods: rockets, missiles (including warheads), missile silos, warships, submarines, fighter aircraft and bombers and tanks.
7. This list is of course not exhaustive but it gives a clear indication of the nature of such goods that are designed specifically for combat operations.
8. From this rather restrictive coverage, it results that many goods acquired by military forces are not to be considered as military goods in national accounts. This is for instance the case of infrastructure (such as ports and air facilities), mobile goods for transportation and transmission/observation equipment. The basic principle is that such equipment can be used for civil purposes (whatever the nature of the user) immediately or following an easy (and not costly) conversion. EU statisticians have not reported significant borderline cases in the classification of equipment.
9. It is reminded that, according to ESA95, military goods do not enter the capital formation of government, but are treated as intermediate consumption in the production of defence services.

II.5.2.2 The time of recording of military equipment expenditure: general rule

10. According to national accounting rules, the accrual time of recording of government expenditure for military goods must be the time of delivery of the goods, as appropriate for goods in the general case.

11. The delivery is assumed to take place when the military takes possession of the goods from an economic point of view, i.e. bearing risks and rewards of the goods. This applies whatever the operation to be effectively carried out with the goods, such as training or military missions; after the moment of delivery, military forces are normally in a position to use the military goods for any operation.

12. Military expenditure data may be derived from cash (payment) data under certain circumstances:

    - when cash data are corrected with observed and accurate data on receivables and payables associated with the contracts in question, or
    - when cash data are used for small deliveries or are corrected for large deliveries, or
    - when the time of payment is close to delivery.

13. Nevertheless, the use of cash (payment) data should be applied only in the short-term, pending further improvements in accounting and statistical systems when such a full accrual recording may be made.

II.5.2.3 The time of recording of the expenditure on military goods in the context of specific long-term contracts

14. Based on an examination of contracts signed by government authorities for acquiring military goods, it appears that the following features (possibly combined) are frequently present:

    - many items are foreseen to be delivered over a number of years,
    - flows of services over a number of years (such as maintenance) are provided in addition to goods delivered,
    - the delivery of final components that are needed to make the complex goods fully operational for military missions. Examples are electronic equipment and arm systems for fighters, possibly delivered by firms other than the main supplier.

15. The time of delivery, and thus the time of recording of government expenditure impacting on government net lending / net borrowing, is as follows:

    - where long-term contracts foresee deliveries of identical (or very similar) items staged over a long period of time, government expenditure should be recorded at the time of actual delivery of each item;
    - where long-term contracts also cover the provision of services, government expenditure should be recorded at the time of the provision of the services, recorded separately from the provision of goods. Standard analytical accounting techniques allow for apportioning the expenditure in relation to the goods and services delivered;
    - where long-term contracts involve complex systems, government expenditure should be recorded at the time of delivery of the individual (and operational in the sense that the individual piece of equipment meets all the necessary specifications to be fully functional when connected to other elements of the complex system) pieces of equipment that compose the systems, and not at the time of completion of delivery of all pieces under the contract.

II.5.2.4 Military goods built over many years

16. A specific type of military contract concerns heavy equipment that takes many years to build, such as large ships or submarines. The issue is to determine when the government expenditure should arise: gradually over time or at the end of the contract, i.e. at the time of actual physical delivery.

17. In the case of military goods built over many years, the time of government expenditure should be the time of the actual physical delivery of the final goods, whatever the contractual provisions for transfer of ownership during the building process. The time of recording is not therefore at the moment when parts of the equipment are purchased or made operational by external suppliers for incorporation in the final goods.

II.5.2.5 The treatment of leases relating to military goods

18. Some manufacturers of military goods (or even government units) have arranged for contracts that make military goods available under leasing arrangements. The question is then whether such leases should be considered in national accounts as financial leases or as operating leases.

19. Leases of military goods should always be considered as financial leases and not as operating leases, which supposes recording an acquisition of these goods by the government lessee and the incurrence of a matching government liability to the lessor.

20. Thus, there is an impact on government deficit at the time when the goods are put at the disposal of military authorities, under the conditions specified below, and not at the time of payments relating to the lease. As the corresponding liability is an imputed loan, government debt is also impacted at that time. Payments are considered as debt servicing, with a part recorded as payment of interest and the remainder as the repayment of the imputed loan.

II.5.3 Rationale of the treatment

II.5.3.1 The time of recording of military equipment expenditure: general rule

21. The time of recording of the acquisition of goods is the time of change of ownership.

22. In the case of military goods, there are several events which might correspond to a stage of change of ownership, notably in the context of long-term contracts: the time of contract signature (as it is very likely that government will eventually take delivery of the goods or at least ensure the financing of the corresponding research and development costs), the time of delivery (to be specified), the time of cash payment, or the time of contract completion (for instance when the equipment is made fully operational).

23. In some limited cases, this time is specified by ESA95 to be in advance of the complete delivery of the goods: construction projects in the framework of contract of sale agreed in advance, own account construction. Military goods do not belong to these specific cases: the reference for these goods is rather the asset category "Machinery and equipment", for which Annex 7.1 of the ESA95 specifies that the time of change of ownership is the delivery.

24. Therefore government expenditure is to be recorded at the time of delivery of the military equipment.

25. As a simple but fundamental consequence, pre-payments on deliveries of military goods must be recorded as financial transactions (financial advances, F.71 asset of government), while subsequent deliveries are booked as expenditures with a counterpart liquidation of this government asset.

26. As regards post-delivery payments for military goods, government expenditure recorded at delivery is to be matched by a financial transaction (F.71 liability of government), while the later cash settlement will consequently be treated as purely a financial transaction (i.e. the redemption of this government liability).

II.5.3.2 Time of recording of government expenditure on military goods in the context of specific long-term contracts

27. Contracts often foresee staged deliveries of similar items over many years. Examples are fighter planes delivered in batches over a given period or a series of warships to be delivered over several years.

28. The application of the accruals rule for recording the acquisition of military goods implies that such staged deliveries should be recorded as government intermediate consumption as they occur. Standard analytical accounting techniques should allow identification of the value of partial deliveries. Confidentiality should not be a major issue, as the precise nature of the equipment is not of course revealed in national accounts data. Thus, the moment of impact on government net lending / net borrowing is not at the completion of the contract, or at the time of payment, but according to the pattern of deliveries. The rationale is that each piece (or a given set delivered together) must be considered separately as regards risks and rewards attached to them.

29. Delivery of sophisticated military goods is often associated with the provision of training and related services. In addition, as the maintenance of specific high technology equipment requires sophisticated skills, there is a growing tendency to closely associate supplying firms to these tasks. This raises an issue in cases where a single and global contract is agreed. The accruals principle implies that government expenditure on services should be accounted for at the time they are actually provided. Standard analytical accounting techniques also allows the apportionment over time of the expenditure in relation to the services delivered, with the relevant information likely to be found in the contract.

30. A complication may arise when the contract foresees that expenditure is incurred for Research and Development purposes in the earlier years of the contract, well before actual deliveries. Here, it is important to examine the nature of such R&D expenditure.

31. If R&D is realised independently of the final product or is definitely acquired (not reimbursed) and, de facto, not exclusively related to the specific military goods to be delivered, the corresponding expenditure is to be recorded, as for any other type of R&D activity purchased by the government, when the work takes place or when the transfer is made by government to finance them.

32. If the R&D is strictly related to the future manufacturing of a given number (which could be revised in future) of military goods, the corresponding expenditure has to be apportioned to the deliverable goods and recorded later. This would, for example, be the case for R&D expenditure relating to the development of the "Joint Strike Fighter", where the R&D is directly related to the future delivery of aircraft. In the case where the payment is used for R&D purposes but does not contractually oblige a definite purchase of military goods, and instead gives a right to future purchases at reduced price, then a transfer is recorded at the time of the payment. If an eventual acquisition of military goods occurs, this is recorded at full market value, as if acquired by a third party not subject to the reduction, and a capital transfer receipt is imputed for the difference.

33. In the case of complex systems, it happens frequently that some post-delivery tasks need to be performed for the equipment to be fully operational. Military goods generally require specific preparation. Goods that have been delivered may not be fully

operational before the completion or assemblage of other kinds of equipment (for instance electronic arms systems).

34. Some military programmes, accounting for significant amounts, are based on the combination of several kinds of components that may be completed in different periods so that the expenditure may be spread over several fiscal years before the system becomes fully operational in its entirety.

35. The issue here is whether post-delivery tasks are under the full responsibility of the authorities/military forces or of the suppliers.

36. Where the post-delivery tasks are under the full responsibility of the supplier, the supplier of the contract has not yet fulfilled its contractual obligations, and the recording of the delivery of the good should only be at that the point when those obligations are met.

37. Where all these tasks (and notably their timetable) are under the full responsibility of the government authorities/military forces, the supplier of the components is assumed to have fulfilled its contractual obligations. As a result, the time of recording of the delivery of the goods should not be the time of completion of the whole contract, but it should be determined according to delivery.

II.5.3.3 Military goods built over many years

38. The issue here is whether government expenditure should be recorded in stages or only once, at the time of final completion and delivery. This does not cover the case of a chain of suppliers, with unfinished goods delivered from one supplier to the next supplier. There is in this case no entry in the government's books until the final physical delivery to it.

39. There could be an argument for recording government expenditure progressively, following the stages of production, by analogy with the treatment of buildings and other structures when a contract of sale agreed in advance (ESA 3.59). A similar treatment could also be adopted when there is transfer of economic or legal ownership, often staged during the building process, and a government liability is thus created.

40. Other references in ESA95 suggest, however, that recording in stages is only appropriate under certain conditions. The definitions of asset categories in ESA95 Annex 7.1 refers to whether the “ultimate user is deemed to have taken ownership” (when dealing with cases of uncompleted dwellings – recording in stages) or “is deemed to take ownership only on delivery” (when dealing with cases of uncompleted machinery and equipment – recording at delivery). The latter case may be seen as more appropriate for military goods.

41. Further support for recording at delivery is provided by the accrual principle, which requires that the liability be recorded when the obligation to pay arises, and that an asset be recorded as purchased when the risks and rewards attached to it have been transferred. It could be argued that this rule is in fact implicitly applicable to all deliveries in national accounts.

42. Moreover, the time of actual physical delivery is particularly relevant for goods that are considered as intermediate consumption, for which the time of recording is when the goods enter the production process, i.e. when consumed (ESA95 3.72). This is because intermediate goods need to have been delivered first, in order to be consumed. But under the Eurostat decision, owing to their nature, military goods are considered as simultaneously delivered and consumed.

43. It is not considered appropriate to extend the interpretation of ESA95 3.59 to military goods, as 3.59 refers to different types of goods. Military goods can only be considered as “used” by military forces when those forces take full responsibility for them, as

mentioned above. Hence government expenditure on military goods that are built over many years is only recorded when the final delivery to government takes place.

44. Under these conditions, any payments made by government during the contract, including those staged to fit with achievement of some tasks (and possibly with legal transfers of ownership), are to be considered as prepayments for the future delivery of the goods. They should be recorded in the financial accounts as an acquisition of receivables by government (ESA95 5.124).

45. Following the same rule, any obligation to pay arising from a progressive transfer of legal ownership is assumed not to give rise to a liability of government in national accounts. Actual cash payments to settle those obligations are treated as acquisition of receivables by government, and not as the redemption of a liability. A government liability would arise only at the time of actual physical delivery, for the amount that exceeds prepayments made until that date.

II.5.3.4 The treatment of leases relating to military goods

46. Military goods can be leased instead of purchased outright. The lease can be called an operating lease or a financial lease in the contract. The question is the appropriate treatment of such leases in national accounts.

47. As a reminder, the classification of leases into financial or operating leases in national accounts rests mainly on the transfer of risk (ESA95 Annex II.4) and is not determined by the legal terminology included in the contract.

48. One issue to consider is if it is possible to record an operating lease or a financial lease on a good that is not a fixed asset in ESA95. The answer is that national accounts can record both, whether the good is an economic asset or not. As an example, cars are not economic assets to households, by convention, in the national accounts system, but financial leases on cars are common and recorded as such.

49. Applied to the case of military goods, the transfer of risk implying a change in ownership occurs when military forces take possession of the goods and are in a position to take any decision as regards these goods under their full responsibility. They will bear all the risks that may be associated with the military missions.

50. A specific characteristic of military missions is to put military goods knowingly at risk, while other economic activities avoid putting goods at risk or otherwise insure against such risks. By their nature military goods are basically to be used in missions where some parties are likely to try to destroy or weaken the capacity of the equipment. Another issue points to the rapid possible obsolescence of such equipment so that replacements quicker than expected are also frequently observed.

51. Under these conditions, by their nature, risks associated with military goods lie with the military authorities, the bodies that have the sole competence to decide if and when to use these goods during conflicts, thereby knowingly exposing the goods to potential damage.

52. In this context, any leasing contract on military goods (as defined above) should be treated in national accounts as a financial lease, even when the contract is labelled as an operating lease. The time of recording of the acquisition of the goods in national accounts will therefore be when the military forces take full responsibility for the use of the equipment. The lessees' liabilities under financial leases are classified as loans (F4) in national accounts, a component of Maastricht debt when the lessee is government (ESA95 5.81g).

II.5.4 Accounting examples

Example 1

Government orders a military good for a value of 100. In year 1, it makes a payment of 45. In year 2, the good is delivered and immediately usable by military forces and government pays 30. In year 3, government pays the residual. (For simplicity, the costs of the supplier are not shown)

YEAR 1

General government

Current account

U			R

Financial account

ΔA			ΔL
F.2	-45		
F.71	+45		
		B.9	0

Closing balance sheet

A			L
AF.71	45		

Supplier

Current account

U			R

Financial account

ΔA			ΔL
F.2	+45		
		F.71	+45
		B.9	0

Closing balance sheet

A			L
		AF.71	45

YEAR 2

General government				Supplier			
Opening balance sheet							
A			L	A			L
AF.71	45					AF.71	45
Current account							
U			R	U			R
P.2 (or P.52)	100					P.1	100
B.9	-100			B.9	+100		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	-30			F.2	+30		
F.71	-45	F.71	+25	F.71	+25	F.71	-45
		B9	-100			B.9	+100
Closing balance sheet							
A			L	A			L
		AF.71	25	AF.71	25		

YEAR 3

General government				Supplier			
Opening balance sheet							
A			L	A			L
		AF.71	25	AF.71	25		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	-25			F.2	+25		
		F.71	-25	F.71	-25		
		B.9	0			B.9	0

Closing balance sheet is empty

Example 2

Government enters into a leasing contract with a supplier for a military good. The contract foresees that the good has a value of 100 and that government will make 10 annual payments of 14, (corresponding to annual interest payments of about 6.6) from the period following the delivery in year 1. The good is usable as soon as delivered. (For simplification, the costs of the supplier are not shown). Note also that the interest recorded will actually decrease throughout the period.

YEAR 1							
General government				Supplier			
Current account							
U			R	U			R
P.2	100					P.1	100
		B.9	-100			B.9	+100
Financial account							
ΔA			ΔL	ΔA			ΔL
		F.4	+100				
				F.4	+100		
		B.9	-100			B.9	+100
Closing balance sheet							
A			L	A			L
		AF.4	100	AF.4	100		

YEAR 2

General government				Market unit			

Opening balance sheet

A			L	A			L
		AF.4	100	AF.4	100		

Current and capital accounts

U			R	U			R
D41	+6.6					D41	+6.6
B.9	-6.6			B9	+6.6		

Financial account

ΔA			ΔL	Δ A			ΔL
F.2	-14	F.4	-7.4	F.2	+14		
				F.4	-7.4		
		B.9	-6.6			B.9	+6.6

Closing balance sheet

A			L	A			L
		AF.4	92.6	AF.4	92.6		

Example 3

A government orders a military good for a value of 100 in year 1 that takes four years to be delivered. Government pays 10 each of the first three years then settles the remaining amount at time of delivery in year 4. The good is assumed to be usable as soon as delivered. For the sake of simplicity the suppliers' costs are not shown.

YEAR 1

General government				Supplier			
Capital account							
ΔA			ΔL	ΔA			ΔL
				P.52	+25	P.1	+25
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	-10			F.2	+10		
F.71	+10					F.71	+10
		B.9	0			B.9	0
Closing balance sheet							
A			L	A			L
AF.71	10					AF.71	10

YEAR 2

General government				Supplier			
Opening balance sheet							
A			L	A			L
AF.71	10					AF.71	10
Capital account							
ΔA			ΔL	ΔA			ΔL
				P.52	25		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	-10			F.2	+10		
F.71	+10					F.71	+10
		B.9	0			B.9	0
Closing balance sheet							
A			L	A			L
AF.71	20					AF.71	20

YEAR 3

General government				Supplier			
Opening balance sheet							
A			L	A			L
AF.71	20					AF.71	20
Capital account							
ΔA			ΔL	ΔA			ΔL
				P.52	25		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	-10			F.2	+10		
F.71	+10					F.71	+10
		B.9	0			B.9	0

Closing balance sheet

A		L	A		L
AF.71	30			AF.71	30

YEAR 4

General government	Supplier

Opening balance sheet

A		L	A		L
AF.71	30			AF.71	30

Current and capital accounts

U		R	U		R
P2 (or P.52) +100					
			P.52	-100	
B.9	-100		B.9	+100	

Financial account

ΔA		ΔL	ΔA		ΔL
F.2	-70		F.2	+70	
F.71	-30			F.71	-30
		B.9 -100		B.9	+100

Closing balance sheet

A		L	A		L

II.6 Grants from the EU Budget

II.6.1 Background to the issue

1. The European Institutions[1] make significant transfers from the EU budget to the Member States for various common policies, mainly the Common Agricultural Policy and the Structural Funds. The nature of these flows can be quite diverse, while the final beneficiaries may be non-government units (as it is the case for most transfers under the Common Agricultural Policy) or government units (as it is the case for a large part of transfers under the Structural Funds).
2. In practice there are two significant cases of EU-grants, which need specific attention for recording in national accounts. First, there are the grants paid from the European Agricultural Guarantee Fund (EAGF). These represent mainly subsidies paid to non-government units as final beneficiaries. Secondly, there are the grants paid in the context of the Cohesion policy, from the Structural Funds (and the European Agricultural Fund for Rural Development (EAFRD), Financial Instrument for Fisheries Guidance (FIFG), European Social Fund (ESF) and European Regional Development Fund (ERDF)) and the Cohesion Fund. These are mainly current or capital transfers paid to both government and non-government units. The current budget of the European Institutions also includes other expenditures. Among them a growing part is dedicated to supporting research and development in the EU. Usually the beneficiaries of this expenditure are non-government units, but in some cases they can also be government units, such as public universities.
3. Besides the above mentioned, three important grant types are worth mentioning: the Schengen-facility, the Transitional facility and the Cash-flow facility, which provide temporary financial assistance to recently joined Member States. In the case of the Schengen and Transitional Facilities, the actions for which they could be spent by Member States are defined by the EU. These actions relate to different common EU policies and initiatives (e.g. Schengen area, customs union, but also common agricultural policy national administrative structures), therefore the rules set out in this chapter relate also to these two facilities. The Cash-flow facility however is provided by the EU unconditionally and without any specification of areas for which they would need to be spent. The European Institutions do not monitor the way in which the beneficiary Member States uses these funds. The EU also does not have the right to stop their monthly payments or claim any amounts to be repaid to the EU budget, therefore the Cash-flow Facility has rather the nature of current transfers in the context of international cooperation as defined in ESA95 4.121-4.124.
4. Transfers are a category of distributive transactions where, often, only two parties are involved, the payer and the receiver. But in the case of transfers paid by the European Institutions there might be in practice three or even more parties involved. In addition, in general, payments transit through government even when the final beneficiaries are non-government units (generally in the context of a co-financing procedure, with the European Institutions supporting an investment effort by government but not substituting it).
5. In practical terms, the European Institutions make payments to final beneficiaries on the basis of information that is transmitted by national governments. Most payments are routed through accounts held by governments (some exceptions are observed only

[1] This document refers to the European Institutions as institutional unit. In most cases, it is the European Commission that distributes the grants.

in the case of payments related to agricultural policy); even if in this case national governments are not involved in the economic decision that determines the payment by the EU. The fact that the transfers are paid from EU-funds to specific accounts managed by government units in the countries is of course a positive factor as regards the availability of the information needed by national accountants. In some countries only one account could be used for all payments from the Member State to the European Institutions and from the European Institutions to the Member State. In such cases the impact of inflows from the EU (for example advance payments at the beginning of a multi-year programme) on the net borrowing should be correctly assessed.

6. Notwithstanding issues stemming from the divergence between data sources (EU budget, Balance of payments) that would need specific investigation while compiling national accounts, there are two important issues to be considered:

7. First, the time of recording, and second the classification in national accounts of the specific transaction, that, in this case, can take one or a mixture of the following forms:

   – subsidy (coded as D.3);

   – other current transfer (coded as D.7);

   – capital transfer (coded as D.9).

8. For reasons of comparability, as this classification may have consequences on some aggregates or balancing items in national accounts (but not on net borrowing/net lending, which is crucial for EDP purposes), transactions of a similar nature should be classified in the same (above-mentioned) ESA95 categories. This chapter does not provide guidance on this classification of transactions.

9. The rules relating to the EU budget are rather complex, and considerably differ in the case of agricultural payments (mostly subsidies) and in the case of cohesion policy payments of structural funds (mostly current or capital transfers), including prepayments, interim and final payments, and these payments are frequently made, as mentioned above, not to the final beneficiary but to a national government agency, which then pays the final beneficiary.

10. The Cohesion policy payments are granted in the framework of 7 year long programming periods. Once the compulsory national programmes are adopted, Member States receive advance payments for the whole period. During the programming period the European Institutions make interim payments to reimburse actual expenditure certified by the Member States up to a maximum of 95% (including the advance payment at the beginning of the programming period). The balance of 5% is paid on the closure of the programme once all documents are submitted and approved by the Institutions.

11. There is an issue concerning the time of recording, which might have a direct impact on deficit data. Once the expenditure by the final beneficiary has occurred (and generally with a very short delay), the managing authority sends to the European Institutions all relevant documents in order to be reimbursed for the appropriate (and legitimate) amount. The European Institutions authorise and undertake payments to beneficiaries only after checking compliance with the agreed rules and conditions, on the basis of supporting documentation that has been forwarded. It generally takes a maximum of two months between receipt of the supporting documentation and the authorisation of payment.

12. Under these conditions, imbalances are observed at the end of each year (mostly due to administrative delays), and there have also been cases of a disallowance or a cancellation of an EU transfer, for example in the case of fraud. A disallowance appears when a national government has paid subsidies or other transfers on behalf of

the EU, but after an auditing process the EU does not approve part or all of the expenses and refuses to reimburse at least some of them.

13. Some aspects of these payments of EU-grants might have major effects on government deficit. It may happen that governments pay agricultural subsidies in advance (for example during September, year n) while the reimbursement from the European Agricultural Guarantee Fund (EAGF) is made only later (for example during January, year n+1). Similarly, the Structural Funds can make prepayments to governments at the beginning of a program period.[2]

14. Eurostat had observed that the practices for recording EU-grants in Member States were rather heterogeneous, so that in some cases the government surpluses or deficits were not fully comparable in this respect. As government is acting as an agent by delegation from the European Institutions while transferring the grants to the final receivers, the method in use influences not only the sector account of the rest of the world but that of government as well. Therefore, this chapter aims at providing clear guidelines that will ensure a better comparability of data relating to EU transactions through a harmonisation of the recording methods, neutralising the timing effect of EU related flows.

15. Eurostat published a guidance note on the appropriate recording of changes in inventories of Market Regulatory Agencies on its website[3] (see also I.4 in this Manual). Therefore this topic is not analysed in this chapter.

16. Finally, this chapter does not deal with the contributions of Member States to the EU budget. Relevant documents about their treatment can be found on Circa.

II.6.2 Treatment in national accounts

General rule

17. As a general rule, EU transfers shall have no impact on government deficit/surplus at the moment in which they are made. In other words, possible time lags observed between the revenue and expenditure flows, or in the financing of these transactions, should not result in national accounts in improving - or worsening - the net lending/net borrowing of the general government.

18. The treatment in national accounts depends on the final beneficiary (the unit undertaking the activity which qualifies for an EU grant) of these EU-grants. Grants received by a government unit as a final beneficiary are treated differently from those for which the final beneficiary is a non-government unit.

II.6.2.1 The beneficiary of the EU grants is not a government unit

General rule

19. In case the final beneficiary is not the government the transfer is recorded in the final beneficiary's accounts as appropriate according to ESA95 rules, and the related transactions are exclusively recorded in the financial accounts of general government, without any impact on government deficit/surplus.

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[2] The amount of these prepayments was usually 7% of the total amount of the 2000-2006 programs. However, to EU-10 the EU Commission has paid in advance 10% in 2004 and another 6% in 2005 of the total amount of programs. In the 2007-2013 programming period the pre-financing is spread over two or three years.

[3] http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/MARKET_REGULATORY_AGENCIES.pdf)

20. In national accounts, these transfers must be recorded as distributive transactions directly between the European Institutions (uses) and the non-government beneficiaries (resources). For subsidies (D.3), the amounts are recorded in the accounting period in which the underlying production or the event giving rise to the subsidy took place. This is a general ESA95 (4.39) rule that should be met as far as possible. However, in some very specific and exceptional cases, it may be difficult to collect information on the precise period when the relating economic activity took place. By convention, the time of the cash payment (either from the European Institutions or from government as an advance – see below) could be considered as a proxy measurement of the period for recording on an accruals basis. Statistical authorities must however make all possible efforts to cover with appropriate information, or adequate estimation methods, most of the transactions where the time lag between the economic activity and the payment could lead to an incorrect picture of the government balance.

21. For other current transfers (D.7), the amounts are recorded in the accounting period in which the obligation to pay arises (ESA95 4.123 "*the time the regulations in force stipulate the transfers are to be made (obligatory transfers) or the time the transfers are made (voluntary transfers).*").

22. For capital transfers (D.9), the amounts are recorded in the period when "*the payments are due to be made*" (ESA95 4.162).

23. *Example: the European Institutions make a payment in February of year n to a non-government unit relating to the fourth quarter of year n-1. If it is a subsidy, it should be recorded in the accounts of year n-1 as a resource of the non-government unit and as a use of the "Rest of the World". If it is a capital expenditure, whatever the period in which this expenditure took place, it should be recorded as revenue of the non-government unit in the year n, when the payment from the European Institutions takes place.*

Specific case of government advance

24. Frequently government makes advanced payments to a non-government unit that is entitled to receive transfers from the European Institutions (mostly as far as farmers are concerned). This is made for the purpose of reducing the financing burden of the beneficiaries, and to compensate them at a time close to the one in which they carried out the relevant economic activity.

25. *Any advanced payment in this respect, whatever its underlying transaction in national accounts (D.3, D.7 or D.9), must be recorded as a financial transaction* (creation of a financial asset of government and a matching liability of the Rest of the World in the category AF.7) at the time it is made by government, or if a commitment accounting system is used, at the time the payment is ordered by the competent authority.

26. With this treatment, there is no impact on government deficit or surplus because the transfers from the EU institutions are not considered as national government expenditure but as EU expenditure. The only expenditure incurred by the government consist of the financing costs of the financial advance.

27. *Example: the government makes a payment on behalf of the EU to a non-government unit in September of year n. This is recorded in the same accounting period as revenue of the non government unit received from the Rest of the World (it is not to be considered as government expenditure), according to the nature of the transaction (D3, D.7, D.9). This payment by government gives rise to a financial claim on the European Institutions (AF.7). Following the verification procedure, the European Institutions repay government in January n+1. This repayment liquidates the government claim at the time it takes place. Thus a government payment to a non-government unit on behalf of*

the EU is recorded as a financial transaction without any impact on government net lending/net borrowing.

Disallowance

28. It might happen that the European Institution decides that part of the amount paid to final beneficiaries by government on behalf of the EU was not justified or that a penalty has to be paid by the Member State (i.e. for agricultural overproduction). In this case the European Institutions will place a sanction either by withholding the reimbursement in the period following the payments to final beneficiaries or deducting the amount from a future payment. There are three main issues: the time of recording, in which sectors the entries should be made, and what to record.

29. The *time of recording* is when the Commission takes the decision of partial reimbursement of the amounts paid by the paying agencies of Member States to final beneficiaries. This should apply in all cases, also when the withheld payment relates to a different EU programme.

30. The *counterpart sector* depends on whether the final beneficiary is allowed to keep the payment or not, or, in the case of sanction for overproduction, whether the government is allowed to pay on behalf of the penalised sector or not (for instance in the case in which it would not be considered as a distortion of competition in the EU Internal Market).

31. If the beneficiaries should have been definitively able to acquire the advanced payment by government (government would be allowed to complete the aid from the EU), then at the time of the European Institution decision on the final reimbursement (or non-reimbursement), the original amount must be recorded as a capital transfer (D.9) from government to the final beneficiary, and, at the same time, as transfer from the final beneficiary to the ROW (Rest of the World) sector (European Institutions).

32. If the advanced payment by government cannot be kept by the beneficiaries (government would not be allowed to pay more than what is defined by the EU rules), two cases must be distinguished.

33. If the final beneficiary is able to pay back the advanced amount to the government, a repayment must be imputed from the final beneficiary to the ROW sector for the repaid amount, and the repayment amount enters the financial accounts of the government, at the time of the European Institution decision.

34. If there is no full repayment from the final beneficiary, and the European Institution penalises the government, the government must record a current transfer from general government to the ROW sector (European Institutions), at the time of the European Institution's decision.

II.6.2.2 The beneficiary of the EU grants is a government unit

35. A government unit is the final beneficiary of the EU transfer if the transfer covers an expenditure carried out by that government unit, for any purpose: social assistance, training, education, or increase in fixed assets held by government. Of course the government unit that takes the economic decision (project manager) must be distinguished from the government unit that receives and reallocates the funds from the EU (cash manager). This is relevant for national accounts if they are in different sub-sectors.

General rule

36. In general, the time of recording of government revenue from the EU is the same time as the national government expenditure. This is for practical reasons to ensure that there is no impact on government deficit/surplus arising from these transactions.

37. *Example: government makes an expenditure in October of year n for an amount of 100 under a given project. Government then sends the appropriate documents to the European Institution in November of year n. Government records in October a transfer from the Rest of the World as government revenue, coded according to the nature of the transaction (which does not influence the time of recording). Government records as a counterpart a claim on the EU in its financial account (F.7). The European Institution then reimburses 100 in February n+1. The claim is liquidated at this time.*

38. If the European Institution decides at a later date not to reimburse the government and the time lag is short (as is normally the case), the past accounts may be revised to remove the government revenue and other accounts receivable or a part of it.

Specific case

39. In some cases it might happen that the time of expenditure differs considerably from the time of submission of claims to the European Institutions, since at the time of expenditure the intention of submitting the claim was not known. In this case, the time of submission of claims might substitute for the time of expenditure for the purpose of defining the time of recording, depending on the availability of information on the expenditure, the amount involved and the size of the time lag between the time of expenditure and the time of the submission of claims. Nevertheless, the time of submission of claims can be used as the time of recording *only in justified cases*.

40. In accordance with paragraph 38, the time of recording is the time of submission of claims, when no reliable information on the date expenditure is available; or, when amounts involved are small; or, when amounts involved are big and the time lag between the moment of expenditure and the submission of claims is small (flexibility option). In order to facilitate the decision about the time of recording for this specific case, a decision tree is placed at the end of this chapter.

41. After sending the claims, in the expectation of the settlement by the European Institution, a counterpart financial transaction of government revenue is recorded in the form of other accounts receivable (a claim on the European Institutions), codified as AF.7. This is liquidated at the time of reimbursement by the European Institutions.

II.6.2.3 Initial advance payment by the European Institutions[4]

42. All payments received by governments from the European Institutions at the inception of multi-year programme periods are treated as financial advances (AF.7 government liability). Thus, there is no impact on government deficit/surplus.

43. This liability is *unchanged* until total payments by the European Institutions have reached a ceiling calculated as 95% of the total amount agreed by the European Institutions in all the multi-year periods less the amount of the initial advances. Then, until a ceiling percentage is reached (usually 95%, since in principle the European Institutions keep 5% of the total agreed), the reimbursement of final beneficiaries` expenditure is recorded as revenue for the same amount, with a counterpart financial transaction in the form of a *reduction* in the advance received by government.

44. The remaining part of the expenditure of the project (5%) has to be pre-financed by the final beneficiary (and treated as other accounts receivable, F.7) and the EU will repay

[4] On arrangements concerning the advances paid by the EU on structural programmes see the Background paragraph 9-10.

these expenditures only later (at which time the other accounts receivable will be neutralised).

45. If at the end of the multi-year period, the total government expenditure does not reach the ceiling percentage of the total agreed amount for the period, the part of the advance not "consumed" by government is reimbursed to the European Institutions, with no impact on government revenue, and with an impact only in the financial accounts.

II.6.3 Rationale of the treatment

II.6.3.1 Non-government unit, as beneficiary

46. Government is not the final beneficiary because either the subsidy is linked to the economic activity of units outside the government sector, or the transfer obviously supports directly the income of a non-government unit, or the transfer covers a capital transaction that is devoted to finance all or a part of the acquisition of non-financial assets by a non-government unit. This includes the case of payments to regulatory units that have been classified as market producers, outside the general government sector (see Part I of this Manual). This is mainly the case for the Common Agricultural Policy but it could also concern some payments from other Structural Funds (notably in the case of the Social Fund and the Cohesion Fund).

47. The treatment follows the ESA95 rules as regards time of recording, based on an "accrual" approach. Subsidies are recorded when the transaction or the event (production, sale, import, etc.) which gives rise to the subsidy takes place (ESA95 4.39). The event might be for example agricultural production or export of goods. For other current transfers (in cash), the time of recording is the time the regulations in force (or contractual agreements) stipulate the transfers are to be made (ESA95 4.123). Investment grants in cash are recorded when payment is due to be made to the unit recording the GFCF expenditure in its own accounts (ESA95 4.162).

48. In practice, amounts to non-government final beneficiaries usually transit via government accounts. However, these flows must be recorded only in the financial accounts of government. This is because the ESA95 (in footnote 12 to 4.122c) establishes that current transfers made by the European Union to resident market producers are shown as subsidies paid by the rest of the world. A similar principle is established in footnote 14 to ESA95 4.152 for investment grants.

49. As far as the time of recording of the transactions is concerned, there might be some confusion between the moment where the obligation is recognised and the time at which the European Institutions will pay. In practical terms nevertheless, once the European Institutions have taken the decision to pay, there is usually only a very short delay before the funds are effectively transferred. In addition, it seems that for some countries the information is available in direct form only on a cash basis in reporting systems.

50. In the case of an advance by government on behalf of the EU to a non-government beneficiary, from an economic point of view the treatment described in paragraph 24 is justified because the financial position of the final beneficiary is affected at the time when government is paying and it is this, which is relevant for its economic behaviour. Government is here acting "on behalf" of the European Institutions. Of course, in national accounts one must record a financial claim of government on the European Institutions.

51. In practice, the amount paid to the beneficiaries by government will be different from the final repayment only in exceptional cases, mainly due to errors and fraud activities.

However, it might happen more frequently that the European Institutions ask for additional documentation such that the reimbursement is delayed.

II.6.3.2 Government unit, as final beneficiary

52. Government unit as final beneficiary can occur in various EU schemes. It is notably the case for Regional Development and Social Funds where a government unit is managing a project under an agreement with the European Institutions but with certain autonomy as regards the completion of the project. The nature of national government expenditure may be of various types: P.2, P.5, P.7, D.1 and, possibly, other distributive transactions (D.3, D.7, and D.9). It seems that government may, in very specific cases, also acquire shares.
53. Once the expenditure by government has occurred (and generally with a short delay), government sends to the European Institutions all relevant documents in order to be reimbursed for the appropriate (and legitimate) amount. However, in exceptional cases the intention of government of submitting the claims is not known at the time of expenditure.

Specific case when the intention of submitting the claim is not known at the time of expenditure

54. Only in this latter case, in order to better reflect economic reality, it might be more appropriate for practical reasons to record the revenue for government at the time government sends the documents to the European Institutions, The conditions under which this may take place are illustrated in the flow chart in Annex I.
55. The treatment envisaged here is based on the experience clearly showing that the European Institutions pay almost always what is effectively declared. Effectively, it is extremely rare (and for very small amounts in comparison of the total of the flows) that the EU does not reimburse government.
56. In the context of the EU agreements, government expenditure by definition must fulfil precise requirements and governments would not try to claim undue revenue. In addition, the European Institutions have imposed domestic controls such that misusing of the funds, non-completion of the program, frauds, etc. are rather exceptional. Nevertheless if the European Institutions do not reimburse government – given that the time lag is normally short – a suitable backward revision of government revenue from the European Institutions would be appropriate.
57. The treatment proposed is also in compliance with ESA95 4.162 where it is said that investment grants in cash are recorded when the payment is due to be made. The "due to be made" reflects the expectation of government of reimbursement. If, at the time of expenditure there was no expectation of the reimbursement, the time of recording shall not be the time of expenditure, but when the expectation arose, that is when the claim was submitted. This corresponds to the principles laid down in the chapter.

Specific case when the precise amount of the expected reimbursement is not known at the time of expenditure

58. If the expectation arose at the time of expenditure on the project but the precise amount (the percentage of the amount of expenditure) of the expected reimbursement was not known, a prudent estimate must be made for the expected revenue, which should be recorded in the same period as the related expenditure.

II.6.3.3 Initial payment by the European Institutions

59. The initial payment by the European Institutions may only be treated as a financial advance in national accounts, with no impact on government deficit or surplus.

60. This treatment is justified by the fact that the EU rules stipulate that it is only when government expenditure has been made that government may ask for the reimbursement by the European Institutions, under determinate and set conditions. Therefore, the advance cannot be recorded as revenue until the occurrence of the corresponding expenditure.

II.6.4 Accounting examples

1. The final beneficiary is not a government unit (case of government advance)

A non-government producer is entitled to receive 1000 from the European Institution as investment aid in year t. It receives this amount from the national government in year t but the European Institution makes a reimbursement payment of 1000 only in year t+1.

Year t

General government

Non-financial account

ΔA/U			ΔL/R

Financial account

ΔA			ΔL
F.2	-1000		
F.7 (ROW)	+1000		
		B.9f	0

Closing balance sheet

A			L
AF.7	1000		

Rest of the World

Non-financial account

ΔA/U			ΔL/R
		D.9	-1000
B.9	-1000		

Financial account

ΔA			ΔL
		F.7 (GG)	+1000
		B.9f	-1000

Closing balance sheet

A			L
		AF.7	1000

Non-government producer

Capital account

ΔA			ΔL
		D.9	+1000
B.9	+1000		

Financial account

ΔA			ΔL
F.2	+1000		
		B.9f	+1000

Year t+1

General government				Rest of the World			
Opening balance sheet							
A			L	A			L
AF.7	1000					AF.7	1000
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	+1000			F.2	-1000		
F.7	-1000					F.7	-1000
		B.9f	0			B.9f	0
Closing balance sheet							
A			L	A			L

2. The final beneficiary is a government unit

A government unit has spent 2000 (here in the form of gross fixed capital formation) in year t in the framework of a project co-financed to the extent of 50%. Appropriate documents are sent to the European Institution but the latter reimburses 1000 only in the course of the following year t+1.

Year t

General government				Rest of the World			
Capital account							
ΔA			ΔL	ΔA			ΔL
P.51	2000	D.9	+1000			D.9	-1000
B.9	-1000			B.9	-1000		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	-2000						
F.7	+1000					F.7	+1000
		B.9f	-1000			B.9f	-1000

Closing balance sheet

A			L	A			L
AF.7	1000					AF.7	1000

Year t +1

General government	Rest of the World

Opening balance sheet

A			L	A			L
AF.7	1000					AF.7	1000

Financial account

ΔA			ΔL	ΔA			ΔL
F.2	+1000			F.2	-1000		
F.7	-1000					F.7	-1000
		B.9f	0			B.9f	0

Closing balance sheet

A			L	A			L

3. Disallowance

3.1. Agricultural allowances when the government is allowed to complement the original payment (paragraph 30)

Government sends a claim of 1000 to the European Institutions for reimbursement of subsidies paid in November of year t, but the European Institutions only pay 800 in January of year t+1, as 200 is withheld as penalty relating to inappropriate claims of earlier periods (t-1 or earlier). The original subsidy is kept by the final beneficiary.

Year t

General government	Rest of the World

Non-financial account

ΔA/U			ΔL/R	ΔA/U			ΔL/R
						D.3	-1000
B.9nf	0			B.9nf	-1000		

Financial account

ΔA			ΔL
F.2	-1000		
F.7(ROW)	+1000		
		B.9f	0

ΔA			ΔL
		F.7(GG)	1000
		B.9f	-1000

Closing balance sheet

A			L
AF.7	1000		

A			L
		AF.7	1000

Non-government producer

Non-financial account

ΔA/U			ΔL/R
		D.3	+1000
B.9nf	+1000		

Non-government producer

Financial account

ΔA			ΔL
F.2	+1000		
		B.9f	+1000

Year t+1

General government

Rest of the World

Opening balance sheet

A			L
AF.7	1000		

A			L
		AF.7	1000

Non-financial account

ΔA/U			ΔL/R
		D.9 (final ben)	-200
B.9nf	-200		

ΔA/U			ΔL/R
		D.9 (final ben)	200
B.9nf	200		

Financial account

ΔA			ΔL
F.2	+800		
F.7	-1000		
		B.9f	-200

ΔA			ΔL
F.2	-800		
		F.7	-1000
		B.9f	200

Non-government producer			
Non-financial account			
ΔA/U			ΔL/R
		D.9 (govt)	+200
		D.9 (ROW)	-200
B.9nf	0		

Non-government producer			
Financial account			
ΔA			ΔL
		B.9f	0

3.2 Agricultural allowances when the government is not allowed to complement the original payment and the final beneficiary is not able to pay back the full amount (paragraph 33)

Government sends a claim of 1000 to the European Institutions for reimbursement of subsidies paid in November of year t, but the European Institutions only pay 800 in January of year t+1, as 200 is withheld as a penalty relating to inappropriate claims of earlier periods. The original penalty cannot be kept by the final beneficiary, but the final beneficiary is not able to pay it back.

Year t

General government			
Non-financial account			
ΔA/U			ΔL/R
B.9nf	0		

Rest of the World			
Non-financial account			
ΔA/U			ΔL/R
		D.3	-1000
B.9nf	-1000		

General government			
Financial account			
ΔA			ΔL
F.2	-1000		
F.7	+1000		
		B.9f	0

Rest of the World			
Financial account			
ΔA			ΔL
		F.7	+1000
		B.9f	-1000

General government			
Closing balance sheet			
A			L
AF.7	1000		

Rest of the World			
Closing balance sheet			
A			L
		AF.7	1000

Non-government producer

Non-financial account

ΔA/U		ΔL/R	
		D.3	+1000
B.9nf	+1000		

Financial account

ΔA		ΔL	
F.2	+1000		
		B.9nf	+1000

Year t+1

General government | **Rest of the World**

Opening balance sheet

A		L
AF.7	1000	

A		L
	AF.7	1000

Non-financial account

ΔA/U		ΔL/R
D.7(ROW)	200	
B.9nf	-200	

ΔA/U		ΔL/R
	D.7(GG)	200
B.9nf 200		

Financial account

ΔA		ΔL	
F.2	+800		
F.7	-1000		
		B.9f	-200

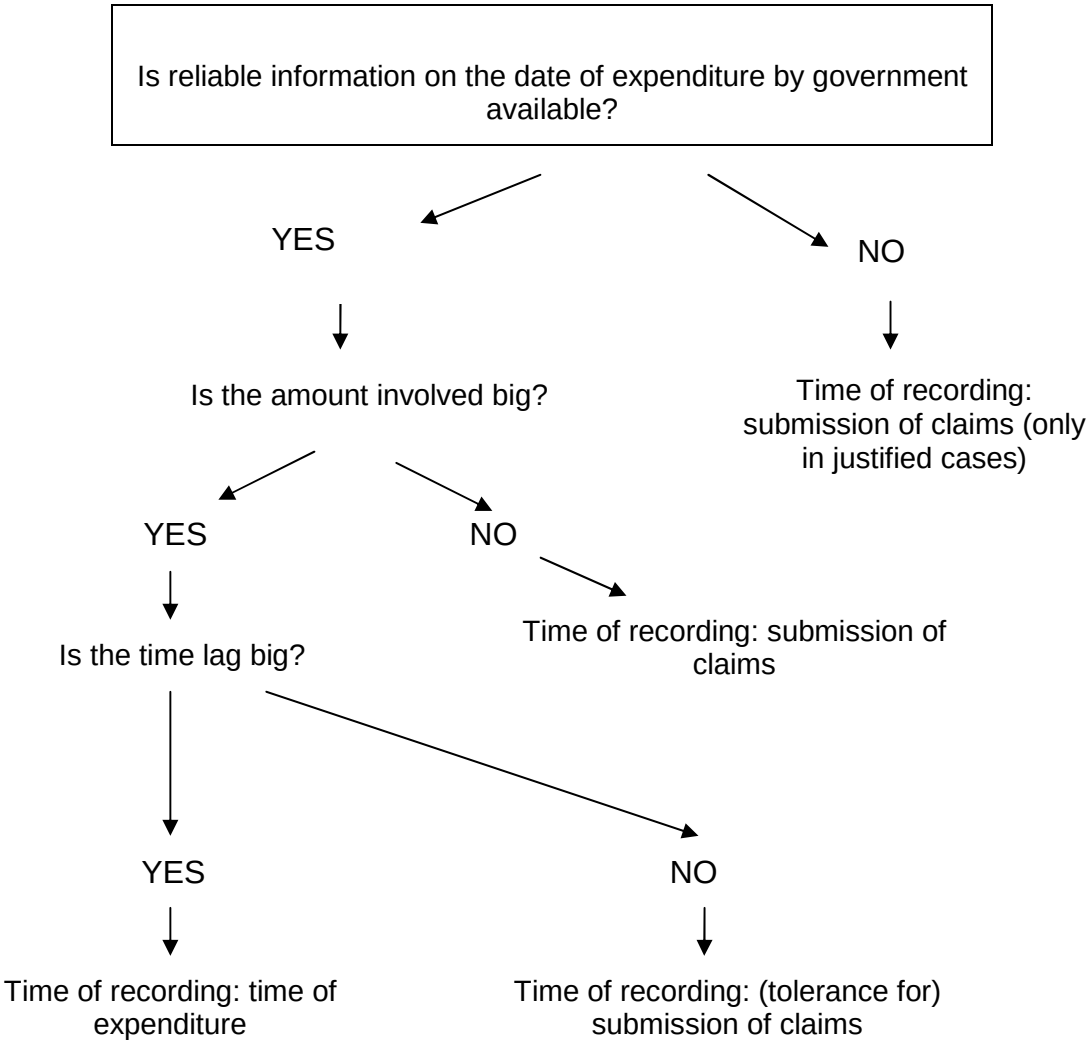
ΔA		ΔL	
F.2	-800		
		F.7	-1000
		B.9f	200

II.6.5 Key-words and references

EU subsidies	ESA95 4.31
Subsidies (time of recording)	ESA95 4.39
Other current transfers (time of recording)	ESA95 4.123
Capital transfers (time of recording)	ESA95 4.166
Other accounts AF.7	ESA95 5.128

Annex

Decision tree: Time of recording of government revenue for the special case when at the time of expenditure the intention for submitting the claim is not known (see paragraph 39)



II.7 Court decisions with retroactive effect

II.7.1 Background to the issue

1. When there is controversy about claims/liabilities, there might be a need for a Court decision - or any other accepted way of settling the dispute - to impose the "mutual agreement" and fix the exact amount of liabilities, which has subsequently to be regarded as directly applicable by the parties involved without further Court actions.
2. Sometimes, amounts could have been due by the government for several years and not paid because of a disagreement.
3. At what time should these claims and liabilities be recorded? For the purpose of statistical compilation, should they be recorded:
   - at the time they were accruing or supposed to be due? or,
   - at the time the Court decision settles the dispute and fixes the amounts irrevocably?

II.7.2 Treatment in national accounts

4. Relevant paragraphs in the ESA95:

   - 1.57: "The system records flows on an accrual basis; that is, when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled."

   - 4.107: "Time of recording of social benefits:

   (a) in cash, they are recorded when the claims on the benefits are established […]"
5. The phrase "when the claims on benefits are established" means the time at which there is sufficient certainty about their existence and size. When there is a disagreement leading to legal procedure, only the Court decision establishes the claim with sufficient certainty. Therefore, the time of recording these claims is the later of the year when the Court decision occurs or the year when the precise amounts to be paid are known as a result of that decision. The amount should be recorded in F.7 accounts/payable receivable until such time as paid in cash.
6. Amounts should not be distributed over the period when they accrued, except for that part of the claims that were not the subject of controversy.
7. A simple postponement of payments by the government without that government disputing the obligation to pay should not prevent recording the payments at the time they are due (see section on "Changes in the due for payment dates") with entries in F.7 accounts / payable receivable for the amounts accrued but not yet paid.
8. The recommended treatment in this chapter was developed for a case involving social benefits. A court ruled that level of benefits government paid to women in the past had been too low. It ordered the government to increase them and pay compensation for the previous years. The guidance can also be applied to other types of transfers such as taxes and wages. In general the timing of recording will depend not only on when the court decision is made but also upon when the amount to be paid is known with some certainty. The amount should be recorded as a capital transfer given that it is compensation for amounts that would have accrued over a number of years.

II.7.3 Rationale of the treatment

9. A distributive transaction – and more generally, claims and liabilities – may be recorded in the accounts when established with sufficient certainty, when known and accepted by both parties (ESA95 1.42).

10. Generally, these characteristics are resulting from:

    - a contractual agreement between two parties
    - the law: the mutual agreement in this case is due to the vote in Parliament by the people's representatives (case of taxes, social contributions and benefits etc., see also ESA95 1.42)

11. In some cases – when a new situation is created (new rights and obligations, for instance) - what is the subject of controversy and dispute can be resolved only by a Court decision which creates the obligation to pay, and also specifies the exact amounts to be paid. The date of the Court decision is therefore the time when the transactions are to be recorded.

12. This is true also for any penalty or interest charge awarded by the Court.

II.8 Keywords and references

Accrued interest and nominal holding gains	ESA95 6.52
Arrears	ESA95 5.121, 5.131
Discounted bonds	ESA95 4.46, 5.138
General accrual principle	ESA95 1.57
Index-linked securities	ESA95 4.46, 5.138
Instruments denominated in foreign currencies	ESA95 6.58
Interest and financial transaction	ESA95 5.17
Mutual fund shares	ESA95 5.141
Social contributions	ESA95 4.96
Taxes on income and wealth	ESA95 4.82
Taxes on production and imports	ESA95 4.26, 4.27
Time of recording	ESA95 1.57
Time of recording interest	ESA95 4.50
Time of recording of social benefits:	ESA95 4.107

III

General Government and public corporations

Part III General Government and public corporations

III.1 Overview

1. The classification of a transaction between government and a public unit can be complicated because of the different roles played by government in the economy. The transaction can arise for several different reasons due to the different objectives of government activity. These activities include Government's role:

   - **as the owner of financial assets:**

     as a long-term investor seeking a profitable return;

     managing its own liquidity through financial operations;

     ultimate owner of gold and foreign exchange reserves.

   - **acting for public policy purposes - supporting economic and social policy:**

     government pays subsidies and investment grants to help employment;

     government sometimes uses public units to help deliver policies – such as for public transport;

     government passes laws which restructure public units so they can use proceeds from asset sales to fund more activity elsewhere.

   - **managing its budget:**

     levying taxes and social contributions;

     carrying out transactions associated with pension obligations.

2. In borderline cases, when determining the classification of a transaction, it is necessary to consider which role the government is playing in the transaction and apply a recording that recognises the economic substance of the transaction if this differs from its legal form. In some cases more than one role can apply and it is necessary to consider which role is more significant for the purpose of recording most accurately the economic reality of the transaction.

3. Some activities are undertaken by government and never by market units: government does not act only as a manager of assets seeking a maximum financial return. It may also manage the assets in a way to support economic activity and meet social objectives. Also, the government is the only agent in a position to make massive transfers to other agents of the economy.

4. This means that flows to and from public corporations are not always recorded in a symmetrical way. For example, an unrequited payment recorded as an « investment grant », a non-financial transaction (« something for nothing », as stated in ESA95, chapter 1) might contribute to a significant improvement of the enterprise's wealth in the mid-term. If the public enterprise would then make an exceptional payment out of its own funds, this payment might be reasonably recorded as a withdrawal of equity (partial liquidation of assets).

5. National accountants consider carefully the legal context of units and transactions for classifying them. However, it is important sometimes to look through the legal form of an institutional unit or of an economic flow, and to report the economic reality. This applies to both the classification of units and the classification of flows.

Examples are given below.

a. A unit might undertake some activities that are typical of government units but the unit might not be included in government in public accounts. Such activities might be for example: making unrequited payments to other units; charging levies on particular industries; securitising poor quality loans; giving guarantees on lending; building public infrastructure, and so on. The first question is whether the unit should be classified to general government (even if it is called a corporation or not normally considered to be part of government). Section I.6 considers the difficult question of the classification of units managing public assets.

b. If the classification as a market unit is correct, the next question is whether it is necessary to impute equal and opposite payments through government (also known as rerouting) to show that some of the unit's transactions are on behalf of government. This could apply for example to any unrequited payments to other units: these would be recorded as payments by government with an adjustment to other transactions between the unit and government to balance the accounts.

c. Rerouting can be appropriate in cases of indirect privatisation when the proceeds are kept by a public corporation to fund the unrequited payments to other units (Chapter V.2.2 discusses this), or to fund loss-making activities within the unit under the instructions of government as part of its economic and social policy (the case of corporation with some non-market activity). In these cases the payments rerouted through government are shown to be funded by payments from the public unit to government in respect of the indirect privatisation.

d. When classifying a transaction in national accounts, one is not necessarily tied by the denomination the transaction may have either in public accounts or in the book keeping of enterprises. For instance, in some specific cases, what is called a tax in the tax legislation or a dividend in corporation accounts might be more appropriately recorded in national accounts as a financial transaction.

e. On the other hand some flows having the legal denomination of equity injection may be classified, in national accounts, as capital transfers either because no economic return (such as increased dividends) is actually expected from the equity injection or because it is linked to the acquisition of a fixed asset (which would make it an investment grant). In this respect an important distinction has to be made between flows channelling income from public corporations to government and other kinds of payment. The first ones undoubtedly have to be classified as non-financial transactions. The second category includes in particular large payments made out of the proceeds of sales of assets by public corporations. They have to be classified as financial transactions. See the decision tree at III.2.2.

6. In general, the principles concerning transactions between general government and public corporations also apply to transactions between Government and private corporations and between Government and other governments. Some private companies might be "too big to fail", or perform some crucial role in the economy such as owning and operating vital infrastructure and utilities, so that Government is forced to continue the existence of such companies when dealing with them. In such circumstance, payments to these companies that are presented as financial (injections of capital or equity) might in economic terms be grants.

III.2 Capital injections into public corporations

III.2.1 Background to the issue

1. Analysts in the media commonly refer to “capital injections” made by the government into a public corporation, when some significant financial support is provided to the corporation in an attempt to capitalise or recapitalise the corporation.
2. The notion of a “capital injection” as such is not defined in the SNA93 or in the ESA95. In the media, the term is used for many types of payment from government to a public corporation which in national accounts are classified in different categories, as capital transfers or as financial transactions. For example, the terminology covers transactions that might be described in public accounts as investment grants, capital grants, commutation grants, loans, equity injections, acquisition of share capital. Other forms of support, like debt assumption, cancellation and rescheduling, may also be considered as capital injections (see chapter VII.2).
3. The payment from the government commonly referred to as a “capital injection” should be recorded in the national accounts as either:
   - a financial transaction: this would be in the general case an addition to equity – or, in other cases, to loans or securities other than shares - recorded in the financial account, with no impact on the government deficit, or,
   - a non-financial transaction: assuming that this is an unrequited payment, it would be a capital transfer, a government expenditure with a negative impact on deficit.
4. In some rare cases, it could be a combination of the two (see the section "Treatment in national accounts").
5. Capital injections are most often made in cash, but can also be made in kind. This chapter deals with injections in cash. Injections in kind are the subject of another chapter (“Capital injections in kind” – chapter III.4). Injections in kind are very specific and do not fulfil some of the characteristics of injections in cash – those recorded as financial transactions - notably a certain degree of freedom of use by the corporation of the funds injected (see also the "Rationale of the treatment").
6. This chapter covers only the case of a *transaction*, i.e. an economic flow that results from the interaction between two institutional units by mutual agreement (or an action within an institutional unit that it is useful to treat as a transaction - see ESA95, 1.33). Therefore, it excludes the case of corporate restructuring, involving a restructuring of assets and liabilities or reclassification of units.
7. This chapter deals with capital injections by government into public corporations (owned, even partially, and controlled by general government), including the central bank. The case of capital injections into public quasi-corporations is covered in chapter III.3.

III.2.2 Treatment in national accounts

III.2.2.1 General principle

8. The principle in the general case, also referred to as "the capital injection test", is the following:
   - When the government, acting in the same capacity as a private shareholder, provides funds while receiving contractually something (usually financial

instruments) of equal value in exchange *and* expecting to earn a sufficient rate of return on its investment, mostly in the form of dividends and interest, *and* a higher value of the financial instrument which represents the government's property rights on the corporation, the capital injection is to be recorded as a financial transaction in shares and other equity (see also box 2 in the section 3. Rationale of the treatment: "a sufficient rate of return"). In national accounting terms, the financial transaction has no impact on the government net borrowing/net lending.

- Often government does not manage funds to acquire profitable assets (like private shareholders do) but to pursue social or collective policy objectives for which private capital might not be available. Acting this way is a management of assets for public policy purposes. Thus, the capital injection is to be recorded as a capital transfer if the funds are provided in one of the following cases:
  - The funds are provided without receiving anything of equal value in exchange;
  - The funds are provided without expecting a sufficient rate of return on investment;
  - The funds are provided to a corporation that has shown a recent series of past losses.

  A capital injection that is recorded as a capital transfer (a non-financial transaction) has an impact on the government net borrowing/net lending (B.9; increasing the deficit or reducing the surplus). A possible change of government's net worth will depend on whether the capital injection gives rise to a revaluation of the corporation's assets (the difference between the assets' valuation on a "going concern basis" and a "non-going concern basis"). The value of the government's equity assets will increase accordingly.

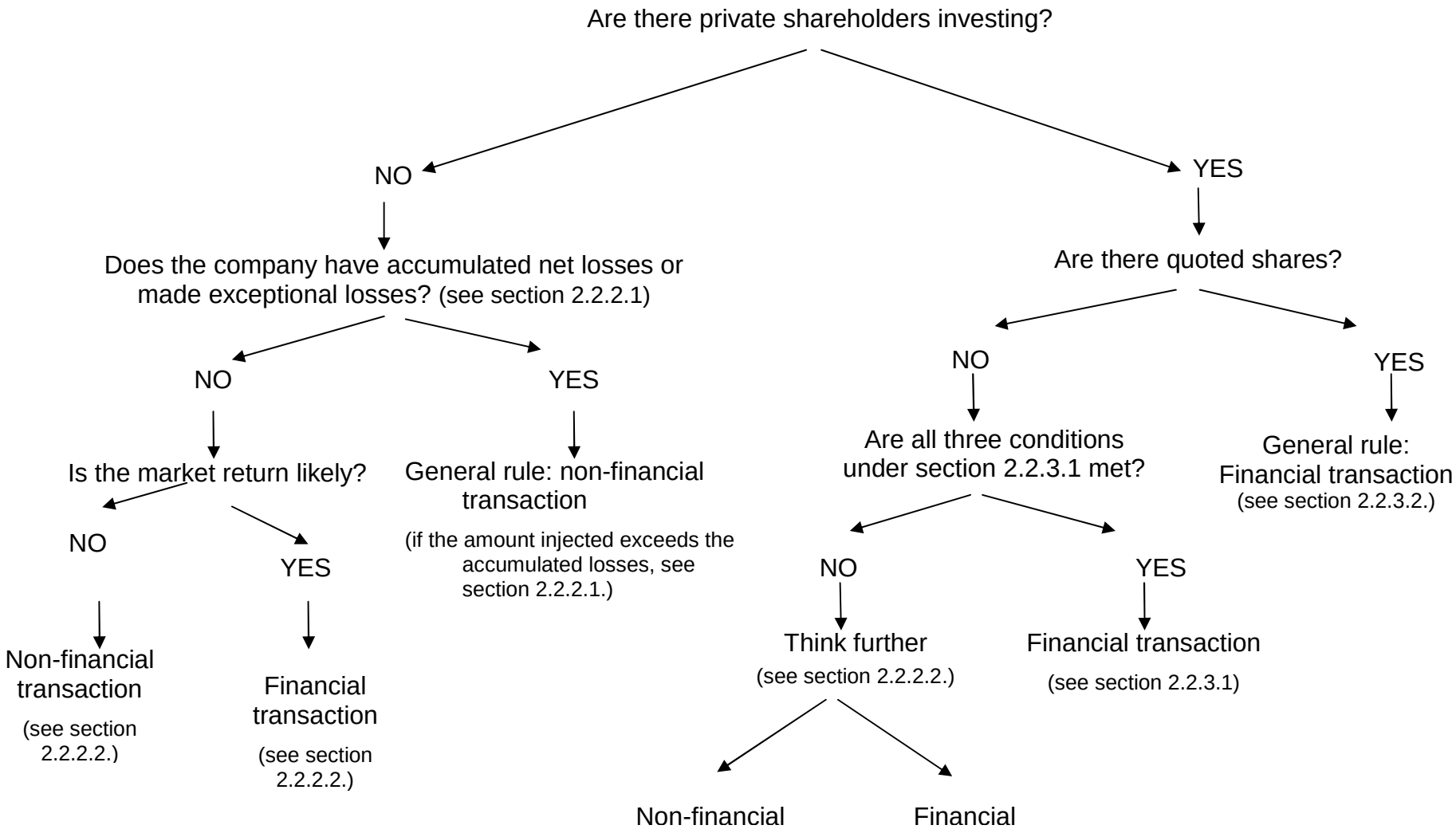
9. Considering the specificity of government, a sufficient rate of return expected on funds invested (see also box 2 in the Rationale of the treatment) would have to be at least equal to:
   - risk adjusted rates of return expected by private investors on similar equity investments in the same sector of activity; or
   - long-term government bonds rates.
10. In both cases, the calculation of the rate of return must be after deduction from the corporation's revenues of relevant transfer payments from government (see box 2).

Operational guidance

11. Generally, the following provisions can only be implemented on a case-by-case analysis, based on the information available. The following key questions must be examined, in order to make this analysis:
    - Is government acting alone (possibly together with one or more public corporations, for a minor part) or jointly with private shareholders (as defined in ESA95 chapter 2) participating in the injection?
    - Has the public corporation accumulated net losses over several years, or exceptional losses, as recorded according to national accounts (e.g. net saving), according to generally accepted accounting principle, or based on other evidence, such as the negative trend of the corporation's own funds? Exceptional losses are large losses recorded in one accounting period in the business accounts of a corporation, which usually arise from downward revaluations of balance sheet assets, in such a way that the corporation is under threat of financial distress (negative own funds, breach of solvency…).
    - Is it likely that government will receive a sufficient rate of return on its investment?

Decision tree for capital injections

(other than investment grants)



III.2.2.2 There are no private shareholders investing

III.2.2.2.1 The corporation has accumulated net losses or made exceptional losses

12. When the corporation has accumulated net losses or has made exceptional losses (as defined above), as a general rule, the capital injection is treated as a non-financial transaction for its full amount.

13. Special case (partition of the transaction): when a capital injection exceeds the net amount of losses and

    a) government can provide evidence that these funds in excess will receive a sufficient rate of return (for example, they are specifically used to make further investment in already profitable operational areas of the corporation's activity, as shown by past results, or in the context of a forthcoming privatisation of the business), or

    b) there is an obvious fundamental restructuring of the corporation, in order to prevent the occurrence of new losses and to return to sustainable profitability after the complete implementation of the new business plan, and evidence that government should benefit from a sufficient return on its new investment. There should be a large consensus that the restructuring will be efficient. This would not be the case if the return on the new investment is still uncertain (the restructuring plan is largely considered as insufficient as regards the main sources of losses and/or the restoring of profitability depends substantially on factors not under the control of the corporation),such that it would take time to offset the accumulated losses.

14. In this special case, the capital injection is treated as a non-financial transaction up to the limit of the losses and as a financial transaction beyond this amount.

15. For this special case, an operational guidance might be the rating - or change in rating - of the debt (notably long-term debt), the significance of management reorganisation, the shift to new activities, the competitiveness on the market etc.

III.2.2.2.2 The corporation has not accumulated net losses

16. Normally, this means that, on a regular basis, the corporation makes profits, either distributed or reinvested.

17. Where government is acting similarly to a private shareholder, meaning that, when it provides funds, it receives in exchange financial assets and expects a sufficient rate of return on its investment (in the form of dividends and higher value of the financial instrument representing the government's property rights in the corporation),

18. The capital injection is recorded as a financial transaction in shares and other equity for its full amount.

19. Where the capital injection is undertaken for specific purposes relating to public policy or in the context of a fundamental change in the conditions in which the activities are carried out and which are imposed by government, the consequence on future profitability of the new government investment must be carefully checked. In such cases:

    - If an expected sufficient rate of return were still very likely, the capital injection would be treated as a financial transaction for its full amount.
    - If a sufficient rate of return were unlikely, the capital injection would be treated as a non-financial transaction for its full amount.

20. Some public corporations may be subject to statutory provisions so that their revenue can equal but not exceed their total costs (this could be the case of market NPIs, classified in the non-financial corporations sector, for instance). By definition, these cannot provide a market return, and government, when investing in such units, is not acting in the same way as a private shareholder. These should be assimilated to cases of capital injections made for public policy purposes.

III.2.2.3 There are private shareholders investing

III.2.2.3.1 Private shareholders participating in the capital injection in unquoted shares

21. Private shareholders may already hold equity in the corporation. This case covers also the initial introduction of private shareholders in the event of the current injection, for instance under a process of restructuring.

22. Where the private investors:

    a) take a significant share in equity during the injection, in proportion to their existing shareholding (where appropriate)

    b) exercise the usual influence of minority shareholders according to rights provided by current Corporate Law,

    c) (bear risks and rewards similar to government, as regards their rights on the net assets, in the event of liquidation (ESA95 5.86) for instance,

    The capital injection is treated as a financial transaction for its full amount.

23. Where the private investors do not fulfil one of the conditions mentioned above, the capital injection should be treated according to rules specified for the cases where there are no private shareholders.

III.2.2.3.2 Private shareholders participating in the capital injection in quoted shares

24. Where, in exchange for its payment to the corporation, the government acquires quoted shares, which it could immediately sell for the price paid, then the transaction is in principle a financial transaction in shares and other equity (F.511).

III.2.2.3.3 Special case: It is a new corporation, or new activity/assets are considered

25. The treatment will depend on the specific examination based on the various indicators as usually used in investment analysis. The presence of private investors would also be a key indicator. In any case, it should be certain that government does not intend to use the new unit only for public policy purposes.

26. As a result:

    - Either, the conditions support the conclusion that, after a "normal" temporary period of losses (as also often observed for similar private investments), the corporation would be structurally profitable, so to earn an overall adequate rate of return, the capital injection by government is treated as a financial transaction for its full amount.

    - Or, on the basis of various factors (an uncertain economic environment, the nature of the activity and of the sector, the non-compensation of some costs imposed by government, the consensus opinion of independent experts in different areas like accountancy, economics and financial analysis, etc.) there are doubts on the long-term profitability of the project, the capital injection is treated as a non-financial transaction for its full amount.

27. If the return on a capital injection turns out to be very different from the return originally expected (e.g. profits or other gains are made instead of planned losses; or conversely losses are made instead of expected profits), the accounting of the capital injection is

not changed *a posteriori* (not revised based on new information or subsequent events, unless the initial plan was misleading and misrepresenting the economic reality, *see box 2*). No revenue or expenditure is recorded to account for these differences in expectations: instead these differences between realisations and expectations are reflected in the revaluation accounts.

28. In particular, returns of money to government by an entity that benefited from a capital injection in previous years that was recorded as a capital transfer expenditure of government, is not necessarily recorded as government revenue. Instead, the proceeds collected by government are subject to the super-dividend test to determine if these are government revenue or withdrawal of equity.

Box 1

Recording transactions: straightforward cases and difficult areas

In practice, compilers are confronted either with straightforward cases that lead to clear statistical treatments, or with borderline cases that require further inquiries and applying various tests.

Straightforward cases

a. Investment grant: D.92

A capital injection that "would consist of a capital transfer in cash or in kind made by government (…) to another resident (…) institutional unit to finance all or part of the costs of its acquiring of fixed assets" is to be recorded as an investment grant (D.92). ESA95 4.152

b. Past losses: D.99

A capital injection made to cover accumulated losses is recorded as an other capital transfer (D.99) (ESA95 4.165b)

c. Acquisition of quoted shares: F.5

A capital injection that results in government acquiring quoted shares of equal value is recorded as a transaction in shares and other equity (F.5).

d. Loans and bonds: F.3 and F.4

- Loans: a provision of funds in the form of a loan evidenced by a legal document specifying the borrower's obligations (redemption date of principal and interest to be paid) is generally recorded as a transaction in F.4.

- Bonds: a provision of funds by the government purchasing bonds issued by the corporation (again to be evidenced by some legal document) is generally recorded as a transaction in F.3.

e. Debt cancellation/assumption

Debt cancellation or debt assumption give rise to a capital transfer, unless it concerns a unit disappearing, or a unit being privatised within the limit of the amount of privatisation proceeds (ESA95 5.16).

f. Privatisation: F.5

A capital injection that is made as part of a privatisation process within a short-term perspective (less than one year), such that government expects to get its money back, are recorded in F.5 within the limit of the amount of the privatisation proceeds (consistently with the rationale of ESA95, 5.16 in the case of debt cancellation/assumption, see also item e) above).

Borderline cases

In the following difficult areas, two guidelines are very useful:

- A pattern of repetitive payments would be an indication and presumption of unrequited transfers, and therefore lead to record a capital transfer;

- The qualification by the European Commission of government payments as "State aids" should be taken into consideration for the statistical treatment. The flows deemed to be State aids have generally to be recorded as capital transfers.

a. Expected future losses/repetitive losses: D.9

A capital injection made to cover expected future losses, perhaps so that the corporation can reduce its borrowing costs, should be recorded as a capital transfer (D.9), even if shares (or equivalent) are issued. In this context, it is likely that the corporation will not be profitable for a long time, because of the specific conditions of its activities. If shares are issued, it can be assumed that they have no value.

b. An expected profitable investment: F.5

A capital injection given to a public corporation with the objective of increasing the government's future dividends should be recorded in F.5. This would be when the corporation is free to use the funds to maximise profits and the government expects a market return on its investment, i.e. a return similar to that, which could be obtained, from the acquisition of shares quoted on the market.

c. Partnership with private sector partner: F.5

If, acting jointly with a private partner, the government makes a capital injection into a unit such that the property rights, including rights to property income, are modified in proportion to the value of the injection, it indicates that the investment is expected to be profitable and could be recorded in F.5.

Where such proportionality does not exist (ownership rights do not change in the same proportion), it could be an indication that the government is serving public policy purposes and is making an unrequited transfer. If this is the case, the injection must be recorded as a capital transfer.

d. Body manages financial assets on behalf of government: F.5

A capital injection to a public holding company or a financial corporation, managing assets in a profitable way on behalf of government, in order to acquire more financial assets, could be recorded as a transaction in F.5. The condition here would be that the assets are managed to maximise the return for government, and that higher dividends are expected.

e. Loans granted in certain contexts

In certain contexts (financial defeasance, business rescuing, export insurance...), the characteristics of "loans" provided by government – and the contractual obligations - should be examined closely to check the relevance of the classification in F.4. In the special case where the public corporation receiving the loan would be in financial distress and not in a position to repay the loan, the provision of funds should be recorded as a capital transfer (D.99). If the public corporation would be in a position to repay most of the loan, but not all, this could be a case to partition the loan into F.4 and D.99 (see ESA95, 1.38 and 40).

III.2.3 Rationale of the treatment

III.2.3.1 Three common ways of providing funds to a public corporation

29. Government may increase a public corporation's holdings of financial assets (generally cash) at a given point in time, usually in three ways: a) providing a grant, b) providing equity capital, c) providing loan capital. It matters in national accounts to clearly distinguish them as they result in different treatments, according to the classification of transactions and assets provided by ESA95:

    a. Providing a grant (i.e. a gift): in national account terms, this is a capital transfer. It has the effect of changing the net borrowing/net lending (B.9), and of changing the net worth due to transactions (B.10.1) (and therefore the own funds of the corporation).

       An important feature of such capital transfers is that they are transactions which are usually undertaken only by governments. The beneficiaries of these transfers are usually enterprises that do not operate in competitive markets. Acting this way, the government expects no return on its investment in the form of dividends (most of the time the enterprise receiving such transfers does not pay dividends) or in the form of other proceeds notably realised in the context of a privatisation. Government is acting for public policy purposes, and only expects some general economic or social results from the use of the funds.

    b. Providing equity capital: this is a financial transaction in shares and other equity. There is no change in the net borrowing/net lending (B.9) and no change in the net worth (but there is a change in own funds due to the increase in equity capital).

       Usually, corporations raising equity capital are competing on markets and need to strengthen their financial position, by increasing their own funds, in order to plan investments etc. In providing equity capital to the corporation, the government acts similarly to a private shareholder, with the strong expectation of a sufficient return on investment. In this regard, the actual payments of dividends to the shareholder and/or the positive trend in the value of the shares are decisive criteria for treating the injection as an increase in equity. In addition, as shown in the decision tree (see section 2: "Treatment in national accounts"), the participation of private shareholders in the business is also a strong indicator for the recording as equity capital, especially if the shares are quoted on the stock exchange. However, the private investors' share of equity in the corporation should not be diluted by the government's new shares acquisition (which would reduce their participation to a level where they could not exercise influence). They must also bear similar risks and rewards to those borne by government notably as regards their rights on the net assets of the corporation in case of liquidation (case of issuance of shares with specific features).

    c. Providing loan capital (or possibly acquiring corporation's bonds): this is generally a financial transaction. In this case, there is no change to the net borrowing/net lending (B.9), no change to the net worth (B.10.1) (and no change to the own funds) of either government or the corporation. As a lender, government is expecting that the public corporation, as a borrower, will be in a position to repay the loans, according to a schedule agreed at inception.

Box 2

A sufficient rate of return

In order to test whether government acts similarly to a private investor/shareholder, so that the capital injection can be treated as an increase in equity (F.5), the expected return on investment is a crucial indicator. Such a return, in the form of dividends or holding gains, provides evidence that the legal financial instrument (e.g. the shares) given to its owners in exchange for the funds injected is a source of future economic benefits (meeting thus the basic definition of an asset in ESA95) and has a market value.

Such an expected "adequate rate of return" or "market rate of return" may be referred to, in government finance statistics, as a "sufficient rate of return" (see III.2.2.1).

Government has a very specific function in the economy. It is in charge of collective concerns and of dealing with externalities so to ensure, in the long run, the prosperity and well-being of the community (public health and education, public order and safety, public infrastructure, environment …) and therefore acts primarily as a non-market producer. Funds invested in this context are provided for public policy purposes, without any expectation of a direct financial return: in national accounts these invested funds are to be recorded as capital transfers (D.9).

However, government also interacts directly in the economy like other investors and shareholders, i.e. through public corporations, with the aim to make them as efficient and profitable as possible, in such a way that they can also be a source of revenue or other gains.

Capital invested by government always has an opportunity cost. Therefore, when government is investing with expectations of a return on investment, it would be appropriate to expect a similar return as for comparable investments by private actors, under ideal circumstances. This calls for using market rates of return as benchmarks. However, there could be reasons for government to target different required expected returns on investment. Capital markets may not function perfectly, and therefore market rates of return may not reflect the correct opportunity cost. Moreover, governments often invest in areas – or at an industrial stage - where no private actors operate, therefore making difficult benchmarking on private sector returns.

To define the appropriate minimum return required on an investment, there are several standard methods known in the theory of finance. These methods often use an opportunity cost approach, which takes into account the rates applicable to alternative investments or to the cost of financing (i.e. other opportunities). These methods investigate both the asset side (investment) and the liabilities side (financing) of the company in order to estimate the expected rate of return on the investment. One commonly used method is the Capital Asset Pricing Model (CAPM), which might be appropriate in some cases. This approaches the return from the asset side and implies estimating a risk adjusted rate of return. This involves calculating a required minimum expected rate of return on an investment as a function of the risk, where the return can be calculated by an equation with the risk-free interest rate, the average market return, and an indicator expressing the risk pertaining to the asset class in question being present.

In practice, the observable return in the past – when there is no indication of a change in future – may be used for determining an expectation of sufficient rate of return, notably in the absence of business plan analysis.

Taking into account the specificities of governments as an investor, the "sufficient rate of return" is used as a proxy for the expected market return as a fundamental benchmark for establishing the appropriate expectations of returns on government investments.

Therefore, considering the specificity of government, a "sufficient rate of return" expected on funds invested would have to be equal at least to:

- risk adjusted rates of return expected by private investors on similar equity investments in the same sector of activity; or

- long-term government bonds rates.

The rates being compared should be on the same basis, real or nominal.

Transfer payments by government or supranational authorities made to producers to cover losses, in the form of subsidies, other current transfers or capital transfer (rather than by outright purchases of products), should be excluded from the measure of the return on investment (i.e. these have to be taken into account, as negative discounted cash flows). These payments, together with all other payments to cover an overall deficit, should not be included in the measure of the capital invested. Some payments however, such as payments granted to any producer in this type of activity (where it is observed that there are both public and private recipients), including all payments linked to the volume or value of output, may be retained in the calculation of the rate of return.

Case where a business plan has been used: the initial classification of the injection transaction should not be revised due to later economic events changing the original outlook. However, evidence that the original business plan was incorrect or misinterpreted, observable from subsequently published annual accounts, updated business plans or audit office reports, should lead to a re-assessment of the original statistical classification and a subsequent data revision.

III.2.3.2 Characteristics of financial and non-financial transactions involved

III.2.3.2.1 Recording a financial transaction in equity

30. A capital injection should be recorded as a financial transaction only when the government receives in exchange a financial asset of equal value to the payment. This is a fundamental characteristic of financial transactions". A holding gain on shares and other equity, possibly recorded after the capital injection, is not a "financial asset received in exchange" (but an "other flow").

31. In the majority of cases, the financial instrument involved is shares and other equity (AF.5). A transaction in equity in this context is the action of "placing funds at the disposal of a corporation" (ESA95 4.53), increasing the equity capital. This is to be recorded in national accounts as a financial transaction, in shares and other equity (F.5). In accordance with ESA95 4.53 and 5.86, this transaction increases the property rights of shareholders of the corporation. The investment is made predominantly under market conditions and not only for public policy purposes.

32. In particular, it should be emphasised that, in providing equity capital to the corporation, the government acts as a shareholder under market conditions, normally with the expectation to receive dividends in return. The actual payment of dividends to the shareholder is an important criterion for treating the injection as equity.

33. Additionally, a capital injection that is made as part of a privatisation process within a short-term perspective (less than one year), such that government expects to get its money back, is to be recorded in F.5, within the limit of the amount of privatisation proceeds (consistently with ESA95 5.16). This case, as well as others described in this chapter, should be considered as exceptions to the rule that implies that recording a flow in the national accounts increasing the "shares and other equity" (F.5) of a quoted corporation should normally be related to actual issuance of new shares.

34. Two cases must be distinguished:

- Case of quoted shares: A capital injection that results in government acquiring quoted shares of equal value is a straightforward case. It has generally to be recorded as an acquisition of equity (F.5). The fact that the shares are quoted means that the shares may be traded on the market by private investors (as defined in ESA95 chapter 2) and therefore that the corporation is respecting some minimum market requirements in the long run.

- Case of unquoted equity: Where the capital injection is given to an unlisted public corporation, the capital injection should be recorded in F.5 only if government has

the objective of increasing its wealth, under the form of dividends or a higher value of the financial instrument received in counterpart (or at least equal to the amount injected, under an ongoing process of privatisation, to be achieved in a short-term perspective).

35. Normally, a condition is that the public corporation has not accumulated net losses as recorded according to generally accepted accounting standards or as measured in national accounts (e.g. net saving) or with evidence, for instance, being given by a negative trend in own funds. However, even in such cases, any part of the capital injection (in excess of the accumulated losses) used for investment in profitable areas of activities on which government will earn an adequate return on its investment may be recorded as financial transaction (typically in F.5).

36. A capital injection may also be recorded as a financial transaction in two specific cases:

- new corporations or quasi-corporations ("start-ups"): If government sets up a new market unit that is not the result of a restructuring of existing corporations, the treatment depends on a close examination of the project, using various indicators similar to investment analysis and taking account of other aspects relating to the transaction. As a result, the transaction may be treated as a financial transaction or as a non-financial one, according to the analysis, for its full amount. This applies also where an existing corporation is starting a completely new activity or is acquiring new kinds of assets for large amounts.

- bodies managing financial assets on behalf of government: a capital injection into a public holding company or a financial corporation managing assets in a profitable way on behalf of government, in order to acquire more financial assets, could be recorded as a transaction in F.5. The condition here would be that the assets are managed to maximise the return for government, and that higher dividends or higher equity value are expected.

III.2.3.2.2 Special cases: Transactions in other financial instruments

37. Not every provision of funds recorded as a financial transaction take the form of acquisition of equity (F.5): other possibilities are the making of a loan (F.4) or the purchase of bonds. (F.3)

38. Loans: a provision of funds in the form of a loan with evidence in a legal document specifying the borrower's obligations (redemption date of principal and interest to be paid) should generally be recorded as a transaction in F.4.

39. One exception is where government grants a loan to a loss-making public corporation, where it is very likely that the corporation would not be in a position to repay most of the loan because of recurrent losses and because there is no expectation of restoring profitability before the maturity date(s). In this case, the funds transferred to the corporation by government should be recorded as a non-financial transaction for their full amount, unless a reliable estimate of the losses would be available, allowing a partition of the loan. If it would be expected that the debtor would reimburse most (but not all) of the loan, this would be a case to partition the loan, the part corresponding to the expected losses being recorded as a capital transfer at the time the loan is made. The stock of loans to be entered in the balance sheet should be increased by the value of the recorded loan transaction. Any subsequent recognition by government of loans or parts of the loans which would not be re-paid should be treated in accordance with the guidance in Chapter VII.2.

40. Thus, in certain specific contexts (financial defeasance, business rescue, export insurance;...), the characteristics of "loans" provided by government (the contractual

obligations) should be examined closely to check whether it is correct to classify them in F.4.

41. Bonds: a provision of funds when the government purchases bonds issued by the corporation (evidence also to be given by some legal document) should be recorded as a transaction in F.3.

42. However, where the corporation has accumulated significant losses and the bonds are purchased almost exclusively by government, the acquisition by government should be considered as a non-financial transaction.

43. In addition, the case of a bond issuance by a corporation with a record of debt service default, such that the purchase of bonds by private investors could be achieved only with a full guarantee from government (with investors' opinion as evidence) should be closely examined. Recording as a transaction in F3 requires that, at the time of the transaction, the corporation is in all likelihood in a position to meet its obligations relating to the debt service (interest and principal) according to the contractual schedule of payments.

III.2.3.2.3 Recording a non-financial transaction

44. Excluding the cases of subsidies (D.3, see ESA95 4.30 and following) and of other current transfers (D.75, see in particular ESA95 4.139b), the non-financial transaction relevant for capital injections is a capital transfer.

45. The case of capital injections in kind (such as transfers of fixed assets) is dealt with in the following part of this chapter III.4, and only capital transfers in cash are considered here.

46. A capital injection should be treated as a non-financial transaction where the provision of funds is an unrequited transaction. The government does not receive in exchange a financial asset of an equal value, and any possible effect on the government's equity is indirect, sometimes not immediate, uncertain and of a different size. This sort of payment is recorded as a capital transfer (D.9). Two transactions in this category are defined in the ESA95 (see below a: D.92 and b: D.99).

47. An important feature of capital transfers is that, in general, they are typically government transactions, made for public policy purposes. Acting this way, the government expects nothing in return in terms of dividends (most of the time the enterprise receiving such transfers does not pay dividends), nothing else than an improvement of the corporation's wealth and the meeting of some social needs (public infrastructures, employment, etc.).

    a. Investment grants (D.92)

    A capital injection that "would consist of a capital transfer in cash or in kind made by government (…) to another resident (…) institutional unit to finance all or part of the costs of its acquiring of fixed assets" is to be recorded as an investment grant (D.92).

    b. Other capital transfers (D.99) for accumulated losses

    A capital injection made to cover accumulated losses (either on a repetitive pattern during several recent fiscal years, or irregularly but with profits not compensating losses), as recorded according to generally accepted accounting principles and, for instance, with evidence given by the trend of the corporation's own funds, is normally treated as a non-financial transaction for its full amount (as a capital transfer D.99), even if some pieces of paper (called "shares" or equivalent) are issued.

48. Similarly, capital injections made to compensate owners of capital goods destroyed by acts of war, other political events or natural disasters are also to be recorded as capital transfers (D.99).

Box 3

ESA Concepts

- **Own funds and equity capital**

ESA95 7.05 defines the own funds in the following way: "Own funds are the sum of net worth (B.90) and shares and other equity issued (AF.5)."

"Equity capital" is not defined as such in the SNA93 or in the ESA95. The notion of "equity capital" is only dealt with indirectly in the ESA95 through the definitions of the transaction categories "dividends" and "shares and other equity".

Corporations raise equity capital to strengthen their financial position on the market, by increasing their own funds. Expressed through the issuance of shares, the equity capital is therefore part of the own funds.

The immediate result of providing equity capital and increasing the own funds is that the corporation is in a better position to finance investment or refund existing debt, borrow additional debt if necessary (creditors are reassured by the financial solvency of the corporation), and finally to make and distribute profits. Shares and other equity (AF.5) in the balance sheet of a corporate enterprise are to be recorded - like most assets and liabilities in the national accounts - at market value (ESA95 7.01, 7.25 and 7.52).

- **Dividends (D.421)**

"*Dividends (D.421) are a form of property income received by owners of shares (AF.5) to which they become entitled as a result of placing funds at the disposal of corporations. Raising equity capital through the issue of shares is an alternative way of raising funds by borrowing. In contrast to loan capital, however, equity capital does not give rise to a liability that is fixed in monetary terms and it does not entitle the holders of shares of a corporation to a fixed or predetermined income.*" (ESA95 4.53)

- **Shares and other equity (F.5)**

"*The category shares and other equity (F.5) consists of all transactions in shares and other equity (AF.5) that is financial assets which represent property rights on corporations or quasi-corporations. These financial assets generally entitle the holders to a share in the profits of the corporations or quasi-corporations and to a share in their net assets in the event of liquidation.*" (ESA95 5.86)The transactions in shares and other equity – for instance, a capital injection providing equity capital to a corporation have thus a strong legal basis, these financial assets representing the property rights on the corporation.

A transaction in equity has usually three characteristics:

- Funds are placed at the disposal of a corporation, which has a large degree of freedom in the way it can use them.
- Shareholders are entitled to receive a return on their investment.
- New shares are issued (for an amount equal or related to the funds placed) in the case of corporations having the legal status of incorporated enterprises.

As a result, in national accounts, shares and other equity must be valued at a market value that reflects the expectations of return, in both the national accounts balance sheet of the holder and the issuer, whereas in the own balance sheet of the issuer they are usually accounted for at historic value (or book value). Where shares are listed on a market, their value is the observed price. Where equity does not consist of shares, or consists of shares that are not tradable on a market - as it is frequently

the case for a public corporation - a proxy market value must be implemented in national accounts (see ESA95 7.54 and following).

Capital transfers (D.9)

The notion of capital transfer is defined in SNA93 (chapter 10) and in ESA95 (chapter 4 principally). A capital transfer imparts a voluntary transfer of wealth between two units ("something for nothing"). Capital transfers have three main characteristics:

- They are *transactions*, made by mutual agreement between two units (unlike other changes of assets).
- There is *no counterpart being received in exchange*.
- They involve a commensurate *change in ownership of assets* (or cancellation of liabilities by a creditor) between the two parties, or acquisition or disposal of assets (SNA93 10.132).

The first two characteristics are common to all transfers (current and capital transfers). In addition, all transfers may be made in cash, or in kind (SNA93 10.131).

Another characteristic of capital transfers is that they tend to be large and infrequent (SNA93 10.132). Two types of capital transfer are then distinguished (SNA93 10.132 and ESA95 4.146):

Capital transfers in cash: these consist of transfers in cash involving changes in ownership of assets. The recipient is often obliged to use the cash to acquire assets as a condition of the transfer (e.g. investment grant) (ESA95 4.146).

Capital *transfers in kind*: cases of transfers of ownership of assets other than cash or of cancellation or assumption of debt without counterpart.

Capital transfers are generally government transactions: public policy purposes may lead government to make transfers without counterpart to corporations. A presumed effect of a capital transfer on the value of the equity (through the reaction of the market, for example) is not a sufficient reason for regarding the transaction as a financial one: again, the effect is not certain, as well as its size.

Therefore, unlike financial transactions, capital transfers are the counterpart flow of those “one-way” changes in assets or liabilities, which means that the recipient is made wealthier, when the other party is made poorer. This is expressed by an increase in net worth in the balance sheet of the first party, and a decrease in net worth in that of the other party.

III.3 Capital injections into public quasi-corporations

III.3.1 Background to the issue

1. One of the cornerstones of the ESA95 system is the concept of institutional units, and the grouping of those into institutional sectors. Since the aim of the system is to describe how economic agents interact in order to underpin economic analyses, the main qualifier for being recognised as institutional units lays in their capacity of exercising autonomous economic decision making in their principal function, rather than other considerations such as their legal status.

2. The concept of public quasi-corporations is intended to separate public entities from their government owners because they are engaged in market activities in such a way that they fulfil the criteria of being a market producer. In addition, even though they are unincorporated enterprises, they are sufficiently independent and they behave differently from their owners and similarly to corporations. In particular, they can be the owner of assets, take economic decisions, and enter into contracts and incur liabilities – ESA95 2.12. Public quasi-corporations must keep a complete set of accounts or it would be possible and meaningful, from both an economic and legal viewpoint, to compile a complete set of accounts if they were required; otherwise, it would not be feasible from an accounting point of view to distinguish them from their owners – ESA95 2.13f. In order to be said to keep a complete set of accounts, a unit must keep accounting records covering all its economic and financial transactions carried out during the accounting period, as well as a balance sheet of assets and liabilities.

3. Since public quasi-corporations are recognised in the system as institutional units and as market producers (i.e. charging economically significant prices), they should in principle be treated as any other corporation. However, for the recording applicable to quasi-corporations, there are some exceptions explicitly mentioned in ESA95 from the treatment of other public corporations. The aim of this chapter is to give a short but comprehensive guidance on when government injections or other transfers to their quasi-corporations should be recorded as financial or non-financial transactions.

III.3.2 Treatment in national accounts

4. The recording of government transfers to their own public quasi-corporations in national accounts should in general follow the same rules as for other public corporations (see chapter III.2), unless there are, in ESA95, explicit prescriptions for the contrary. The capital injection test, as defined in sub-section III.2.2, should be applied based on whether the quasi-corporations are making losses or profits.

5. The following operational guidance applies:

   For the completeness of the operational guidance below, all cases pertaining to public quasi-corporations are described, even if the treatment would be similar to corporations.

   I. When a public quasi-corporation is making profits and expecting to make sufficient profits in future, government transfers of a capital nature, such as for the purpose of acquiring assets or reducing liabilities, should be recorded as financial transactions, other equity F.513 – ESA95 4.61 and 5.95e, otherwise a capital transfer should generally be recorded.

II. When a public quasi-corporation is running a persistent operating deficit, regular government transfers should be recorded as non-financial transactions, subsidies D.3 – ESA95 4.61.

III. When a public quasi-corporation receives transfers from government to cover accumulated losses or exceptional losses beyond the control of the entity, these should be recorded as non-financial transactions, other capital transfers D.99 – ESA95 4.165b. However, any part of a capital injection in excess of accumulated losses, may be recorded as a financial transaction (F.513) when appropriately documented. Payments intended to cover future losses are also treated as other capital transfers D.99.

IV. When the government owner cancels financial claims against, or assumes liabilities from, a public quasi-corporation, this should lead to the recording of financial transactions, equity F.513 – ESA95 4.165f and 5.16, unless the operation is intended to cover accumulated losses or an exceptionally large loss, or is in the context of persistent losses or– ESA95 4.165b and 4.61 by recording a subsidy D.3 in the latter case, and otherwise by recording an other capital transfers D.99. In case of expected future losses, these are also treated as other capital transfers D.99.

V. When government transfers to public quasi-corporations take the form of investment grants, these are to be recorded as financial transactions, equity F.513 – ESA95 4.157 and 4.61, unless these payments are intended to cover accumulated losses or in the context of an exceptional large loss, in case of which they are recorded as other capital transfer D.99 – ESA95 4.165 b. This treatment also applies in case of future losses. Similarly, payments intended to cover persistent losses are recorded as D.3 – ESA95 4.61. Furthermore, in case of persistent losses, the capital transfer equals the positive net fixed capital formation of the public quasi-corporation since consumption of fixed capital is included in the calculation of the subsidy to the public quasi-corporation.

6. However, any part of a capital injection in excess of losses, accumulated or expected, may be recorded as a financial transaction (F.513) when appropriately documented.

7. This means that government inflows, in cash or in kind, into non-profitable public quasi-corporations should be recorded as non-financial transactions. Therefore, 4.165b prevails over 4.165 f, 5.16 and 4.61 in these cases. However, government inflows in excess of losses, accumulated or expected, may be recorded as financial transactions when appropriately documented.

III.3.3 Rationale of the treatment

8. The concept of public quasi-corporations is introduced into the system because their behaviour is different from their government owners and similar to corporations; they are therefore recognised in the system as institutional units and market producers. Thus, one in national accounts aims at reflecting the economic nature of the transactions between quasi-corporations and their government owners. Due to their similar behaviour, it is appropriate to bring the treatment of public quasi-corporations as close as possible to the treatment of other public corporations.

9. In order for a public quasi-corporation to be recognised in national accounts, government must allow the management of the entity considerable discretion with respect to the management of the production process and the use of own funds as defined in ESA95 7.05; for the decision making autonomy criteria to be fulfilled - ESA95 2.12. Public quasi-corporations must be able to maintain their own working balances and business credit and be able to finance some or all of their capital formation out of their own savings, depreciation reserves or borrowing. The ability to

distinguish flows of income and capital between quasi-corporations and government implies that their operating and financing activities can be fully distinguished in finance statistics from government revenue in practice, despite the fact that they are not separate legal entities. The net operating surplus of a public quasi-corporation is not a component of government revenue, and the accounts for government record only the flows of income and capital between the quasi-corporation and government. If the entities cannot be separated in these respects from their government owners, the entities cannot be treated as quasi-corporations.

10. The zero net worth convention for quasi-corporations (equity is valued at the own funds of the entity, i.e. its net assets in ESA95) stated in ESA95 7.03 has sometimes been emphasised as a conceptual rationale for determining the recording of transactions between governments and their quasi-corporations (as transactions in equity). However, the fact that quasi-corporations' net worth is zero in practice does not by itself justify treating transactions as financial rather than non-financial. This is because capital injections are generally net worth neutral for beneficiaries, as the valuation of their equity liability generally increases by the amount received. For example, the equity of unquoted public corporations may routinely be valued as the net assets, but this would not preclude applying the capital injection test. In these cases, recording capital injections as non-financial transactions only entails an entry in the revaluation account. The recording of transactions between governments and their quasi-corporations should reflect the economic nature of the transaction, irrespective of the valuation method used for equity.

11. When government payments to public corporations and public quasi-corporations are intended to cover losses, accumulated or foreseeable, these should be treated as capital transfers in accordance to ESA95 4.165b as further elaborated in chapter III.2 of this Manual. When regular government transfers are conducted in favour of public quasi-corporations running persistent operating deficits, subsidies should be recorded D.3 in accordance to ESA95 4.61, 4.35c.

12. When governments conduct debt cancellations or debt assumptions benefiting their quasi-corporations, the transactions are by convention recorded as financial transactions, by exception to the general recording applicable to corporations (capital transfer), according to ESA95 4.165f, unless this is to cover losses, in which case ESA95 4.165b prevails. ESA95 4.165b is applicable to debt cancellations/ assumptions as well as to cash transfers because means to recapitalise entities, in cash or in the form of other financial assets/liabilities, should generally not change the accounting recording of the transaction in question.

13. In the case of transfers in the form of investment grants, these are recorded as capital transfers (D.92) when granted to public enterprises recognised as independent legal entities- ESA95 4.157. This paragraph (together with ESA95 4.61) has been interpreted to prevent recording investment grants (D.92 – ESA95 4.152) to quasi-corporations, as by definition quasi-corporations are not independent legal entities. Assuming that government payments into quasi-corporations cannot be recorded as investment grants (D.92), as per ESA95 4.157 and 4.61 the following rules apply: government payments into loss-making quasi-corporations should be recorded as either subsidies (D.3) or other capital transfers (D.99) – ESA95 4.165b, 4.61; and government payments into profit-making quasi-corporations should be recorded as acquisitions of equity (F.5).

III.3.4 Accounting examples

Example 1

A government carries out an injection in cash of 100, in period 2, to a loss making quasi-corporation (that had losses of 50 in period 1 and 2).

Period 1

General government				Quasi-corporation			
Opening balance sheet							
A			L	A			L
AF.2	200			AN.1	1000	AF.4	100
AF.5	1000	B.90	1200	AF.2	100	AF.5	1000
						B.90	0
Production and capital account							
U+ΔA			R+ΔL	U+ΔA			R+ΔL
		D.9	0	D.1	100	P1	200
				P.2	150	D.9	0
B.9	0			B.9	-50		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	0			F.2	-50		
F.5	0						
		B.9	0			B.9	-50
Revaluation accounts (K.11)							
ΔA			ΔL	ΔA			ΔL
F.5	-50					F.5	-50
		B.10.3	-50			B.10.3	+50
Closing balance sheet							
A			L	A			L
AF.2	200			AN.1	1000	AF.4	100
AF.5	950	B.90	1150	AF.2	50	AF.5	950
						B.90	0

Period 2

General government				Quasi-corporation			
Opening balance sheet							
A			L	A			L
AF.2	200			AN.1	1000	AF.4	100
AF.5	950	B.90	1150	AF.2	50	AF.5	950
						B.90	0
Production and capital account							
U+ΔA			R+ΔL	U+ΔA			R+ΔL
		D.9	-100	D.1	100	P1	200
				P.2	150	D.9	100
B.9	-100			B.9	+50		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	- 100			F.2	+50		
F.5	0						
		B.9	-100			B.9	+50
Revaluation accounts (K.11)							
ΔA			ΔL	ΔA			ΔL
F.5	+50					F.5	+50
		B.10.3	+50			B.10.3	-50
Closing balance sheet							
A			L	A			L
AF.2	100			AN.1	1000	AF.4	100
AF.5	1000	B.90	1100	AF.2	100	AF.5	1000
						B.90	0

Example 2

A government carries out an injection in cash of 100, in period 2, to a profit making quasi-corporation (that had profits of 20 in period 1 and 2).

Period 1

General government				Quasi-corporation			
Opening balance sheet							
A			L	A			L
AF.2	200			AN.1	1000	AF.4	100
AF.5	1000	B.90	1200	AF.2	100	AF.5	1000
						B.90	0
Production and capital account							
U+ΔA			R+ΔL	U+ΔA			R+ΔL
		D.9	0	D.1	100	P1	200
				P.2	80	D.9	0
B.9	0			B.9	20		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	0			F.2	20		
F.5	0						
		B.9	0			B.9	+20
Revaluation accounts (K.11)							
ΔA			ΔL	ΔA			ΔL
F.5	20					F.5	20
		B.10.3	20			B.10.3	-20
Closing balance sheet							
A			L	A			L
AF.2	200			AN.1	1000	AF.4	100
AF.5	1020	B.90	1220	AF.2	120	AF.5	1020
						B.90	0

Period 2

General government				Quasi-corporation			

Opening balance sheet

A			L	A			L
AF.2	200			AN.1	1000	AF.4	100
AF.5	1020	B.90	1220	AF.2	120	AF.5	1020
						B.90	0

Production and capital account

U+ΔA			R+ΔL	U+ΔA			R+ΔL
		D.9	0	D.1	100	P1	200
				P.2	80	D.9	0
B.9	0			B.9	20		

Financial account

ΔA			ΔL	ΔA			ΔL
F.2	-100			F.2	120		
F.5	100					F.5	100
		B.9	0			B.9	+20

Revaluation accounts (K.11)

ΔA			ΔL	ΔA			ΔL
F.5	+20					F.5	+20
		B.10.3	+20			B.10.3	-20

Closing balance sheet

A			L	A			L
AF.2	100			AN.1	1000	AF.4	100
AF.5	1140	B.90	1240	AF.2	240	AF.5	1140
						B.90	0

III.4 Capital injections in kind

III.4.1 Background to the issue

1. Sometimes governments transfer fixed assets (such as buildings), and/or non-produced non-financial assets (such as land), to a public corporation that already exists or has been created for that purpose of holding such assets. The capital injection does not take the usual form of a flow of financial assets, but instead a flow of non-financial assets. This is done to allow the enterprise to use these assets in the production process, usually because the enterprise might be in a better position than the government to operate this economic activity.
2. In some cases, the government expects to receive some direct benefits from the transfer of the asset, in the form of property income streams (dividends, for instance). In other cases, the government is satisfied that there are sufficient economic and social benefits for the nation as a whole to justify the government's loss of an asset. In some countries, such transfers of assets take the form of "public utility concessions" when, for example, there is private management of public infrastructure under a time-limited contract.
3. As a result, the rules to be followed may also apply to transactions with private corporations.

III.4.2 Treatment in national accounts

Two solutions are relevant:

III.4.2.1 A straightforward transfer

4. A straightforward transfer of a non-financial asset, with no other rights or obligations being established, nor new units being created, is a gift made by government to the corporation, and is to be recorded as a non-financial transaction.
5. In this context, the transfer of the non-financial assets is an investment grant in kind (D.92) made by the government, counterbalanced by a decrease in capital formation, P.5 (and/or K.2, if any land is involved).
6. The result of recording two flows of an equal amount in the capital account is that there is no impact on net borrowing/net lending.
7. There is an increase in the corporation's net worth due to the capital transfer (investment grant), and symmetrically a decrease in the government's net worth. Depending on the method used in national accounts to value the government's equity in the corporation, it might be necessary to assume that the equity of general government in the public enterprise absorbs the increase in net worth of the latter. If so, the transformation in the enterprise's account of the positive net worth (B.10.1) into equity capital (F.5) may be described via a holding gain (K.11) in the revaluation account.

III.4.2.2 Expectation of higher return

8. Governments sometimes transfer non-financial assets to a public corporation in the expectation of receiving a higher economic return than by directly exploiting the asset itself. Often the transfer is part of a package of events that changes some aspect of the

relationship between government and the corporation (perhaps through new obligations, rights and claims) or creates new units.

9. This situation can be regarded as the exchange of a non-financial asset for a financial one (government's equity in the public corporation). No transactions need to be recorded. Instead the other change in the volume of assets accounts, in particular K.12.1 "change in sector classification and structure", should be used to explain the changes in the balance sheets.

10. In this case, as in the previous one, there is no impact on the net borrowing/net lending. There is no impact on net worth either, since two flows of an equal amount are recorded which balance in the other changes in assets account.

III.4.3 Rationale of the treatment

III.4.3.1 For treatment as investment grant

11. **ESA95 1.36:** The system records all transactions in monetary terms. The values to be recorded for non-monetary transactions must therefore be measured indirectly or otherwise estimated.

12. **ESA95 4.145:** Capital transfers are different from current transfers by the fact that they involve the acquisition or disposal of an asset, or assets, by at least one of the parties to the transaction. Whether made in cash or in kind, they should result in a commensurate change in the financial, or non-financial, assets shown in the balance sheets of one or both parties to the transaction.

13. **ESA95 4.146:**" A capital transfer in kind consists of the transfer of ownership of an asset (other than inventories and cash), or the cancellation of a liability by a creditor, without any counterpart being received in return."

14. **ESA95 4.153:** "Investment grants can be made in cash or in kind. Investment grants in kind consist of transfers of transport equipment, machinery and other equipment by governments to other resident or non-resident units and also the direct provision of buildings or other structures for resident or non-resident units."

15. The paragraphs above show that recording the gift of a fixed asset as a capital transfer in kind is valid within ESA95 (another way to view it, equivalent in terms of accounting impact, would consist in considering the capital transfer as an imputed flow of funds, then used by the corporation to buy the asset from government).

III.4.3.2 For treatment in other flow accounts

16. Restructuring of assets and liabilities via a significant transfer of assets may be considered as different from *transactions* in the usual meaning of this word, and, in any case, different from a simple grant of an asset.

17. **SNA93 12.58 and 12.59:** "When a corporation is legally split up into two or more institutional units, new claims and liabilities, including shares and other equity, may appear between the new institutional units. The appearance of these financial instruments is recorded in this category (change in sector classification and structure)."

18. **ESA95 6.30:** Changes in classification and structure (K.12.1): "Changes in structure of institutional units cover appearance and disappearance of certain financial assets and liabilities arising from corporate restructuring."

19. It is supposed that K.12.1 can also apply to non-financial assets. "Changes in structure" is assumed to include significant changes in the balance sheet of unit when they coincide with other changes such as the functions of the unit.

III.4.3.3 Comment on recording the event as an injection of other equity in F.5.

20. To record an injection of other equity through the financial account is not appropriate. The use of F.513 (other equity = equity not evidenced by shares) in the ESA95 is restricted to a limited number of well-defined cases. Such treatment would artificially improve the net lending/borrowing of government (through the counterpart transaction in P.5 or K.2).

21. Moreover, even if it would not be incorrect from a pure accounting point of view, this would have no economic content. In fact, when a unit has a net borrowing, this means that it needs financing which may imply a reduction of its assets, or which usually is not immediately available. In the present situation, the appearance of other equity has a kind of automaticity that is more appropriately recorded in the other changes in the volume of assets accounts.

III.4.4 Accounting examples

In the following example, it is assumed that government gives a building worth 100 to a public corporation. In the first case it is a pure gift; there are no associated events nor does the government expect increased property income arising from the transfer of the asset. In the second case the transfer of the asset is part of a reorganisation of the delivery of some services involving the corporation.

a. Recording a capital transfer and capital formation

In the following example, the capital transfer is assumed to result, in the first instance, in an increase of the public enterprise net worth. Subsequently, it would be possible to assume that this increase in net worth is "absorbed" by an equivalent increase in the equity of government in the public enterprise, via the revaluation account: this second step is not described here. Moreover, in the closing balance sheet, only the change in net worth is shown.

General government				Public enterprise			
Opening balance sheet							
A			L	A			L
AN.11	100						
Capital account							
ΔA			ΔL	ΔA			ΔL
P.51	-100	D.92	-100	P.51	+100	D.92	+100
B.9	0	B.10.1	-100	B.9	0	B.10.1	+100
Closing balance sheet							
A			L	A			L
AN.11	0			AN.11	100		
		ΔB.90	-100			ΔB.90	+100

b. Recording a change in classification and structure

General government				Public enterprise			
Opening balance sheet							
A			L	A			L
AN.11	100						
Other changes in the volume of assets account							
ΔA			ΔL	ΔA			ΔL
AF.5 (K.12.1)	+100			AN.11(K.12.1)	+100	AF.5 (K.12.1)	+100
AN.11 (K.12.1)	-100						
		B.10.2	0			B.10.2	0
Closing balance sheet							
A			L	A			L
AF.5	100			AN.11	100	AF.5	100
AN.11	0						
		ΔB.90	0			ΔB.90	0

III.5 Dividends, super dividends, interim dividends

III.5.1 Background to the issue

1. Payments made by public corporations to governments as shareholders are usually called "dividends" with reference to commercial law and business accounting. In most cases, these payments are also recorded as property income (dividends, D.42) in the ESA framework. The question addressed in this chapter is if there are payments made by public corporations to governments which, though they might qualify as dividends with reference to business accounting, require a different treatment in the ESA framework, for macro-economic statistics purposes, i.e. whether they need to be recorded differently from property income.
2. Two elements may notably challenge the nature of the transaction and therefore the ESA classification of the payment: the size of the payment, in relation with the accrued profit of the corporation, and the timing of the payment, and sometimes a combination of the two.
3. Dividends are paid and recorded in a corporation's accounts when decided by the owners of the corporation (often in a general assembly), usually based on the observed profit of an accounting year. This decision is commonly made in the year after the accounting year of the realised profit. However it is not uncommon, notably for large corporations preparing quarterly accounts, that interim dividends are paid during the accounting year, before the final yearly earnings are known. In commercial company accounting, this is a commonly and widely accepted practice. Some public corporations (including central banks) in the EU have a similar practice. ESA95 does not explicitly address the case of interim dividends.
4. Another issue is the size of the payment. According to the definition of income in national accounts (see above 2.1.1 "Overview of principles"), a large payment may not result from the profit of the year realised by the corporation, but from a withdrawal from its own funds. Payments made to the government, whether made to the government after the annual profit of the corporation is known, or before (interim payments), must be closely analysed for the relevant recording of transactions in national accounts.

III.5.2 Treatment in national accounts

III.5.2.1 Dividends and super-dividends: definitions

5. Dividends: ESA95 4.53: "Dividends (D.421) are a form of property income received by owners of shares to which they become entitled as a result of placing funds at the disposal of corporations."
6. In the ESA framework, the following principles are established:
   - The resource available for distribution by a unit (a corporation) as dividends (…) is the entrepreneurial income (B.4) of the unit.
   - Following this logic, the resources from which dividends have to be paid should neither include the proceeds of sales of assets nor the revaluation gains. (…) In order to preserve the net wealth of the enterprise, revaluation proceeds, as well as assets sales' proceeds, are not distributable income.
   - A large payment out of reserves, reducing the own funds of a corporation, is not a distribution of income. Such a payment is in substance a capital withdrawal, to be recorded as a transaction in shares and other equity.

7. Corporations may smooth the amounts of dividends they pay from year to year. In one year they may put part of the profit into a reserve and distribute it in the following year, for the purpose of dividend smoothing. Whilst it is conceptually acceptable within the national accounts framework to record some smoothed payments as dividends, since they are the distribution of entrepreneurial income, the case of large payments made from reserves accumulated from more than one year earlier is considered in substance to be a withdrawal of capital, to be recorded in national accounts as a financial transaction in shares and other equity.

8. Super-dividends: they are different in nature from dividends, as they are paid out of accumulated reserves, accounted for in the own funds of the corporation. Any withdrawal from own funds is to be recorded as a withdrawal of equity (F.5), at least for the amount in excess of the entrepreneurial income of the accounting year.

9. The "super-dividend test" must be applied to all payments that appear to be sizable and potentially out of proportion to the usual rate of return of the corporation. Only the part of the payment equivalent to the entrepreneurial income can be recorded as property income. Any amount in excess to the entrepreneurial income of the corporation is to be recorded as a transaction in equity (F.5). In practice, the operating profit of the corporation can be used as a proxy for entrepreneurial income as unit-level national accounts data on corporations is usually not available. This recommendation applies to all corporations, including the central bank.

III.5.2.2 Time of recording

10. The present guidance in the ESA95 is the following:

- For dividends (D.421), paragraph 4.55: "Time of recording: Dividends are recorded at the time they are due to be paid as determined by the corporation."
- For withdrawal from the income of quasi-corporations (D.422), paragraph 4.62: "Time of recording: Withdrawals from the income of quasi-corporations are recorded when they are made by the owners."

11. Thus, the time of recording dividends is the time when it is due to be paid, as determined by the corporation. For final dividends, this usually means the date approved by the general assembly of shareholders for this distribution to take place. In the special and rare case of withdrawals from income from quasi-corporations, the time of recording is when the cash is withdrawn.

III.5.2.3 The case of interim dividends

12. An "interim dividend" refers to the case where the corporation makes a payment to the shareholder during the accounting year, before the final annual result of the corporation is known.

13. General principle: as a consequence of the definition of dividends – as income - and of super-dividends – as capital withdrawals - interim payments made to the government by public corporations, including the central bank, cannot be deemed to be always treated in national accounts as property income at the time the payment is due and need to be examined on a case by case basis.

14. Under certain conditions an interim dividend payment can be recorded as property income (D.42) in national accounts provided that the amount of dividend paid is based on hard evidence from the corporation's intra-annual accounts that it is making sufficient profits to be able to fund the dividend from its expected income for the whole year. In practice, this implies that, in addition to the final dividend payment made in the following year, only one interim dividend, decided in the second half of the accounting year, can be recorded as property income.

15. If this condition is not met, the interim payment is to be recorded as a financial advance (for government, another account payable, F.7). The whole dividend would then be recorded as property income (D.42) in national accounts – being subject to the "super-dividend test" - only when the final dividend is decided as due to be paid, which is after the annual results of the corporation are known with certainty (in the following year)

III.5.2.4 Rules to record and partition the transaction

Interim dividends

16. In order to decide how to partition an interim dividend between the dividend and financial components, the amount distributed is compared to the entrepreneurial income for the period from the start of the accounting year to when it was declared. If the entrepreneurial income is higher than the amount distributed, the entire amount is recorded as a dividend. Any excess of the distribution over the entrepreneurial income is recorded as another account payable of government, awaiting the final annual result. This flow at the final assessment will be converted either as dividend, or as withdrawal of equity in case of super-dividend.

Final dividends and super-dividends

17. The general approach for partitioning a final dividend or super-dividend between dividend and financial components is to compare to the entrepreneurial income for the relevant period less any amounts recorded as dividends relating to interim dividends paid since the last annual dividend was paid.

18. If the entrepreneurial income is higher than the amount distributed, the entire amount is recorded as a dividend. Any excess of the distribution over the associated entrepreneurial income is recorded as withdrawal of equity.

19. As a final dividend usually relates to income earned in the corporation's accounting year prior to when the payment is made, this is the relevant period for the entrepreneurial income.

III.5.3 Rationale of the treatment

20. The rationale of the recording of distributions as dividends is that they must derive from the entrepreneurial income of the corporation, accruing in the period to which the dividend relates. In such a case, there is a close link between the dividend payment and the accrued income of the corporation.

21. The rationale for recording super-dividends as financial transactions is to consider that super-dividends are different in nature from dividends: whilst dividends correspond to a distribution of income, super-dividends correspond to a distribution of the corporation's wealth, reducing the own funds of the corporation. In the case of large payments out of accumulated reserves, there is no link with the accrued income of the corporation during the relevant accounting year. Only the entrepreneurial income can be distributed as property income (D.42) in national accounts.

22. The rationale behind the possibility to record an interim dividend as property income is that, under certain conditions, based on a few criteria (the profitability and the trend in growth of the corporation, and the appropriate transparency and timing of the payment), the interim payment may be considered as a transfer of accrued income. In this case, the recording of a property income, before the annual results are known, does not contradict the basic statistical and accounting rules.

23. When the criteria and conditions to record a dividend at the time of interim payment are not met, this payment is recorded as a financial advance, with reference to 5.128 in the ESA: other accounts receivable / payable, excluding trade credits and advances,

(F.79) are "financial claims that arise from timing differences between distributive transactions (…) and the corresponding payment." Dividends are an example provided in 5.129. The rationale to record a financial advance is that, before knowing with certainty the annual result and the distributable profit, there is a risk that the payment may turn out to be higher than the distributable profit, thus including an element of super-dividend.

III.6 Payments to government from transfer of pension obligations

III.6.1 Background to the issue

1. This concerns lump sum payments to government in the context of the transfer of pension obligations.

III.6.1.1 Employers' pension schemes

2. In several Member States, corporations, including public corporations, may set up specific pension schemes for their own staff which they manage directly. They are referred to as "non-autonomous employers' pension schemes" in ESA95. These corporate pension schemes are not treated in national accounts as social security schemes, i.e. the flows of contributions (or injections of funds by employers) and pension benefits are not part of government revenue or expenditure (except if government organises such a scheme for its own employees). Therefore the flows are allocated to the sector in which the employer organising the scheme is classified. See ESA95 4.88 b and c. (unfunded schemes set up by employers for their employees).
3. In this context, employers may set up unfunded or funded schemes. The main difference is whether "segregated reserves" exist.
4. A non-autonomous *funded* pension scheme organised by an employer for its own staff is funded in the case where the employer builds up a segregated reserve – because of legal obligations, specific regulations, contractual clauses, accounting standards or only on a voluntary basis - for the explicit and exclusive purpose of paying pensions to their employees, ex-employees or their dependants. Consequently, the book value of this reserve as reported in the employer's balance sheet is likely to represent a predominant part of the actuarial value of the pension obligations.
5. This reserve ensures a strong protection of the pension rights of the beneficiaries, notably in the case of bankruptcy of the employer, or in the case of mergers. The reserve is invested in assets that are identifiable in the balance sheet of the corporation.
6. In ESA95, this obligation is recorded as AF.612 ("Net equity of households in pension funds reserves"). Depending on the nature of the fund, the liability is valued differently in national accounts. If it is a defined-benefit funded scheme, it is the present value of the promised pension benefits. If it is a defined-contribution funded scheme (named "money purchase schemes" in ESA95), it is the market value of the corresponding assets invested on markets. For public corporations the first case is the most frequent. In the balance sheet of the corporation, generally the reserve is recorded at book value. Note that if, at a point in time, the book value of the segregated reserve is not a predominant part of the actuarial value of the pension obligations, the scheme is still considered as funded if it is obvious that the firm is acting in order to reach such a target in the medium term.
7. By contrast, in a non-autonomous *unfunded* pension scheme, employers make only the commitment to ensure the payment of a defined level of pension benefits. The pension rights of the employees, that are normally legally recognised, are based in this case on the commitment made by the firm and its capacity to face the payment obligations at the time they are due.

III.6.1.2 Transfer of employers' pension obligations to government

8. The case of transfer to government of a funded scheme that will remain funded after the transfer is not treated here. In this case, the rules stated in part 1 of this Manual (see I.3) as regards the classification of funded pension schemes would strictly apply.

9. For various reasons, government, as owner of the public corporations, may intend to "clean" their balance sheets, for instance with a view to privatising these corporations, as investors would be reluctant to purchase the corporation encumbered by these obligations.

10. As a result of the transfer of the pension obligations to government, the employer's pension scheme is suppressed and the pension obligations are transferred to the government into the general social security scheme or into an unfunded scheme for government employees (where the employees have a status similar to civil servants). The new scheme is unfunded (referred to as "Pay As You Go system"). In the case of a previously funded scheme, the transfer involves a change in the organisation of the pension scheme.

11. Note that various arrangements might be observed in the context of this transfer of pension obligations. Government could take responsibility for the payment of all the future pensions to existing employees of the corporation or only to a certain group of those employees. It could also take responsibility for only part of the future pensions. Government could pay additional amounts to pensioners in order to guarantee them a level of pensions on the basis of a current arrangement more advantageous than the new scheme they join.

12. The common point is that, as counterpart to the future commitments taken by government, government receives a "lump sum" that is assumed to cover the future burden of the pensions that will be paid by government. This "lump sum" is an amount determined at the time of transfer of obligations, which may however be paid in several or many instalments over time.

13. This amount paid to government is often an actuarial estimate of the present value of the future related government disbursements, which will commonly be reflected in the accounts of the public corporation where they are prepared in line with international standards. However it is possible that the lump sum is higher or lower than the present value of future pension payments, which would then need to be further analysed.

III.6.1.3 The key issue in national accounts

14. In general economic terms, the transaction between the public corporation and general government can be considered as a transfer of a liability in the sense of "future and certain obligations", with, as counterpart, a transfer of cash (or other financial assets). On an economic basis, the "real" net worth of both agents has not changed because of the transaction. The increase in cash of general government is compensated in economic terms by the increase in its liabilities towards the future retired employees. In parallel, the decrease in assets (cash or other financial assets) held by the public corporations is compensated by the decrease in its liabilities towards the same future retired employees. However, ESA95 does not record obligations for unfunded pension schemes as assets of households nor as liabilities of government. This often makes it difficult for national accountants to determine how to record the lump sum payments and the future payments of pensions after the transfer of responsibility from the public corporations to government as there is no specific liability in national accounts in the balance sheet of government, even when this liability was previously recorded in the balance sheet of the corporation.

15. This chapter explains the treatment that has been considered as relevant in the current national accounts framework.

III.6.2 Treatment in national accounts

16. Payments received by a government from a public corporation in the context of the transfer of obligations under either unfunded or funded pension schemes that the corporation operates for its own employees, into an unfunded scheme operated by government, are treated as unrequited transactions, classified as capital transfers (codified D.99 in ESA95), recorded as government revenue and therefore have a positive impact on government surplus or deficit (EDP B.9). The pension obligations taken over by government are not recorded in the form of an ESA95 liability.

17. However, this improvement in the government surplus or deficit will be offset in the future by the effective payment of pension benefits, recorded as government expenditure, to the beneficiaries of the scheme previously managed by the public corporation. Therefore, normally, the transfer of pension obligations is globally neutral for general government surplus / deficit (or very close to neutrality) over time.

18. In general the transaction value is equal to the actuarial value of the pension obligations taken on by government. However it is possible that the payment received is significantly different from the actuarial value. Two cases can be analysed:

    - The payment may be significantly greater than the actuarial value. In this case the excess of the payment over the pension obligations should be treated as a withdrawal of equity (coded as F5 in national accounts) by government from the public corporation.
    - The payment may be significantly less than the actuarial value. In this case the payment is recorded in its entirety as a capital transfer received by government.

19. As regards the time of recording, the capital transfer, and therefore the impact on government surplus or deficit, is recorded when government becomes legally responsible for the payment of the future pension benefits to the employees previously covered by their employer scheme. It is recorded for the amount agreed as payment from the corporation to government, unless the payment exceeds the actuarial value of the pension obligations.

20. However, the arrangement between the corporation and government might foresee a set of payments after the legal transfer and not a single payment. Where the payments are spread over many years in the future, as capital transfers they should be recorded when they are due to be paid in future years. However in the case where the payments are spread over 2 or 3 years (even if pension payments may extend over many years), it would be more appropriate to record the total in national accounts as a single payment when government becomes legally responsible for future pensions, with the part to be paid in future years treated as a transaction in financial instrument AF.7 (accounts receivable of government).

21. In some cases, the arrangement could foresee a transfer of pension obligations in several steps, covering each time a proportion of the employees. For each transfer, the corresponding agreed payment should be considered and any timing difference with the effective payment would be recorded as a financial transaction.

III.6.3 Rationale of the treatment

22. The treatment is based on the fact that ESA95, like SNA93, currently does not recognise a liability, in the sense of a financial instrument, for the obligations relating to pensions in the context of an unfunded scheme.

23. Under these conditions, it has not been considered possible that government incurs a liability as counterpart of the amount paid by the public corporation and representing the present value of these obligations, which should therefore be recorded as a

financial transaction without an impact on government deficit/surplus. From a general point of view, while the existence of new future commitments taken by government in exchange for the cash paid by the firm is acknowledged, the conditions in the ESA95 for the recognition of unfunded pension-related liabilities are not met. It may also be noted that some transactions recorded as transfers in national accounts may imply specific obligations for the receiver. For instance, an investment grant is generally paid only under the condition that the cash is used for acquiring certain capital goods. It is notably the case for grants from EU Structural Funds.

24. The payment is recorded as a capital transfer (D9) on the basis of the one-off occurrence (as evidenced by the list given in ESA95 for "other capital transfers" in 4.165) and the high value of the transaction.

25. The above treatment was developed under the expectation that the payment would be identical to, or very close in size to, the actuarial value of the pensions to be paid in future years. However it may be that the payment is in fact significantly different from the actuarial value. Where the payment is greater than the actuarial value, the excess is treated as a withdrawal of equity by the government. In the case where the payment is lower than the actuarial value, no further transactions are recorded. This is equivalent to a “net” recording, since the underlying flows could be shown gross (with matching capital transfers in each direction between the government and corporation), however for pragmatic reasons of simplicity a net recording is preferred.

26. This payment could not be treated as an exceptional social contribution paid on behalf of the employees. This may be observed on an individual basis only where some employees voluntarily move from one employer to another, which involves the renunciation of a social insurance scheme and implies the transfer of past contributions to the new scheme in order to reconstitute new rights. But in the case under review, the transfer does not result from an individual decision. In addition, this would have the effect of artificially increasing the fiscal burden during the fiscal year in which the transaction takes place.

27. In the specific case of a funded scheme organised previously by the employer, there is no transfer of a liability to government. Actually, again because ESA95 does not recognise liabilities for future pensions in the case of an unfunded scheme, at the time the pension obligations are transferred to the government, the liability AF.612 disappears as the scheme is effectively transformed into an unfunded scheme, without any change in the rights acquired by the participants. This is an unquestionable feature of the new pension for the corporation’s employees, unless government allocates the assets received from the corporation into a segregated reserve with the explicit and exclusive aim of ensuring the majority of the future pension benefit payments. As already stressed, government usually merges these specific obligations into the general social security obligations (or the scheme organised for civil servants in some cases) such that it becomes fully inappropriate to continue recording the specific liability of the corporation towards its employees in the national accounts.

28. Under these conditions, there is no transfer of a liability corresponding to the obligations previously borne by the corporation and the disappearance of the liability AF.6 must be recorded in the account of the corporation at the time of the transfer.

29. The disappearance of this liability is recorded as an “other change of volume of assets” (K.10) in both accounts of households and of the corporation. Under these conditions, the pension obligations no longer take the form of a financial instrument at the time of the transfer of the scheme to the government and, therefore, the transfer of the financial assets from the corporation to the government is recorded as an unrequited transaction, i.e. a capital transfer improving government deficit/surplus as there is an increase in government revenue (capital transfer received).

30. According to the ESA95 treatment of the time of recording of capital transfers, a transfer payment made over many years should be recorded in the periods when the payments are due to be made. However, where a transfer payment is spread over only a few years, and therefore gives the impression that it has been artificially split for financing reasons, the entire transfer payment should be recorded when the government takes responsibility for future pension payments.

III.6.4 Accounting examples

III.6.4.1 Initial unfunded pension scheme

A public corporation transfers to the government its obligations related to pensions for its staff that the corporation has organised on its own in the form of an unfunded pension scheme. Government accepts to pay future pensions and in exchange receives a cash payment of 1000. In a future given year (t+*), pensions paid to retired staff from the public corporation amount to 50.

Year t

General government				Public corporation (NFC)			
Capital account							
ΔA			ΔL	ΔA			ΔL
		D.9	+1000			D.9	-1000
B.9	+1000			B.9	-1000		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	+1000			F.2	-1000		
		B.9	+1000			B.9	-1000

Year t+* (adaptable to any year other than t)

General government				Households			
Current/Capital account							
U/ΔA			R/ ΔL	U/ΔA			R/ ΔL
D.621	50					D.621	50
B.9	-50			B.9	+50		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	-50			F.2	+50		
		B.9	-50			B.9	+50

III.6.4.2 Initial funded pension scheme

The conditions of the transfer are similar but the scheme was organised in the form of a funded pension scheme. The government accounts are similar to the case of an unfunded scheme. Accounts of the corporation are different for year t while the accounts of households are now affected.

Year t

General government				Public corporation			
Opening balance sheet							
A			L	A			L
				Assets	1000		
						AF.612	1000
Capital account							
ΔA			ΔL	ΔA			ΔL
		D.9	+1000			D.9	-1000
B.9	+1000			B.9	-1000		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	+1000			F.2	–1000		
		B.9	+1000			B.9	-1000
Other change in volume							
ΔA			ΔL	ΔA			ΔL
						AF.612	-1000
						B.10.2.	+1000
Closing balance sheet							
A			L	A			L
F.2	1000			F.2			

Households					

Opening balance sheet

A			L		
AF.612	1000				

Other Change in volume

ΔA			ΔL		
AF.612	-1000	B.10.2	-1000		

Closing balance sheet

A			L		

III.6.4.3 Initial unfunded pension scheme where lump sum payment is greater than value of pension obligations

A public corporation transfers to the government its obligations related to pensions for its staff that the corporation has organised on its own in the form of an unfunded pension scheme. The pension obligations have an actuarial value of 900. Government accepts to pay future pensions and in exchange receives a cash payment of 1000. In a future given year (t+*), pensions paid to retired staff from the public corporation amount to 50.

Year t

General government				Public corporation (NFC)			

Capital account

ΔA			ΔL	ΔA			ΔL
		D.9	+900			D.9	-900
B.9	+900			B.9	-900		

Financial account

ΔA			ΔL	ΔA			ΔL
F.2	+1000			F.2	-1000		
F.5	-100					F.5	-100
		B.9	+900			B.9	-900

Year t+* (adaptable to any year other than t)

General government				Households			
Current/Capital account							
U/ΔA			R/ ΔL	U/ΔA			R/ ΔL
D.621	50					D.621	50
B.9	-50			B.9	+50		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	-50			F.2	+50		
		B.9	-50			B.9	+50

III.6.4.4 Initial unfunded pension scheme where the lump sum payment is spread over two years

A public corporation transfers to the government its obligations related to pensions for its staff that the corporation has organised on its own in the form of an unfunded pension scheme. The pension obligations have an actuarial value of 1000. Government accepts to pay future pensions and in exchange receives a cash payment of 1000 spread equally over two years (year t and year t+1).

Year t

General government				Public corporation (NFC)			
Capital account							
ΔA			ΔL	ΔA			ΔL
		D.9	+1000			D.9	-1000
B.9	+1000			B.9	-1000		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	+500			F.2	-500		
F.7	+500					F.7	+500
		B.9	+1000			B.9	-1000

Year t+1

General government				Households			
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	+500			F.2	+500		
F.7	-500					F.7	-500
		B.9	0			B.9	0

III.7 Summary of relevant ESA95 transactions

III.7.1 Payments by public corporations to government

"No special issues" means that the classification of a transaction to this line is not complicated by the fact that the transactors are government and a public corporation. As such, the Government controls the corporation and is not merely an inactive owner of shares in the corporation.

D.2 (Taxes on production and imports)

No special issues.

D.5 (Taxes on income and wealth), **D.91** (Capital taxes)

In general it should be clear what is a tax, and public corporations pay taxes as the others do. However, in some specific cases, for classification questions, the government's role levying taxes might conflict with its role as the owner of the public unit, such that it is more appropriate to treat a payment of tax as a withdrawal of equity. This is more likely to apply to taxes on transactions initiated by government.

Relevant examples are:

– the case of a large payment related to privatisation

– the case of large payments related to an exceptional sale or revaluation of foreign assets reserves

D.41 (Interest)

No special issues.

D.75 (Miscellaneous current transfers)

Could be transactions related to abnormal pension charges (in symmetry with 4.139b).

D.421 (Dividends)

Dividends arise from government's ownership of the unit. They apply to payments from the unit to government that are funded from the unit's income. Dividends do not apply to payments funded by asset sales, capital gains, or reserves accumulated over several years (with the exception of those which are foreseen for smoothing of dividends), even if they are called dividends in the accounts of the unit. These should be treated as withdrawals of equity in F.5.

See section above on the notions and income and dividends.

D.6 (Social contributions), **D.8** (Adjustment to households equity), **D.92** (Investment grants)

Not applicable.

D.99 (Other capital transfers)

Generally not applicable.

Capital grants are unrequited payments and so it is difficult to envisage circumstances in which D.99 would be appropriate for the classification of a payment from a market unit to government. Why should a business give its money away in return for nothing? ESA95 lists only two possibilities:

4.165 h Compensation for extensive damage or serious injuries.

4.165 i Extraordinary payments into social insurance funds to increase the actuarial reserves of those funds. This option requires the existence of an actual fund of assets to finance the social benefits, with assets and liabilities recorded in AF.6. It would not apply to unfunded social insurance schemes run by government.

Public corporations might give fixed capital assets to government as part of a restructuring operation. The transfer of assets might also happen at the end of a leasing-type contract when an asset reverts to government ownership after a period during which the public corporation was allowed to exploit the asset under certain conditions. In these cases the use of K.12 (changes in classification and structure) is the most appropriate treatment for the difference between the price paid and the market value of the assets.

F.2 (Currency and deposits), **F.3** (Securities), **F.6** (Insurance technical reserves), **F.7** (Other accounts receivable)

No special issues.

F.4 (Loans)

This includes actual repayment of lending and imputed repayments associated with debt cancellation. In most cases debt cancellation should be recorded as a transaction in F.4; the counterpart is usually a capital transfer from government - D.99 - (except when privatisation is imminent: the counterpart is a transaction in shares and other equity - F.5).

In some cases the debt write-off is recorded in K.12 (changes in classification and structure) or K.10 (other volume changes) if the write-off is associated with appearance and disappearance of units, or with significant changes in the structure and functions of units.

F.513 (Other equity)

- Withdrawal of equity

This includes significant one-off payments made to Government. The payment is funded by the liquidation of assets such as drawing on accumulated reserves; sales of financial or non-financial assets; or realised capital gains. It excludes those payments that can be classified as dividends either for theoretical or practical reasons (see D.4 above).

Payments to government that arise from significant sales of assets at the request of government, or as part of a government policy, should be recorded as withdrawals of equity rather than as dividends or other non-financial transaction.

The classification is appropriate even when the public accounts of the unit describe the transaction as something else such as dividend or, in some circumstances, a tax.

This treatment applies to indirect privatisation (see II.2.1). The treatment of privatisation receipts in national accounts consists basically of considering the sale of the government's equity as an exchange of a financial asset (shares and other equity) for another type of financial asset (in general liquid assets). Following this logic, the privatisation receipt as such does not improve the government deficit, but modifies its financing. The government's new liquid assets should go towards reducing the government debt, either directly by repurchasing government debt securities, or indirectly by reducing the need for new debt issuance.

In order to ensure consistency and transparency, this treatment of direct privatisation is extended to indirect privatisation, that is to say the cases where government equity is sold through an intermediary – usually a public holding company – and the proceeds of the sale

paid back to the government (whatever the legal form of this repayment to the government: dividend, tax, transfer, etc.).

To be consistent with the sale of financial assets the treatment also applies to the indirect sale of significant non-financial assets.

- Withdrawals of equity in kind

The case of payments in kind to government is difficult because of the conflicting desire to be consistent with both the treatment of the indirect sale of non-financial assets (treated as F.5) and the desire for symmetry with payments in kind by government to the public corporation (see D.9 below).

When the transfer of assets between public corporations and government is associated with other restructuring and changes in functions and responsibilities, it is appropriate to record the transfers in kind as a change in classification and structure (K.12), in the other changes in volume of assets account.

- Withdrawals of equity from central bank

- The classification F.5 also applies to some transactions between government and central banks. This is because central bank assets are treated in national accounts as public property, so for example a fall in the central bank's gold and foreign exchange reserves would reduce the value of government's equity in the central bank.

- **K.12** (Changes in classification and structure)

This is appropriate when units are created, closed down, or merged; or when there is a significant change in the functions and responsibilities of units that it is not possible to record adequately in the transaction accounts. This category also applies when assets revert to government ownership after a period during which the public corporation has been allowed to exploit them (see chapter 6.4 on public infrastructure financed and operated by corporations).

III.7.2 Payments by government to public units

In several of these cases it is important to consider whether government is making payments to increase its investment in financial assets, as any rational investor might do, or whether it is seeking to support particular types of economic activity. The phrase "capital injection" is often used to describe large payments from Government to public corporations. It is not a national accounts concept. In national accounts it could be either a capital transfer or transaction in equity.

D.2 (Taxes on production and imports)

Not applicable.

D.3 (Subsidies)

These are regular payments by government to reduce prices charged by the unit and cover losses.

It is inappropriate to consider such payments as injections of equity (F.5) because they fund current expenditure and they are often paid conditional on the unit behaving in a particular way, such as charging low prices, which can reduce the value of the equity.

D.4 (Property income), **D.7** (Other current transfers)
No special issues. Abnormal pension charges would be in D.75 (4.139b).

D.5 (Taxes on income and wealth), **D.6** (Social benefits), **D.8** (Adjustment to households equity)
Not applicable.

D.92 (Investment grants)

This applies to all unrequited payments to public units conditional on the funds being used for fixed capital formation rather than current expenditure.

The capital expenditure financed by the government payments can result at the end in an increasing of the value of the government's equity in the public corporation. However, this is not a sufficient reason for classifying the payment as an injection of equity (F.5) because there is no certainty that the value of the government's equity will increase for the same amount. The capital formation is usually used by the corporation to implement the government's economic and social policies (for example building railway lines or hospitals) rather than to increase profitability. In other words it is important to consider the government's objectives when making "capital injections" into a public corporation.

"Capital injections in kind" are when government transfers the ownership of fixed capital assets from itself to a public corporation (see II.3.2). Straightforward cases of a gift by government to the corporation should be recorded as investment grants, with corresponding negative amounts recorded in fixed capital formation. This leaves government net borrowing unchanged.

In more complicated cases, where the injection in kind is associated with other restructuring of assets and liabilities and, perhaps the creation of new units, it is better to record the outcome in the other changes in the volume of assets account (K.10) or changes in classification and structure account (K.12). This also leaves government net borrowing unchanged.

D.99 (Other capital transfers)

ESA95 (4.165) identifies that D.99 is appropriate in the following cases:

a. compensation for damage

b. payments to cover losses made over several years or exceptional losses

f. counterpart to the cancellation of debts except when part of a privatisation (record in F.5)

D.99 is also relevant for the acquisition of financial assets by government in cases where the transactions are not undertaken at market prices, but are undertaken primarily to support the unit. For example government might buy bad debts or give soft loans. In these cases it is necessary to estimate the difference between the market value of the financial assets acquired and the price paid by government. This difference is to be recorded as a capital transfer from government to the unit. In effect the payment by government is treated partly as an acquisition of financial assets and partly as a gift. This treatment is often appropriate for financial defeasance structures set up to rescue banks.

F.2 (Currency and deposits), **F.3** (Securities)

No special issues.

F.4 (Loans)

When classifying payments to public units as loans it is important to examine the likelihood of repayment and the commercial arrangements for repayment and payment of interest. In some cases where repayment is uncertain, it might be more appropriate to record the loans as capital transfers, or where the interest payments are not fixed, to record them as the acquisition of other equity.

F.5 (Shares and other equity)

Acquisition of equity in public corporations.

This category excludes any payment conditional on the acquisition of fixed capital and payments in kind: these should be recorded as investment grants. An important characteristic of an injection of equity is that the public unit should have freedom to use the funds in the way it thinks best to increase the value of the business. There are three cases:

a. Government is the only shareholder in the public unit

   Category F.513 (other equity) might be appropriate for the classification of some payments by government to the unit, but only if strict conditions apply. The payments must be made for financial reasons with the same objectives that a rational private investor would have when investing in a business.

   In other words, government must expect to earn a market rate of return, for example in the form of higher dividends from its investment; or it must intend to sell the business and receive a higher price because of the injection of equity. Payments to the unit for other purposes (for example, to cover losses) must be classified as capital transfers.

b. Government and some other units are partners in ownership

   Some payments by government might entitle it to a larger share of the unit and its future profits. If the unit were run in a commercial way such that the government would earn a return on its investment, classification as F.5 would be appropriate.

   If the increase in the government's shareholding would not provide financial benefits, perhaps because the unit's objectives are to support government's social policies rather than profit making, classification as a capital transfer would be more appropriate.

c. Government owns tradable shares in the public unit

   If the government acquires tradable shares for its payment, which it could immediately sell for the price paid, then classification as the acquisition of shares is correct.

F.6 (Insurance technical reserves), **F.7** (Other accounts receivable)

No special issues.

III.8 Keywords and references

Capital transfers	ESA95 4.145 and following
Capital transfers in kind	ESA95 4.146
Changes in classification and structure	ESA95 6.30
Corporate restructuring	ESA95 6.30 and SNA93 12.58 & 59
Debt cancellation	ESA95 5.16
Debt cancellation, assumption of liabilities	ESA95 4.165, 5.16
Defined-benefit pension schemes	ESA95 7.59
Dividends	ESA95 4.53
Employer social insurance pension scheme	ESA95 4.88
Entrepreneurial income	ESA95 8.28
Equity capital	ESA95 4.53
Financial transactions	ESA95 5.01, 5.02
Institutional unit	ESA95 2.12
Investment grants	ESA95 4.152, 4.157
Money purchase pension schemes	ESA95 7.59
Net equity of households in pension funds reserves	ESA95 5.110 – 5.113
Net worth	ESA95 7.01 to 05
Non-monetary transactions	ESA95 1.36
Other accounts receivable / payable	ESA95 5.120, 5.128, 5.129
Other capital transfers	ESA95 4.164 – 4.167
Own funds	ESA95 7.05
Persistent losses	ESA95 4.35c, 4.61
Property income	ESA95 4.41
Quasi-corporation	ESA95 2.13
Shares and other equity	ESA95 5.86
Social security schemes	ESA95 4.88
Subsidies	ESA95 4.30

IV

Relations between government and the financial sector

Part IV Relations between government and the financial sector

IV.1 Overview

1. This part of the manual concerns the recording of relations between the government and the national central bank (NCB), and between government and other financial institutions in the context of public support for them.
2. Some NCBs have been observed making significant payments to government. These reduce the government deficit if they are recorded as non-financial transactions. It is not always easy to determine whether such transactions are financial or non-financial because the government is in a sense the owner of the national central bank and so can influence it to undertake transactions with the objective of reducing the government deficit. A key issue is in determining whether government receipts from the NCB that are labelled as dividends or taxes should be recorded in national accounts as withdrawals of equity because that reflects better the economic reality (but does not improve the government deficit).
3. Government support for financial institutions in times of severe financial crisis is not covered by this manual but is subject to separate recording conventions developed by Eurostat. Cases of financial support outside of such times, sometimes referred to as “financial defeasance” are dealt with in Chapter IV.5.

IV.2 Payments between the Central Bank and government

IV.2.1 Background to the issue

1. The management of asset portfolios and interventions in foreign exchange markets for monetary policy purposes may generate capital gains for central banks which are liable to be distributed to general government, generally in the form of dividends. The amounts involved may sometimes be very large. Capital gains are not income in national accounts and therefore payments to government financed out of capital gains cannot be recorded as property income. This chapter describes how the recording of capital gains made by the central bank as property income in the government accounts should be avoided. It also proposes to apply the rules on capital injections when government makes a payment to the central bank. Such payments by government may be made to cover losses made by the central bank. Capital losses may occur due to foreign exchange holding losses. Operating losses may occur due to the fact that interest and other operating income do not cover operational costs made by the central bank.

IV.2.2 Treatment in national accounts

2. In national accounts, capital gains have to be excluded from the distributable profits of the central bank. For this purpose, a practical method may be applied using general available information on the central bank's profits and losses and payments between the central bank and government. It consists of comparing the two following amounts:

   A. The amount of operating profits/losses: This amount is equal to the total profit/loss of the NCB before distribution minus the capital gains/losses included in the total profit/loss. Thus, it is equal to net interest income and other operating income minus operational costs, such as staff costs.

   B. The amount paid to general government as part of distributed profits.

3. For the central banks that apply the Eurosystem accounting rules (including many EU Members not part of the euro area), the item "net result of financial operations, write downs and risk provisions" (items 2.1, 2.2 and 2.3 of the profit and loss account in Annex IX of ECB/2006/16) should be deducted from the total profit/loss for the year, to arrive at the operating profit/loss. The net result of financial operations includes realised holding gains/losses arising from financial operations as well as unrealised holding losses (so-called "write-downs") and transfers to/from provisions for foreign exchange rate and interest rate risks. To compute the operating profit/loss in a harmonised manner among Member States, unrealised gains on financial assets that are part of the total profit of non-Eurosystem central banks should be deducted from the total profit together with any realised holding gains and (un)realised losses included in the total profit.

4. The following rules apply:

   1. If the payment to government (B) is equal to the operating profit (A), the whole payment to government (B) is recorded as property income (D.4) in the government accounts.

   2. If the payment to government (B) is lower than the operating profit (A), the whole payment to government (B) is also recorded as property income in the government accounts. This is true for all cases where the payment to government (B) is lower

than the operating profit (A), whether due to capital losses or due to an addition to the central bank's reserves.

3. As a consequence, if there is no payment to government, no property income is recorded in the government accounts even though A may be positive.
4. If the payment to government (B) is higher than the operating profit (A), an amount equal to (A) is recorded as property income. The difference between (B) and (A) is recorded as an equity withdrawal by government.
5. As a consequence, if the operating profit (A) is zero or if there is an operating loss, no amount can be recorded as property income. The whole payment (B) is recorded as a withdrawal of equity (F5.) by government.

5. These rules apply to payments that the government receives in its capacity as a shareholder of the central bank. Regular corporate taxes on profits (that are also levied on the profits of other corporations) paid by the central bank to government are recorded as a current tax on income and wealth.
6. If government is not the only recipient of the central bank's profits and they are distributed among several owners, the rules in this section have to be used to determine which part of total distributable profit should be recorded as property income paid by the central bank to all owners and which part as a withdrawal of equity by all owners. When government receives a part of the distributable profits, then the same proportion of total property income can be recorded in the government accounts as property income and the same proportion of the total withdrawal of equity should be recorded in the government accounts as a withdrawal of equity by government.

IV.2.3 Rationale of the treatment

7. Holding gains and losses result from changes in the price of assets. They are not the result of production or the distribution of income from production and are recorded in the other changes in assets account as a change in the value of the assets and liabilities (see paragraphs 1.43 and 1.46 of ESA95). Because holding gains are not transactions, their distribution should not be recorded as property income (see ESA95 4.01). Capital gains, as referred to in private bookkeeping, are not conceptually different from holding gains, as understood in national accounts: the only difference consists in the way they are calculated. The bookkeeping of the Eurosystem central banks for instance includes realised holding gains and both realised and unrealised holding losses as capital gains/losses in total profit. The non-Eurosystem central banks may also include unrealised holding gains in their total profit. Irrespective of how capital gains are computed, they are not part of income.
8. When a payment to government from the central bank (B) is lower than the operating profit (A) due to capital losses, the total payment (B) is recorded as property income (see rule 2 in the previous section). In such a case it is not allowed to record an amount (A) as property income and the difference between (B) and (A) as an acquisition of equity in the central bank by government. Thus capital gains and losses are somehow not treated symmetrically. This is explained in more detail in Table 1. This asymmetrical treatment is nevertheless justified for the purpose of appropriately measuring government deficit. Consider the following two cases in Table 1:
   - case X presents the case where the central bank experiences a capital loss;
   - case Y describes the case where the central bank has a capital gain.
9. In both cases the total profit is distributed to government.

Table 1: Annual accounts of the central bank and government

Recording in central bank's bookkeeping	**Case X**	**Case Y**
Operating profit (a)	100	100
Capital gain/loss (d)	-20	20
Total profit (e) = (a) + (d)	80	120
Payment to government (b)	80	120
Recording payment in government accounts	**Case X**	**Case Y**
D4R Property income	80	100
B.9 Net lending/ net borrowing	80	100
F.2 Currency and deposits	80	120
F.5 equity injection	0	
F.5 equity withdrawal		-20
Revaluation of F.5	0	20

The upper part of the table shows the recording in the central bank's bookkeeping system.

The lower part of table 1 shows the recording of case X and Y according to the rules set out in section 2.

10. Rule 2 in the section 2 determines that the whole payment in case X should be recorded as property income. Rule 4 determines that part of the payment in case Y should be recorded as property income and that part of the payment should be recorded as a withdrawal of equity. A symmetric recording of capital gains and losses would have led to the recording of 100 as property income and 20 as an equity injection by government in case X. Such a treatment would have been appropriate within a reinvested earnings framework, but this approach is only accepted in the international accounting standards (ESA95, IMF Balance of Payments Manual) in the case of foreign direct investment.

IV.2.3.1 Legal and economic ownership

11. The rules in section 2 only apply to payments made to government in its capacity as shareholder of the central bank. Even if, from a legal point of view, there is no ownership relation between government and the central bank, equity is to be recorded in national accounts to reflect the fact that the central bank holds and manages reserve assets on behalf of the nation, and hence of government. Moreover, if the government receives part of the profits on a regular basis or has a right over the net assets in case of liquidation, this also indicates that government is the economic owner of the central bank. In such cases where government has economic ownership despite not being the legal owner, government ownership in the central bank is recorded as "other equity" in national accounts.

IV.2.3.2 Valuation of government equity

12. The equity stake of government in the central bank is valued on the basis of net assets. This includes equity capital (issued), revaluation reserves (notably gold and foreign exchange), legal and dedicated reserves, and retained earnings.

IV.2.3.3 Other payments

13. The rules above do not apply to payments made by the central bank for services provided by government or to the payment of taxes. Regular corporate taxes to which other corporations are also subjected, paid by the central bank to government are recorded as a tax on income (D.51) with the exception of taxes paid on exceptional transactions (see chapter IV.3). The fact that capital gains may be taxed as well is not an issue. According to ESA95, taxes on income are not only levied on income, but also on profits and capital gains (see ESA95 4.78).

IV.2.4 Accounting examples

Table 2 shows some stylised examples of the annual profit and loss account of the central bank and payments to government. The proper recording in the government accounts can be determined by comparing the payment to government (B) with the operating profit/loss (A). The holding gains/losses in F5 held by general government are computed by deducting the amount of property income paid from the total profit.

Table 2: Payments from central bank to government and their recording in national accounts

	1	2	3	4	5	6	7	8
Total profit (+) / loss (-)	100	150	150	100	100	150	50	50
Operating profit (+) / loss (-)	100	100	100	150	150	100	-50	-50
Capital gain (+) / loss (-)	0	50	50	-50	-50	50	100	100
Payment from NCB to Government	100	100	50	100	-50	0	0	-50
Change in reserves due to retained earnings*	0	50	100	0	150	150	50	100
Recording in Government accounts								
D4R property income received	100	100	50	100	150	100		
Impact on B.9 net lending (+)	100	100	50	100	150	100		
F5A acquisition of equity								
F5A withdrawal of equity						-50	-50	-100
F5A Holding gain (+) loss (-)		50	100	0	-50	50	50	50

* - Change in reserves due to other reasons is neglected in these examples (legal and dedicated reserves)

Table 3: Profit and loss account of a central bank

The table below represents the published profit and loss accounts of a central bank that applies the Eurosystem accounting rules.

1.1. Interest income
1.2. Interest expense
1. Net interest income
2.1. Realised gains/losses arising from financial operations
2.2. Write-downs on financial assets and provisions
2.3. Transfer to/from provisions for foreign exchange rate and interest rate risks
2. Net result of financial operations, write-downs and risk provisions
3.1. Fees and commissions income
3.2. Fees and commissions expense
3. Net income/expense from fees and commissions
4. Income from equity shares and participating interests
5. Net result of pooling of monetary income
6. Other income
Total net income
7. Staff costs
8. Administrative expenses
9. Depreciation of tangible and intangible fixed assets
10. Banknote production services
11. Other expenses
12. Income tax and other government charges on income
(Loss)/profit for the year

The operating profit/loss can usually be computed by deducting item 2 of the profit and loss account “net result of financial operations, write downs and risk provisions” from the total profit/loss for the year, to arrive at the operating profit/loss and by deducting all other provisions and reserves not recorded inside item 2, since it cannot be completely excluded that, apart from item 2, other items of the profit and loss account of a central bank also contains provisions and reserves (for instance item 5).. These will then also have to be deducted from the total profit/loss to obtain the operating profit/loss.

IV.2.5 Annex: Bookkeeping in Central Banks

IV.2.5.1 Introduction

14. Following the creation of the euro area, the European System of Central Banks (ESCB) has in a great extent harmonised its accounting practices. This harmonisation has been materialised by an ECB Accounting Guideline initially released in the preparatory phase on December 1998. After the introduction of the euro another Guideline has been released on 5 December 2002 on the legal framework and financial reporting in the European System of Central Banks (ECB/2002/10) and then repealed by the Decision of the ECB of 10 November 2006 (ECB/2006/16). While the ECB Guidelines are legally binding to euro area NCBs (the Eurosystem), the majority of EU NCBs of non-participating Member States have also aligned their practices to them as preparatory step to a possible adoption of the euro. The Guidelines are not mandatory for some items ("Other assets") for which the rules are only recommended.

15. The implementation of the ECB Guideline ECB/2006/16 has harmonised the accounting treatment of gains and losses within the Eurosystem. However, the distribution of NCB profits is not determined by above-mentioned Guideline, but is governed by national law or based on an agreement with the Ministry of Finance and is still very heterogeneous from one country to another.

IV.2.5.2 Recording capital gains/losses

16. Realised gains or losses occur when financial assets are sold; while unrealised gains or losses are generated when financial assets are kept on the books and revalued. This annex presents firstly, the treatment of both realised and unrealised gains and losses in the Eurosystem and ESCB bookkeeping, and secondly the existing practices regarding the profit distribution of the EU NCBs. The terminology used hereafter relate to bookkeeping which doesn't exactly cover the same concept than the wordings in National Accounts (e.g., income).

IV.2.5.2.1 Rules in the Eurosystem bookkeeping

17. The rules for income recognition and balance sheet valuation are based on a prudent accounting approach where it is inappropriate to recognise unrealised capital gains as income (and then to distribute it). The following main rules apply:

- Realised gains and losses are taken to the profit and loss account;
- Unrealised gains are not recognised as income but they are recorded on balance sheet in a revaluation account;
- Unrealised losses are taken at year-end to the profit and loss account if they exceed previous revaluation gains booked in the revaluation account; the unrealised losses taken to the profit and loss account can not be netted-out by new unrealised gains in subsequent years;
- There is no netting of unrealised losses in any security, in any currency or in gold holdings against unrealised gains in other securities or currencies or gold.

18. These rules apply to gold, assets and liabilities in foreign currency and holdings of securities other than participating interests, illiquid equity shares, financial fixed assets and non-marketable securities, all of which are valued at cost.

IV.2.5.2.2 Other systems

19. For those NCBs that have not yet implemented the ESCB Guideline, a balance sheet revaluation item that includes unrealised gains may also be available. However, in

limited cases all valuation gains and losses are accounted in the profit and loss account.

IV.2.5.3 Recording distribution of profits

20. Governments are usually the main shareholders of National Central Banks and therefore are the main beneficiaries of their profits. The modalities in which the profits of the NCBs are attributed and distributed to the respective governments are, though, rather heterogeneous across the different EU Member States as this is subject to national practices.

21. For most NCBs, the allocation of profit is in most cases codified in national law but in a few cases the profit distribution is based on an agreement between the Central Bank and the Ministry of Finance. In one case, where the government is not a legal shareholder, the main part of the NCB's profit is transferred to the government. In this case the government's economic ownership of the NCB is recognised in the national accounts with the government recorded to hold "other equity" in the NCB.

22. The level of profit distributed to shareholders varies across the ESCB. In some cases the profit is equally shared between the NCB and the shareholders, while in other cases the shareholders (mainly the government) receive the bulk of the net profit. While some NCBs distribute pre-determined percentages of the net profit, other NCBs restrict the profit distribution depending on the level of reserves and provisions.

23. To protect themselves against foreign exchange and interest rate risk, a number of NCBs may transfer part of the profits to provisions and reserves. The profit distribution to government is asymmetrical in the sense that the profits at least partially lead to payments to governments while losses do not necessarily lead (only in exceptional cases) to a payment from government to the NCB. In order to cover possible losses when they arise, general risk provisions and reserves might be created as financial buffers. While the creation of provisions and reserves is subject to national legislation, a common definition of these two terms is as follows (and is the case for the ESCB accounting guideline):

    - "**Provisions** are defined as amounts set aside before arriving at the profit or loss figure in order to provide for any known or expected liability or risk, the cost of which cannot be accurately determined".
    - "**Reserves** are considered as amounts set aside out of distributable profits, which are not intended to meet any specific liability, contingency or expected diminution in value of assets known to exist at the balance sheet date".

IV.2.5.4 Special transitional rules for countries entering the euro area:

24. NCBs revalue all financial assets and liabilities at the date they become members of the Eurosystem. Unrealised gains which arose before entry into the euro area are separated from those unrealised valuation gains arising after the entry into the euro area. The ECB Accounting Guideline recommends the NCBs not to distribute unrealised gains during the transitional period leading to the entry into the Eurosystem. In this case, unrealised gains which arose before entry into the euro area can be distributed once they have actually been realised through transactions that occur after the entry in the euro area.

IV.3 The sale of gold and foreign exchange by the central bank

IV.3.1 Background to the issue

1. The proceeds of a sale of gold or other reserve assets by the central bank are often transferred to government. It has sometimes been argued in the past that such a transfer should reduce the government deficit (B.9). This chapter explains that it does not, because it is a withdrawal of equity.
2. It is worthwhile, first, to give a definition of reserve assets. Such a definition may be found in the IMF's Balance of Payment Manual: « *Reserve assets are those external assets that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for intervention in exchange markets to affect the currency exchange rate, and for other related purposes (such as maintaining confidence in the currency and the economy, and serving as a basis for foreign borrowing). Reserve assets must be foreign currency assets and assets that actually exist. Reserve assets comprise monetary gold, SDR holdings, reserve position in the IMF, currency and deposits, securities (including debt and equity securities), financial derivatives, and other claims (loans and other financial instruments)* ». In the following sections, only gold and foreign exchange assets are considered.

IV.3.2 Treatment in national accounts

3. A central bank may sell a significant part of its reserve assets and pay part or all of the proceeds to government. In such a case, the payment of proceeds to government is completely recorded in the financial accounts of government and the central bank. It is recorded as a withdrawal of shares or other equity (F.5) from the central bank by government, with a counterpart entry as an increase in a financial asset (most likely deposits, F.2) held by government, or, possibly, a decrease in a financial claim of government (loans, F.4 for instance) on the central bank.
4. This treatment in the national accounts has to be made irrespective of how the payment is labelled in the central bank's bookkeeping or in public accounts, such as a dividend or taxes for instance. In the case of large payments related to an exceptional sale of gold or foreign exchange reserves, the payment of taxes has to be recorded as a withdrawal of equity (see chapter IV.2).
5. In national accounts the correct recording of the sale of gold in the NCB's accounts depends on whether the gold sold is monetary gold or not. Monetary gold is a financial asset and is gold to which the monetary authorities (or others who are subject to the effective control of the monetary authorities) have title and is held as reserve assets. Non-monetary gold is a valuable and hence a non-financial asset. The sale of monetary gold will have no impact on the net lending/net borrowing of the central bank. The sale of non-monetary gold (i.e. monetary gold that has been demonetised) will impact net lending/net borrowing of the central bank. In both cases the payment of proceeds by the central bank to government has no impact on the net lending/net borrowing of government.

IV.3.3 Rationale of the treatment

6. The rationale of the rules needs some explanation since, although in complete conformity with national accounts principles, they do not explicitly appear in ESA95.

IV.3.3.1 The specific nature of reserve assets

7. Reserve assets have specific features compared to other financial instruments. Although the central bank has a full autonomy for managing them, this institution does not act in self-interest like a corporation, i.e. by maximising their shareholder's profits or wealth. The role of the central bank concerning the management of foreign assets is fixed by specific legislation. They are managed for macro-economic purposes and for the public interest, in the framework of monetary policy. Thus, these assets are not really owned by the units that manage them. They are owned by the nation, represented in national accounts by general government.

IV.3.3.2 The recording of foreign exchange in central bank's balance sheet

8. The above-mentioned specific nature of foreign exchange held by central bank has to be reflected in national accounts under the form of equity recorded on the asset side of general government and on the liability side of the central bank. Considerations and uniformity of statistical treatment across member states are given a more prominent role than the legal status of the central bank. Even if, from a legal point of view, there is no ownership relation between government and the central bank, equity is to be recorded in national accounts to reflect the fact that the central bank holds and manages reserve assets on behalf of the nation, and hence of government, or that government is the economic owner of the central bank, because it has right over the net assets in case of liquidation or receives part of the profits on a regular basis (ESA95 5.86).

9. The question is how to value the equity of government in the central bank in respect of the reserve asset holding. To answer this question, it is worth considering the money creation process due to foreign transactions: at the time reserve assets are acquired by the central bank, there is most likely, in its balance sheet, a counterpart entry on the liabilities side to record the issuance of (base) money. When the market price of reserve assets acquired in this way increases, there is a holding gain. In national accounts balance sheets, the holding gain leads to increase in the value of the instrument on the asset side of the central bank's balance sheet. This increase on the asset side has a counterpart on the liability side: an increase in government equity.

10. Thus, at a given point in time, the value of government equity in the central bank's balance sheet in respect of reserve assets will be captured by the difference between the prices at which these assets were acquired by the central bank and their present market prices. More precisely, it is equal to the accumulation of holding gains/losses minus any withdrawals of equity made by government. At this stage, it is useful to make a distinction between monetary gold and foreign exchange assets.

11. Gold was generally acquired by central banks a long time ago and gold prices have greatly increased since that time. As a consequence, government equity in respect of the holding of monetary gold is generally important insofar as central banks have kept reserve assets under this form.

12. It is more difficult to be so conclusive about the equity related to foreign exchange assets: the final influence of movements in exchange rates depends on too many factors, such as impact on both imports and exports, currency of settlements, etc. It might happen that the value of equity declines and even becomes negative due to holding losses.

13. Nevertheless, the existence of payments to government, related to foreign exchange assets, implies a positive difference between the present market value of foreign currencies and their acquisition price; if there were a loss, there would be no room for payments from central bank to government. So, in the cases under consideration there

has been a holding gain, and as a consequence the value of government equity in the central bank in respect of foreign exchange assets has increased.

14. All payments made by the central bank to government related to the activity of holding and managing reserve assets, occur because government has equity in the central bank in respect of these reserve assets. They are thus treated as a withdrawal of shares and other equity (F.5).

IV.3.3.3 Monetary vs. non-monetary gold

15. The sale of monetary gold is recorded differently in the NCB's accounts than non-monetary gold. Monetary gold is a financial asset held by monetary authorities (the central bank or in some countries the central government) as part of the foreign reserves (see ESA95 5.26). If gold is sold by the NCB to other (i.e. foreign) monetary authorities, it is recorded in the financial accounts of the domestic central bank as a decrease in financial assets with as a counterpart entry a decrease in the liabilities of the central bank vis-à-vis foreign monetary authorities (or an increase in the financial claims of the central bank on foreign monetary authorities). If gold is sold to non-monetary authorities, it is treated as a disposal of a valuable. Such a sale is preceded by a demonetisation of monetary gold in the central bank's accounts. Demonetisation, meaning the reclassification from monetary to non-monetary gold, is recorded in the other changes in the volume of assets accounts of the central bank (K12.21, see ESA95 6.32). Although the sale of non-monetary gold is recorded differently in the central bank's account than the sale of monetary gold, the transfer of the proceeds is in both cases recorded as an equity withdrawal because in both cases gold is managed by the central bank on behalf of the nation and hence of government. Furthermore, the sale of gold does not impact the operating profits of the central bank. The transfer of the sale proceeds to government can therefore not be recorded as property income in the government accounts irrespective of whether gold has been sold to monetary authorities or other institutional sectors. This treatment of the sale of non-monetary gold is consistent with the recording of indirect sales of non-financial assets (see sub-section 5.2.2.4).

16. A gold sales agreement over 5 years between a number of European central banks has been renewed in 2009 proposing a concerted program of sales over a period of 5 years and a threshold of annual sales that is not to exceed 500 tons in total. See http://www.ecb.int/press/pr/date/2009/html/pr090827.en.html

IV.3.4 Accounting examples

Example 1

- Assume that the central bank holds monetary gold that increases by 100 million Euros in value in year 1.
- In year 2 the central bank sells 90 million Euros worth of gold to foreign monetary authorities.
- In year 3 the proceeds are transferred to government.

YEAR 1

General government

Opening balance sheet

A		L
AF.2	a	
AF.5	z	

Other changes in assets account

ΔA		ΔL
F.5	100	

Closing balance sheet

A		L
AF.2	a	
AF.5	z + 100	

NCB

Opening balance sheet

A		L	
AF.1	y	AF.2	b
		AF.5	z

Other changes in assets account

ΔA		ΔL	
F.1	100	F.5	100

Closing balance sheet

A		L	
AF.1	y + 100	AF.2	b
		AF.5	z + 100

YEAR 2

General government

Opening balance sheet

A		L
AF.2	a	
AF.5	z + 100	

Financial account

ΔA		ΔL

Closing balance sheet

A		L
AF.2	a	
AF.5	z + 100	

NCB

Opening balance sheet

A		L	
AF.1	y + 100	AF.2	b
		AF.5	z + 100

Financial account

ΔA		ΔL	
F.1	-90	F.2/S.2	- 90

Closing balance sheet

A		L	
AF.1	y + 10	AF.2	b -90
		AF.5	z +100

YEAR 3

General government				NCB			
Opening balance sheet							
A			L	A			L
AF.2	a			AF.1	y + 10	AF.2	b – 90
AF.5	z + 100					AF.5	z +100
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	90					F.2/S.13	+ 90
F.5	-90					F.5	- 90
Closing balance sheet							
A			L	A			L
AF.2	a +90			AF.1	y+10	AF.2	b
AF.5	z+10					AF.5	z+10

Example 2

- Assume that the central bank holds monetary gold that increases by 100 million Euros in value in year 1.
- In year 2 the central bank sells 90 million Euros worth of gold to financial corporations. The gold is demonetised before the actual sale takes place.
- In year 3 the proceeds are transferred to government.

YEAR 1

General government				NCB			
Opening balance sheet							
A			L	A			L
AF.2	a			AF.1	y	AF.2	b
AF.5	z			AN.13	0	AF.5	z
Other changes in assets account							
ΔA			ΔL	ΔA			ΔL
F.5	100			F.1	100	F.5	100
Closing balance sheet							
A			L	A			L
AF.2	a			AF.1	y + 100	AF.2	b
AF.5	z + 100			AN.13	0	AF.5	z + 100

YEAR 2

General government | **NCB**

Opening balance sheet

A		L	A		L	
AF.2	a		AF.1	y + 100	AF.2	b
AF.5	z + 100		AN.13	0	AF.5	z + 100

Other changes in assets account

ΔA		ΔL	ΔA		ΔL	
			AN.13	+90		
			AF.1	-90		

Non-financial account

U		R	U		R	
			AN.13	-90		

Financial account

ΔA		ΔL	ΔA		ΔL	
					F.2/non S.13	-90

Closing balance sheet

A		L	A		L	
AF.2	a		AF.1	y+10	AF.2	b -90
AF.5	z + 100		AN.13	0	AF.5	z +100

YEAR 3

General government | **NCB**

Opening balance sheet

A		L	A		L	
AF.2	a		AF.1	y+10	AF.2	b -90
AF.5	z + 100		AN.13	0	AF.5	z +100

Financial account

ΔA		ΔL	ΔA		ΔL	
F.2	90				F.2/S.13	+ 90
F.5	-90				F.5	- 90

Closing balance sheet

A		L	A		L	
AF.2	a +90		AF.1	y+10	AF.2	b
AF.5	z+10		AN.13	0	AF.5	z+10

IV.4 Non-returned banknotes and coins after a cash changeover

IV.4.1 Background to the issue

1. During a cash changeover, banknotes and coins in circulation denominated in national currency are returned to the respective issuers, which are the national central banks for banknotes and, in most cases, the national governments for coins. However, part of the national currency previously in circulation will never be returned because it has been destroyed or lost, or because holders have decided to keep it for collection or other reasons.
2. When an NCB no longer exchanges or expects to exchange old national banknotes, it writes off a liability. This write-off is then recorded as a profit in the profit- and loss statement of the NCB. The profits from the non-return of banknotes in national currency may ultimately accrue to government, either as a separate payment or as part of the regular payment of dividends and/or income taxes by the National Central Banks (NCB). The issue is whether such a payment affects government deficit according to ESA95.
3. The ESA95 recording rules only apply to the recording of stocks and flows in national accounts and do not prescribe rules for the actual bookkeeping done by the NCBs. ECB Guideline 2006/16 provides the legal framework for accounting and financial reporting in the European System of Central Banks.
4. In general, coins are a liability of government and the question arises whether their non-return impacts Government Deficit and Debt.
5. The recording principles in this chapter do not only apply to the case of a cash changeover to the euro, but also to other cases when existing series of coins or banknotes are substituted by new series of coins and banknotes, for instance due to a change in design of banknotes.

IV.4.2 Treatment in national accounts

IV.4.2.1 Non-returned banknotes

6. Gains from non-returned banknotes have no impact on government deficit. Banknotes in circulation appear in the balance sheet of the NCB under the category "currency and deposits" (AF.2). In a cash changeover, old national banknotes that have ceased to be legal tender and have not been returned to the NCB will be classified as "other accounts payable" (AF.7) in the balance sheet of the NCB. When banknotes that are not legal tender are exchanged against new banknotes, a reduction of “other accounts payable” is recorded with a counterpart entry in “currency and deposits”.
7. The non-returned national banknotes are written-off from the NCB balance sheet in national accounts, when the NCB no longer exchanges them against new notes. In those countries where old national banknotes can be redeemed indefinitely against new ones, the old banknotes are written-off from the NCB’s balance sheet when it is certain that they will no longer be returned even though the legal obligation to redeem the old banknotes still exists. In practice it seems generally prudent that statisticians derecognise NCB liabilities for the purposes of compiling the financial accounts, when the NCB’s own accountants have done so. These write-offs are recorded as an “other change in volume” in the “other accounts payable” of the NCB.

8. The value of equity the government holds will increase by the same amount as that of the write-off, assuming that government is the only shareholder entitled to the gains from non-returned banknotes. This increase is recorded in the “other changes in assets account” of both the NCB and the government. When gains on non-returned banknotes are distributed to government, the amounts distributed have to be recorded as financial transactions (a withdrawal of equity (F.5) by government), not as government revenue (dividends, taxes on profits or capital transfers). In certain countries the government is not the legal shareholder of the NCB, but is nevertheless entitled by legislation to receive the proceeds from non-returned banknotes. In such cases national accounts recognise the economic ownership of government and record government holding “other equity” (F.513) in the NCB.

9. In cases where the NCB makes payments to government in anticipation of the write-off of the non-returned banknotes, the payments are treated in national accounts as advance payments. The payments are recorded as “other accounts payable” (F.7) in the government accounts and as “other accounts receivable” (F.7) in the accounts of the NCB, with counterpart entries in “currency and deposits” (F.2). When the actual write-off takes place, the amounts previously recorded in F.7 are reversed against the withdrawal of equity by government.

IV.4.2.2 B. Non-returned coins

10. Non-returned coins have an impact on government debt as defined for the Excessive Deficit Procedure, but leave government deficit unchanged. The treatment in national accounts is similar to the treatment of non-returned banknotes.

11. Coins in circulation normally appear in the balance sheet of government under the category "currency" (unless they are the NCB’s liability in which case section A also applies to non-returned coins). In a cash changeover, old national coins that have ceased to be legal tender and have not yet been returned to government, but can still be officially exchanged against legal tender, are reclassified as "other accounts payable" (F.7) by an “other change in volume”(K.10) in the “other changes in assets accounts”. This reduces the stock of debt when old currency ceases to be legal tender, since "other accounts payable" are not part of government debt. If old currency is returned against new coins, government debt increases, as the amount of coins in circulation rises.

12. The write-off of the non-returned national coins in government’s balance sheet takes place when the government no longer exchanges the old national coins against the new legal tender or when it is certain that they will no longer be returned. This should be recorded in national accounts through an "other change in volume" (K.10) of “other accounts payable” (AF.7) leaving the deficit unchanged.

IV.4.3 <u>Rationale of the treatment</u>

13. The ESA95 category "currency" (F.21) consists of coins and banknotes that are commonly used to make payments (see ESA95 5.38). Once old national banknotes and coins cease to be legal tender, they can no longer be used to make payments and therefore have to be excluded from the ESA95 asset category “currency” (F.21). This is not an interaction between institutional units by mutual agreement and as a consequence is not recorded as a financial transaction (see ESA95 5.02). Rather, an asset reclassification other than (de)monetisation of gold (K12.22) is to be recorded (ESA95 6.33) in the “other changes in assets accounts” of both debtor and creditor. As long as old coins and banknotes can be exchanged against new ones, they still represent a financial claim on the issuers and they still have to be considered financial assets (unlike valuables) and are reclassified to the ESA95 category “other accounts

receivable/payable". They de facto function as a store of value to the holders, while the issuer has a liability, as it must redeem these instruments on presentation.

14. When old national banknotes and coins can no longer be exchanged against new currency and, thus, discontinue to constitute a claim against the issuer, an other change in volume of financial assets and liabilities (K.10) has to be recorded in the "other changes in assets account" of both debtor and creditor, because it is not the result of an interaction by mutual agreement and neither a financial transaction nor a capital transfer. In practice, accountants also write-off old currency when it is (almost) certain that the old banknotes and coins will no longer be exchanged, even though the legal obligation to exchange them still exists. Accountants know from experience that not all old banknotes and coins will be exchanged either due to exceptional losses (see ESA95 6.27c) or because old coins and notes are kept as collectibles. In this case, statisticians follow the same approach as the accountants and also record a write-off in the national accounts, so as to reflect economic rather than legal reality. If old banknotes and coins that have already been written off are, against expectation, handed in for exchange against new banknotes and coins, the write-off has to be reversed through the "other changes in assets account" of both debtor and creditor.

15. The value of the equity government holds in the NCB will increase due to the write-off of banknotes, since the amount of outstanding liabilities of the NCB is reduced. Changes in valuation of equity are also to be recorded in the "other changes in assets accounts" (in the "revaluation account").

16. Payments made to government by the NCB following the gains made due to non-returned banknotes cannot be recorded as dividend income (given that equity is valued at the NCB`s net assets). These gains were not the result of production or the redistribution of production but the result of write-offs and therefore cannot be part of the operating profit of the NCB. This is the reason for which the payment made to government has to be recorded as a withdrawal of equity by government, leaving the government deficit unchanged.

17. Reclassifications or write-offs of old coins also leave the government deficit unchanged. Government debt, as defined for the purpose of the Excessive Deficit Procedure, consists of "currency and deposits" (F.2), "securities other than shares" (F.33) and "loans" (F.4). A reclassification of old coins from "currency and deposits" to "other accounts payable" once they cease to be legal tender, reduces the stock of debt, since "other accounts payable" are not part of government debt. If old currency is returned against new coins, government debt increases¸ as the amount of coins in circulation rises.

IV.4.4 Accounting examples

Example 1

- The euro is introduced on day 1 of year 1.
- After half a year old national banknotes are no longer accepted as legal tender. 100 millions Euros worth of old banknotes have not yet been exchanged against Euros by the end of year 1.
- After one and half years the old banknotes can no longer be exchanged against Euros. 15 millions Euros worth of old banknotes have not been exchanged against Euros by the end of year 2 and have been written-off accordingly.
- The amount of 15 million Euros is paid to the government by the NCB in the course of the second half of year 2.

- For the sake of simplicity, it is assumed that old banknotes are exchanged against new banknotes and not against coins or deposits.

YEAR 1

General government | **NCB**

Opening balance sheet

A		L	A		L
AF.22	a			AF.21	x
AF.5	y			AF.22	a
				AF.5	y
				AF.7	z

Other changes in assets account

A		L	A		L
				AF.21	-100
				AF.7	100

Closing balance sheet

A		L	A		L
AF.22	a			AF.21	x - 100
AF.5	y			AF.22	a
				AF.5	y
				AF.7	z + 100

YEAR 2

General government				NCB			
Opening balance sheet							
A			L	A			L
AF.22	a				AF.21	x - 100	
AF.5	y				AF.22	a	
					AF.5	y	
					AF.7	z + 100	
Financial accounts							
A			L	A			L
F.22	15				F.21	85	
F.5	-15				F.22	15	
					F.5	-15	
					F.7	-85	
Other changes in assets account							
A			L	A			L
AF.5	15				AF.5	15	
					AF.7	-15	
Closing balance sheet							
A			L	A			L
AF.22	a+15				AF.21	x-15	
AF.5	y				AF.22	a+15	
					AF.5	y	
					AF.7	z	

Example 2

- The euro is introduced on day 1 of year 1.
- After half a year old national banknotes are no longer accepted as legal tender. 100 millions Euros worth of old banknotes have not yet been exchanged against Euros by the end of year 1.
- After one and half years the old banknotes can no longer be exchanged against Euros. In year 2, 15 million Euros worth of old banknotes are written off from the NCB's balance sheet. The amount of 15 million Euros is paid to the government by the NCB in advance in the course of year 1.
- For the sake of simplicity, it is assumed that old banknotes are exchanged against new banknotes and not against coins or deposits.

YEAR 1

General government | **NCB**

Opening balance sheet

A		L	
AF.22	a	F.7	b
AF.5	y		

A		L	
F.7	c	AF.21	x
		AF.22	a
		AF.5	y
		AF.7	z

Financial accounts

A		L	
F.22	15	F.7	15

A		L	
F.7	15	F.22	15

Other changes in assets account

A		L	

A		L	
		AF.21	- 100
		AF.7	100

Closing balance sheet

A		L	
AF.22	a+15	F.7	b+15
AF.5	y		

A		L	
F.7	c +15	AF.21	x - 100
		AF.22	a+15
		AF.5	y
		AF.7	z + 100

YEAR 2

General government				NCB			
Opening balance sheet							
A			L	A			L
AF.22	a+15	F.7	b+15	F.7	c +15	AF.21	x -100
AF.5	y					AF.22	a +15
						AF.5	y
						AF.7	z + 100
Financial accounts							
A			L	A			L
F.5	-15	F.7	-15	F.7	-15	F.21	85
						F.5	-15
						F.7	-85
Other changes in assets account							
A			L	A			L
AF.5	15					AF.5	15
						AF.7	-15
Closing balance sheet							
A			L	A			L
AF.22	a+15	F.7	b	F.7	c	AF.21	x-15
AF.5	y					AF.22	a+15
						AF.5	y
						AF.7	z

Example 3

- The euro is introduced on day 1 of year 1. Coins are a government liability.
- After half a year old national coins are no longer accepted as legal tender. 100 millions Euros worth of old coins have not yet been exchanged against Euros by the end of year 1.
- After one and half years the old coins can no longer be exchanged against Euros. 15 millions Euros worth of old coins have not been exchanged against Euros by that date. Of the 85 millions old coins that were exchanged at banks, 40 million were exchanged against new euro coins. 45 million Euros worth of old coins were deposited on bank accounts.

YEAR 1

Government sector

Opening balance sheet

A		L	
AF.22	a	AF.21	x
		AF.7	y

Other changes in assets account

A		L	
		AF.21	-100
		AF.7	+100

Closing balance sheet

A		L	
AF.22	a	AF.21	x - 100
		AF.7	y + 100

Note that government debt is diminished by 100 million Euros at the end of year 1 due to the reclassification of old national coins.

YEAR 2

Government sector

Opening balance sheet

A			L
AF.22	a	AF.21	x - 100
		AF.7	y + 100

Financial accounts

A			L
F.22	- 45	F.21	+ 40
		F.7	- 85

Other changes in assets accounts

A			L
		AF.7	- 15

Closing balance sheet

A			L
AF.22	a - 45	AF.21	x – 60
		AF.7	y

The final impact on government debt by the end of year 2 due to the cash changeover is smaller than the impact after year 1 due to the fact that a large amount of old coins have been exchanged against new legal tender.

IV.5 Financial defeasance

IV.5.1 Background to the issue

1. In the SNA1993 (see §11.24), defeasance was dealt with only in the case of "debt defeasance": "debt defeasance allows a debtor (…) to remove certain liabilities from the balance sheet by pairing irrevocably assets of equal value to the liabilities. (…). Defeasance may be carried out (a) by placing the paired assets and liabilities in a trust account within the institutional unit concerned, or (b) they may be transferred to another statistical unit." Many other defeasance arrangements could be observed in various commercial contexts.

Definition

2. According to recent experience in Europe, financial defeasance has been identified in a more specific context, concerning mainly the management of bad assets that a financial institution wants to remove from its balance sheet. In this context, the involvement of government has been a key characteristic of financial defeasance. In this Manual and in national accounts, it will then be defined as a rescue process of financial institutions, having three major characteristics:

   – A financial institution has become financially distressed due to its involvement into bad assets

   – Most of the time (but not always), the rescue process involves the creation of an entity dedicated to the management of bad assets, the defeasance structure, also referred to sometimes as the "bad bank". This allows the restoration of the profitability of the financial institution (the "good bank").

   – Government is involved, directly or indirectly, in the rescue process, facilitating the financing of the rescue, at least through the granting of guarantees, in such a way that it may be considered as placing itself at risk. Thus, government may be viewed as taking over the risk and rewards attached to some assets of bad quality. This element – government involvement – is the source of the major difficulty in the production of statistical data.

3. It is important to note that there may be also situations where the solvency and/or liquidity of banks, private or public, might be at stake, in such a way that it might be necessary for the government and / or the Central Bank, to intervene, commonly by providing collateral / liquidity. This sort of rescue operation will not be referred to here as "defeasance", as the financial institution is not relieved from bad or illiquid assets. Nevertheless, these cases may show common features and may lead to similar recording recommendations (through for instance recognising the government as "the principal party to the transaction", see below IV.5.2.4)

4. There may be a direct intervention of the general government, which may take various forms, for instance:

   – government gives its guarantee to the financial institutions in difficulties: this guarantee is called when these institutions make losses on the bad assets;

   – government buys directly the bad assets from the financial institutions;

– government creates on purpose public bodies to finance and/or to manage the sale of assets (or liability)[5].

5. There may be more complicated arrangements, where government intervenes in a more indirect way – at least in the first stage of the rescue process – through units over which it has some influence: for instance, public financial corporations. The role of government will have to be ascertained in such situations, taking into consideration the guarantees that are usually granted by some government units to one of the entities involved in the rescue process.

IV.5.2 Treatment in national accounts

IV.5.2.1 Classification issues

6. When government only gives its guarantee to a financial corporation in case of occurrence of losses born by the latter, there is no issue concerning the sector classification of units. The involved assets may also stay in the financial corporation's balance sheet.

7. Institutional arrangements concerning the organisation of the defeasance may be different according to economic circumstances and according to countries. For instance, the management of the assets acquired under the defeasance and the financing of the costs of defeasance may be given to one or more - new or existing - public units. In any case, where a public body is created by government and has, at least, the task of assuming directly the cost of the defeasance (the losses), it should be classified in the general government sector.

8. In other cases, where the assets are allocated to another entity (not created by government), the sector classification has to be decided following the general rules governing the actual existence of an institutional unit, the characteristics of a financial intermediary and analysing carefully the degree of government sponsoring of the rescue process. Any time the government could be considered as bearing most of the risks in the rescue process, typically through providing guarantees to the newly created entity, a special purpose vehicle for instance, this would imply that the rescuing entity is "acting on behalf" of the government.

9. Two consequences would then follow:

   – When the rescuing entity is a special purpose vehicle, not bearing most of the risks and not acting as a private investor would do, it should be considered as acting on behalf of government. Therefore, it will be regarded as a government-sponsored defeasance structure and should then be classified inside the general government sector.

   – When the rescuing entity is an existing public financial corporation, there are no specific unit classification issues, but any government-sponsored transactions should be rerouted through the general government sector (see §2.4 below). One of the reasons for this is that, by engaging in these specific transactions, the rescuing entity goes far beyond its normal activity, enjoys government financial support and in reality acts on behalf of the government.

[5] In the context of the financial crisis affecting Europe starting in 2008, a decision related to the statistical recording of various forms of government support was published by Eurostat on 15 July 2009. However, this decision applies exclusively to activities undertaken within the context of the financial crisis, which is from the summer of 2007 until the point where Eurostat informs EU Member States authorities that (for statistical purposes) the financial crisis can be assumed to have ended.

IV.5.2.2 Treatments to be followed when government is only involved by its guarantee

10. Government may give its guarantee to the financial institutions themselves or to specific units controlled by them, which are classified outside the general government sector. The guarantee may also be given directly to the defeasance structure or through the public entity specifically in charge of financing the defeasance (if any).

11. The government guarantee may be called, for instance, when the concerned units suffer losses, as the result of the writing-down of the depreciated assets, or of their sale, or after having written-off some loans extended to bad debt, or to the cancellation of a claim that government has towards the unit.

12. Where the underlying transactions have not been previously rerouted through the general government sector, the call on the guarantee results in the recording of a capital transfer, for the amount called, from government to the involved units, following the general rules for calls of government guarantees (see MGDD, chapter VII.4). Under the assumption that these units do not belong to the government sector, the capital transfer has a negative impact on general government net lending/borrowing.

IV.5.2.3 Treatments to be followed when government buys the depreciated assets

13. Let us then assume that government buys (or takes over) the depreciated assets. It does this directly or through specific units created on purpose which are considered to be part of the government sector. In the following, both will be referred to as purchases by government.

14. Government buys (or takes over) the depreciated assets from the financial institution at a price that might differ / be higher than the market value (or fair value) at that moment.

    The rules to be followed depend on the availability of reliable information.

a. <u>Recordings related to setting up the defeasance</u>

15. As a general principle, a capital transfer should be recorded when government buys the assets from a financial institution. The amount of the capital transfer in favour of the financial institution should be equal to the difference between the amount paid for buying them and their market value.

    It is useful to make a distinction between different kinds of assets.

16. Most assets, being traded on the market on a regular basis have an observable market value. This applies to securities, quoted shares and real estate. Indirect investment in real estate could also be part of the defeasance structure. It is assumed that, in the defeasance, the sale price of these assets deviates from the market value. In this case, the amount of the capital transfer is equal to the difference between the sale price of the assets and the market value.

    - For real estate assets, in general, it may be assumed that the financial institutions are in distress because of the falling prices on the real estate market, rather than because of their involvement in specific – bad - assets. So, price indexes for real estate may be applied to their purchaser price, in order to calculate their market value.
    - For securities and shares (other than those linked to real estate), except in the case of a general stock exchange crisis, market prices can be derived from stock exchange information for quoted instruments. This would be more difficult for unquoted shares.

17. The case of loans is a bit different. Loans that enter the defeasance are probably bad ones; anyway, they are sold by the financial institutions usually at their redemption value (see below in §35 the definition of redemption value), and it may be very difficult to know what could be their fair value. Therefore, in this context of defeasance, there would usually be no capital transfer associated with the sale of loans; unless a market value of the loan portfolio could be identified or approximated (and where the transaction is not made for purely commercial considerations, see ESA95, 5.136): in this case, a capital transfer should be imputed for the difference between the transaction price and the market price.

18. Nevertheless, if there is reliable information that some loans are irrecoverable (fully or for nearly their total amount), these loans should be accounted for at zero. They should be written off by the financial institution before the transaction with the defeasance unit, in such a way that a capital transfer is recorded for their full amount at the time of the transaction with the defeasance structure.

19. The capital transfers have a negative impact on government net lending/borrowing, at the time this type of defeasance is implemented, i.e. at the time the assets are transferred to the defeasance structure.

b. <u>Recordings to be made during the management of the defeasance</u>

Here, too, it is necessary to make a distinction between the transferred assets.

20. Non-financial assets may be transferred to the defeasance structure. This is the case for instance for buildings or, more generally, for real estate. As a consequence, their market value may move during the time they are held by the defeasance structure. This has to be recorded in the revaluation account, with no impact on government net lending/borrowing. If they are sold to units classified outside the general government sector, their sale is recorded as a disposal of non-financial assets, with a positive impact on lending/borrowing of government.

21. The same holds for securities and shares, except that their sale has no impact on government net lending/borrowing.

22. For loans, if they are not finally repaid at their full redemption value, they may be subject to two possible procedures: a cancellation implying a capital transfer if there is mutual agreement (which is normally the case when the debtor still exist), or a write-off to be recorded in the other changes in volume of assets account if there is only recognition by the defeasance structure that the loans cannot be repaid (which is normally the case when the debtor does not exist any more).

IV.5.2.4 The case where government is recognised as the principal party to the transaction

23. Even if the rescuing unit – any public financial corporation for instance - is not reclassified inside the general government sector, the government could still be considered the principal party to a transaction (ESA95, 1.41).

24. This would be the case when the rescuing unit enjoys government financial support – through direct or indirect funding (for instance granting specific guarantees) – in order to carry on a transaction that no normal private investor would undertake and that goes beyond the unit's usual activity. The rescuing unit would then be considered to be "acting on behalf of the government" when carrying on this particular transaction. In such a case, "the transaction should be rerouted in the accounts of the government" (ESA95, 1.39 and 1.41).

IV.5.3 Rationale of the treatment

IV.5.3.1 Classification issues

25. The defeasance structures could be considered as involved in some kind of financial activity: they borrow to finance the purchase of the assets put in the defeasance. However, they cannot be considered as being financial intermediaries, because they do not really place themselves at risk by acquiring financial assets and incurring liabilities on their own account, which is a typical feature of a financial intermediary according to ESA95 2.33. On the contrary, they act on behalf of government. This is the rationale for classifying them in the general government sector.

26. The above rationale applies to all Special Purpose Vehicles that may be established during the rescue operation, which have as their main purpose financial defeasance and the characteristics as described in section 2.1 of this chapter.

IV.5.3.2 Recording of transactions where government is deemed to be the principal party

27. ESA95 1.41 specifies that when a unit carries out a transaction on behalf of another unit, the transaction is recorded exclusively in the accounts of the principal.

IV.5.3.3 The general principle for recording capital transfers

28. There are three situations where the recording of a capital transfer from government could take place (with an impact on general government net borrowing/net lending):

    – at the time of setting up the defeasance, when government buys (or takes over) the involved assets at a value which is higher than their fair value;

    – during the management of the defeasance, when government, through guarantee calls, assumes losses from the financial institutions or other units classified outside general government;

    – during management of the defeasance, when government cancels loans it has acquired, by mutual agreement.

29. In the three situations, a capital transfer is recorded because there is a redistribution of wealth among the different units involved. This is in line with the definition of other capital transfers (D.99), given in ESA95 4.164.

30. The capital transfer is recorded at the time the transfer of wealth occurs. This can be, in the case where assets are taken over by government, at the time when the operation is agreed between the parties.

IV.5.3.4 Valuation issues for assets other than loans[6]

31. The general rule for valuing these kinds of assets in national accounting is to record them at their market price (fair value). Since the implementation of the International Financial Reporting Standards (IFRS 39) in the EU, it should often also be the rule in company accounting.

32. However, it may happen – and it happened in the recent past – that in the internal bookkeeping of the financial institutions, the gross value of impaired assets – i.e. value before amortisation or other provisions – corresponds to the price paid for their acquisition. More generally, it may happen that the book value of these assets just does not correspond to the market value. Let us call this their accounting value.

[6] The Eurostat decision of July 2009 made in the context of the financial crisis provides useful criteria for the valuation of assets.

33. If such assets are placed in the defeasance, it is certainly because their market value has fallen below their accounting value.

    If they are transferred at this accounting value, a capital transfer needs to be recorded in national accounts to reflect this difference between the accounting value and the market value. In the case where the market value is not available but where an estimation of the expected losses is available, this estimate could be used as a proxy for the difference between accounting and market value.

34. Subsequent changes in the market price of these assets, when held by units classified inside general government, give rise to the recording of holding gains/losses.

IV.5.3.5 The case of loans

35. The valuation of loans is dealt with in ESA95 7.51. The general rule is to record, in the balance sheets of both creditors and debtors, "the amounts of principal that the debtors are contractually obliged to repay the creditors, even in cases where the loan was traded at a discount or premium". This is the redemption value. The notion of fair value,(or market value) commonly used in business and banking accounting systems, is not recognised for loans in the balance sheets in the system of national accounts.

36. In 5.79 and 6.51, the ESA95 gives further guidance when loans are traded at a price which is different from the redemption value. Two opposite entries have to be recorded in the revaluation accounts of both seller and purchaser in order that the transaction price be recorded in their financial accounts, and the redemption value recorded in their balance sheet before and after the transaction.

37. In a financial defeasance, when loans are sold by the financial institutions to a government unit, the transaction value may often equal their redemption value.

38. Nevertheless, it is common sense to assume that the loans put in the defeasance are indeed bad loans, with a low expectation that they will be repaid for their full amounts, and the transaction is undertaken by government for other than purely commercial considerations (ESA95 5.136). Accordingly, the transaction values would have to be identified with the "current market values" of the loans, which are usually not available in practice. However, it might happen that estimates on expected losses might become available in the context of the financial defeasance which could be used as a proxy for the difference between the amount paid and the market value (see also §3.4). In addition, loan portfolios are likely to have been subject to provisions for bad debt in the internal bookkeeping of financial institutions (in terms of company accounting) which may provide supplementary information on the potential size of a capital transfer. It is recalled that in ESA95, "provisions for bad debt [...] do not appear anywhere in the system" (§4.165, f).

39. However, if, at the time the defeasance is implemented, there is reliable information leading to think that some loans will never be repaid, these loans have to be removed from the financial institutions' balance sheet before the transaction, for their full value. This is recorded in the other changes in volume of assets account of the financial institutions, as if they would have been actually written off. Their value is therefore zero and any payment made to acquire them will thus be part of the capital transfer from government. During the management of the defeasance, they will not appear in the defeasance unit's balance sheet.

IV.5.3.6 Global assessment of the treatments

40. When undertaken by government, defeasance leads to an impoverishment of general government. There are three ways in which this occurs, according to the above rules:

- in one instance, when a capital transfer is recorded when a government unit buys the involved assets: this has a direct impact on its net lending/borrowing at the time the transfer is recorded;
- on several occasions, when government acts through its guarantee: this has an impact on its net lending/borrowing every time the guarantee is called;
- on several occasions, when the assets bought by a government unit are loans which have been transferred without the recording of a capital transfer[7]. This has an impact on government net lending/borrowing if the loans are cancelled by mutual agreement; when the debtor no longer exist, the impact on government wealth is recorded through an other change in the volume of assets.

41. The classification inside the general government sector of units in charge of the defeasance financing may also have an impact on government debt if these units borrow their funds or issue securities, or take over liabilities; it will then also have an impact on net lending/borrowing of the general government sector through the financing cost (interest).

IV.5.4 Accounting examples

42. The example illustrated here deals with the case where a unit, classified inside general government, buys from a financial institution some bad assets at their bookkeeping value.

    The cases of guarantees are not illustrated (see the chapter dedicated to government guarantees). The government equity in the financial institution is not shown.

IV.5.4.1 Setting up the defeasance

Assets transferred from financial institutions to the public unit in charge of the defeasance are the following ones:

- Securities / shares, with a bookkeeping value of 40, and a market value of 25 (value in the opening balance sheet);
- Buildings, with a bookkeeping value of 10, and a market value of 5 (in the opening balance sheet);
- Loans, with a redemption value of 50 (in the opening balance sheet): during the year and at the time the defeasance is set up, some loans are considered as being irrecoverable, for an amount of 10.

As the bookkeeping value of the assets is 100 (10+40+50) and as the market value is falling to 70 (5+25+40), a capital transfer of 30 is recorded.

[7] The possible holding gains/losses on the other assets are not dealt with here.

The government unit is assumed to have borrowed all its funds.

General government unit				Financial institution			
Opening balance sheet							
A			L	A			L
AF.2	x	AF.4	x	AN	5		
				AF.4	50		
				AF.5/AF.3	25		
Capital account							
ΔA			ΔL	ΔA			ΔL
P.5	5	D.99	-30	P.5	-5	D.99	+30
B.9	-35	B.10.1	-30	B.9	+35	B.10.1	+30
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	-100			F.2	+100		
F.4	+40			F.4	-40		
F.5/F.3	+25	B.9	-35	F.5/F.3	-25	B.9	+35
Other changes in volume of assets account							
ΔA			ΔL	ΔA			ΔL
				K.10 on AF.4	-10	B.10.2	-10
Closing balance sheet							
A			L	A			L
AN	5			AF.2	100		
AF.2	x -100						
AF.4	40						
AF.5/AF.3	25	B.90	-30			B.90	+20

IV.5.4.2 Management of the defeasance

Starting from the establishment of the defeasance until liquidation of the unit in charge of management of the assets, the following events occur:

- securities are finally sold for 30,
- buildings are finally sold for 8,
- of the total amount of 40 of loans: 30 are finally repaid, 6 are written-off, and 4 are cancelled by mutual agreement.

The repayment by the unit of the loan it has acquired, as well as interest payments are not shown.

General Government Unit

Opening balance sheet

A			L
AN	5		
AF.2	x – 100		
AF.4	40		
AF.5/AF.3	25		

Capital account

ΔA			ΔL
P.5	-8	D.99	-4
B.9	+4	B.10.1	-4

Financial account

ΔA			ΔL
AF.2	+68		
AF.4	-34		
AF.5/AF.3	-30		
		B.9	+4

Other changes in volume of assets

ΔA			ΔL
K.10 on AF.4	-6		
		B.10.2	-6

Revaluation account

ΔA			ΔL
K.11 on AN	+3		
K.11 on AF.5/3	+5	B.10.3	+8

Closing balance sheet

A			L
AN	0		
AF.2	x -32		
Other AF	0	B.90	-2

IV.6 Key-words and references

Rerouting and principal party to a transaction	ESA95, 1.39, 1.41
Financial intermediation / intermediary	ESA95, 2.32, 2.33
Other capital transfer	ESA95, 4.164, 4.165
Valuation of transactions	ESA95, 5.136, 5.79, 6.51
Valuation of assets	ESA95, 7.33, 7.51, 7.69

V

Sale of assets

Part V Sale of assets

V.1 Overview

1. Governments sell financial and non-financial assets to raise cash and/or to improve the efficiency with which such assets are used. Governments might also transfer flows of receipts, or incur a future obligation to make payments, in return for cash today. In most cases, a simple sale of an asset is recorded for the transaction in national accounts. However some cases are more complicated, particularly when:
   - sales take place through public corporations;
   - the economic risks and rewards are not fully transferred by the “sale”;
   - the government’s remuneration for the sale is not in cash or differs from the value of the assets sold;
   - the “asset” that appears to be sold is not an asset recorded in the Government’s balance sheet in national accounts.
2. In the guidance that follows, the key principles applied are the recording of economic substance over legal form, especially the concept of economic ownership; the distinction between financial and non-financial flows; and the notion of income.

V.2 Sales of financial and non-financial assets

V.2.1 Background to the issue

1. Privatisation normally means general government giving up, control over a public enterprise by the disposal of shares and other equity in the enterprise. The scope of this note is larger than just that operation: it also addresses more general case of general government selling shares and other equity in enterprises, without necessarily having control on them or, if having it, without giving up this control. These sales may be made directly or indirectly. Sales of non-financial assets are also dealt with.
2. Four cases may be distinguished:
   a. The government sells shares or other equity in an enterprise. This sale is said to be "direct".
   b. Assume government owns enterprise A (typically a holding company), which sells shares or other equity in an enterprise B and gives the proceeds of the sale to government. This sale is said to be an "indirect" sale by government of financial assets.
   c. The government sells non-financial assets. This is said to be a "direct" sale of non-financial assets.
   d. Assume government owns enterprise A (typically a holding company), which sells non-financial assets and gives the proceeds of the sale to government. This sale is said to be an "indirect" sale by government of non-financial assets.
3. The funds provided by the enterprise to government through an indirect sale may take various forms other than cash. For example they could consist of such as the redemption of amounts owed by the enterprise to the government. In the following, only provision of assets is considered, but this assumption does not change the proposed treatments.

V.2.2 Treatment in national accounts

V.2.2.1 Direct sale of financial assets

4. The direct sale of financial assets has to be completely recorded in the financial accounts of general government and of the involved enterprise: it is a withdrawal of shares or other equity (F.5) from the enterprise which was, partially or totally, owned by government, with a counterpart entry as an increasing of a financial asset (most of the time, liquid assets, F.2).
5. This has no impact on the net lending/net borrowing of general government.

V.2.2.2 Indirect sale of financial assets

6. The indirect sale of financial assets also has to be recorded in the financial accounts of general government and of the above-mentioned enterprise A: it is a withdrawal of shares or other equity from enterprise A, with a counterpart entry as an increasing of a financial asset. This is true whether or not enterprise A gives to its owner, the government, *all* or *parts* of the proceeds of the sale. The indirect sale of financial assets has no impact on the net lending/net borrowing of general government.

V.2.2.3 Direct sale of non-financial assets

7. The direct sale of non-financial assets has to be recorded in the capital account of general government: it is a disposal of non-financial assets, with a positive impact of net lending/borrowing of general government. Non-financial assets include fixed assets, inventories, valuables, land or other non-produced non-financial assets.

V.2.2.4 Indirect sale of non-financial assets

8. The general government accounts would record the indirect sale of non-financial assets as a financial transaction: it is a withdrawal of shares or other equity from the enterprise A which was, partially or totally, owned by government, with a counterpart entry as an increase in a financial asset in respect of the funds received.

V.2.2.5 Time of recording, amounts to be recorded

9. In the general government accounts:
   - in cases of direct sales, transactions have to be recorded when the change of ownership takes place;
   - in cases of indirect sales, when the proceeds of the sales are paid back to general government.
10. The amounts to be recorded are the full amounts of the proceeds of the sale (less any amount kept by the owning company in the case of an indirect sale), as they are paid by purchasers: they correspond to the market value of the assets, which are sold at the time of transaction.
11. In particular, in the case of indirect sales, it may happen that the total or some parts of the proceeds are recorded as dividends, taxes or other kinds of flow in the internal bookkeeping of the parties to the transaction. They have nevertheless to be recorded as financial transactions in national accounts.
12. In the case of a partial refund to government of the proceeds of an indirect sale, the full payment to government is treated as financial transaction. In practice, such sales may require government to employ the services of financial intermediaries or other non-financial services. This is especially true in case of privatisation. The cost of these services has to be recorded as intermediate consumption. If they are actually paid out of the proceeds of the sales (through a reduction in the amount passed to government), an imputation has to be made so that the total proceeds of the sale are recorded before netting off the service charge. Of course, if payments are made to general government - e.g. as dividends or taxes - in addition to the proceeds of the sales of assets, they have to be recorded, if relevant, in the specific non-financial transactions.
13. The case where a part of the proceeds of the sale is kept by enterprise A is dealt with in the following chapter V.3.
14. The cases of indirect sales addressed here deal with sales of assets of a substantial amount that are made with the intention to pay back the proceeds to general government. Frequently these sales are part of a privatisation plan decided by the government. However, it may happen that, as part of their normal operations, enterprises sell a few assets and thus realise some capital gains. These capital gains might then be distributed to general government through dividends or specific taxation, in such a way that the proceeds of the sale of assets can be seen to contribute financial resources to the amount paid back to general government. It is not always possible for statisticians to sort out these flows. As a result, it is not considered necessary, in such cases, to treat these flows as financial ones.

V.2.3 Rationale of the treatment

15. The rationale of the rules dealing with direct sales is straightforward. For the sales of financial assets, they stem from the definition of financial transactions (ESA95 5.02, 5.15) and of the financial account (ESA95 8.50). Basically, in this direct exchange of one financial asset for another in the balance sheet of the government, there is no change in wealth, nor no flow of income. For the sales of non-financial assets, they stem from the definition of the disposal of the concerned assets and of the capital account (ESA95 8.46).

16. The rationale for the treatment of indirect sales is first based on the fact that the payment of the proceeds of the sales is not a transfer of income, but a transfer of wealth/assets. However, it cannot be considered as a capital transfer: the definition of other capital transfer (ESA95 4.165) does not make room for such a treatment. Moreover, in these cases, payments are provided only because of the rights of ownership that government has on the involved enterprises.

17. This is the rationale for the exclusion from capital transfers of the payment of privatisation proceeds, as indicated in ESA95 4.165, g: “However, the counterpart transactions of transfers to general government of the proceeds of privatisation made indirectly (through a holding company for example) have to be recorded as financial transactions in shares and other equities (F.5) and have therefore no direct impact on the level of net lending/net borrowing of the general government”.

18. Paying back the proceeds of the sale to the government diminishes the assets of enterprise A. It can be viewed as a partial liquidation. The result is logically a decrease of the equity of the owner in enterprise A. This treatment of indirect privatisation is easily extended to any case of indirect sale of financial assets, and is also extended to the case of indirect sales of non-financial assets.

19. The notion of dividend in national accounts is clear: this is a property income. Dividends must result from income streams and not from sale of assets or from revaluation of assets. Distributing income should not diminish the net wealth/net assets of the enterprise. What may be distributed to the owners is the entrepreneurial income (ESA95 8.26-29).

V.2.4 Accounting examples

In all the following examples, the counterpart flow of sales is a transaction in currency and deposits (AF.2). The enterprise of which general government sells shares or other equity or from which it receives the proceeds of such a sale is called public enterprise, even if government does not actually control it.

V.2.4.1 Direct sale of financial assets

General government				Public enterprise			
Opening balance sheet							
A			L	A			L
AF.5	z					AF.5	z
Financial account							
ΔA			ΔL	ΔA			ΔL
F.5	-x						
F.2	+x	B.9	0				
Closing balance sheet							
A			L	A			L
AF.5	z –x					AF.5	z
AF.2	+x	Δ B.90	0			Δ B.90	0

V.2.4.2 Indirect sale of financial assets

General government				Public enterprise A			
Opening balance sheet							
A			L	A			L
AF.5	z			AF.5	y	AF.5	z
Financial account							
ΔA			ΔL	ΔA			ΔL
F.5	-x			F.5	-x	F.5	-x
F.2	+x	B.9	0			B.9	0
Closing balance sheet							
A			L	A			L
AF.5	z –x			AF.5	y -x	AF.5	z -x
AF.2	+x	ΔB.90	0			ΔB.90	0

V.2.4.3 Direct sale of non-financial assets

General government

Opening balance sheet

A			L
AN	z		

Capital account

∆A			∆L
Disposal of AN	-x		
B.9	+x		

Financial account

∆A			∆L
F.2	+x		
		B.9	+x

Closing balance sheet

A			L
AN	z -x		
∆AF.2	+x	∆B.90	0

V.2.4.4 Indirect sale of non-financial assets

General government				Public enterprise A			
Opening balance sheet							
A			L	A			L
AF.5	z			AN	y	AF.5	z
Capital account							
ΔA			ΔL	ΔA			ΔL
				AN	-x		
				B.9	+x		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.5	-x			F.2	+x -x	F.5	-x
F.2	+x	B.9	0			B.9	+x
Closing balance sheet							
A			L	A			L
AF.5	z –x			AN	y -x	AF.5	z -x
ΔAF.2	+x	ΔB.90	0			ΔB.90	0

V.3 Privatisation proceeds in a public holding

V.3.1 Background to the issue

1. In some EU Member States, holding companies have been set-up by the government to restructure the public sector with the aim of making the enterprises more competitive and profitable and, in the long run, disengaging the government. Often their main activity is to organise the privatisation efficiently and transfer the proceeds of the sale of shares to other public corporations (owned by the holding company or not), through grants, loans or capital injections.
2. It may also happen that, in other countries where public holding companies have existed for a long time – created in a different context and with different strategic views – some could be given this same function. This may also concern some public entities like regional development agencies managing funds (including shares and other equity) belonging to government or possibly to European institutions (structural or cohesion funds).
3. The main issue is: what is the relevant sector classification of this sort of unit managing privatisation and possibly making grants to other enterprises? Should this activity been considered as taking place on behalf of the government?

V.3.2 Treatment in national accounts

4. There are four possibilities:
    1. The public holding company is a market unit and moves funds around within the group as part of a business strategy for the group, in the same way that a private corporation would behave.

       Solution: record no government transactions
    2. The public holding company is a market unit and moves funds around within the group to support loss-making activities as part of government's economic and social policy.

       Solution: reroute transactions through government if the subsidies and grants made for non-market reasons can be clearly identified.
    3. The public holding company is a market unit but gives grants and subsidies to units outside the group.

       Solution: reroute the payments through government.
    4. The public holding company is a non-market unit.

       Solution: classify to government.

V.3.3 Rationale of the treatment

5. ESA95 2.14:"Holding corporations are institutional units whose main function is to control and direct a group of subsidiaries". Holding corporations may usually be considered market producers, either non-financial or financial, according to the main activity of the group (see 2.100).
6. A problem arises when the main function of the public holding is not really to define and implement a development strategy for its subsidiaries (in the framework of a long-term plan for the group), but to restructure and change the ownership status of public

corporations, as well as channelling the funds from one to the other, redistributing income and wealth.

7. This public sector reorganisation project, involving management of assets and redistribution of income and wealth, is a direct implementation of a central government macro-economic strategy. In many EU Member States, this is (or was) often implemented by the Treasury itself. In the case examined here, the Treasury uses an intermediary, which is supposed to manage public assets and to redistribute funds in a short or medium-term context.

8. This type of activity should be regarded as a management of assets for public policy purposes, taking place on behalf of the government.

9. There can be a contradiction between the economic nature of relationships and of transactions between units, and the legal presentation of these units and of their relationships. Some provisions in the ESA95 (notably in chapter 1) allow for a statistical treatment that might diverge from the legal arrangements:

   - 1.38: "Rearranged transactions

   (...) However, some transactions are rearranged in order to bring out the underlying economic relationships more clearly. Transactions can be rearranged in three ways: rerouting, partitioning and recognising the principal party to a transaction."

   - 1.39: "Rerouting

   (...) Another type of rerouting is that of transactions recorded as taking place between two or more institutional units, although according to the parties involved no transaction takes place at all."

   - 1.41: "Recognising the principal party to a transaction

   When a unit carries out a transaction on behalf of another unit, the transaction is recorded exclusively in the accounts of the principal (...)."

10. These statements derive from the general principle, according to which: "the basic principles of national accounts require that all transactions occurring in different legal settings, but having the same economic effects, are to be recorded in the same way".

    <u>Some further elaboration of these solutions</u>

11. If the public holding is a real corporation, "controlling and directing a group of subsidiaries" in a usual corporate manner, and only a minor part of its activity consists of acting for public policy purposes (privatising, supporting public corporations...) on behalf of the government:

    – To reroute the flows related to this part of its activity:

    – The proceeds of the sale of assets being routed directly to the government

    – The payments to public corporations being recorded as government grants or whatever sort of transactions is relevant in this context.

12. In the case of the transaction with the public subsidiary being a financial one (a loan for instance), it could be recorded first between the government and the public holding, and then between the public holding and the subsidiary. In the case of an investment grant, a direct recording between the government and the public enterprise would be preferable.

13. If the major part of the public holding activity consists of acting for public policy purposes (privatising, supporting public corporations), on behalf of the government:

    – To classify the public holding inside the government sector, regardless of its legal status.

14. See the case of public holdings dedicated to the management of assets on behalf of the government in chapter I.7.

15. When the public holding company provides grants or any other type of transfers to enterprises (whether private or public) outside of its group, there is an even stronger presumption that it is acting this way on behalf of the government.

V.3.4 Accounting examples

Government owns a holding company that is classified in the non-financial corporation sector. This holding disposes – for an amount of 100 – of shares it has in a subsidiary A, as part of a privatisation programme decided by government. The holding company keeps the proceeds of this disposal; from these proceeds, it pays 20 to another subsidiary B. This payment is analysed as being of a government nature – another subsidy on production, for instance – because there is no financial asset received in exchange and no expectation of return in form of property income. At the beginning of the period, equity of government in the holding company amounts to x, equity of the holding company in its subsidiary B amounts to z.

General government				Holding company				Subsidiary B			
Opening balance sheets											
A			L	A			L	A			L
AF.5	x			AF.5	z	AF.5	x			AF.5	z
Non financial accounts											
U			R	U			R	U			R
		D.39	-20					D.39	-20		
B.9	-20							B.9	+20		
Financial accounts											
ΔA			ΔL	ΔA			ΔL	ΔA			ΔL
F.2	+20			F.2	+100	F.5	-20	F.2	+20		
F.2	-20			F.2	-20						
F.5	-20	B.9	-20	F.5	-100	B.9	0			B.9	+20
Closing balance sheets											
A			L	A			L	A			L
AF.5	x -20			AF.5	z -100	AF.5	x -20	AF.2	+20	AF.5	z
				AF.2	+80						
		ΔB.90	-20			ΔB.90	0			ΔB.90	+20

V.4 Restitution and use of vouchers for privatisation

V.4.1 Background to the issue

1. In transition economies, the concept of privatisation can be extended to also include any transfer (disposal) to the public or former (private) owners of government assets previously nationalised or confiscated.
2. Three cases have been identified:

V.4.1.1 Restitution in kind

3. Restitution in kind refers to the return to the original owner of non-financial assets (in general land and buildings, but also production plants in some cases) formerly nationalised or confiscated by the State, and generally owned at the time of restitution by the government but in some cases by public corporations. The non-financial assets may, therefore, be fixed assets, inventories, valuables, land or other non-produced assets.

V.4.1.2 Restitution through financial compensation

4. In cases where the property to be returned to former owners does not exist or cannot be returned, financial compensation can be made in the form of money or other financial instruments such as bonds or shares.

V.4.1.3 Privatisation through the issue of vouchers

5. For carrying out the privatisation of publicly owned assets in some transition economies, governments have distributed vouchers to the population, either free of charge or sold at nominal prices. Holders of vouchers can acquire shares and other equity (directly or indirectly) or non-financial assets.

V.4.2 Treatment in national accounts

V.4.2.1 Restitution in kind

6. Restitution in kind represents a transfer of non-financial assets from the government to the sectors benefiting from the restitution. Two cases can be distinguished:

   a. **The non-financial asset to be returned is roughly the same as the one nationalised or confiscated in the past. This may be the case for land and other non-produced assets.**

      This type of restitution should be considered as a return of an uncompensated seizure to be recorded in the other changes in volume of assets account. Therefore a flow is to be recorded in the other changes in volume of assets account of general government. Such a flow has no impact on the net lending/net borrowing of general government. However, it has an impact on the stock of assets recorded in the balance sheets, and therefore increases the net worth of the sectors benefiting from the restitution and simultaneously decreases the net worth of general government.

b. The non-financial asset to be returned is different (in terms of appearance and value) from the one nationalised or confiscated in the past. This may be the case for dwellings and other tangible fixed assets.

In this case, the return should be recorded as a transaction, a negative capital formation in the government account, counterbalanced by a "payment of a capital transfer in kind (with reversed sign in the accounts of the receiving sector). As both flows are balanced in the capital account, there is no impact on the net borrowing/net lending of general government. However, the capital transfer leads to an increase of the net worth of the sectors benefiting from the restitution and simultaneously to a decrease of the government's one.

V.4.2.2 Restitution through financial compensation

7. Restitution through financial compensation represents a transfer of financial assets from the government sector to the sectors benefiting from the compensation. It should therefore be recorded in the government accounts as a decrease in financial assets, counterbalanced by a capital transfer in kind or in cash (payable), and in the accounts of the receiving sectors as an increase in financial assets, offset by a capital transfer in kind or in cash (receivable). The capital transfer has a negative impact on the net lending/net borrowing of general government, as well as on the net worth.

V.4.2.3 Privatisation through the issue of vouchers

8. The vouchers are used (mostly by households) to acquire financial or non-financial assets and can be seen as a commitment by the government to redeem them against those financial or non-financial assets. In general, vouchers are only conditional upon the acquisition of financial and non-financial assets and therefore considered, as *contingent assets* not recorded in the system.

9. In the system, contingent assets are considered as financial assets under certain conditions (ESA95 5.05):

- if tradable: a market develops where they can be traded or offset;
- if information exists on vouchers: on transactions carried out, and on market prices;
- if the market has a sufficient volume of transactions so that the total value of the market can be derived.
- if considered as financial assets, vouchers may be considered as special kind of financial derivatives (F.34).

10. A distinction can be made between the following two cases depending on whether vouchers are considered as financial assets or not:

V.4.2.3.1 <u>Vouchers are considered as financial assets when issued</u>

11. In this case, the vouchers are recorded in the national accounts system at the time of their issuance.

a. Acquisition of financial assets

The transfer of vouchers should be recorded as a financial transaction (in financial derivatives F.34), counterbalanced by a capital transfer in kind from general government. This has a negative impact on the net borrowing/net lending of general government, as well as on the net worth.

To the extent that vouchers can be traded or offset on the market, a market will develop and their value will be determined on that market. Transactions in the vouchers are to be recorded as *financial transactions* between the respective sectors. Variations in the value of the vouchers during the same period should be recorded as

holding gains and losses in the *other changes in assets accounts* (revaluation account) of the various sectors involved.

The exchange of vouchers for shares in public corporations is to be entirely recorded in the financial account of general government. This has no impact on net lending/net borrowing of general government.

b. Acquisition of non-financial assets

Vouchers are exchanged for commodities sold by non-financial corporations. The non-financial corporations acquire a claim against general government, and use it for bidding for shares owned and offered for sale by the general government.

The exchange of vouchers for commodities should be recorded as final consumption expenditure (P.3), counterbalanced by a decrease in financial derivatives (F.34) on the assets side of households. The government should record a decrease in financial derivatives (F.34) on the liability side and a decrease of shares and other equity (F.5) in the public corporations on the asset side. As a result, there is no impact on the net borrowing/net lending and on the net worth of the general government.

V.4.2.3.2 Vouchers are only contingent assets

12. If vouchers are considered to be contingent assets they are not recorded in the system at issuance. They can only be used to acquire financial or non-financial assets.

13. In this case, no recording of the vouchers is done at the time of their issuance but only when the exchange for financial or non-financial assets takes place.

a. Acquisition of financial assets

The exchange of vouchers for shares in public corporations should be recorded as a financial transaction in shares and other equity (F.5), counterbalanced by a capital transfer in kind (D.9) from general government. This leads to an increase in shares and other equity of households on the asset side, and to a decrease of shares and other equity of government on the asset side. The exchange has a negative impact on the net lending/net borrowing of general government, as well as on the net worth.

b. Acquisition of non-financial assets

The exchange of vouchers for non-financial assets should be recorded as a negative capital formation (P.511), counterbalanced by a capital transfer in kind (D.9) from general government. This has no impact on net lending/net borrowing of general government. However, the exchange leads to a decrease of the net worth of general government.

V.4.2.4 Impact of vouchers on government debt

14. In the ESA95 framework, the recording of vouchers in the balance sheet of the government (as soon as considered financial liabilities) will increase the stock of government liabilities.

15. In the excessive deficit procedure framework, to the extent that we assume that the appropriate assets/liabilities for recording them are financial derivatives (F.34), vouchers would not influence the calculation of government debt (see part VIII).

V.4.3 Rationale of the treatment

V.4.3.1 Restitution in kind:

16. The two following cases can be analysed differently:

    1. The returned asset is the same as the one seized by government: this is a unilateral restitution of wealth giving back a non-financial asset, that the government took possession of in the past without compensation. The uncompensated part of such unilateral seizures is not a capital transfer (ESA95 6.24), but to be recorded in the other change in volume of assets account (K8). The confiscation and the restitution are treated in a symmetrical way.

    2. The returned asset has changed: the restitution is analysed as a voluntary transfer of wealth, made by mutual agreement (unlike other changes in volume of assets). The counterpart transaction is considered as a capital transfer (Other capital transfers, D.99: ESA95 4.164). This is concluded from the definition of capital transfers (ESA95 4.146: A capital transfer in kind consists of the transfer of ownership of an asset (other than inventories and cash), or the cancellation of a liability by a creditor, without any counterpart being received in return). One may also consider that the transfer will require some government financing.

V.4.3.2 Restitution though financial compensation:

17. The compensation is normally made many years after the confiscation (often 40 to 50 years). In distinction to restitution in kind (when the asset has not changed), restitution through financial compensation needs to be financed by the government. Like in all cases of transfer of wealth made by mutual agreement, the counterpart transaction is a capital transfer (Other capital transfers, D.99: ESA95 4.164).

V.4.3.3 Exchange of vouchers:

18. When considered financial assets, the exchange of vouchers for shares and other equity (AF.5) stem from the definition of financial transactions (ESA95 5.02, 5.15) and of the financial account (ESA95 8.50): in direct exchange of one financial asset for another in the balance sheet of the government, there is no change in wealth, nor flow of income. For the exchange of vouchers for non-financial assets, the rules stem from the definition of the disposal of the concerned assets and of the capital account (ESA95 8.46).

V.4.4 Accounting examples

V.4.4.1 Restitution in kind

i. The non-financial asset to be returned is roughly the same as the one nationalised or confiscated in the past.

In the following examples, the government is assumed to return non-financial assets (land) worth 100 to the households sector.

General government				Households			
Opening balance sheet							
A			L	A			L
AN.21	100						
Other changes in volume of assets account							
ΔA			ΔL	ΔA			ΔL
K.8 (AN.21)	-100			K.8 (AN.21)	+100		
		B.10.2	-100			B.10.2	+100
Closing balance sheet							
A			L	A			L
AN.21	0			AN.21	100		
		Δ B.90	-100			Δ B.90	+100

The non-financial asset to be returned is different (in terms of appearance and value) from the one nationalised or confiscated in the past.

In the following example, the government sector is assumed to return dwellings worth 100 to the households sector.

General government				Households			
Opening balance sheet							
A			L	A			L
AN.111	100						
Capital account							
ΔA			ΔL	ΔA			ΔL
P.511	-100	D.9	-100	P.511	+100	D.9	+100
B.9	0	B.10.1	-100	B.9	0	B.10.1	+100
Closing balance sheet							
A			L	A			L
AN.111	0			AN.111	100		
		Δ B.90	-100			Δ B.90	+100

V.4.4.2 Restitution through financial compensation

In the following example, the government is assumed to compensate former owners of e.g. land or dwellings (households) with shares worth 100.

General government				Households			
Opening balance sheet							
A			L	A			L
AF.5	100						
Capital account							
ΔA			ΔL	ΔA			ΔL
		D.9	-100			D.9	+100
B.9	-100	B.10.1	-100	B.9	+100	B.10.1	+100
Financial account							
ΔA			ΔL	ΔA			ΔL
F.5	-100			F.5	+100		
		B.9	-100			B.9	+100
Closing balance sheet							
A			L	A			L
AF.5	0			AF.5	100		
		Δ B.90	-100			Δ B.90	+100

V.4.4.3 Privatisation through the issue of vouchers

In the following examples, a privatisation agency (belonging to the general government sector) is assumed to issue vouchers to be distributed to the household sector, free of charge. Households can, during a stipulated period of time, be used to acquire shares and other equity owned by the government in public corporations and/or non-financial assets (e.g. fixed assets, AN.11).

i. Vouchers are considered as financial assets when issued

General government				Households			
Opening balance sheet							
A			L	A			L
		AF.34	0	AF.34	0		
Capital account							
ΔA			ΔL	ΔA			ΔL
		D.9	-100			D.9	+100
B.9	-100	B.10.1	-100	B.9	+100	B.10.1	+100

Financial account

ΔA		ΔL	ΔA		ΔL
	F.34	+100	F.34	+100	
	B.9	-100		B.9	+100

Closing balance sheet

A		L	A		L
	AF.34	100	AF.34	100	
	Δ B.90	-100		Δ B.90	+100

Acquisition of financial assets

General government				Households			
Opening balance sheet							
A			L	A			L
AF.5	100	AF.34	100	AF.34	100		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.5	-100	F.34	-100	F.34	-100		
				F.5	+100		
		B.9	0			B.9	0
Closing balance sheet							
A			L	A			L
		AF.34	0	AF.5	100		
		Δ B.90	0			Δ B.90	0

ii. Vouchers are only contingent assets and therefore are not recorded in the system at issuance. They can only be used to acquire financial or non-financial assets.

Acquisition of financial assets

General government				Households			
Opening balance sheet							
A			L	A			L
AF.5	100						
Capital account							
ΔA			ΔL	ΔA			ΔL
		D.9	-100			D.9	+100
B.9	-100	B.10.1	-100	B.9	+100	B.10.1	+100
Financial account							
ΔA			ΔL	ΔA			ΔL
F.5	-100			F.5	+100		
		B.9	-100			B.9	+100
Closing balance sheet							
A			L	A			L
AF.5	0			AF.5	100		
		Δ B.90	-100			Δ B.90	+100

Acquisition of non-financial assets

General government				Households			
Opening balance sheet							
A			L	A			L
AN.11	100						
Capital account							
ΔA			ΔL	ΔA			ΔL
P.511	-100	D.9	-100	P.511	+100	D.9	+100
B.9	0	B.10.1	-100	B.9	0	B.10.1	+100
Closing balance sheet							
A			L	A			L
AN.111	0			AN.11	100		
		Δ B.90	-100			Δ B.90	+100

V.5 Securitisation operations undertaken by general government

V.5.1 Background to the issue

1. Governments may become involved in securitisation arrangements, a kind of operation commonly undertaken by banks to improve, among other things, capital solvency requirements and sources of funding.
2. The government finance statistics issue is whether a securitisation operation by government entails a government borrowing, thus entering government debt, or a government sale of an asset.

V.5.1.1 Securitisation arrangements and definition

3. Securitisation is a financial technique that consists in issuing securities (bonds) on the basis of cash flows expected to be generated by assets or other kinds of rights, belonging to the originator of the arrangement. Securities issued this way are usually referred to as "asset backed securities" (ABS).
4. The originator conveys the legal ownership rights over assets and/or over specific future flows, to a securitisation entity, which in return pays an amount to the originator. The securitisation entity finances this payment by issuing securities using the assets and/or rights to future flows transferred by the originator as collateral. Such a securitisation entity is often, though not always, a special purpose vehicle (SPV) specially established for the purpose of the securitisation and legally separated from the originator. Issuance of securities may be managed by a third party, for example a private bank, however this third party usually takes on no risk or reward within the operation.
5. Investors buy securities issued by the securitisation entity only on the basis of the flows that are generated by the assets/rights, and not on the basis of the credit position of the originator. The investors usually have a direct and legal claim on the receipts generated by the assets or other rights in the event that the securitisation entity does not pay the interest and capital due.
6. Thus, a securitisation operation typically differs from a collateralised borrowing operation: in the latter case the investor has both a claim on assets or other rights and a claim on the initial owner. Most securitisations operations do not provide for a recourse for investors against the originator.

V.5.1.2 Issues for national accounts

7. The key question is how to record in national accounts the proceeds received by government from a securitisation and whether there should be an impact on general government debt and/or deficit (B.9).
8. It is necessary to determine whether the securitisation entails a sale of an existing ESA95 asset to the securitisation entity, or entails borrowing using future cash receipts as collateral. A secondary issue deals with the impact on the government deficit, which may be affected when non-financial assets are the object of the securitisation operation.

9. A disposal of assets by a general government originator is recorded in national accounts at the time the securitisation operation takes place if:

- the items subject to the securitisation operation are assets recognised as such in national accounts and as transferable, and
- the operation is designed in such a way that all the risks and rewards attached to these assets are fully transferred to the securitisation entity, and
- the securitisation entity that acquires the assets from the originator is an institutional unit that is not part of the general government sector.

V.5.1.3 Scope of the chapter

10. The aim of this chapter is to provide rules on what can be recorded as a sale in national accounts in the context of a securitisation arrangement involving the government. The chapter not only discusses the securitisation by government of its assets, but also considers the case where a non-government unit securitises a flow of future payments from government to it, such as grants.

V.5.2 Treatment in national accounts

11. There are two possible recording options in national accounts for securitisation proceeds collected by a government originator:

- sale of an asset, i.e. the disposal of economic ownership of assets by government, in exchange for cash or other assets; or
- government borrowing (incurring a liability).

12. The consecutive criteria used to decide the appropriate recording are shown in the decision tree below.

V.5.2.1 Recognition of assets in national accounts

13. A necessary, but not sufficient, condition for a securitisation operation to be recorded as the sale of assets by government is that the assets are recognised in national accounts as assets, and therefore recorded as such in the national accounts balance sheet of government at the time the securitisation takes place. In this context it is useful to distinguish between financial assets and non-financial assets, when discussing the notion of risks and rewards. The following paragraphs deal with cases where the securitised items are not recognised as assets or are not considered transferable in national accounts. In all these cases, the securitisation is recorded as government borrowing.

V.5.2.2 Securitisation of flows attached to unrecognised asset

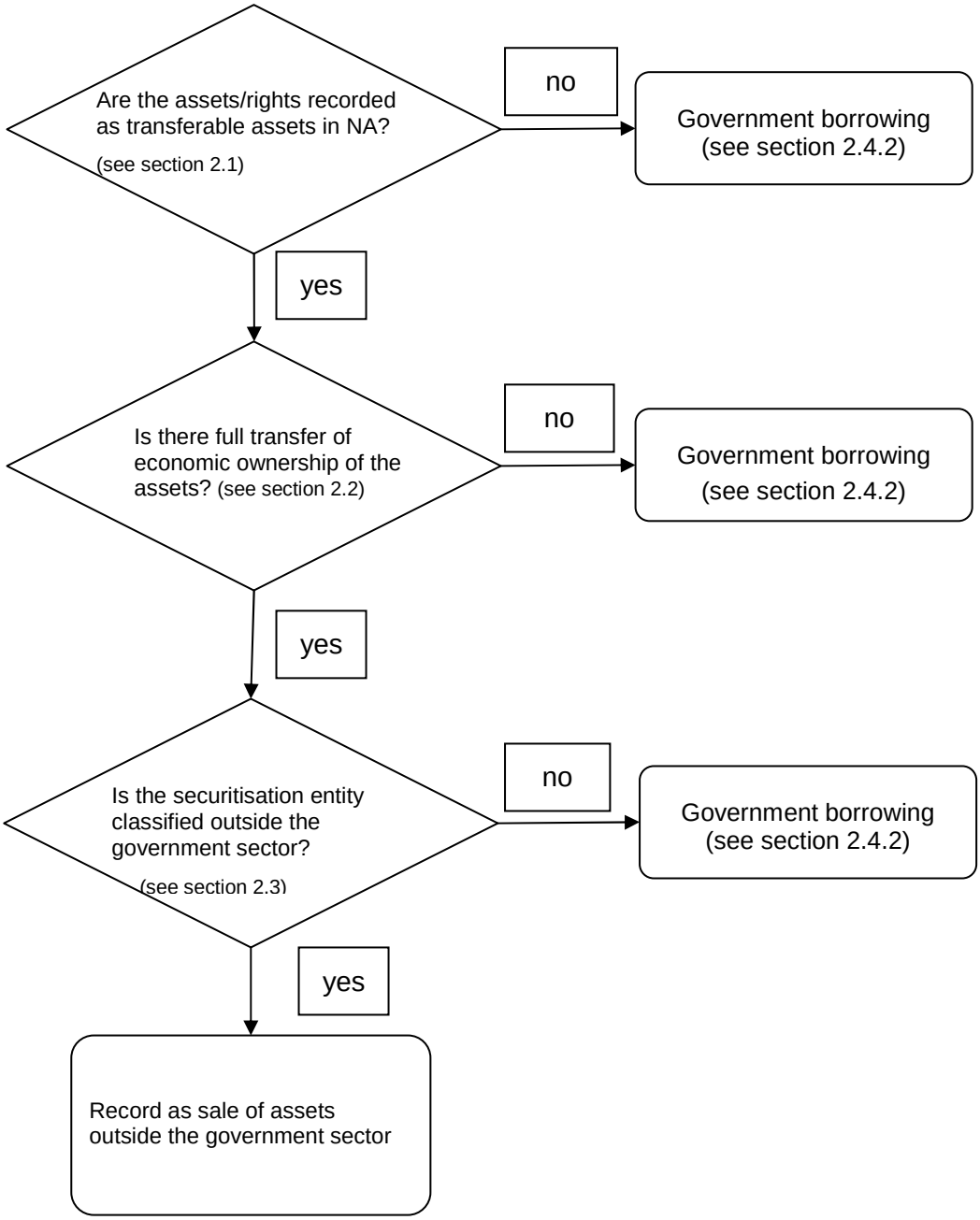
14. Government may securitise future revenues that are unrequited transfers, such as future tax revenue. However, since the entitlement to receive such transfers is not recognised as an asset in national accounts, it is not possible to record the sale of an asset in such cases. The revenue has not yet accrued, presumably because the event that leads to the tax liability has not yet taken place, and consequently no asset exists in the national accounts balance sheet. Thus, the securitisation by government of future tax revenue before the taxpayer's liability accrues is always recorded as government borrowing in national accounts.

15. The same recording (government borrowing) applies to the securitisation of transfers that government units may expect to receive from EU institutions or other international bodies, or from lottery receipts, licence fees or fines. More generally all unrequited

distributive transactions should be treated as government borrowing, as long as no entry has been reported in the national accounts balance sheet.

16. Loans assets that were not recognised as such in national accounts at inception, due to the low likelihood of recovery, are recorded as borrowing when securitised.

Decision tree: Sale of an asset or government borrowing?



V.5.2.3 Securitisation of fiscal flows

17. The ownership of certain assets recorded in the government's balance sheet in national accounts may be deemed economically non-transferable. In these cases, their securitisation is necessarily treated as government borrowing.

18. An example is financial claims in respect of taxes already accrued and recorded as financial assets in the national accounts balance sheet, sometimes referred to as “fiscal claims”. These fiscal claims (receivables) differ from the rights over future tax revenue (discussed in the previous section above). The revenue has been recorded in national accounts, together with a financial asset in the national accounts balance sheet (fiscal claims).

19. The national accounts balance sheet entry for fiscal claims should not be confused with the government’s book-keeping accounts, as the former excludes the amounts deemed to be uncollectible (see below 3.1.2). The securitisation of amounts deemed uncollectible is also recorded as government borrowing in national accounts.

20. Even if government outsources their collection, taxes (and compulsory social contributions) are still considered government revenue.

V.5.2.4 Securitisation of flows from non-transferred assets

21. Government may securitise the ‘income stream’ flows generated by assets that are recorded in the national accounts balance sheet. These flows include rentals, rents, interest, dividends and other property incomes (P.1 and D.4). For instance, non-residential buildings generate rentals paid by the buildings’ occupiers.

22. When government securitises several rental periods only amongst all the future rentals that they expect to receive, it does not dispose of the full risks and rewards of the assets, and therefore of the economic ownership on the buildings themselves. In such cases, the securitisation arrangement should be recorded as government borrowing in national accounts.

23. Similarly, the securitisation of (partial) future streams of property income generated by financial assets is also recorded as government borrowing when the economic ownership of the financial assets is not fully transferred. Criteria to determine the transfer of ownership are discussed in section 2.2 of this chapter.

V.5.2.5 Transfer of ownership: risks and rewards

24. Assuming that the securitised items are recognised as transferable assets in national accounts, a sale of these can only be recorded in national accounts if there is a full transfer of economic ownership from government to the securitisation entity. There is a full transfer of economic ownership of assets when the risks and rewards that are attached to these are completely transferred. If the risks and rewards are not fully transferred from government to the securitisation entity, the securitisation is recorded as government borrowing.

V.5.2.6 Notion of risks and rewards

<u>Financial assets</u>

25. The risks and rewards associated with financial assets are:

- the risk of default, delays, and early redemption of principal and interest;
- the variability of accruing interest in the case of floating rate loans and bonds;
- the variability of dividends in the case of shares;
- holding gains and losses.

26. The risk of defaults and delays is frequently referred to as “credit risk”.

27. In some cases, the government, in return for a fee, acts as an agent collecting the property income from financial assets sold, which it then passes to the purchaser. This might be because it would be costly to transfer such operations to the new owner or

because of agreements with borrowers when the assets were first created. The originator's retention of the collection function is frequently observed in the private financial sector. In such circumstances, the sale can still be recorded as a disposal of financial assets, provided that the collection arrangement does not affect the transfer of risks and rewards to the securitisation entity. The sole fact that government is collecting the property income alone would not affect the economic ownership being with the purchaser (see §74 - 75).

Loans

28. Loans are also frequently sold together - as a "loan book" - rather than sold individually. In this context, a partial sale of a loan book often takes place, which can be arranged in different ways, such as by randomly selecting (at time of securitisation) borrowers whose repayments are sold to the purchaser, or by selling a fixed proportion of the portfolio repayments received every day from the loan book. The partial sale of loan book through the sale of claims specifically selected can be recorded as a sale of loans in national accounts. The sale by government of a fixed proportion of the total repayments cannot be recorded as a sale of loans in national accounts, and is to be recorded as government borrowing.

Non-financial assets

29. Usually, the securitisation entity does not take possession of non-financial assets with the intention of holding them until the end of their economic life; instead, it intends to resell them. Therefore, in addition to the risks of default on the income (rentals and rents) that are associated with these assets, there is a risk of holding losses, and conversely there are possible rewards if holding gains arise (as for financial assets) which may lead to lower or higher than expected revenue from the eventual sale of the assets.

30. The transfer of operational risks and rewards, such as the variability of maintenance and insurance costs, must also be considered when judging risk transfer in cases of securitisations involving non-financial assets.

V.5.2.7 Judging risks and rewards transfer

31. The risks and rewards associated with the asset are judged as not fully transferred, leading to a recording as government borrowing, if any of the following applies:

- Restrictions are imposed by government on the securitisation entity's right to subsequently sell the assets.
- Securitised flows concern only a fraction of flows associated to a given asset;
- There exists a "Deferred purchase price (DPP)" clause or equivalent, which demonstrates some residual ownership;
- Government provides guarantees or other forms of risk alleviation to securitisation entities, including by way of a "substitution clause" or other arrangements;
- Other ongoing involvement of government in the asset which prevents a full transfer of risks and rewards.

Equity tranche and DPP

32. In some securitisations, different tranches of securities issued are backed by different parts of the flows from the securitised assets. This means that there is a differentiation in the risks and rewards that are borne by investors. By this process, it is possible to include some mechanisms by which the originator, government, keeps a residual risk/reward (sometimes called an "equity tranche" or "last tranche"), to protect investors against an excessive under-performance of the securitised assets. This makes the

securities more attractive to investors. This mechanism prevents a full transfer of risks to the securitisation entity and leads to the recording of the securitisation arrangement as government borrowing.

33. In a securitisation contract, a “Deferred purchase price (DPP)” is another device of credit enhancement whereby the securitisation entity promises the originator to pay (performance related) instalments of the purchase price at a later date. When such clauses exist, the assets are disposed of at a value fixed below their market value. A DPP should not be confused with delayed settlements of a fixed price, which must appear as originator's receivables and as the securitisation entity's liabilities at inception, in accordance with the accrual principle.

34. Securitisation of arrangements including equity tranches, DPPs or similar clauses should be recorded as government borrowing, because such clauses provide evidence that not all the risks and rewards of the operation have been transferred to the securitisation entity.

Ex-ante guarantees

35. Government guarantees may be granted before (*ex ante*) securitisation. In a securitisation contract, government may commit itself to repay the debt incurred by the securitisation entity in the event of the latter being unable to do so from its own resources. This is an *ex ante* guarantee. Government securitisation arrangements that include *ex ante* guarantees should be recorded as government borrowing. This rule does not apply to *ex ante* guarantees that have a general purpose and that are offered to other units for similar events, such as covering against the consequences of limited external events such as natural disaster, terrorism and war.

36. Substitution clauses are a specific kind of guarantee. These typically involve an option to substitute the original assets transferred to the securitisation entity with new ones, for example if the transferred ‘asset’ is later found not to exist or impossible to collect. The existence of a substitution clause is important when judging the transfer of risks and rewards between the government and the securitisation vehicle.

37. Except for marginal cases limited in scope and deriving purely from technical reasons or material errors and where the substituted assets have the same value as the new ones, the existence of a substitution clause should lead to a recording as government borrowing.

Ex-post guarantees

38. Government may compensate ex-post the securitisation entity, although this was not a requirement of the contract. Such compensation may take the form of cash, debt assumption, or a direct or indirect guarantee. A further situation is where government introduces or modifies legislation, which leads to a *de facto* compensation of the securitisation entity.

39. At the time compensation is decided, the event should be recorded as a simultaneous purchase by government of the assets securitised, against an incurrence of a government liability (loan) towards the securitisation entity. This should be equal to the amount of the securitisation entity’s outstanding debt securities issued to finance the acquisition of the securitised assets.

40. If the market value of the purchased asset is lower than the liability incurred, a capital transfer is recorded from government to the securitisation entity for the difference.

41. A purchase of a financial asset will not affect the surplus/deficit of general government (B.9), unless the market value of the assets acquired is lower than the debt incurred.

42. A purchase of a non-financial asset increases any government deficit by the amount of the debt incurred because the acquisition of non-financial assets impacts on net lending / net borrowing.

43. The same rule applies when there is no ex-ante clause for the substitution of assets (see paragraph 37), but practice reveals that a significant amount of the securitised assets are replaced by others of higher market value. The incurrence of a government liability should be imputed against a repurchase of the asset at the time the substitution is decided.

44. These rules do not apply if compensation is paid by government to the securitisation entity as a result of an actual or potential court decision arising from government breaking the terms and conditions of the sale contract.

Restriction to subsequent sales

45. Any restriction to on-selling the acquired assets, or other rights to future cash flows, would provide evidence that economic ownership has not been transferred.

V.5.2.8 Classification of the securitisation entity

46. If the securitisation entity has no autonomy of decision concerning the management or disposal of the transferred assets or concerning its liabilities, the securitisation entity is not a separate institutional unit according to national accounts criteria (as stated in ESA95 2.12).

47. Assuming that the securitisation entity has been established to serve a government unit, a lack of autonomy of decision could be indicated, among other factors, by:

- management of the securitisation entity's debt by government; or
- the absence of the right or capacity to actively manage its assets in response to market conditions, such as government having the right to approve any significant disposal; or
- a pre-arranged contract signed by government which fully determines the securitisation entity's operations.

48. In most cases a securitisation entity will be formally set up by a private institution to purchase and securitise government assets. In these cases, if the securitisation entity does not have autonomy of decision (see above), it is necessary to determine whether it should be classified within the government sector or within the financial corporations sector. Generally it should be classified within government, since – to the extent that the government initiates the transaction - unless the financial institution arranging the securitisation places itself at risk and the securitisation entity has "substance" in the sense that it is required to make significant decisions during the life of the securitisation and such decisions are not made by the government unit but by the arranger or other entities investing in the securitisation entity or purchasing its securities.

49. If the securitisation entity meets the conditions to be considered as a separate unit, it should be classified as a financial corporation (S.12).

V.5.3 Recording rules

V.5.3.1 Recording as a sale of an asset

50. The transaction with the securitisation entity is recorded as a sale of a general government asset outside the general government sector if the three conditions set out in paragraph 9 above are met:

51. When the transaction is recorded as the sale of an asset, there is no direct impact on government debt. There would be an indirect (downward) effect if the proceeds from the securitisation were used to reduce government debt.

Financial assets

52. The sale of a financial asset to the securitisation entity will not affect the government deficit (B.9). In some cases the government unit, in return for a fixed fee, acts as an "arms-length" agent for the collection of debt repayments and property income from the sold financial assets, which it passes to the purchaser. This would be recorded as government output.

Non-financial assets

53. The sale of a non-financial asset to the securitisation entity will improve the government deficit (B.9). Some non-financial assets may continue to be used by government. As an example, in the case of the sale of residential buildings, the securitisation entity will typically acquire such buildings for the purpose of their resale. However, during the time between their acquisition and their resale, the buildings continue generating income in the form of rentals. Assuming that all the conditions relating to the transfer of ownership are fulfilled, the fact that the securitisation entity has the economic ownership of the securitised buildings implies that, in national accounts, the operating surplus that they generate is recorded with the securitisation entity (see section 6.3 of this manual on sale and leaseback operations for further guidance on this matter).

54. The production process consisting of operating the buildings for residential purposes may be allocated directly to the securitisation entity. This treatment should be adopted when the entity takes on board all the daily management of the buildings and has a full access to the rentals generated by the buildings. If the former owner, i.e. the government unit, keeps the daily management of the securitised buildings, and retains as management fees a part of the rentals generated by the buildings, most of the income should still be allocated to the securitisation entity.

The price fixed in the securitisation arrangement

55. In national accounts, the disposal of assets should be recorded at the market price that prevails at the time the transaction takes place. It is generally the observed sale price (contract price). However, if the observed sale price is lower than the market value:

- it may indicate that the operation is not carried out on a pure commercial basis and that there is an implicit support of the securitisation entity. In such a case, it is necessary to record a capital transfer from government to make up the difference between the observed price and the market value as the sale is recorded at market price in national accounts;
- it may be associated with the existence of DPP clauses (see above) and the transaction should not be recorded as a sale but as government borrowing.

56. If there is no obvious market price for specific assets, then, in order for an arrangement to be recorded as a sale, there should be a public process to determine an equivalent market price. The absence of such a process could be interpreted as a lack of autonomy of the securitisation entity, such that it should be classified to government.

V.5.3.2 Recording as government borrowing

57. If the securitisation operation does not fulfil the criteria necessary for it to be recorded as a sale of assets in national accounts, the securitisation proceeds collected by government should be recorded as the incurrence of a government liability, with an impact on the government debt. If the securitisation entity is classified to the government sector, the securities (AF.33) it issues are part of government debt. If the

securitisation entity is not classified to the government sector: either no sale is recognised, and the securities (AF.33) the securitisation entity issues are not directly part of government debt, and instead a loan is imputed from the securitisation entity to government is part of government debt; or a true sale is recognised, and there is no entry in government debt.

58. The cash flows generated by the securitised items (such as the rental income generated by buildings), first received by government and then passed over to the securitisation entity, continue to be recorded in the government accounts, as if no securitisation operation had occurred: as revenue, or as the disposal of a nonfinancial or financial asset, as appropriate. Payments made by government to the securitisation entity, when government continues to manage the assets, are recorded as government servicing its loan liability; these are imputed flows of interest and loan repayment. Any fee retained by the securitisation entity to cover its operating costs is recorded as intermediate consumption of government. This holds even if the fee is paid up-front, reducing the funds provided to the government unit, in which case an imputation is to be made.

V.5.3.3 Recording at the end of the arrangement

59. If at the end of the operation the payments made by government to the securitisation entity, when government continues to manage the assets, exceed the government liability, no further redemption of government debt can be recorded, and payments to the securitisation entity are recorded as a current transfer expenditure of government, when accrued.

60. If payments made to the securitisation entity terminate before extinction of the government liability, for example the rare case of the bonds being in default, the remaining liability is removed from the government balance sheet in national accounts by way of another change in volume.

61. When the securitisation arrangement is treated as government borrowing and the securitisation entity subsequently sells the (recognised) underlying assets to a non-government unit with a full transfer of ownership rights, the sale is recorded as a disposal of assets by general government and the securitisation is simply deemed to act as an agent of government. The effect of such an arrangement is to postpone the disposal/sale of assets by the government from the time of securitisation to the time of actual sale by the securitisation entity. The correct time of recording is particularly important when non-financial assets are involved due to the impact on government net borrowing (B.9).

V.5.3.4 Securitisation by non-government units of receipts from government

62. In some cases, a non-government unit will, for its own purposes, securitise regular receipts from government.

63. When this occurs, the contractual obligations of government must be examined to check whether the substance of the transaction is such that the government has incurred a new obligation to provide sufficient funds to finance the borrowing of the non-government unit.

64. If the securitisation by the non-government unit has no impact on the government's contractual obligations to make future payments, there should be no impact on the government sector accounts as a result of the securitisation.

65. If there is in effect a new government liability, a capital transfer should be recorded from government to the non-government unit equivalent to the net present value of all the promised future payments; and a loan of the same size recorded from the non-

government unit. The future government payments are recorded as interest and loan repayments.

V.5.4 Rationale of the treatment

V.5.4.1 Recognising a transferable assets in national accounts

66. Transfers, i.e. unrequited distributive transactions, are not generated by assets. For instance, the capacity of governments to raise taxes does not constitute an asset recognised in national accounts. Expected future receipts of international transfers, lottery tickets, licence fees or fines are not classified as assets. The future flow of these transfers does not meet the definition of assets in ESA95 7.10. It is not possible to record a transaction in assets if the asset does not exist in the national accounts balance sheet to start with. So, as the assets are not recognised in national accounts, only a government borrowing can be recorded for securitisation of these items.

67. Future streams of income on assets - which will be recorded in P.1 and D.4 when they accrue - also do not constitute assets by themselves according to ESA95. Unless the ownership of the underlying assets is deemed to have been transferred, the securitisation of such flows can therefore not be recorded as a sale of assets in national accounts.

68. Similarly, a sale cannot concern a limited set of several future periods of use of an asset, for instance several future streams of property income to be earned on financial assets, or several future streams of rentals/rents to be derived from the use of non financial assets, unless the corresponding assets are wholly sold themselves.

V.5.4.2 The case of fiscal claims

69. Taxes are uniquely established by the taxing powers of governments and can only be raised by governments or international organisations. Taxes are also subject to specific valuation rules, following Regulation 2516/2000. One must distinguish securitisation of future taxes from securitisation of tax receivables (fiscal claims).

70. Securitisation of taxes that will accrue in the future, on future income or on future events, cannot give rise to a disposal of an asset because no asset exists in national accounts. Therefore they must be considered as borrowing. Securitised taxes that accrue in the future must be attributed to general government in the national accounts system, whatever the specific collection arrangements under a securitisation.

71. Fiscal claims, which reflect taxes accrued in the past but not yet settled because they are either not yet due or in arrears, are financial assets and are recorded as AF.7 in national accounts. However, they cannot be transferred to non tax-raising units given that – by convention- in the ESA95 only general government, the institutions of the European Union or the Rest of the World can levy taxes (ESA95 4.14 and 4.77). In the ESA95, social contributions may be considered the resource of any sector. Nonetheless, given the proximity between taxes and social contributions, securitisations of all fiscal claims follow the same rule (recording as borrowing), be they tax receivables or social contributions receivables to be collected by government, private units or by other non-government units (at least for compulsory social contributions).

V.5.4.3 Transfer of risks and rewards

72. One condition for a securitisation to be recorded as a sale in national accounts is that the risks and rewards associated with the asset are transferred to the securitisation entity. According to ESA95 7.10, "*economic assets are entities […] over which ownership rights are enforced by institutional units, […]; and from which economic benefits may be derived by their owners by holding them or using them over a period of*

time." Furthermore ESA95 rules on financial leasing, that corresponds to a situation in which "*all risks and rewards of ownership are, de facto though not* de jure*, transferred from lessor to lessee*" (Annex II, 4) indicated that economic ownership is determined by the allocation of risks and rewards of ownership.

73. The economic reality rather than legal formalities determines ownership in national accounts. Most guarantees, substitution clauses, last tranches or DPPs indicate that the risks and rewards associated with the asset have not been transferred. In those cases government borrowing is recorded. Furthermore, any restriction imposed by government on the securitisation entity's right to subsequently sell the assets on to a third party is regarded as evidence that there is not a sale since it could give the government exposure to potential rewards from the asset.

V.5.4.4 Risks and rewards associated with financial assets

74. Economic benefits that may be derived from financial assets consist of the property incomes that are earned through holding them and of the holding gains that accrue on them, which may be realised when assets are sold. Symmetrically, holding losses are also possible and are thus part of the risks associated with ownership.

75. Usually the most important risk associated with financial assets is the credit risk. Credit risk refers to possible defaults on payments due, which may be distinguished between payment of interest and repayment of principal. The economic owner of a financial asset is the unit that, ultimately, bears the credit risk associated with these assets. The economic owner may subsequently acquire insurance or derivatives to offset that risk, but that does not change the ownership.

V.5.4.5 Risks and rewards associated with non-financial assets

76. The rewards that are associated with non-financial assets consist of the operating surpluses that accrue from the operation of fixed assets, and net rents derived from renting non-produced assets. In addition, non-financial assets may generate holding gains and losses, which is an important feature when they are acquired for resale. The owner bears costs in order to avoid the non-performance of the assets in terms of generating income, by undertaking their maintenance, or buying insurance for compensation in case they accidentally degrade, deplete or destruct. Attributes of ownership include deciding:

- the level of the rentals/rents;
- the time at which assets are sold.

V.5.4.6 Classification of the securitisation entity

77. Concerning the sector classification of the securitisation entity when it is an SPV, ESA95 paragraph 2.55f states that it should be classified within "Other financial intermediaries" (S.123): *"In particular, the following financial corporations and quasi-corporations are classified in subsector S.123 unless they are MFIs:… (f) financial vehicle corporations, created to be holders of securitised assets;…*". This is based on the assumption that such "vehicles" are institutional units and they conduct financial intermediation (or other auxiliary services).

78. To be a separate institutional unit, the criteria stated in ESA95 2.12 must be met. In order to be classified to S.123, the SPV should have complete autonomy of decision in respect of the management of the debt securities that it issues: indicators of this are issuance rhythm, debt management, repayment strategy, etc. It should be clear that the SPV does not act on behalf of government. It should also have complete autonomy concerning the management and disposal of its assets. Otherwise the SPV should not be recorded as separate institutional unit.

79. Concerning the recognition of when an institutional unit is a financial intermediary, ESA95 2.33 states that "a financial intermediary does not simply act as an agent for these other institutional units but places itself at risk by acquiring financial assets and incurring liabilities on its own account".

80. Concerning the classification of new financial assets resulting from a securitisation, 5.63 of ESA95 states that securities issued by an SPV are to be classified under AF.3 "Securities other than shares".

V.5.4.7 Securitisation by non-government unit of receipts from government

81. In some cases a non-government unit (perhaps through an SPV) will, for its own purposes, securitise receipts from government. Though these unilateral actions might have at first sight no consequence for government sector accounts, the arrangement must be examined to correctly identify the contractual obligations of government. It is necessary to check whether the contract promising the future payments commits the government to pay a sufficient amount to service the debt of the non-government unit receiving these payments.

82. If the government takes an obvious commitment to pay a sufficient amount to cover the debt servicing or other commitments of the non-government unit, the operation should be classified as government borrowing. Government borrowing is not recorded when the government's obligations are conditional on the performance of the non-government unit in delivering the government's policy objectives.

V.5.5 Accounting examples

The examples only show those transactions with an impact on the government accounts.

Example 1: Building sold with DPP

Government sells buildings to a private sector bank that intends to resell them in the following year as market conditions improve.

Data

The buildings are estimated to be worth 100

Government:

- receives 90 immediately for the sale of the buildings
- also has a DPP agreement such that, if the bank receives more than 90 for the resale of the buildings, the receipts above 90 shall be given to government up to a maximum of 25

The bank, via an SPV it owns and sets up, issues bonds to the value of 90

In the second year the buildings are resold for 120:

- the government receives an additional payment of 25 in DPP
- the bank makes a profit of 5 after the SPV has repaid its borrowing

Analysis and national accounts treatment

The transaction is judged not to be a genuine sale because of the existence of the DPP.

- it has to be recorded as government borrowing in year 1 of 90
- the building is shown as a negative GFCF by government in year 2, when sold at a market price

– the bank's profit is recorded as bonus interest earned on the imputed loan which is shown as being redeemed when the arrangement is completed. For simplicity of recording this is shown as being retained in the SPV at the end of year 2.

YEAR 1

General government				SPV			
Opening balance sheet (before the arrangement)							
A			L	A			L
AN.11	100			AF.2	0		
Non-financial accounts							
U / ΔA			R / ΔL	U / ΔA			R / ΔL
B.9	0			B.9	0		
Financial account							
ΔA			ΔL	ΔA			ΔL
		F.4	+90	F.4	+90	F.3	+90
F.2	+90			F.2	0		
		B.9	0			B.9	0
Closing balance sheet							
A			L	A			L
AN.11	100	AF.4	90	AF.2	0	AF.3	90
AF.2	90			AF.4	90		

YEAR 2

General government				SPV			
Opening balance sheet							
A			L	A			L
AN.11	100	AF.4	90	AF.2	0	AF.3	90
AF.2	90			AF.4	90		
Current accounts							
U			R	U			R
D.41	5					D.41	5
B.8	- 5			B.8	5		
Capital account							
ΔA			ΔL	ΔA			ΔL
P.5	-120	B.8	- 5			B.8	5
B.9	+115			B.9	+5		

Financial account

ΔA			ΔL
F.2	+25		
		F.4	-90
		B.9	+115

ΔA			ΔL
F.2	+5	F.3	-90
F.4	-90		
		B.9	+5

From the sale to the market, government receives 25 and the SPV receives 95; the SPV then uses 90 of AF.2 to repay its bonds (AF.3).

Revaluation account

ΔA			ΔL
AN.11	+20		

ΔA			ΔL

Closing balance sheet

A			L
AN.11	0	F.4	0
AF.2	115		

A			L
F.4	0	AF.3	0
F.2	5		

<u>Example 2</u>: Building sold without a DPP

Government sells buildings to a private sector bank that intends to resell them on the market in the following year.

<u>Data</u>

The buildings are estimated to be worth 100 and are sold for that price.

The bank transfers the buildings to an SPV that it sets up and owns:

- the SPV issues 5-year bonds for 100
- there is no DPP, nor are there any guarantees
- the SPV services the debt interest from rental income and sells the buildings for 110
- the bank extracts profit of 10 from the SPV

<u>Analysis and national accounts treatment</u>

This is recorded as a sale - negative GFCF - by government since government is no longer exposed to the risks and rewards of ownership.

YEAR 1							
General government				SPV			
Opening balance sheet (before the arrangement)							
A			L	A			L
AN.1	100			AF.2	100		
Capital account							
ΔA			ΔL	ΔA			ΔL
P.5	-100			P.5	+100		
B.9	+100			B.9	-100		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	+100			F.2	0	F.3	100
		B.9	+100			B.9	-100
Closing balance sheet							
A			L	A			L
AF.2	100			AN.1	100	AF.3	100

Example 3: a company securitises subsidies from government

Data

A government unit promises to pay future subsidies of up to 20 per year to a private company over 5 years so that it can provide public transport services.

With government approval the unit establishes an SPV to receive the future subsidies:

- the SPV issues bonds to the value of 60 which it passes to the company to finance the purchase of a fleet of buses
- the SPV uses the subsidy receipts firstly to finance its debt, and passes the remainder to the company which it uses as a contribution to operating the buses.

Part of the government subsidy payments are unconditional in that a minimum of 15 must be paid each year to the SPV even in the event of the company failing to supply public transport services and/or becoming insolvent. The remaining payments, up to 5 per year, depend on the performance of the bus service. In the example, the full amount is paid each year.

Analysis and national accounts treatment

The transaction would be classified as a capital transfer to the bus company and borrowing of the same amount, in respect of the minimum guaranteed payments of 15, and annual subsides for the remaining amounts paid. The 15 is split into 12 repayments of capital, and 3 of interest. For simplicity the transactions between the SPV and bus company are not shown in the tables below.

YEAR 1

General Government				SPV			

Opening balance sheet (before the arrangement)

A			L	A			L
AF.2	100						

Current accounts

U			R	U			R
D.41	3	D.3	-5	D.3	-5	D.41	3
B.8	-8			B.8	8		

Regular payment of 20: 5 is a subsidy; 12 is repayment of capital and 3 is interest in respect of the imputed loan.

Capital account

ΔA			ΔL	ΔA			ΔL
		B.8	- 8			B.8	8
		D.99	- 60			D.99	+ 60
B.9	-68			B.9	+68		

Financial account

ΔA			ΔL	ΔA			ΔL
		F.4 new	+60	F.4	+48	F.3	+48
F.2	-20	F.4 repay	-12	F.2	+68		
		B.9	-68			B.9	+68

Closing balance sheet

A			L	A			L
AF.2	80	AF.4	48	AF.2	68	AF.3	48
				AF.4	48		

YEAR 2

General government				SPV			

Opening balance sheet

A			L	A			L
AF.2	80	AF.4	48	AF.2	20		
				AF.4	48		

Current accounts

U		R	
D.41	3	D.3	-5
B.8	- 8		

U		R	
D.3	-5	D.41	3
B.8	+ 8		

Capital account

ΔA		ΔL	
		B.8	- 8
B.9	-8		

ΔA		ΔL	
		B.8	+ 8
B.9	+8		

Financial account

ΔA		ΔL	
F.2	-20	F.4	-12
		B.9	-8

ΔA		ΔL	
F.2	+20		
F.4	-12		
		B.9	+8

Closing balance sheet

A		L	
AF.2	60	AF.4	48

A		L	
AF.2	40		
AF.4	36		

Example 4: Building sold, ex-post guarantee paid

Data

In year 1 government sells an office building with a market value of 100 to an SPV for 100. The SPV issues bonds to the value of 100.

In year 2 the demand for office accommodation falls sharply and the rentals are insufficient to service the bonds. The market value of the building falls to 80. Government fears a collapse of the financial institutions that finance property deals and so pays the interest of 5 due on the SPV's bonds, even though it had no contractual obligation to do so.

The receipts of building rentals and interest on the bonds are ignored for the sake of simplicity.

Analysis and national accounts treatment

By activating an ex-post guarantee, it is demonstrated that the debt of the SPV should have been attributed to government, and that the building should not have been treated as sold by the government to the SPV.

Therefore the entire outstanding debt of the SPV, and the associated building, are transferred to the government balance sheet in year 2, along with capital transfers of 5 and 20, to reflect respectively the interest paid by government and the difference in value between the SPV debt and the building.

YEAR 1

General government | **SPV**

Opening balance sheet (before the transaction)

A		L		A		L	
AN.11	100			AF.2	0		

Non-financial accounts

A		L		A		L	
P.5	-100			P.5	+100		
B.9	+100			B.9	-100		

Financial account

A		L		A		L	
						F.3	+100
F.2	+100	B.9	+100	F.2	0	B.9	-100

Closing balance sheet

A		L		A		L	
AN.11	0			AN.11	100	AF.3	100
AF.2	100			AF.2	0		

YEAR 2

General government | **SPV**

Opening balance sheet

A		L		A		L	
AN.11	0			AN.11	100	AF.3	100
AF.2	100			AF.2	0		

Capital account

A		L		A		L	
P.5	+80			P.5	-80	B.9	-105
D.9	+20			D.9	-20		
D.9	+5	B.9	-105	D.9	-5		

D.9: 5 cash compensation;

20 imputed for the difference between the value of building and outstanding bond debt

Financial account

A			L	A			L
F.2	-5	F.4	+100	F.2	+5		
		B.9	-105	F.4	+100	B.9	+105

Revaluation account

A			L	A			L
				AN.11	-20		

Closing balance sheet

A			L	A			L
AN.11	80	AF.4	100	AN.11	0	AF.3	100
AF.2	95			AF.2	5		
				AF.4	100		

The SPV's cash would be used to pay the interest on the bonds.

V.6 Keywords and references

Capital account	ESA95 8.46
Contingent assets	ESA95 5.05, 7.22
Entrepreneurial income	ESA95 8.26 to 29
Financial account	ESA95 8.50
Financial transaction	ESA95 5.01, 5.02, 5.15
Holding corporation	ESA95 2.13e, 2.14 and 2.100
Market/non-market units	ESA95 3.27 to 37
Non-financial non-produced assets	ESA95 7.16
Non-financial produced assets	ESA95 7.14
Other changes in volume of assets account	ESA95 8.53
Privatisation	ESA95 5.16
Rearranged transactions	ESA95 1.38 to 41
Shares and other equity	ESA95 5.86

VI

Leases, licences and concessions

Part VI Leases, licences and concessions

VI.1 Overview

VI.1.1 Background on general principles

1. Among government receipts are licence fees, tolls, administrative charges and royalties, some of which may arise under leasing contracts, concessions, public-private partnerships (PPPs) or franchises given by government. They cover different types of transactions in national accounts, explained in various chapters in ESA95.
2. Part 1 of this manual considers when payments between public units can be recorded as sales of services. Part 3, 4 and 5 explain how to record proceeds from the sale of assets and payments from public corporations and from the central bank. This part highlights the problem of distinguishing between output of government (sales of goods or services), taxes, rent, and sales of assets. The analysis is categorised as follows:
   a. Receipts from sale of goods and services produced by government (that could be supplied by other units in the economy).
   b. Receipts for the use of a produced asset owned by government.
   c. Receipts for the use of a non-produced asset owned by government.
   d. Note on intangible non-produced assets
   e. Receipts in return of permission from government to undertake an activity.

Terminology

3. The development of various forms of long-term contracts between government units and corporations, notably under the wording of "public-private partnerships", requires a clarification of the terminology used in the context of national accounts.
4. Concessions: these are commonly implemented for infrastructure equipment that can be subject to commercial exploitation. In this type of long-term contract, the corporation (or group of corporations) is responsible for the building, operating and maintenance of the equipment and is predominantly remunerated by the final users (households, corporations etc.) of the equipment who pay tolls or other fees. Chapter VI.4 deals with the accounting recommendations related to this type of contracts.
5. PPPs: more recently, in many countries, government units have required the service of corporations (or group of corporations or specific vehicles) to build and maintain equipments designed to render some public services, not typically subject to commercial activity: public hospitals, schools and universities, prisons, etc. It is recommended to use the term PPPs in national accounts only for those contracts where government is the main purchaser of the service. Chapter VI.5 in this Manual deals with this type of contracts.

VI.1.2 General treatment in national accounts

VI.1.2.1 Receipts for goods and services (that could be supplied by other units)

6. The receipts could be less than, the same as or more than the costs of production: it does not affect the classification.
7. **Treatment:** record as a sale – output (P.1), notably market output (P.11) .

Examples: payments for provision of training; fees charged for advice to businesses or for research contracts, or testing the ability of somebody to drive a motor vehicle.

VI.1.2.2 Receipt for the use of a produced asset

8. The receipts could be less than, the same as or more than the costs of production: it does not affect the classification.

9. This category is divided into three sub-categories depending on the time period.

   i The payments are made **each time the asset is used, or there is a single payment allowing use of the asset for a period of time less than one year** (and this is not part of a contract requiring payments for use over a longer period).

   Treatment: record as a sale – output (P.1), notably market output (P.11)

   Examples: rental of a public building; road and bridge tolls; vignette for use of specific roads for a certain length of time; charges for use of sports centre or swimming pool; entry fee to a public building.

   ii The payment is part of a contract that allows use of the asset for a **period of more than one year, but for less than the economic life** of the produced asset, e.g. in concession or PPP-type of contracts. One or several individual payments might be required under the contract. It is the time period of the contract that matters, not the number of payments.

   Treatment: apply the operating lease/finance lease test (ESA95 annex II) and in the case of PPPs, the assessment of the distribution of risks (see chapter VI.5). Although it is unlikely that government would see itself as being in the business of providing financial leasing, it could be appropriate to record the sale of the existing asset by government when the purchasing unit assumes most of the risks and rewards of ownership for the period of the contract.

   Operating lease and PPPs off government balance sheet: record as a production of market service – P.11 (in the case of one initial payment it would be necessary to accrue over the period of the contract and record the prepayment as a financial advance, F.7)

   Examples:

   A single payment by a company to occupy a <u>government owned building</u> for five years: record as rentals (P.11), accrue it over the five years, and record a financial asset in F.7.

   Payments for the right to use an intangible asset <u>produced by government</u>: record as P.11. Do not include payments that arise only because of government's unique power to make the law – see section d.

   Finance lease and PPPs on government balance sheet: The asset provided through a finance lease is recorded in the balance sheet of the lessee, and modifies gross fixed capital formation (P.51) (if it is a producer). This creates a financial asset since the regular payments to the lessor are regarded as the reimbursement of an imputed loan (AF.4) and are to be split into two transactions: reimbursement of the principal (F.4) and interest (D.41).

   Note that you should not record the sale of an intangible asset (the lease) instead of the sale of the tangible asset. After the transaction, the balance sheet of government includes the produced asset, valued at market price, which here is equal to the market price of the asset for whole life use minus the payables under

the time limited contract (equivalent to the government's reversionary interest in the asset).

Example: a single payment by government to use a building for 20 years, after which it reverts to government, with government assuming most of the benefits, costs, risks and rewards of ownership during the 20 years: record as a sale of the building (P.51) at the market value.

See also VI.3 on sale and leaseback, VI.4 on public infrastructure financed and exploited by the corporation sector and VI.5 on Public-Private Partnerships (PPPs).

VI.1.2.3 Receipts for the use of a tangible non-produced asset

10. Non-produced assets include land, sub-soil assets, and other tangible natural assets over which ownership rights of government have been enforced, either through legal ownership or international agreement or convention. These are tangible natural assets, which may or may not be owned and traded by other units in the economy. This category excludes the following:

- payments demanded by government for the use of natural assets if such payments arise from special legislation giving government the right to demand such payments when it is not the legal owner of the assets;
- payments demanded by government when economic ownership is not established and it is not credible to regard government as the economic owner of the assets;
- payments for the use of "assets" which are not regarded as economic assets in ESA95 – see 7.12b.

11. Receipts for the use of a tangible non-produced asset include the following two types of payments:

- The payments are made each time the asset is used, or there is a single payment allowing use of the asset for a period of time
- The tangible non-produced asset is made available by government through a lease, for a limited period of time.

12. **Treatment:** record as rent (D.45). (in the case of one initial payment, it would be necessary to accrue it over the period of the contract and to record the prepayment as a financial advance, F.7)

Example: government receives royalties paid for the extraction of oil.

13. If there is a single payment by a company to exploit offshore oil reserves for five years: record as rent (D.45), accrue over the five years, and record a prepayment in F.7. Note that an intangible non-produced asset (AN.22) would appear on the balance sheet of the company if subsequently the market rent rose above the rent agreed in the contract, and the company had the right to sell the contract (transferable lease).

14. If a payment is made to use the asset for the rest of its economic life then is should be treated as the sale of a non-produced asset (K.2). Example: government sells land.

VI.1.2.4 Note on intangible non-produced assets

15. Transactions in intangible non-produced assets (K.22) are to be recorded only in certain defined circumstances. In general, payments for leases, franchises, or concessions would be recorded as sales of services (P.11) or rent (D.45), or the sale of the produced asset being exploited (P.51 in a finance lease), as described above.

16. A transaction in an intangible non-produced asset should be recorded when a unit has a right to buy services at a particular price (which could differ from the current market price), and transfers that right to another unit (see ESA95 6.17d). This can apply to the payment of rent as well as to the purchase of services. Such assets arise for example when the price to be paid for the consumption of services is agreed, or paid, in advance under a contract for a number of years, and subsequently the actual market price becomes higher than the contract price.

17. Assume for example that a unit (Unit B) buys five years worth of services from another unit (Unit A) and pays in advance. The accounts of unit B would record regular payments for the services and a financial asset in F.7, in respect of the prepayment, which is gradually reduced. Suppose that after two years unit B sells the right to the services to a third unit (Unit C) for an amount greater than it would have had to pay itself (the value of the prepayment financial asset). The accounts of unit B would show the sale receipt split between an amount to purchase the initial prepayment for the financial asset and the sale of an intangible asset, which arose in the accounts of Unit B under K.3 "Economic appearance of non-produced assets" in the "Other changes in volume of assets accounts" and was recorded in the balance sheet of Unit B under AN.22 "Intangible non-produced assets". The sale of the intangible asset would be recorded under K.2 (see ESA95 6.12). The purchaser (Unit C) would have both the financial asset and the intangible non-produced asset on its balance sheet, and would record payments for services, or rent, at the original contract price (corresponding to the financial asset), while the amortisation of the intangible non-produced asset would be recorded over time in the accounts of unit C under the item K.62 'Other changes in volume' (see SNA93 12.34 and ESA95 6.21b.4).

18. It is possible to record the sale of intangible non-produced assets not only in the case of transferable contracts but also in other cases such as described above and also in paragraph c below.

    For the specific case of sale of mobile phone licences, see section VI.2.

VI.1.2.5 Receipts in return for permission to undertake an activity

19. This might involve the use of an asset owned by the payer, or an asset owned by neither the payer nor the government, or no assets at all. It excludes payments for the use of an asset owned by government – see (b) and (c) above. The key point is that legally the activity requires permission from government, and so it is not a payment that could be demanded by other units in the economy. In addition to the administrative procedures required to give the permission and enforce the rules, the government may (or may not) provide a service to the payer, or to society (assessment of conformity, quality checks etc.).

    Treatment:

    a. Sale of service

20. Record as **sale of a service** – output (P.1) (notably market output, P.11) if the government undertakes work specifically related to the payer (typically to assess whether the payer should be granted the permission requested) and the payment is not out of all proportion to the cost of the work undertaken by government.

21. The calculation of costs, to assess whether they are out of proportion, should include all costs that a private company would need to cover when setting a price and so includes compensation of employees, intermediate consumption, capital consumption and taxes (see ESA95 3.33). A government unit might provide a range of similar services but price them differently to reflect the different amounts of effort required by each or because of a desire to influence demand in a way that allows the service to be delivered more efficiently (for example the price might be higher at certain times of the

day when demand is normally highest; or the price for the service delivered over the internet might be lower than a more personal delivery of the service). Such differential pricing does not mean that the higher priced services should be classified as taxes even if the prices exceed costs. The ESA term (§4.79, footnote 5) “Out of all proportion“ in this instance covers situations whereby the unit deliberately charges prices to generate a significant surplus over costs as a whole to provide funds for government to be used for other purposes. The payment for this service should be recorded at the time when the work is undertaken even if the permission granted is for many years, or for life.

22. In some special cases, in some countries, the government might split the receipts into two or more parts and give them to other public units to fund specific activities. The part that finances the cost of a service to the payer (if satisfying the cost condition above) would be recorded as a sale of service; other parts would be recorded as taxes (see below), if used by those other public units for activities unrelated to the payer.

23. ESA95 4.80d and footnote 5 describe this in more detail.

24. Examples: passport fees, driving licences, gun licences.

b. Tax

25. Record as a **tax** if the conditions above do not apply.

26. The tax would be recorded as D.29 if paid by a business, or D.59 if paid by households. A capital tax D.91 would be recorded if it were an infrequent levy on the ownership of an asset, or a levy on the increase in value of an asset as a result of government permission - perhaps to construct a building on a particular piece of land (see ESA95 4.149b on betterment levies).

    Examples: an annual licence for permission to use a motor vehicle irrespective of where and when it is used; a licence to fish or shoot that is required wherever the hunting and fishing takes place; a charge on the use of buildings when the government does not own them; charges for the permission to own particular types of assets; fees levied on industries to fund consumer protection or research where the work is undertaken to benefit consumers and/or the industry in general rather than funding services delivered directly to the individual business paying the levy.

c. Intangible non-produced asset

27. In some cases, when government receives payment for granting permission to do something, the permission is given **exclusively** to one unit or to a restricted number of units. Other units cannot obtain government permission to undertake the activity, and government ensures that the restriction is enforced. This exclusion of other units may give rise to an **intangible non-produced asset** on the balance sheets of the units that have the permission.

28. In many cases, these assets are traded directly. They can also be traded indirectly through transactions in the ownership of the units that hold the assets.

29. The appearance of an asset on the balance sheet of these units needs to be accounted for through transactions or other flows. Appearance of intangible assets is recorded under "Other Flows". If the permission granted is time limited, the balance sheet of the unit would show falls in the value of the intangible asset using K.6 "other flows" (amortisation of the asset).

30. Thus, in cases where a permission is given exclusively to only one or a restricted number of units, receipts for granting such permission should be recorded as the sale by government of an intangible non-produced asset.

VI.1.3 Rationale of the general treatment

VI.1.3.1 Receipts from sale of goods and services (that could be supplied by other units):

31. The treatment is always to record an output (P.1) of government. The only difficulty might be to distinguish between market output (P.11) and payments for non-market output (P.131). The distinction refers to the notion of economically significant price and to the ESA95 50% criterion (see ESA95 3.43 to 3.45 and part I in this Manual).

VI.1.3.2 Receipts for the use of a produced asset:

32. The main distinction is to be made between operating lease (market output, P.11) and financial lease (sale of an asset, P.51). According to ESA95 annex II:

    1. An operating lease of a durable good
        - covers a certain period of time which may be long or short and not necessarily settled in advance
        - implies no transfer of ownership of the good (nor the risks/maintenance related to ownership)
    2. A financial lease
        - covers a predetermined and protracted period of time, usually all, or most of, the economic lifetime of the durable good
        - risks and rewards of ownership (in particular maintenance) are transferred from lessor to lessee.

33. In a finance lease, economic ownership of the good has been transferred. The lessor's role is purely financial. The ESA recognises the economic reality behind financial leasing in considering that the lessor provides the lessee with a loan enabling him to purchase a durable good of which the lessee becomes the *de facto* owner.

34. In the specific case of concession under public law for financing and exploiting public infrastructure and PPPs, see further VI.4 and VI.5, respectively.

VI.1.3.3 Receipts for the use of a non-produced asset:

35. The distinction is to be made between the recording of rent (D.45), which is the normal case of using (or exploiting) a tangible non-produced asset (economic assets of natural origin like land, sub-soil assets or other biological resources - ESA95 4.72 to 4.76), and the case of recording the sale of an asset (usually in this case an intangible non-produced asset, see ESA95 6.12). A specific example of this sort is developed in the following section (6.2).

VI.1.3.4 Receipts for permission granted to undertake an activity:

36. The distinction is to be made between the recording of a tax and of sale of services (output, P.1, notably market output, P.11).

<u>Distinction between taxes and sales of services</u>

37. Footnote 5 attached to 4.80d – in addition to 4.23e - recalls the criteria to distinguish taxes and sales of services (see also SNA93 8.45):

    "The borderline between taxes and purchases of services from government is defined according to the same criteria as those used in the case of payments made by enterprises: if the licences are granted automatically on payment of the amounts due, their payment is treated as taxes. But if the government uses the issue of licences to

organise some proper regulatory function (such as checking the competence, or qualifications, of the person concerned), the payments made should be treated as purchases of services from government rather than payment of taxes, unless the payments are clearly out of all proportion to the cost of providing the services."

38. Government acts in an economy in two ways:

Civil commercial law

39. Under civil commercial law government undertakes economic transactions that can also be undertaken by other units. For example, it employs staff, consumes goods and services, rents land, owns fixed capital assets, sells the output of services using assets, and so on. For government transactions under civil law, ESA95 chapter 3 is applied to classify the productive activity of government; chapter 4 is relevant for classifying the compensation of employees and property income.

40. ESA95 3.38 to 3.45 explain that it is possible for government receipts to be classified as sales: either as market output or as payments for non-market output. It is recalled that, under ESA95, a non-market institutional unit can have market output. Market output is not restricted to units classified to the corporation sectors. ESA95 4.73 explains that charges for the use of produced fixed assets are treated as sales of services, not rent. Paragraph 4.41 infers that rent applies to payments for the use of tangible non-produced assets, not payments for the use of produced assets. ESA95 6.12 describes when to record transactions in intangible non-produced assets.

Public law

41. Government has the ability to make laws that result in economic transactions that are unique to government. For example, in the context of government receipts, government can raise taxes, enforce social security schemes, grant permissions and sell licences, and impose fines.

42. The paragraphs in ESA95 chapter 4 on taxes and social security contributions are relevant here. Paragraphs 4.23e and 4.80d (footnote 5) explain the differences between sales of services and taxes.

43. Note that ESA95 4.79d refers to payments required by government for the use of assets (vehicles, boats, and aircraft) owned by the payer or hired to the payer. It does not apply to charges for the use of assets owned by government: this is either output (for sale of a service) or rent, not tax.

VI.1.3.5 Summarised table: Classification of some government receipts

	Type of receipt			ESA95 transaction
NOT UNIQUE TO GOVT.	Receipt from sale of goods and services (that could be supplied by other units by non-government units)			Output (P.1)
	Receipt for the use of a produced asset (can be tangible or intangible)	Payment when used, or for use < one year		Output (P.1)
		Payment(s) for use > one year but < asset life	Operating lease	Output (P.1)
			Finance lease	Sale of produced asset (P.5)
		Payment for use for ever		Sale of produced asset (P.5)
	Receipt for the use of a tangible non-produced asset	Payment for use for a limited period of time		Rent (D.4)
		Payment for ownership transfer		Sale of tangible non-produced asset (K.21)
	Receipts for the sale of transferable contracts			Sale of intangible non-produced asset (K.22)
UNIQUE TO GOVT.	Receipt for permission granted to undertake an activity	Service is provided directly to payer and receipt not "out of proportion" of production cost		Output (P.1)
		Permission granted to a restricted number of units		Sale of intangible non-produced asset (K.22)
		No service to payer, or if any, receipt greatly exceeds production cost (and permission not restricted)		Tax (D.29, D.59, D.91)

VI.2 Allocation of mobile phone licences

VI.2.1 Background to the issue

1. In most European Union Member States, third generation mobile phone licences (in most cases UMTS - *Universal Mobile Telecommunications System*) were allocated to private operators between 1999 and 2001. These transactions followed a European Parliament and Council decision of 14 December 1998 on the co-ordinated introduction of a third generation mobile and wireless communications system in the Community, planned to be made available to users in 2002.
2. The allocation of these licences by governments was made through very diverse methods according to country: free of charge (or almost free) in two of them, subject to payment, but with different procedures, in the others (comparison of offers - also referred to as "beauty contest" -, or by auction). Financial flows involved were very significant in some countries (up to 3% of GDP), affecting the government accounts in an exceptional way.
3. Faced with this situation and the diversity of procedures, Eurostat had to make a decision on a homogeneous accounting treatment of these government receipts (News Release n°81:2000, 14 July 2000). The following reflections and recommendations apply as well to other types of comparable licences (such as mobile telephony of second generation) allocated in analogous conditions.
4. Treating this transaction as *a tax* or as *a sale of a service* by government was rejected on the following grounds:
   - in principle, a licence recorded as a tax would be automatically granted to any applicant ready to pay. Moreover, this is not an unrequited payment (something for nothing in exchange), and recording as a tax would not fit well with the case of a sale by auction of a scarce good.
   - the transaction cannot be the purchase of a service provided by government: payments are obviously out of proportion with the cost of producing the service. In fact, it may be argued that government does not provide any service at all.
5. The market nature of the transaction being not really questioned, the discussion between national accountants dealt principally with the characterising of enterprises' payments to government as either:
   - the payment of *a rent*,

   or,
   - the *purchase of an asset*.
6. Eurostat concluded that, except in some very exceptional cases, it would be more appropriate to record these payments from enterprises to government as a purchase of a non-financial asset (the licence). This was also the conclusion of the member organisations of the Inter-Secretariat Working Group on National Accounts (OECD, IMF, World Bank, UN, Eurostat) meeting in June 2000 (see SNA News and Notes n°12, December 2000) and April 2001 in Washington DC.

VI.2.2 Treatment in national accounts

VI.2.2.1 General case

- The licence for using the electromagnetic spectrum (the radio waves) is to be considered as an economic asset, non-financial, of the AN.22 type ("intangible non-produced assets", ESA95 7.16 and 7.19, table 7.1).
- Its allocation, subject to payment and over a long-term period, is to be construed as a *sale of an asset*.

7. This analysis is definitely the most appropriate for any disposal made by auction. By extension, it should also be considered appropriate to the other forms of disposal (comparison of offers, spread out payments), if, as in the case of disposal by auction, the licence is granted for a long-term (by convention, more than five years) and the transaction amount is known with certainty from the beginning.
8. The sale of the non-financial asset (the licence, AN.22) is to be recorded in the capital account, as transaction K.22 (acquisitions less disposals of intangible non-produced assets, ESA95 8.49). This improves once-for-all the net borrowing/net lending of the general government sector. For the purpose of calculating government expenditure and revenue (referring to Commission Regulation n° 1500 /2000 of 10 July 2000 implementing Council Regulation EC n° 2223/96), the sale proceed must be recorded as a negative expenditure.
9. Beforehand, another flow K.3 (appearance of intangible non-produced assets, AN.22) should be recorded in the other changes in volume account of the central government (ESA95 6.17d), increasing the net worth in the balance sheet (without impacting net borrowing/net lending).

Time of recording

10. The accruals basis rule for recording flows (ESA95 1.57) leads to take into account the following elements:
    - *time*: this is the time when economic value is created and when the rights to this value are clearly established; in other words, *the time when the licence is legally allocated according to the contract* signed by the government and the operators.
    - *value*: this is *the total amount of the disposal*, whatever the methods of payment could be (the schedule of payments affects only the financial account), if this total amount is known with certainty by the contracting parties.

VI.2.2.2 Special cases

11. Two special cases should be considered, according to the characteristics of the contract, relating to the length of the contract, and the possible uncertainty on the value of the disposal. In these two cases, it seems more appropriate to record the payment of a *rent* (D.45), in the allocation of primary income account:

    1. The contract is not of a long-term type: it applies to a period of five years or less.

       In this case, the operator's payment, if it is an upfront lump sum payment, will be considered a financial advance (or pre-payment) (F.7) on rent, to be spread over the lifetime of the contract. Only the annual rent (D.45) will improve the net borrowing/net lending of the general government sector - each year.

    2. The contract does not name the total price of the disposal:

       In this case, the total value of the licence cannot be known with certainty at the time of the transaction because it depends, at least for a part, on the economic

performance of the corporation. Payments are, by definition - and for the most part - spread over the life time of the contract, and may be more relevantly analysed as rent, due for using another asset: the electromagnetic spectrum. It is as if the government was somewhat sharing the economic risk with corporations.

In the special case where the largest payment would be made at the time of the contract signature, and only small residual regular payments, depending on the performance of the corporation, would follow every year, the payment(s) at the beginning should be analysed as the sale of a non-financial asset (the licence), while the residual regular payments would be recorded as rent for the use of the spectrum.

In these cases, the impact on the net borrowing/net lending of the general government sector is spread out, according to actual payments, recorded as rent.

VI.2.3 Rationale of the treatment

12. The type of assets described in this paper (spectrum, licence) is not explicitly dealt with in ESA95 and SNA93.

13. Therefore, the conceptual basis of Eurostat decision may still be developed and refined.

VI.2.3.1 In the major cases, rent is not the appropriate transaction

14. Recording the transaction as a rent would raise a lot of difficulties, in particular in the case of a sale by auction:

- in SNA93, rent is a property income (D.4) usually subject to regular payments "received by the owners of financial assets and tangible non-produced assets, mainly land and subsoil assets." [...] "The term 'rent' is reserved in this manual for rents on lands and subsoil assets, payments under operating leases being described as 'rentals' (SNA93 7.87)"
- property income (interests, dividends, rents, etc.) usually has the following characteristics: regular payments, valuation with reference to market prices of similar transactions, to performance of the asset and to the cost of using it. In addition to that, the legal owner of the asset keeps the financial risks related to the asset. These characteristics are not those of the allocation of licences (subject to a sale by auction). On the contrary, by selling the licence, government transfers all risks and benefits to the licensees.

VI.2.3.2 Two distinct assets can be considered

15. Let us first recall the definition of economic assets in ESA95 7.10:

"Economic assets are entities functioning as a store of value over which ownership rights are enforced by institutional units, individually or collectively, and from which economic benefits may be derived by their owners by holding them or using them over a period of time." (see also SNA93 10.2).

The electromagnetic spectrum (radio waves) can satisfy this definition, even though it could be considered a borderline case, between:

- natural assets described in 7.12b as non-economic assets (like the air, the oceans, and river water)
- non-financial tangible non-produced assets (AN.21), of natural origin, like land and subsoil assets.

16. The spectrum should be treated as an asset because its economic and commercial potential is undeniable, and because it results in financial transactions in the market. In the period of commercial exploitation, despite the fact that it cannot itself be sold (unlike land and subsoil assets), it can be attributed a value in terms of tangible non-produced assets (type AN.21).

<u>The licence</u>

17. The electromagnetic spectrum is owned by the government who can make it available to private operators by creating a licence, this licence being directly subject to financial transactions on the market.

18. This sort of licence is to be analysed as an intangible non-produced asset (AN.22). These assets are defined in ESA95, annex 7.1 to chapter 7 (annex to chapter XIII in SNA93): "Non-produced assets that are a construct of society. They are evidenced by legal or accounting actions, such as the granting of a patent or the conveyance of some economic benefit to a third party. Some entitle their owners to engage in certain specific activities and to exclude other institutional units from doing so except with the permission of the owner. "

19. As it does not fit quite well with the definition of patented entities (AN.221), leases and other transferable contracts (AN.222), or purchased goodwill (AN.223), the licence for using radio waves should be classified within *other intangible non-produced assets* (AN.229).

VI.2.3.3 The licence is an asset

a. The granting of this licence is not similar to the authorisation given to other producers (authorisation sometimes named "licence" or "right to use") to use originals such as books, recordings, films, software…It should be recalled that in ESA95 3.67, this sort of authorisation is considered as producing a service.

b. The granting of this licence does not amount either to a transaction which may seem quite close: the granting of a lease on land (or on subsoil assets). Indeed the electromagnetic spectrum remains an asset of a quite specific nature: while land - which can be easily developed - is liable to private appropriation and transferability, radio waves are still – mainly for strategic reasons - the property of government and not transferable. Moreover, the spectrum becomes exploitable as an economic asset only under condition of large investment in equipment, and through the creation and allocation of a licence.

c. However, a legal issue may be raised: these licences for using radio waves are not transferable in all European countries. And, when they are, this is usually under the supervision of government authorities (again for strategic reasons).

20. In some European countries, transferability is considered a strict condition for recording an asset in company accounts and balance sheets. One could reply to this objection that the licences are indeed *de facto*:

    – an economic asset "from which (significant) economic benefits may be derived by their owners by holding them or using them over a period of time" (ESA95 7.10). In some EU Member States, the acquisition price has been very high, - and as a result, a source of considerable indebtedness -, because profits generated are expected to be so as well. In one way or the other, corporations will have to record an asset in order to balance their accounts[8].

    – transferable from an economic point of view: even if the licence is not legally deemed to be transferable, the purchaser corporation is so, and the case already

[8] U.K. Companies have recorded the licence as an asset in their accounts for the year 2000

happened in the E.U. that a corporation acquired the licence by acquiring another corporation.

The allocation of a long-term contract by auction is similar to a sale

21. Having analysed the licence as an economic asset, its allocation by auction - in a long-term contract - is logically to be recorded as *a sale*. The relevance of this analysis is not to be contested if one considers also that:

    – In the biggest European countries, the sale price amounted to a level of between 1% and 3% of the gross domestic product

    – In several cases, whatever the level of the price, it was actually paid at the time of the contract.

22. By extension, one should consider that contracts which were differently designed (selection of acquirers not by auction but through a comparison of offers - "beauty contest" -, and spread out payments) are also the sale of an economic asset, as long as it is a long-term contract and the value of the asset (the total disposal price) is known with certainty at the time of the contract.

    In the latter case, the total value of the sale is to be recorded once-for-all in the capital account, "when the asset changes hands, not when the corresponding payment is made" (ESA95 1.57). Spread-out payments appear as cash flows (F.2) in the financial account, at the time of the actual payments, diminishing progressively the AF.7 stock initially equal to the total disposal price.

23. It is prudent and relevant to distinguish, in principle, contracts allocating licences of this type, according to the term of the contract. In a short-term contract, the purchaser corporation will not be committed to heavy investments, which would be difficult to make profitable: it is then reasonable to consider that the corporation does not acquire a new asset, but rather that it rents an asset (the radio waves), still in government hands. It is quite different from the case when the contract is a long-term one, and when the licence is an economic asset whose value may be very high.

24. The Eurostat decision has fixed the limit between the two types of contract at five years. Why five years?

    – A *one* year limit was suggested: it is common, in national accounts (as well as in other statistical and accounting systems), to consider that a good which is used for more than one year in the production process is a capital good (and thus an asset), as opposed to those goods that are consumed and disappear in the year that follows their production.

    – However, particularly in the field of financial assets, it is usual to fix a limit between the short and mid-term on one hand, and the long-term on the other hand at *five* years.

25. By convention, the limit for these licences has been fixed at five years. It should be recalled that all third generation mobile phone licences known at this time are designed to last between 15 and 25 years.

VI.3 Sale and leaseback

VI.3.1 Background to the issue

1. A sale and leaseback transaction is a linked arrangement whereby the owner of an asset sells that asset and immediately leases it back from the purchaser. The subject of the sale and leaseback is usually a building, but may be another fixed asset. In an attempt to improve the management of its assets and the public finance, government - at any level, local, state or central - may be involved in such arrangements.
2. From the national accounts point of view, the implementation of sale and leaseback by government raises two questions, which are actually linked together:
   - What is the unit involved in this transaction with the government and what is its relevant sector classification?
   - What is the overall intention behind the arrangement: is it to really "privatise" the management of these assets or to achieve a reorganisation within the public sector?
3. Depending on the way these questions are answered, the reality of the "sale" may be questioned, and the "transaction" recorded in very different ways.
4. The principles relating to the classification of the purchasing unit can also be applied to units set up to acquire assets created through the securitisation of future government payments or receipts - sometimes called "special purpose vehicles".

VI.3.2 Treatment in national accounts

5. Three cases may be distinguished depending on the nature of the unit involved in a leaseback arrangement with the government:
   - the unit is created on purpose by government,
   - the unit is an existing public corporation,
   - the unit is a private operator.

VI.3.2.1 The unit is created on purpose by government

6. The main issue in this case is a classification issue.
7. As long as the main activity of the involved unit is to provide renting facilities to the government which created it, it has to be classified in the general government sector.
8. If its activity is only devoted to provide services to the government's units which created it, it has to be considered as engaged in a kind of ancillary activity (see SNA93 4.40 to 44 and 5.9 to 16). It is thus not considered as a unit which would be separate from its parent units, and no specific accounts have to be compiled for it. No transaction has to be considered: neither any transaction on assets when created, nor later any transaction on goods and services - output and intermediate consumption.
9. As a second best solution, it may be useful to treat it as a separate institutional unit, if the ordinary conditions for doing so are fulfilled. It could be for instance the case if this unit provides services to several units belonging to general government, or if it is deliberately set up to achieve a particular statistical classification. It has however to be classified in the general government sector. The creation of the unit is to be recorded in the other changes in volume of assets accounts, under changes in classification and

structure. Nevertheless, if the unit actually purchases the asset from its own financial resources - by borrowing in its own right, for instance - this transaction could be treated as a sale of assets, usually gross fixed capital formation (GFCF, P.51). There would thus be no impact on net lending/net borrowing of general government as a whole. Any payments made afterwards by general government to the unit are not to be treated as payments for services, but as transfers inside general government.

10. This unit will remain classified inside the general government sector as long as most of its activity is devoted to provide services to government. For a possible reclassification outside the general government sector, one has to follow the rules guiding the market/non market distinction and definitions of control.

11. Note that in these cases it is not necessary for the government to appoint a majority of the board of directors for it to be classified to government.

VI.3.2.2 The unit is an existing public corporation

12. There seems to be two conditions for a transfer of fixed assets from government to an existing public corporation to be treated as a sale of assets under GFCF (having an impact on net lending/net borrowing):

    – the corporation must be an actual one, usually involved in this type of activity, and its size must be adequate to the transaction: i.e. the assets which are transferred must not be out of proportion with the assets already owned by the corporation;

    – the corporation finances the acquisition of the assets from its own resources (or own borrowing on the market).

13. However, if one of these conditions is not fulfilled, the nature of the operation has to be addressed. In particular, the whole process could be considered as a restructuring of assets within the public sector, leading to a more efficient management of these assets. The transfer of assets would be recorded in the other changes in the volume of assets accounts. If there is an actual "sale" payment to government previously financed by a loan by government, the overall operation should be broken into two parts:

    – first, the transfer of assets (the buildings for instance), increasing the equity capital of the unit, to be recorded in the other changes in the volume of assets account,

    – then, financial transactions: the borrowing (F.4) by the unit, and the payment to government analysed as a capital withdrawal (F.5).

14. As a result, in the context of such a restructuring of assets, there is no impact on net lending/net borrowing of general government.

VI.3.2.3 The unit is an existing private operator

15. In this case, a transaction in fixed assets (GFCF) will usually be recorded, improving the general government net lending/borrowing. It would not be recorded as a sale if the arrangement were judged to be a financial lease in which case the asset would remain on the government balance sheet.

VI.3.3 Rationale of the treatment

VI.3.3.1 The unit is created on purpose

16. SNA93 describes the notions of ancillary corporation (4.40 to 4.44) and ancillary activities (5.9 to 5.16). For instance, having the legal status of a corporation, an ancillary corporation is a subsidiary unit, "wholly owned by a parent corporation […] (and) strictly confined to providing services to the parent corporation." […] (SNA93 4.40). Sale and leaseback of buildings is one of the reasons quoted in 4.42 for creating

ancillary corporations. According to 4.43, "the ancillary corporation should be treated as an integral part of the parent and its accounts consolidated with those of the parent."

17. The same line of reasoning should be applied to the case of ancillary units created by the government for identical purposes (solely providing services to government). Then, all transactions between government and such units should be consolidated when compiling national accounts.

18. If, however, such a unit is considered to be a full institutional unit, payments made by government for renting services provided by this unit would not be considered as market output because:

    - in order to be a sale, a payment must be in a position to have a significant influence on supply and/or demand;
    - in the present case, in which government creates a unit which manages public buildings and provides housing services to government departments, payments made by these departments cannot, in general, be considered as sales since they are unlikely to have a significant influence on the demand made by government services, even if rentals are fixed by reference to market prices. Moreover, such payments are likely to imply only entries in Treasury bookkeeping records, without any actual flow of funds. The financial counterpart of such a payment is quite a « notional » financial transaction.

19. Of course, this does not mean that such an arrangement is not efficient for the management of the public buildings. But it will lead, at best, to a reallocation of public buildings among government departments, and probably to a situation where some public buildings will be left by government departments, being thus available for a private use. (In this latter case, payments made by private users will of course be treated as sales). This rearrangement of assets within the government sector does not however correspond to a market activity.

20. Being non market, the unit has thus to be classified in the general government sector, at least as long as payments made by government departments constitute its main resources.

VI.3.3.2 The unit is an existing public corporation

21. In the simple case of an existing public corporation buying capital assets from government at market price, with no other associated transactions between government and the corporation, it is appropriate to record the sale of non-financial assets in the capital account (GFCF, P.51), improving government net borrowing/net lending.

22. However, in some cases of this type, there are other events taking place. For example, the transfer of assets can be associated with a major change in the function of the corporation such that it takes on new activities and responsibilities previously the function of government. The transfer of assets might not be at the market price; or there might be no payment at all; or the purchase might be financed by a loan or equity injection from government. In these more complex cases, the recording of several separate transactions may have an artificial impact on government net borrowing/net lending.

23. The whole process could be considered as a restructuring of assets within the public sector, aiming to a more efficient management of these assets. By difference with a straightforward sale transaction on the market, this type of transfer of assets, like in the context of corporate restructuring, is to be recorded as other flows in the other changes in the volume of assets account. (For more details, see the present Manual's provisions concerning "capital injections in kind", II.3.2).

VI.3.3.3 The unit is an existing private operator

24. The unit would be classified as a private corporation (in S.11002) if it is an existing private sector unit (or backed on existing corporations) and if there is no change in how it is controlled or in its purpose. If it is a new unit, it would be private if set up and controlled by other private units who have invested equity in it. Classification as a private corporation should be questioned in cases where:

    – government appoints some of the directors of the unit;

    – there is no private equity at risk;

    – government guarantees the debts of the unit.

25. It is not possible to give specific rules here to cover all eventualities since such cases vary greatly. The structure of the unit and its operations must be considered as a whole to determine whether classification as a public or as a private corporation is most credible.

26. Government might enter into a sale and leaseback operation with a private unit for a number of reasons including:

    – to reduce the risks associated with ownership of the asset;

    – to obtain the benefits of private sector management;

    – to reduce its debt.

27. An operation with a private unit must be recorded through transactions and not as a restructuring of assets in other flows. The main question to address is whether the leaseback is a finance lease - in which case the sale of the asset would not be recorded since it would remain on the government balance sheet - or as an operating lease - ESA95 annex II applies.

VI.4 Public infrastructure financed and exploited by corporations

VI.4.1 Background to the issue

1. Governments' contracts with corporations to finance, design, construct and operate public infrastructure may take various forms. The most common different types of long-term contracts are:

VI.4.1.1 "Build and delivery" contracts

2. In this case, the non-government party is only committed to build an asset and deliver it to government, according to its requirements (normally checked by a third party). The asset will be used by government fully under its own responsibility. These contracts are normally treated as a "one-off" government capital expenditure that may nevertheless be recorded on an accrual basis under some conditions. This does not exclude an ancillary provision of services (that can be separately specified and which are treated adequately in national accounts). Such services are strictly related to the assets, such as technical maintenance work.

VI.4.1.2 Purchases of services on regular basis

3. Government is only purchasing services over a given long-term period but without fixing specific requirements as regards the assets, i.e. different from general regulatory standards. This contractual link may be important to ensure continuity in supplying, both in quantitative and qualitative terms. The treatment in national accounts, based only on flows occurring in one fiscal year, does not raise any specific issue.

VI.4.1.3 Equity stakes

4. Such arrangements involve the creation of a new unit (a "joint-venture") in which both government and non-government partners have equity stakes in a company managing a given infrastructure. ESA95 rules, as supplemented by the Manual on government deficit and debt, give quite explicit provisions, notably as regards the treatment of flows between government and this unit. A "pure" joint-venture market entity with a strict equality in equity stakes is classified as a public corporation when government is judged to exercise a control over the general policy of the unit.

VI.4.1.4 Leases

5. Government is the user, during a given period, of an asset that is legally owned by a nongovernment unit. According to the "risks and rewards" borne by each party (that is the basis of the concept of "economic ownership"), the lease is considered either as an "operating lease" or as a "financial lease", which gives rise to different treatments in national accounts, fully specified in ESA95 (Annex II). This concerns also cases of "Cross border leases" (which take the form of a set of interlinked lease agreements commonly referred to as "head" and "sub" leases). If government enters in a financial lease agreement, its deficit and debt would be impacted for the full value of the assets at the time government takes possession of the assets.

6. The most relevant part of ESA95, concerning leasing of durable goods, is Annex II where the distinction between finance leases and operating leases is made. This is based on whether the lessor or the lessee is exposed to most of the risks and rewards inherent in the asset, and stresses the economic reality of these arrangements, rather than their legal features.

7. Different criteria are proposed in national accounts in order to decide on whether the lease must be considered as an operating lease or a finance lease. Their relevance must be judged for each particular case.

8. In this context, a strong correlation between the term of the contract and the expected economic life of the asset would be a rather strong indication of a finance lease. This would mean that the lessor would not be in a position to lend the good to another lessee or to use it otherwise at the end of the contract.

9. Similarly, where government pays directly for most of the maintenance of the asset – and insurance in case of some types of durable goods - and is bearing the risk of variations in such costs, this suggests a finance lease. It would be also the case if government was committed for repayment of the corporation's debt in the event of early termination of the contract.

10. On the contrary, an operating lease should be considered where the leasing corporation has significant and ongoing power on how to fulfil the contract, makes the key decisions on the design and construction of the asset, and decides how it is to be operated and maintained to provide the services required.

11. In addition, the nature of the partner could give an indication for classification where government enters into a lease contract with units that are clearly specialised either in operating leases or in finance leases. Examples are units providing only operating leases for equipment such as transport equipment, computers or, on the contrary, institutions specialised in financial leasing either in the form of property leasing (offices occupied by government units) or in equipment leasing. In all cases, it is important to check whether government is contracting according to normal commercial/market conditions.

VI.4.1.5 Concessions

12. This term is used in this context for contracts where government asks a corporation, generally after a competitive procedure, to operate an asset, which may be either existing or to be constructed, during the entire contract (but this unit may sub-contract some tasks to other suppliers under its sole responsibility), while directly charging the final users. For example a corporation might build a road or a bridge and levy tolls on vehicles using it. In some cases, assets may also be transferred to government at the end of the concession.

13. Under these contracts the major part of the partner's revenue comes from a direct sale of services to a variety of units under fully commercial conditions (under the form of e.g. tolls, fees), but possibly with specific government requirements (sometimes compensated by government in the form of subsidies). It may also be the case that the price is not freely set by the private partner or agreed by the private partner and the end-users but is fixed in the bidding documents and only adjusted upon the occurrence of certain events and adjusted to inflation. There may also be payments from the corporation to government. Payments may occur initially (for example they may be described as a purchase of a related licence) or during the lifetime of the contract (royalties, specific taxes, etc.).

14. A clear distinction should be drawn between concessions and Public-private partnerships (PPPs) in national accounts. In the context of this chapter, the term "concession" is used solely to describe such long-term contracts, in which the majority of partner's revenue comes from the final users of the service, i.e. in which government makes no regular payments to the partner or such payments do not constitute a majority of the partner's revenue. In contrast, in PPPs arrangements the majority of the partner's revenue under the contractual arrangement comes from government payments (e.g. shadow tolls).

15. This chapter describes the statistical treatment of concessions, whereas the recording of PPPs is discussed in VI.5.

VI.4.1.6 The key issue in national accounts

16. In a concession-type contract, a corporation might, for example, build a road or a bridge and levy tolls on vehicles using it. There may be or not payment from the corporation to government.

17. The questions are as follows:

    – In the balance sheets of which sector – corporation sector or general government sector – should the infrastructure asset be recorded during the period of exploitation?

    – How should the transactions linked to the contracts be recorded, and what is their impact on government net lending/borrowing?

18. The corporations involved in these operations can be either public or private. If the corporation is public, the first question to ask is whether it is genuinely a market unit (see Part I of this Manual).

VI.4.2 Treatment in national accounts

19. In cases of such concessions where government payments in cash or in kind do not constitute the majority of the corporation's revenue under the contracts, either directly or indirectly, and government is not providing any other support in the form of guarantees or direct financing (see chapter VI.5 for a wider discussion on guarantees), the infrastructure should be recorded in the corporation's balance sheet during the period of exploitation.

20. In concessions where government is providing payments to the partner, a further analysis is necessary to evaluate if the expected stream of government payments would not constitute a majority of partner's revenue. If this is the case, such long-term contracts are to be considered as PPPs in the meaning of national accounts, and analysed according to chapter VI.5 of this Manual.

Case 1 a: the new asset is built by the corporation

21. When the infrastructure is a new one built by the corporation, it is GFCF of the corporation with no impact on government accounts.

22. If at the end of the period of exploitation the infrastructure is sold to government, it enters the government's balance sheet through GFCF. In cases when the infrastructure is given to government, a capital transfer ("Other capital transfers" D.99) is recorded, with no overall impact on government net lending/borrowing (D.9).

23. When payments are made by the corporation to the government during the contract, they should be recorded as rents (D.45) if the government makes available to the corporation a non-produced asset (such as land upon which the infrastructure is built) and rental (output P.1) if government provides a produced asset. They should be recorded as taxes ("Other taxes on production" D.29) if government does not provide anything in return for the payment.

Case 1 b: an existing produced asset is transferred to the corporation

24. It may happen that government transfers an existing infrastructure to the corporation at the start of the concession period. This is recorded as a capital injection in kind in the other changes in volume of assets account, with no impact on government net lending/borrowing: the situation can be regarded as a restructuring of fixed assets, property rights and obligations; it is an exchange of a non-financial asset for a financial

one (government's equity in the corporation, AF.5), to be recorded according to the rules defined in chapter III.4 of this Manual.

25. If the infrastructure is given back to government at the end of the period of exploitation, it enters the government's balance sheet through the other changes in volume of assets account, with no impact on government net lending/borrowing (See chapter III.5 of the Manual concerning payments by public corporations to government).

26. If payments are made by the corporation to the government during the contract, they should be recorded as dividends (D.421).

VI.4.3 Rationale of the treatment

27. Whatever the situation is, output is produced by the corporation by means of the infrastructure. This output is consumed by users of the infrastructure. It is thus relevant to record the infrastructure in the corporation's balance sheet during the period of exploitation.

Case 1 a: the new asset is built by the corporation

28. Possible payments from the corporation to government can arise because:

– Government provides something in exchange:

The classification of the payment will depend on what government provides. Typically government will provide the land upon which the infrastructure is built. In this case, the regular payments from the corporation to government should be classified as rent (D.45).

or:

– Government demands a payment simply for allowing the corporation to undertake the operation:

This is like a licence for which no actual service is provided by government. The payment should be classified as other taxes on production (D.29). ESA95 4.23 (e) refers.

29. If the infrastructure is given to government at the end of the period of exploitation, it is unlikely that the reversion is without counterpart. The infrastructure is given to government as the counterpart for the corporation either to use the public land or to undertake the operation. GFCF recorded in government's accounts at the end of the concession period could be thus balanced by the account receivable associated with accrued property income (D.4). However, it should be balanced by a capital transfer ("Other capital transfers" D.99) as the operation is exceptional.

Case 1 b: an existing produced asset is transferred to the corporation

30. When government transfers an existing infrastructure to the corporation it is recorded as a capital injection in kind in the other changes in volume of assets account, with no impact on government net lending/borrowing: the situation can be regarded as a restructuring of fixed assets, property rights and obligations. It is an exchange of a non-financial asset for a financial one (government's equity in the corporation, AF.5), to be recorded according to the rules defined in chapter III.4 of the Manual.

31. Because of this equity, it is relevant to classify possible payments from the corporation to the government as dividends (D.421), even though part of them could be regarded as rents.

32. Reversion of the infrastructure to government is recorded by symmetry to the initial transfer: an exchange of a non-financial asset for a financial one (AF.5), shown in the other changes in volume of assets account.

VI.4.4 Accounting examples

Accounting treatments related to the two cases are presented below.

The full sequence of government and corporation's accounts is not provided: only those accounts, which are relevant for the cases involved, are shown.

VI.4.4.1 Case 1 a: the new asset is built by the corporation

– The infrastructure is built by the corporation

– Rents/taxes are paid by the corporation to government (payments are 100 the first year)

– The infrastructure reverts to government at the end of the period of exploitation (it has a residual value of 200).

Construction and first year of exploitation

General government				Enterprise			
Non-financial accounts							
U/ΔA			R/ΔL	U/ΔA			R/ΔL
		D.45/D.29	+100			D.45/D.29	-100
B.9	+100			B.9	-100		

Reversion of the infrastructure at the end of exploitation

General government				Enterprise			
Capital account							
ΔA			ΔL	ΔA			ΔL
P.51	+200	D.99	+200	P.51	-200	D.99	-200
B.9	0						
Closing balance sheet							
A			L	A			L
AN.11	200						

VI.4.4.2 Case 1 b: an existing produced asset is transferred to the corporation

- The infrastructure is transferred by government to the enterprise at the beginning of the exploitation (for an amount of 1 000)
- Dividends may be paid by the corporation to government (this is not the situation in the example below)
- The infrastructure reverts to government at the end of the period of exploitation (it has a residual value of 200).

Initial transfer of the infrastructure to the enterprise

General government				Enterprise			
Opening balance sheet							
A			L	A			L
AN.11	1 000						
Other changes in volume of assets account							
ΔA			ΔL	ΔA			ΔL
AN.11(K.12.1)	-1 000			AN.11(K.12.1)	1 000	AF.5(K.12.1)	1 000
AF.5(K.12.1)	1 000						
Closing balance sheet							
A			L	A			L
AN.11	0			AN.11	1 000	AF.5	1 000
AF.5	1 000						

First year of exploitation of the infrastructure

K.1 = 40

General government				Enterprise			
Capital account							
ΔA			ΔL	ΔA			ΔL
				K.1	-40	B.10.1	-40
Revaluation account							
ΔA			ΔL	ΔA			ΔL
AF.5(K.11)	-40					AF.5(K.11)	-40
		B.10.3	-40			B.10.3	+40
Closing balance sheet							
A			L	A			L
AF.5	960			AN.11	960	AF.5	960
		ΔB.10	-40			ΔB.10	0

Reversion of the infrastructure to government at the end of exploitation

General government		Enterprise	

Other changes in volume of assets account

ΔA		ΔL	ΔA		ΔL	
AN.11(K.12.1)	+200		AN.11(K.12.1)	-200	AF.5(K.12.1)	-200
AF.5(K.12.1)	-200					

Closing balance sheet

A		L	A		L	
AN.11	200					

VI.5 Public-Private Partnerships (PPPs)

VI.5.1 Overview

1. The term "Public-Private Partnerships" (PPPs) is widely used for many different types of long-term contract between government and corporations for the provision of public infrastructure. In these partnerships government agrees to buy services from a non-government unit over a long period of time, resulting from the use of specific "dedicated assets", such that the non-government unit builds a specifically designed asset to supply the service. It is usually due to the fact that these equipments render some core public services, as seen for health (hospitals), education (schools and universities), public security (prisons) or for the use of some transport infrastructure. The services bought by government might also be to meet its own needs (such as an office building).
2. In the context of this chapter, the term "PPP" is used solely to describe a particular type of long-term contracts, in which government is paying to a partner all or a majority of the fees under a contractual arrangement. In national accounts, this aspect distinguishes PPPs from concessions (see chapter VI.4), in which government makes no regular payments to the partner, or such payments do not constitute a majority of fees received by the partner.
3. The key statistical issue is the classification of the assets involved in the PPP contract – either as government assets (thereby immediately influencing government deficit and debt) or as the partner's assets (spreading the impact on government deficit over the duration of the contract). This is a similar issue to distinguishing between operating leases and finance leases, explained in annex II of ESA95 (see also chapter VI.4).
4. As a result of the methodological approach followed, in national accounts the assets involved in a PPP can be considered as non-government assets only if there is strong evidence that the partner is bearing most of the risks attached to the asset (directly and linked to its use) of the specific partnership.
5. In this context, it was agreed among European statistical experts that, for the interpretation of risk assessment, guidance should focus on three main categories of risk:

   "construction risk": covering events like late delivery, respect of specifications and additional costs,

   "availability risk": covering volume and quality of output (performance of the partner),

   "demand risk": covering variability of demand (effective use by end-users).
6. PPP assets are classified in the partner's balance sheet if both of the following conditions are met:
   - the partner bears the construction risks;
   - the partner bears at least one of either availability or demand risk, as designed in the contract.
7. If these conditions are met, and there is no other mechanism in place (such as a guarantee or grantor financing) to return these risks to government, then the treatment of the contract is similar to the treatment of an operating lease in national accounts; it would be classified as the purchase of services by government.
8. If the conditions are not met, or if government assumes the risks through another mechanism, then the assets are to be recorded in the government's balance sheet.

The treatment is in this case similar to the treatment of a financial lease in national accounts requiring the recording of government capital expenditure and borrowing.

9. In borderline cases it is appropriate to consider other criteria, notably what happens to the asset at the end of the PPP contract.

VI.5.2 Background to the issue

VI.5.2.1 The development of PPPs

10. PPPs imply a long-term relationship (by convention, at least three years) in the framework of contracts, where the obligations and rights of each partner are clearly specified.

11. In addition to using the corporation's skills and competence to improve the quality of public services and reduce their cost, PPPs may also be motivated by budget constraints which push governments to look for alternative resources for developing collectively-used equipment. Usually, such contracts allow for a spread of the cost of new assets over the time they are used, thus avoiding large initial government capital expenditure.

12. It is not the role of statisticians to examine the motives, rationale and efficiency of these partnerships, or to voice an opinion about the “economic viability” and the “financial viability” of the underlying projects. Their role is to provide clear guidance on their treatment in national accounts and, in the context of the excessive deficit procedure, their impact on general government deficit and debt. It is important to develop general national accounts principles in this domain in order to ensure homogeneity of government statistics in all EU Member States, such that deficit and debt figures are fully comparable[9].

13. Similarly, it is not up to the statisticians to provide a strict definition of PPPs, as the expression is widely used to describe various arrangements, whereas a specific definition would not be appropriate in a context of complexity and innovation. Instead, they should spell out basic criteria which allow national accountants to clearly distinguish the different arrangements that may be observed.

VI.5.2.2 Characteristics of PPPs

14. This refers more specifically to the forms of partnerships (referred to as “Public-Private Partnerships” - PPPs) designed to provide public services, with government payments constituting a majority of fees received by the partner under the contract. The Eurostat decision of 11 February 2004 covered explicitly and exclusively this case (see News release 18/2004).

15. In practice, PPPs occur in areas of activity where government has usually a strong involvement (e.g. transport, education, health, security, etc.). Government concludes with one or several experienced commercial partners, directly or through a special legal entity set up for the specific purpose of a PPP, a contract for the delivery of services derived from a specific asset.

16. This type of contract mentions specifically-designed assets, which generally either need a significant initial capital expenditure or major renovation or refurbishment (which is precisely why government uses such arrangements in many instances), and the delivery of agreed services, requiring the use of these assets and according to

[9] It should be acknowledged that the private sector accounting standards (IFRIC 12 – Service Concession Arrangements) setting out the accounting rules for the long-term contracts between government and corporations, including also PPPs as described in this Manual, adopt criteria of control over the asset which differs from the risk and rewards approach applied as a matter of principle in national accounts, and needs unquestionable definition.

given quality and volume standards that are specifically defined in the contract. It is the service component that makes PPP contracts differ from leases.

17. The contract may refer either to a new asset or to significant refurbishment, modernisation or upgrading of existing assets, including assets already owned and managed by government but provided that the expenditure for renovation, etc., will represent a predominant part of the value of the asset after renovation.

18. A key feature of PPPs is that government is the main purchaser. It is in this respect that they differ from "concessions", as defined for national accounts purposes (see chapter VI.4). In PPPs, government purchases the service through making regular payments once the assets are supplied by the partner, irrespective of whether the demand originates directly from government itself or from third party users (as for health and education services, and some types of transport infrastructures). There is no need to specify a given threshold between government and third party demand on this point. Although it only needs to be just above 50%, in reality it is usually much higher, generally above 90%, because most contracts refer to "typed" economic models. The expression "shadow tolls" is frequently used, notably in the case of transportation infrastructure, and refers to remuneration by government for a given usage volume of the transport infrastructure.

19. The use of the assets is specifically defined in the contract and there are limitations in the way in which the assets can be used by the partner. For example, the partner cannot dispose of them at will, and, where applicable, has to give priority to government users over other possible users. Note that many contracts do not rule out payments by "third parties", but these are likely to represent a minor (even negligible) part of the partner's revenue and frequently refer to a secondary activity associated with the dedicated assets (for instance "private" use of some sportive, educational or cultural infrastructure in a given period or fees collected for telephone cables laid along, or under, a motorway).

20. In addition, it must be stressed that "government" in this context refers to the whole government sector ("General Government", sector S.13 in ESA95). Different government units, even classified in different sub-sectors of government, may take part in the contract to various degrees but this should have no impact on the treatment in national accounts.

VI.5.2.3 The key issue in national accounts

21. In national accounts, long-term contracts and notably PPPs, raise questions about which sector's balance sheet the related assets are included in. This refers to the advance (a priori, when the contract is signed, or enters into force for existing assets or at delivery for new assets) recording of the assets involved, either in the government's balance sheet or in the partner's balance sheet. A recording in the government's balance sheet may have important consequences for government statistics, both for government deficit (the capital expenditure is recorded as government gross fixed capital formation in the non-financial account, under the category P.51), and government debt (the financial account matches the capital expenditure by imputing government borrowing, which increases gross debt as the amounts outstanding on the imputed loan are included in AF.4, part of the "Maastricht debt" concept).

22. Moreover, according to national accounts rules, when the assets (in the form of buildings or other structures) are considered government assets, the capital expenditure is recorded on an accrual basis as the works proceed, and not at the end of the construction/refurbishment period. For practical reasons, the existence of phased payments (instalments) received by the constructor or manufacturer may be used as a proxy for indicating the appropriate time of recording.

23. There are also consequences as regards the recording of the flows that are observed between government and the partner during the lifetime of the contract. If an imputed loan has been recorded in the government's balance sheet, the redemption of the corresponding principal must be spread over the entire period (with no impact on government surplus or deficit), while imputed interest must also be calculated and included in government expenditure together with the cost of services charged to government in the context of the contract.

VI.5.3 Treatment in national accounts

VI.5.3.1 Sector classification of the partner

24. The corporations involved in long-term contracts with government, and more specifically in the case of PPPs as described above in VI.5.2.2, can be either public or private. If the corporation is public, this usually means that according to national accounts rules, government or a public unit determines the general corporate policy of this market unit.

25. The public partner should be classified as non-financial corporation as long as it acts as a market unit (50% cost coverage criterion) and payments by government may be considered as sales (counterpart of the provision of services).

26. However, specific attention should be given to cases where the public corporation is 100% government-owned (or to a level close to 100%), and thus there is an absence of private investors in the public corporation who would exercise a significant influence to ensure commercial profitability and efficiency. In cases where payments by government under this contract are a predominant part of the partner's revenue, these payments should be analysed to determine if they can be classified as sales, particularly if this contract alone results in a significant change in the size or nature of its activities. Following the application of the rules described in part I of this Manual, this corporation could be reclassified as a government unit.

27. As regards contracts with special units, created on purpose (frequently referred to as special purpose vehicles – SPVs), the only case to be considered is where such a unit is created mainly by government and is fully controlled by it.

28. Finally, whenever government deliberately offers support to a partner classified outside the government sector as compensation for events that were not mentioned as clear commitments when the contract was signed with the partner, this support must be recorded as a transfer affecting deficit/surplus of government at the time the decision to provide the support is taken.

29. A reclassification of the assets to the government's balance sheet will result from the reclassification of the partner as a government unit. This may occur if a recurrent support results in a shift of the unit from a market activity to a non-market activity (the majority of the production costs no longer being covered by payments considered as "sales", but instead by transfers from government).

VI.5.3.2 Assessment of the risks borne by each contracting party

General principle

30. In national accounts, the assets involved in a long-term contract between a government unit and a non-government unit can be considered as non-government assets only if there is strong evidence that the non-government partner is bearing most of the risks attached to the asset all over the contract.

31. ESA95 states (see notably annex II, paragraph 4) that *"all risks"* must be transferred. But what is observed in reality in partnerships between government and its counterparts is a sharing of risks. However, as mentioned further, it may be seen as normal that some risks are taken by government (for instance in the case of very exceptional events or for government action that change the conditions of activity that were agreed previously). Therefore, this analysis of risks borne by the contractual parties is the core element as regards classification of the assets involved in the contract, to ensure the correct accounting of the impact on the government deficit of this type of partnerships.

32. It has to be noted that these arrangements deal with a single asset or a set of assets that are not contractually divisible. They should not be split in national accounts. The rule is that one asset appears in the balance sheet of only one economic agent, for its total value.

33. For the purpose of classifying PPPs in national accounts, in order to simplify the analysis, three main categories of risks have been selected:

34. "Construction risk" covers events related to the state of the involved asset(s) at the commencement of services. In practice it is related to events such as late delivery, non-respect of specified standards, significant additional costs, legal and environmental issues, technical deficiency, and external negative effects (including environmental risk) triggering compensation payments to third parties.

35. "Availability risk" covers cases where, during the operation of the asset, the responsibility of the partner is called upon, because of insufficient management ("bad performance"), resulting in a volume of services lower than what was contractually agreed, or in services not meeting the quality standards specified in the contract.

36. "Demand risk" covers the variability of demand (higher or lower than expected when the contract was signed) irrespective of the performance of the private partner. In other words, a shift of demand cannot be directly linked to an inadequate quality of the services provided by the partner. Instead, it should result from other factors, such as the business cycle, new market trends, a change in final users' preferences or technological obsolescence. This is part of a usual "economic risk" borne by private entities in a market economy.

37. Normally, the demand risk should not be applicable for contracts where the final user has no free choice as regards the service provided by the partner. This applies of course for equipment such as prisons but it may also be the case for hospitals or schools under certain conditions, and in some cases sportive and cultural infrastructures.

38. In addition, some contracts may be designed that government payments are mainly linked to the effective use of the assets (volume indicators), whatever the extent of final user's own initiative and although the volume used may be in fact related to the performance of the private partner. In this case, the demand risk would be in the core of the analysis of risks sharing.

39. Finally, some contracts may combine payments linked to both availability and demand risks in a quite balanced way, as reflected in the indicators relating to the level of payments where no category seems to be predominant.

40. Therefore, the analysis of the risks borne by each party must assess which party is bearing the majority of the risk in each of the categories mentioned above.

41. However this assessment does not consider risks that are not closely related to the asset(s) and that can be separated from the main contract, as it is the case where part of the contract might be periodically renegotiated, and where there are performance or

penalty payments that do not significantly depend on the condition of the main assets or on service quality.

Guidance for contracts relating to purchase by government of services based on the use of dedicated PPP assets

42. The assets involved in such PPPs are to be recorded in the partner's balance sheet, and therefore recorded "off-balance sheet" for government, only if both of the following conditions are met:

    - the private partner bears the construction risk, and
    - the private partner bears at least one of either availability or demand risk, as designed in the contract and, in some specific cases mentioned above, both of them.

43. Therefore, if the construction risk is borne by government, or if the private partner bears only the construction risk and no other risks, the assets are recorded in the government's balance sheet.

44. A key criterion is the possibility for government to apply penalties in cases where the partner is defaulting on its service obligations. Application of the penalties should be automatic (i.e. clearly stated in the contract) and should also have a significant effect on the partner’s revenue/profit and, therefore, must not be purely symbolic. Should the asset not be available for a significant period of time, the government payments for that period would be expected to fall to zero. As a corollary, if the partner is in a position to provide services, according to conditions specified in the contract, at lower costs than expected, it should be entitled to keep all or most of the subsequent profit.

45. Furthermore, any other mechanisms by which government re-assumes the majority of risks of the project (e.g. guarantees or majority financing - see below VI.5.3.4 and VI.5.3.5) would have an impact on which balance sheet the asset is recorded in.

VI.5.3.3 Allocation of the assets at the end of the contract

46. An analysis of the clauses relating to the disposal of the PPP assets described at the end of the contract can be used as a supplementary criterion for determining overall risk transfer, notably where the risk analysis mentioned above, does not give clear conclusions (for instance if risk distribution is estimated as balanced or is based on fragile hypotheses). However, as such, the final allocation of the assets could not be the single and straightforward criterion for the recording of the PPP assets but, notwithstanding this, it might give in some cases additional insight into risks among the contract partners as the clauses concerning the final allocation of the asset might help to assess whether a significant risk remains with the private partner.

47. If the assets remain the property of the partner at the end of the project, whatever their economic value at this time (but frequently their future economic life remains quite significant, notably in cases of infrastructure that has only slightly depreciated over time), then recording in the partner’s balance sheet would have an additional justification.

48. In other contracts government may hold merely an option to buy the asset at the current market value that would be estimated at a given point in time. In these cases, the partner bears the risks associated with the continued demand for the asset and its physical condition. This also reinforces the recording of the assets in the partner's balance sheet.

49. On the contrary, government may have the firm obligation to acquire the assets at the end of the contract at a pre-determined price.

50. The following cases could give strong additional arguments for recording the assets as government assets :

- the pre-determined price is fixed as a remaining part of the initial cost of capital, without any reference to a possible market value at the end of the contract; or
- the pre-determined price is obviously higher than the expected economic value of the assets at the end of the contract; or
- the price paid by government is lower than the economic value (or even nil) but government has already paid for the acquisition of the assets throughout the contract by making regular payments that reached a total amount very close to the full economic value of the assets (see also VI.4).

51. Note that, in some cases, at the end of the contract, the unit managing the asset and providing services to final users is wound up, or is absorbed by government. This transfer of the assets to government at the end of the contract should be recorded as "other change in volume"**.** However, this is more likely to be observed in the case of "concession contracts" than for PPPs arrangements.

Termination clauses

52. PPP contracts naturally include termination clauses in case the government or the partner cannot fulfil the contract or they persistently fail to meet their contractual obligations. In addition, government may use exceptional sovereign right.

53. Termination clauses will often require the government to acquire the asset and take on board part or all of the debt, and a penalty to be paid by the party at fault. This is because the PPP asset is often a "dedicated asset" with limited resale value on the market for the partner and because government usually wants to retain a major influence on the asset.

54. In the event of a termination due to the partner's default, if the contract requires a refund by government based on the capital costs (or operation), instead of the assessed market value of the asset at the time, the construction risk (or availability/demand risks, respectively) is generally deemed to be with government.

55. Renegotiations are a kind of termination without explicit penalty. They can be considered as cancelling the previous contract and creating a new one. Such renegotiations need to be analysed in order to assess whether changes introduced in the contract are substantial and if they alter the distribution of risks between government and the partner.

VI.5.3.4 Government financing

56. Normally, an important aim of government's long-term partnerships with non–government units is to spread the recording of capital expenditure and related financing over a long period of time.

57. However it may be that government takes part itself in the financing. This is different from a possible capital injection into a given structure in the form of an equity stake. Frequently a private partner is not able to borrow at the same rate of interest as government, thus increasing the cost of the project.

58. Therefore, government may offer a certain level of financing for the PPP project, to entice greater interest by private sector entities in the project, to reduce the total cost of financing, and / or simply to ensure the viability of the project.

59. If, at inception, or during construction, the capital cost[10] is predominantly covered by government (in various forms, e.g. investment grants, loans, etc), this would be an indication that government bears a majority of risks. If government involvement increases from a minority level to a majority level, this triggers a reclassification of the assets to government accounts at the time of the increase.

VI.5.3.5 Government guarantees

60. Government may also provide a guarantee, partially or fully covering the project-related borrowing of the partner. Generally, this helps the partner to raise funds at lower cost on markets and improve its credit rating.

61. In some cases, a debt guarantee can trigger a classification of the partner's debt as government debt, such as the existence of legal provisions transferring to government all or part of the debt service, or where there is an obvious inability of debt servicing by the partner.

62. Moreover, because guarantees have an impact on the distribution of risks between the parties, guarantees should be used in the analyses of risks in PPPs, especially where the majority of the value of the PPP assets (including any refurbishment cost) results from a transfer of the assets from government.

63. The scope of a guarantee, depending on its coverage and how it is structured (notably when its coverage is wider than just one specific, project-related debt instrument), may influence the recording of the PPP assets. It may result in the (re-)assumption by government of some of the risks analysed above in this chapter.

64. In PPPs, government guarantees can be granted to the partner to cover the repayment of the debt and/or to ensure a return on equity. For instance, government could ensure a given return on equity, whatever the performance of the partner or the effective level of demand from final users. The government guarantee could also cover the clear majority of the project-related debt of the project.

65. If at inception or during construction, government guarantees cover a majority of the capital cost of the PPP project, the asset is recorded in the government's balance sheet. It would be the same if a given return is insured to the partner in all circumstances.

66. The guarantees to consider when analysing the risk distribution between government and the partner take into account guarantees provided to the creditors or to the partner, in various forms, such as by way of insurance or derivatives, or any other arrangements with similar effects.

67. For the evaluation of the risk distribution between government and the partner, both tests for majority financing and guarantees in relation to the capital costs of the PPP project must be done jointly. It might well be the case in PPP contracts, that government provides a minority of the total capital costs, but then guarantees a major part of the remaining project finance (directly relating to the partner loan liabilities or indirectly e.g. through guaranteed availability payments). In this case, the combined effect of the government's support would represent more than a majority of capital costs, leading to the conclusion that a majority of risks rest with government. Additionally, in the cases where a PPP is majority financed by equity, a special analysis needs to be undertaken assessing the impact on the risk distribution between government and the partner from the contract provisions relating to the equity stake.

68. Finally, when a guarantee is effectively called, there may be a change to the economic ownership of the assets and its reclassification (at their remaining value), especially if

[10] The term "capital cost" refers to the cost of construction or refurbishment of the asset referred to in the PPP project contract. Another term used in some countries with the same meaning is "capital value".

this event profoundly changes the share of risks borne by the parties. This could be the case if government takes control of the partner, and pays no longer on the basis of the asset availability and demand, but mainly on the basis of operating costs.

VI.5.3.6 Classification of some transactions between a corporation and government

69. When government makes regular payments to the partner corporation, the treatment depends on which balance sheet the asset is recorded in.

70. If the asset is included in the partner's balance sheet, the corporation provides a service to government that constitutes government intermediate consumption expenditure, valued by the payments to the corporation.

71. If the asset is included in the government balance sheet, the service to the community is provided using government infrastructure. The acquisition of the asset by government is recorded as in a “standard” financial leasing contract. Government payments to the partner over the whole life of the contract are split between redemption of principal (F.4), payment of interest (D.41) and, possibly, purchase of services for the tasks performed by the corporation and purchased by government (P.2).

VI.5.4 Rationale of the treatment

VI.5.4.1 Sector classification of the partner

72. A special case of PPP between government and a public corporation should fulfil certain conditions.

73. The public corporation should show a clear competence in the area of activity covered by the PPP (directly or in the case of creation, from the unit(s) controlling it), and the PPP contract with government should be one among several commercial activities of the public corporation.

74. In the case of a 100% public-owned corporation in which the contract with government is almost exclusively the source of its revenue, a reclassification as a government unit is not required if there is evidence that market-oriented payments (meaning of a similar kind to that observed between other market units) are made to the corporation, and if government bears only risks that a commercial entity would not normally be expected to bear (very high political or security risks, for instance).

75. In some contracts, the execution of the contract takes place under the legal umbrella of a special purpose vehicle (SPV). Normally, such a legal entity would have a finite life limited to the length of the PPP contract, or just to the construction period. It can be expected to have been created solely for legal purpose.

76. If one or several private partners that are the operational contracting parties control this unit, there is no question as regards its classification as a non-government unit. This may be observed in the case of building innovative and complex assets that need the close cooperation of firms in different technical areas. But this may also take the form of a pooling of banks where the financing requirements are quite significant. Therefore, an SPV generally does not itself play an operational part in the execution of the contract, neither as a project manager, nor as the builder or operator of the PPP asset.

77. Complications arise when such a special unit partner is created by government or by a public unit. In this case it must be closely checked whether the unit can be considered as an independent institutional unit according to national accounts, and whether the unit is a true market producer. The unit must have the capacity to acquire assets and incur liabilities in its own right, and to enter into contracts with non-government units.

Otherwise, it could be a case of classifying it as an “ancillary” unit, notably by reference to SNA93 4.40 to 4.44 (also implicitly in ESA95), such that it might be more appropriate to say that the fees paid by government are not sales receipts for a “real partner”, but just transfers within the general government sector.

VI.5.4.2 Assessment of the risk

78. The core issue is the share in all risks that are associated to the contract and are directly related to the state of the assets involved or depends on some management tasks that must be carried out by the partner in the framework of its contractual obligations. This refers to the concept of “economic ownership”, clearly distinguished from “legal ownership”, used in most accounting standards both for national accounts purposes and in business accounting. The analysis of risks sharing must rely both on the potential effect on profits of the private partner (lower income and/or higher costs) and on the probability (even roughly estimated) of occurrence of the risk, by analogy to the "mathematical expectancy" concept. Thus, it should not be acceptable that a private partner bears only risks with highly potential damageable effects but with a very low reasonable expectancy.

79. As regards **the construction risk**, a government’s obligation to start making regular payments to a partner without taking into account the effective state of the assets that are delivered would be evidence that government bears the majority of the construction risk and is acting de facto as the final owner of the assets since the inception. This is also true where payments are made by government to cover systematically any additional cost, whatever their justification.

80. The magnitude of the different components of this risk can be estimated by the amount that each partner would be obliged to pay if a specific deficiency were to occur. This risk might be quite significant where the assets involve major research and development or technical innovation, whereas it could be more limited for conventional structures. An important point is that government should not be obliged to pay for any event resulting from a default in the management of the construction phase by the partner, either as a direct supplier or only as a coordinator/supervisor.

81. By contrast, the partner need not be responsible for unexpected exogenous events, not normally covered by insurance companies. This risk must not be confused with the appropriateness of the “design” of the assets, where the degree of initiative of the partner may be very limited. The main point here is that a partner normally would not agree to bear risks relating to the construction, if government’s requirements are unusual, and alter the commercial viability of the asset. In addition, the partner should not be taken as responsible in case of a government action such as changing specifications in the course of the construction or modifying some standards requirements. A specific case to be considered is where the partner receives an existing government asset as a necessary part of the project (either as an element or for a significant refurbishment). The construction risk applies only to the new capital expenditure under the responsibility of the partner, whatever the conditions in which the asset has been transferred.

82. As regards the **availability risk**, government is assumed not to bear such a risk if it is entitled to reduce significantly its periodic payments, like any “normal customer” would require if certain performance criteria are not met. Under these conditions, government payments must depend on the effective degree of availability ensured by the partner during a given period of time. This would mainly apply where the partner does not meet the required quality standards, resulting from a lack of performance. It may be reflected in non-availability of the service, in a low level of effective demand by final users, or low level of user satisfaction. This is generally reflected in performance indicators mentioned in the contract, for instance, an available number of beds in a hospital, of classrooms, of places in a prison, of lanes of a highway opened to traffic, etc. Normally,

the partner is assumed to be in a position to avoid the occurrence of this risk. In some cases, the partner could invoke an "external cause", such as a major policy change or “force majeure”. But such exceptions should be accepted only under very restrictive conditions, explicitly stated in the contract.

83. The application of the penalties where the partner is defaulting on its service obligations must be automatic and must also have a significant effect on the partner revenue/profit. They must affect significantly the operating margin of the unit and could even exceed it in some cases, so that the partner would be heavily financially penalised for its inadequate performance. It may also take the form of an automatic renegotiation of the contract and even, in an extreme case, of dismissal from the contract of the original partner.

84. It is important to check that penalties for inadequate performance are not purely "cosmetic" or symbolic. The existence of marginal penalties would be evidenced by a reduction in government payment far less than proportional to the amount of services not provided, and such a situation would be contrary to the basic philosophy of a significant transfer of risks to the partner. Furthermore, the existence of a maximum amount or percentage of penalties that could be applicable in the event of defaulting performance would also suggest that this risk has not been significantly transferred to the partner. In the case of no availability of the asset for a significant period, it would be expected that the government's payments would fall to zero.

85. As regards the **demand risk**, government is assumed to bear this risk where it is contractually obliged to ensure a given level of payment to the partner independently of the effective level of demand expressed by the final users, rendering irrelevant the fluctuations in the level of demand on the partner’s profitability. However, the variability of demand is not due to the behaviour (management) of the private sector partner, which is already covered by the provisions above. In other words, the availability standards stated in the contract are fulfilled. Therefore this risk covers a direct change in final users’ behaviour due to factors such as the business cycle, new market trends, direct competition or technological obsolescence.

86. For the asset to be recorded in the partner’s balance sheet, when there is an unexpected decrease in the partner’s revenue, the partner must be able to manage the situation by various actions under its own responsibility, such as increasing promotion, diversification, redesign, etc. In this respect, the partner is carrying out its activity in commercial manner. Thus, the existence of contractual clauses allowing the partner to use the assets for purposes other than those that have been agreed with government (of course, within certain limits) is frequently an indication that the partner is effectively bearing the demand risk, as defined here.

87. Where the shift in demand results from an obvious government action, such as decisions by government (and thus not necessarily only by the unit(s) directly involved in the contract) that represent a significant policy change, or such as the development of directly competing infrastructure built under government mandate, the absence of an adjustment in the regular payments or even a compensation payment to the partner would not imply the recording (or the reclassification) of the assets in the government’s balance sheet.

88. Finally, like for the previous category of risks, some exceptional “external” events might have a significant impact on the level of the demand. Such risks can be retained by government without requiring the classification of the asset on its balance sheet. They must be considered under very restrictive conditions and should be limited to those for which insurance coverage is not available on the market at reasonable price. Normally, the partner is contractually required to subscribe to an insurance policy.

89. As regards other mechanisms by which government may assume the risk of the project, the presence of government financing and guarantees on the private sector

financing should be analysed. One could argue that this “financing risk” is an integral part of “construction risk”, since the absence of suitable financing means that the asset cannot be created, or cannot be created to required standards.

90. In those cases where government finances a part of the PPP and also guarantees all or part of the partner's equity and/or debts, these actions should be seen as cumulative from the aspect of risk analysis. Such an analysis should be made in relation to the capital cost of the project, to discover if government is covering a majority of the capital cost through these mechanisms.

VI.5.5 Accounting examples

VI.5.5.1 The PPP asset is recorded in the partner's balance sheet

- The asset is built by a corporation (GFCF=1 000). It depreciates by 40 in first year.
- Government makes regular payments to the corporation during the period of exploitation according to availability (payment is 100 for the first year)
- The infrastructure is purchased by government at the end of the period of exploitation (for an amount of 200).

Capital expenditure and first year of exploitation

General government				Enterprise			
Current accounts							
U			R	U			R
P.2	100					P.12	1 000
				K.1	40	P.11	100
B.8 net	-100			B.8 net	1 060		
Capital accounts							
ΔA			ΔL	ΔA			ΔL
		B.8 net	-100	P.51	1 000	B.8 net	1 060
B.9	-100			K.1	-40		
				B.9	100		

Purchase by government at the end of exploitation

General government				Enterprise			
Capital account							
ΔA			ΔL	ΔA			ΔL
P.51	200			P.51	-200		
B.9	-200			B.9	+200		
Closing balance sheet							
A			L	A			L
AN.11	200	AF.4	200				

VI.5.5.2 The PPP asset is recorded in the government's balance sheet

- The asset is built by a corporation (GFCF=1 000). It depreciates by 40 in first year.
- Government makes regular payments to the corporation during the period of exploitation. (Payment is 100 for the first year)

Capital expenditure

General government				Enterprise			
Current accounts							
U			R	U			R
K.1	40					P.11	1 000
B.8 net	-40			B.8 net	1 000		
Capital accounts							
ΔA			ΔL	ΔA			ΔL
K.1	-40	B.8 net	-40			B.8 net	1 000
P.51	1 000						
B.9	-1 000			B.9	+1 000		

Capital expenditure

General government				Enterprise			
Financial account							
ΔA			ΔL	ΔA			ΔL
		F.4	+1 000	F.4	+1 000		
		B.9	-1 000			B.9	+1 000
Closing balance sheet							
A			L	A			L
AN.11	1 000	AF.4	1 000	AF.4	1 000		

First year of exploitation of the infrastructure

Payment of partner of 100 is split into: D.41 = 50
P.2=30
F.4 = 20

General government				Corporation			
Current accounts							
U			R	U			R
						P.11	30
D.41	50					D.41	50
P.2	30						
K.1	40						
B.8 net	-120			B.8 net	+80		
Capital account							
ΔA			ΔL	ΔA			ΔL
K.1	-40	B.8 net	-120				
B.9	-80	B.10.1	-120	B.9	+80		
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	-100	F.4	-20	F.2	100		
		B.9	-80	F.4	-20	B.9	+80
Closing balance sheet							
ΔA			ΔL	ΔA			ΔL
AN.11	960	AF.4	980	AF.4	980		
ΔAF.2	-100	ΔB.90	-120				

VI.6 Keywords and references

Economic asset	ESA95 7.10
Economic disappearance of non-produced assets	ESA95 6.21 (b) 4
Financial leases/operating leases	ESA95 annex II
Non-financial non-produced assets	ESA95 7.16 and table 7.1
Other current taxes	ESA95 4.79 to 4.80
Other taxes on production	ESA95 4.23
Output	ESA95 3.14 to 3.68
Property income	SNA93 7.87 ESA95, 4.41
Rent	ESA95 4.72 to 4.76
Time of recording flows	ESA95 1.57
Transaction in non-produced assets	ESA95 6.06 to 6.13

VII

Debt related transactions and guarantees

Part VII Debt related transactions and guarantees

VII.1 Overview

1. This part of the manual deals with the treatment of debts owed to government (government assets) rather than debt as a liability of government (see part VIII). Sometimes governments, because of policies to do with social and economic development, or international relations, reduce the burden on units from whom money is owed to government. This has an impact on government net lending/borrowing since it is a voluntary transfer of wealth (recorded as a capital transfer).
2. Exceptionally, government might cancel the debts of a corporation it owns in order to secure a higher price when selling the corporation immediately after; or the debts might be cancelled because the debtor no longer exists. In these cases the debt cancellation might be recorded as a financial transaction, or as an "other flow", neither of which would affect net lending/borrowing directly.
3. In some cases, for example sovereign debt rescheduling through the Paris Club, rather than debts being cancelled the profile of required repayments is changed. Guidance is given on the treatment of these cases.
4. The final chapter looks at how to record guarantees given by government. This is notably where government pledges repay certain debts of a non-government unit in the event of that unit not being able to pay.
5. It is made clear that, even though the debt operations examined here concern mainly corporations or foreign governments, the basic principles apply to the relationship of the general government with all institutional sectors (including households and NPISH).

VII.2 Debt assumption and debt cancellation

VII.2.1 Background to the issue

1. In the restructuring processes of public sectors, the assumption and redemption, by general government, of debts, which are liabilities of public corporations, are important issues. It is worthwhile to first clarify the terminology.

   - Debt assumption is a trilateral agreement between a creditor, a former debtor and a new debtor, under which the new debtor assumes the former debtor's outstanding liability to the creditor. The new debtor – here the government - takes the place of the former one vis-à-vis the creditor, and is liable for repayment of the debt. After it has been assumed, the debt, which was originally a liability of the former debtor, becomes a liability of the new one. This happens notably when the debt of the former debtor is guaranteed by the new debtor and when the guarantee is called see chapter VII.4 on government guarantees.

   - Debt cancellation is a bilateral agreement between a creditor and a debtor to cancel (or to "forgive") part or all of a liability outstanding, incurred by the debtor to the creditor. As a consequence of the debt cancellation, the liability of the debtor and the related asset of the creditor do not exist any longer.

   - Write-off: there is write-off when a creditor recognises unilaterally that a claim can no longer be collected, mainly because of bankruptcy of the debtor. The creditor removes the claim from the asset side of his balance sheet.

   - Debt repudiation: this is a unilateral cancellation of a liability by a debtor. It is unlikely to happen in the case of public corporations.

   - Special case: debt assumption including a transfer of non-financial assets. An example is a debt assumption organised by the government involving a transfer of fixed assets from the unit benefiting of the debt assumption – typically a public corporation managing public infrastructure (i.e. railways), public transportation etc. – to the government entity taking over the debt. This might also involve other non-financial assets, like land.

VII.2.2 Treatment in national accounts

VII.2.2.1 Mutual Agreement

2. The counterpart transaction of debt assumption and debt cancellation made by mutual agreement is a capital transfer.
3. Thus, when government assumes a debt of a public corporation or cancels a claim it has against a public corporation, the counterpart transaction of the financial flows recorded in the financial accounts is a capital transfer, more precisely an other capital transfer (D.99), an expenditure which has a negative impact on the net lending/net borrowing (B.9) of general government.
4. In many cases, general government takes the initiative of debt cancellation or debt assumption. The acceptance of this action by the public corporation, and the fact that this corporation still exists afterwards, is interpreted as mutual agreement.

VII.2.2.2 Other cases

5. There are three exceptions to the mutual agreement treatment (ESA95 5.16): as a result, in these cases, the debt assumption/cancellation has no impact on government net lending/net borrowing.

VII.2.2.2.1 Debt of a quasi-corporation

6. If the public enterprise is a profitable quasi-corporation, debt assumption and debt cancellation by the general government of debts of this quasi-corporation does not give rise to the recording of a capital transfer. The counterpart transaction has to be recorded as a financial transaction (transaction in shares and other equity).
7. However, this is relevant to the extent that the public quasi-corporation is not making losses, requiring permanent government support. In the latter case, the general rule would apply to record the debt assumption or cancellation with a capital transfer.

VII.2.2.2.2 Operations preceding the privatisation of a public corporation

8. When the government cancels or assumes debts from a public corporation “as part of an ongoing process of privatisation to be achieved in a short-term perspective”, the counterpart transaction is not a capital transfer, but a transaction in shares and other equity.
9. Privatisation means giving up control over that public corporation by the disposal of shares and other equity.
10. This rule should only be applied when there is enough certainty that the privatisation will occur in the short-term (less than one year). In any case, the existence of a privatisation plan is not in itself sufficient for considering the debt assumption/cancellation “as part of an ongoing process of privatisation to be achieved in a short-term perspective”.
11. Moreover, the flow of debt assumed or cancelled is to be recorded as a financial transaction up to the limit of the privatisation proceeds. Amounts assumed or cancelled by the government in excess of this limit are to be recorded according to the general rule, as a capital transfer expenditure of the government.

VII.2.2.2.3 Write-off

12. The only case liable to give rise to a write-off by general government of claims against a public corporation is when the cancellation of the claim is preceded by the liquidation of the corporation. The liquidation should be assessed from an economic point of view, e.g. if the corporation legally continues to exist, it would be considered as liquidated if it has lost its financial substance and its main economic function.
13. The write-off of bad debt is recorded as another change in volume of assets.

VII.2.2.2.4 Special case: debt assumption including a transfer of non-financial assets

14. There may be two ways to describe and to record the economic event, both having the same impact on the net borrowing / net lending of the general government.

"Gross recording" of the debt assumption:

15. The gross recording consists of two simultaneous but separate transactions:
    - the debt assumption, which requires the recording of a capital transfer (D.99) expenditure of government for the same amount as the liability assumed (F.3 and/or F.4), exactly like in the typical case of debt assumption.
    - the transfer of assets, which is recorded as gross fixed capital formation (GFCF, P.51). As this transfer is a grant / a gift, it is counterbalanced by a capital transfer

in kind (D.92) revenue, making the transfer of assets neutral on the net borrowing / net lending.

16. The "gross capital transfer", equal to the whole liability assumed, has a negative impact on the net borrowing / net lending of the general government.

“Net recording" of the debt assumption:

17. One can also consider that what impacts the net borrowing / net lending of the government is the difference between the liability assumed and the value of the assets transferred: this is the "net capital transfer". However, since there is a simultaneous increase of the gross fixed capital formation (GFCF, P.51), the final impact on the net borrowing / net lending of the general government - net capital transfer plus GFCF - is exactly the same as in the "gross" recording.

VII.2.2.2.5 Time of recording, amounts to be recorded

18. Debt assumption and debt cancellation have to be recorded when the liability is actually removed from the debtor’s balance sheet, and the corresponding entries made in the government balance sheet.

19. Moreover, the recording of debt assumption / cancellation has to be made in one time: in particular, the successive dates of repayment, which were previously foreseen in the context of the former debt, are not relevant.

20. The amount to be recorded – the capital transfer expenditure - is the full amount of the outstanding debt, which is assumed or cancelled. In the special case (VII.2.2.2.4) a capital transfer revenue is recorded at the same time equal to the value of non-financial assets transferred.

VII.2.3 Rationale of the treatment

VII.2.3.1 Mutual agreement

21. In case of such a transaction, made by mutual agreement, the rule is to record a capital transfer. This stems from the definition of capital transfers (ESA95 4.146). More precisely, “other capital transfers (D.99) cover transfers [...] which do not themselves redistribute income but redistribute saving or wealth among the different sectors or sub-sectors of the economy or the rest of the world” (ESA95 4.164).

22. By assuming or cancelling a debt of a public enterprise, the general government is transferring to this enterprise, not income, but a part of its own wealth. As the change in government liabilities (debt assumption) or the change of government financial assets (debt cancellation) is a one-way transaction – representing a voluntary transfer of wealth - the counterpart transaction is a capital transfer.

VII.2.3.2 Other cases

23. **Quasi-corporation:** To consider an exception for profitable quasi-corporations is based on their specificity as units: a quasi-corporation is a market producer which may not be legally independent from its owner, especially from the point of view of assets and liabilities, but is regarded as fulfilling sufficient criteria to be considered an institutional unit in the system of accounts. There is a kind of unity of wealth between a quasi-corporation and its owner, so that a transfer of wealth between a quasi-corporation and its owner may be considered as something questionable. This results also in the convention that the net worth of a quasi-corporation is normally close to zero. As a consequence, a transfer of assets between a quasi-corporation and its owner may be directly reflected in the value of its equity. However, in the case where a public quasi-corporation is regularly making losses, in coherence with the ESA95

provisions that covering these losses represent government transfers (subsidies) and with the chapter on capital injections (see III.3), the recording of debt assumption or cancellation should be in accordance with the general rule (a capital transfer).

24. **Privatisation**: The exception made for transactions occurring as parts of an ongoing process of privatisation to be achieved in a short-term perspective is an ESA95 convention based on the assumption that the cost of the debt write-off will be fully recovered in the sale price achieved in the privatisation. It is therefore recorded as an injection of equity (F.5) – the same instrument as the receipts from the privatisation. However this treatment would not apply if the value of the debt cancellation exceeds the expected privatisation receipts. .

25. **Write-off:** The general definition of transactions (ESA95 1.33) gives the rule for delineating the cases when, respectively, a capital transfer or another change in the volume of assets has to be recorded. This rule is based on the assumption of mutual agreement between parties (see above VII.2.2.1). This is why a write-off cannot be considered as a transaction, in particular in the case of the disappearance of the public corporation. The write-off of bad debt of a bankrupt and disappearing unit is recorded as another change in the volume of assets.

VII.2.3.3 Special case: a transfer of non-financial assets

VII.2.3.3.1 <u>The acquisition of non-financial assets as expenditure</u>

26. In principle, an acquisition of non-financial assets has a negative impact on the net borrowing / net lending (B.9) of the government entity, since it has to be recorded as an increase of the gross fixed capital formation (GFCF, P.51), on the expenditure side of government. In the case of a transfer / acquisition made on a free basis, as a gift, the impact is neutral (see below).

27. Whilst the immediate impact of such a transaction on the net borrowing / net lending is negative, it may have a positive impact in the future, to the extent that the acquired assets have a real market value, have "service potential" and can be regarded as a source of future revenue. However, at the time of acquisition, the GFCF is expenditure as it normally creates a net borrowing for the acquirer. If the acquisition of assets is due to a grant, the GFCF may be counterbalanced by a capital transfer in kind, making it neutral on the net borrowing / net lending (gross recording). Alternatively, where the acquisition takes place in the context of a debt assumption / cancellation, its value may be deducted from the capital transfer representing the "cost" of the debt assumption (choice of the net recording, see below). But in all cases, the GFCF as such is recorded for its full value on the expenditure side of the acquirer of assets.

VII.2.3.3.2 <u>The final impact on B.9</u>

28. Gross recording: from an analytic point of view, the clearest way to analyse the economic event is to recognise it as two distinct transactions, which occur in the same accounting period:

    - the grant of fixed assets, which is neutral on the net borrowing / net lending (B.9), as described above;
    - the debt assumption which negatively affects the net borrowing / net lending (B.9) for the amount of the capital transfer, exactly like in the general case.

29. Net recording: the debt assumption might also be viewed as a means of payment by government to acquire the fixed assets. In this case, the "gift" component – recorded as capital transfer - would be the difference between the liability assumed and the value of the assets. However, the final impact on the B.9 is the same as in the gross recording pattern, due to the full recording of GFCF (P.51).

30. **NB**: A debt assumption organised by the government in favour of public corporations is not to be recorded through other change in the volume of assets (K.12.1), as in the case of flows due to "corporate restructuring" outside of government control targeted by ESA95 6.30. The direct involvement of the government, having as a major objective to ease the debt burden of a public corporation, implies that the debt assumption is recognised as a transaction, made by mutual agreement even though there might have been a restructuring or reorganisation of the public corporations at the same time. The only case where a debt assumption would be recorded as an "other change in volume" is the case of disappearance / liquidation of unit (ESA95 5.16).

VII.2.4 Accounting examples

VII.2.4.1 Recording a capital transfer

In the following examples, capital transfers are assumed to result, in a first step, in an increasing of the public corporation net worth. In a second step, it would be possible to assume that this increasing of net worth is "absorbed" by an equivalent increasing of the equity of government in the public corporation, via the revaluation account: this second step is not described here. Moreover, in the closing balance sheets, only the changes in net worth are shown.

Debt assumption

Assume that a financial corporation has made a long-term loan (F.42) to a public non-financial corporation. Before maturity, general government assumes the long-term loan outstanding from the public non-financial corporation.

General government				Public corporation			
Opening balance sheet							
A			L	A			L
AF.5	100					AF.42/S.12	30
						AF.5	100
Capital account							
ΔA			ΔL	ΔA			ΔL
		D.99	-30			D.99	+30
B.9	-30	B.10.1	-30	B.9	+30	B.10.1	+30
Financial account							
ΔA			ΔL	ΔA			ΔL
		F.42	+30			F.42	-30
		B.9	-30			B.9	+30
Closing balance sheet							
A			L	A			L
AF.5	100	AF.42/S.12	30			AF.42/S.12	0
						AF.5	100
		ΔB.90	-30			ΔB.90	+30

Debt cancellation

Assume that the general government has made a long-term loan (F.42) to a public non-financial corporation. Before maturity, general government cancels its claim (the long-term loan outstanding).

General government				Public corporation			
Opening balance sheet							
A			L	A			L
AF.42/S.11	30					AF.42/S.13	30
AF.5	100					AF.5	100
Capital account							
ΔA			ΔL	ΔA			ΔL
		D.99	-30			D.99	+30
B.9	-30	B.10.1	-30	B.9	+30	B.10.1	+30
Financial account							
ΔA			ΔL	ΔA			ΔL
F.42	-30					F.42	-30
		B.9	-30			B.9	+30
Closing balance sheet							
A			L	A			L
AF.42/S.11	0					AF.42/S.13	0
AF.5	100					AF.5	100
		ΔB.90	-30			ΔB.90	+30

VII.2.4.2 Recording a financial transaction

This recording applies for the case of quasi-corporations not making losses and of a debt assumption/cancellation occurring in an ongoing process of privatisation to be achieved in a short-term perspective. Recordings are the same in both cases: they imply transactions in shares and other equity (F.5).

Debt assumption

General government				Public corporation			
Opening balance sheet							
A			L	A			L
AF.5	100					AF.42/S.12	30
						AF.5	100

Financial account

ΔA			ΔL	ΔA		
		F.42	+30		F.42	-30
F.5	+30				F.5	+30
		B.9	0		B.9	0

Closing balance sheet

A			L	A		L
AF.5	100+30	AF.42/S.12	30		AF.42/S.12	0
					AF.5	100+30
		ΔB.90	0		ΔB.90	0

Debt cancellation

General government				Public corporation		

Opening balance sheet

A			L	A		L
AF.42/S.11	30				AF.42/S.13	30
AF.5	100				AF.5	100

Financial account

ΔA			ΔL	ΔA		ΔL
F.42	-30				F.42	-30
F.5	+30				F.5	+30
		B.9	0		B.9	0

Closing balance sheet

A			L	A		L
AF.42/S.11	0				AF.42/S.13	0
AF.5	100+30				AF.5	100+30
		ΔB.90	0		ΔB.90	0

VII.2.4.3 Recording an other change in volume of assets

This recording applies for debts of public corporations towards government, which are written off by the latter (the debtor is bankrupt or liquidated).

General government				Public corporation			
Opening balance sheet							
A			L	A			L
AF.42/S.11	30					AF.42/S.13	30
AF.5	100					AF.5	100
Other changes in volume of assets account							
ΔA			ΔL	ΔA			ΔL
K.10 on AF.42	-30					K.10 on AF.42	-30
		B.10.2	-30			B.10.2	+30
Closing balance sheet							
A			L	A			L
AF.42/S.11	0					AF.42/S.13	0
AF.5	100					AF.5	100
		ΔB.90	-30			ΔB.90	+30

VII.2.4.4 Special case: debt assumption including a transfer of non-financial assets

Gross recording of the debt assumption with assets

General government				Public corporation			
Opening balance sheet							
A			L	A			L
				AN.11	20		
						AF.42/S.12	30
AF.5	100					AF.5	100
Capital account							
ΔA			ΔL	ΔA			ΔL
GFCF(P.51)	+20	D.92	+20	P.51	-20	D.92	-20
		D.99	-30			D.99	+30
B.9	-30	B.10.1	-10	B.9	+30	B.10.1	+10

Financial account

ΔA			ΔL	ΔA			ΔL
		F.42	+30			F.42	-30
		B.9	-30			B.9	+30

Closing balance sheet

A			L	A			L
AN.11	20			AN.11	0		
		AF.42/S.12	30			AF.42/S.12	0
AF.5	100					AF.5	100
		ΔB.90	-10			ΔB.90	+10

Net recording of the debt assumption with assets

General government				Public corporation			

Opening balance sheet

A			L	A			L
				AN.11	20		
						AF.42/S.12	30
AF.5	100					AF.5	100

Capital account

ΔA			ΔL	ΔA			ΔL
GFCF (P.51)	+20	D.99	-30+20	P.51	-20	D.99	+30-20
B.9	-30	B.10.1	-10	B.9	+30	B.10.1	+10

Financial account

ΔA			ΔL	ΔA			ΔL
		F.42	-30			F.42	-30
		B.9	-30			B.9	+30

Closing balance sheet

A			L	A			L
AN.11	20			AN.11	0		
		AF.42/S.12	30			AF.42/S.12	0
AF.5	100					AF.5	100
		ΔB.90	-10			ΔB.90	+10

VII.3 Debt rescheduling

VII.3.1 Background to the issue

1. Debt rescheduling may be an alternative arrangement to debt cancellation or a step in a process leading to debt cancellation.
2. This transaction is often set up by government with foreign transactors, in particular from developing countries but may also happen with public corporations. Foreign debtors maybe government units themselves or non-government units. The Paris Club is dedicated to public debt negotiations. The London Club is dedicated to private debt negotiations. In the following, "government" is only used to describe the creditor government.
3. The issue is how to record the rescheduling of claims and liabilities? What amount has to be recorded on the asset side of the government balance sheet, when the terms of the debt contract have changed following a rescheduling arrangement, and at what time?
4. Case under review

   The case is when government has directly extended a loan to the government of a foreign country, and the debtor is defaulting and suspending its payments:

   – as a first step there is a negotiation to reschedule the debt;

   – as a second step, the debt may be cancelled, or even sold.

   Only loans are considered.

   The case of credit insurance is not dealt with.

VII.3.2 Treatment in national accounts

5. It is only if the outstanding amount of the claim (the loan) is diminished that a capital transfer has to be recorded in favour of the defaulting debtor, for the amount of the claim which is cancelled: this amounts to a debt cancellation (see 7.2 in this Manual).
6. It is not necessary in the other cases, in particular:

   – if the payment of the claim is only delayed, rescheduled

   – if only the amount of interest is renegotiated.

VII.3.2.1 Recording of a loan

7. The amount of the debtor's liability to the creditor at any point of time is the principal outstanding: it is the amount that the debtor must repay to discharge the liability and thereby extinguish the creditor's claim over the debtor. It is the principal outstanding which has to be recorded in balance sheets of both creditor and debtor.
8. Loans may take various types (see VII.3.2.5 below on Recording of loans (principal and interest): technical note). Nevertheless, whatever their type the total annual payments, principal and interest, is contractually fixed and can only be changed by contract. The future series of interest flows is not recorded as a claim of the creditor.
9. The interest rate may be fixed or it may be revised - cases of floating rates are included. The loan contract gives provisions for revision rules.

10. If, at some point in time, some previous payments have been defaulting, the corresponding amounts have to be added to the present principal outstanding. These amounts also include interest that has been accrued and added to the principal in the national account balance sheet but have not been paid in due time (interest arrears).

11. In any case, possible provisions made by the creditor are not recorded in national accounts.

VII.3.2.2 Rescheduling of the loan: ordinary cases

12. In ordinary cases, the outstanding claim will not be changed in the rescheduling arrangement: the payment of the claim is only delayed, rescheduled, and/or the amount of interest is renegotiated.

13. There are three main ways for rescheduling a loan:

    1. It is possible to *change the maturity of the principal*. As, in general, the aim is to lighten the annual burden of repayment, the duration is likely to be lengthened. However, even though the interest rate is unchanged, the total interest charge will be increased (see example).

       This does not change the value of the outstanding principal. The consequence is a new schedule of annual repayments, which will differ from the original one.

    2. It is possible to *change the interest rate* of the contract. This will have only an impact on the series of interest payments. The initial principal outstanding does not change. If the interest rate does change it is likely that the required regular payments will change.

       A particular arrangement of this type may include the cancellation, by the creditor, of the future stream of interest payments, with various alternatives for the repayment of the principal. There is no change to the amount of principal outstanding in balance sheets: it is similar to a revision of the interest rate of the loan, with the new interest rate being nil.

    3. It is possible to *delay payments of principal during a grace period*. There is generally a corresponding increase in duration. The original outstanding amount is unchanged. Interest during the grace period may be paid every year, or capitalised and added to the principal that will be amortised after the grace period.

VII.3.2.3 Determining the new amount outstanding

14. In order to determine whether it is necessary to record a capital transfer, and calculate its value, the difference between the outstanding amount of the claim before and after the rescheduling must be known. Normally the new amount outstanding would be quoted in the rescheduling agreement. But in some rare cases it might not be. In these cases, it should be calculated from the stream of future annuities and interest rate quoted in the new agreement (see formula in box). If the rate of interest is not given, the value of the outstanding amount should be calculated as the net present value of the future annuities using a discount rate equal to the interest rate that applied to the initial agreement.

15. In other words:

    – if, at any point of time, the principal outstanding of a loan has a given value V,

    – and if a rescheduling arrangement, implemented at this point of time, leads to a situation in which the present value of the annuities - calculated with the interest rate after arrangement - after rescheduling is different from the above principal outstanding V,

– this means that, in fact, there is a change in the principal outstanding value to be recorded under AF.4 in balance sheets of both creditor and debtor,

16. As, in this case, it is likely that the new principal outstanding be lower than the previous one, a capital transfer - in kind (D.99) - has to be recorded from the creditor to the debtor, since there is a *de facto* partial debt cancellation.

VII.3.2.4 Cancellation of a debt following a rescheduling arrangement

17. It may happen that, despite a rescheduling arrangement has been implemented, the creditor government cancels the remaining. A capital transfer has thus to be recorded from government to the debtor, at the time of the cancellation agreement. The amount of the capital transfer (normal treatment of debt cancellation in ESA95) is equal to the principal outstanding of the loan after rescheduling.

<u>Sale of a loan</u>

18. It may happen that, after a rescheduling arrangement, government sells a loan, to a financial institution for instance. It may also happen that, because of the difference between the contractual rate of interest prevailing on the loan and the corresponding market rate for the same kind of loan, the sale takes place for an amount of principal far below the principal outstanding as contained in the rescheduling arrangement.

19. In this case, the difference between the principal outstanding after rescheduling and the principal outstanding as traded in the sale has to be recorded as a holding loss in government revaluation account (ESA95 6.51).

20. *NB:* In case the debtor would go refunding its debt to the first creditor, the transaction between the two creditors would not be regarded as the sale of a claim (the loan) but as a new loan granted by the new creditor to the former one.

VII.3.2.5 Recording of loans (principal and interest): technical note

21. At inception, the principal outstanding is equal to the amount, which has been lent. It is also equal to the present value of all the annuities, using the interest rate of the loan contract as discounting rate: see formula (1) in the box.

22. At any point of time, the outstanding amount of principal is equal to the present value of the remaining annuities, still using the interest rate of the loan contract as discounting rate: see formula (2) in the box for case when all previous annuities have been paid.

23. The amortisation table of a loan may be shown as follows:

– V_0 being the amount of the loan at inception

– r the interest rate of the contract

– n the duration of the loan

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	V_0	F_1	D_1	A_1
…	…	…	…	…
p	V_{p-1}	F_p	D_p	A_p
…	…	…	…	…
n	V_{n-1}	F_n	D_n	A_n

The following numerical relations may be observed for a given period p:

$$A_p = D_p + F_p$$
$$F_p = r \ V_{p-1}$$
$$D_p = V_{p-1} - V_p$$
$$V_n = 0$$

24. Three main kinds of conventional loans - excluding index-linked ones, for instance - exist in practice:

1. Loans with a final repayment:

$$D_p = 0, \forall p \neq n$$
$$D_n = V_0$$
$$F_p = F = r \ V_0, \forall p$$

2. Loans with constant amortisation:

$$D_p = D = \frac{1}{n} V_0, \forall p$$

3. Loans with constant annuities:

$A_p = A, \forall p$, A being calculated using the formula given below.

<u>Basic formulae</u>:

25. Whatever the type of loan could be, the various components may be calculated using the following basic formula - V_0, n, and r being given:

$$V_0 = \sum_{p=1}^{p=n} A_p \frac{1}{(1+r)^p} \qquad (1)$$

which means that the present value - using the interest rate of the loan contract as discounting rate - of all the annuities is equal to the amount which is lent, whatever these annuities could be.

26. Moreover, at any point of time, the outstanding amount of principal is equal to the present value of the remaining annuities. Thus, after the p-1 annuities have been paid, the following formula holds:

$$V_p = \sum_{m=1}^{m=n-p} A_{p+m} \frac{1}{(1+r)^m} \qquad (2)$$

27. If no payment occurs from the beginning until p - p being included -, V_0 is recorded under AF.4 at the end of period p. Moreover, there is a liability corresponding to the unpaid amounts of interest, equal to:

$$\sum_{m=1}^{m=p} F_m \qquad (3)$$

VII.3.3 Rationale of the treatment

VII.3.3.1 Recording of a loan

28. The values to be recorded under AF.4 in the balance sheets of both creditors and debtors are the amounts of principal that the debtors are contractually obliged to repay the creditors, even in cases where the loan was traded at a discount or premium (ESA95 7.51).

VII.3.3.2 Rescheduling of a loan

29. There is no real guideline for treating such a case. Mention is only made of rescheduling of loans in 11.23 of SNA93 ("changes in claims resulting from debt rescheduling should be reflected in the financial account when the terms of the debt contract (maturity, interest rate, etc.) change [...]". Nevertheless, some conclusions may be derived from considerations stemming from financial rules and national accounts principles.

30. The main point is that a loan is a contractual arrangement. The split between repayment of the principal and payment of interest is determined in the loan contract, even for loans with floating rates, and can only be changed by contract.

31. It has particularly to be noted that a loan has no market price: see ESA95 6.51. The changes which may occur on financial markets for interest rates for similar loans has thus no direct impact on the principal outstanding of existing loans. Moreover, such changes may have no influence on the future amounts of interest, and thus no influence on the split between principal and interest.

VII.3.3.3 Debt cancellation

32. ESA95 4.165 f and 5.16 (see II.4.1 in this Manual).

VII.3.3.4 Sale of a loan

33. ESA95 makes provision for the case a loan is traded (ESA95 5.79). In the present case, the difference between the redemption « price » and the transaction « price » is recorded in the revaluation account (ESA95 6.51).

VII.3.4 Accounting examples

VII.3.4.1 Common features

Case a: recording a loan

Amount of the loan = 10 000; duration = 5 years; interest rate = 6 %

1. Loan with a final repayment

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	0	600
2	10 000	600	0	600
3	10 000	600	0	600
4	10 000	600	0	600
5	10 000	600	10 000	10 600
Total		3 000	10 000	13 000

2. Loan with constant amortisation

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	2 000	2 600
2	8 000	480	2 000	2 480
3	6 000	360	2 000	2 360
4	4 000	240	2 000	2 240
5	2 000	120	2 000	2 120
Total		1 800	10 000	11 800

3. Loan with constant annuities

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	1 774	2 374
2	8 226	494	1 880	2 374
3	6 346	381	1 993	2 374
4	4 353	261	2 113	2 374
5	2 240	134	2 240	2 374
Total		1 870	10 000	11 870

VII.3.4.2 Numerical example of rescheduling

Case b1: maturity is lengthened

The loan over 5 years is transformed into a loan over 8 years; the rate of interest is unchanged

1. Loan with a final repayment

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	0	600
2	10 000	600	0	600
3	10 000	600	0	600
4	10 000	600	0	600
5	10 000	600	0	600
6	10 000	600	0	600
7	10 000	600	0	600
8	10 000	600	10 000	10 600
Total		4 800	10 000	14 800

2. Loan with constant amortisation

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	1 250	1 850
2	8 750	525	1 250	1 775
3	7 500	450	1 250	1 700
4	6 250	375	1 250	1 625
5	5 000	300	1 250	1 550
6	3 750	225	1 250	1 475
7	2 500	150	1 250	1 400
8	1 250	75	1 250	1 325
Total		2 700	10 000	12 700

3. Loan with constant annuities

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	1 010	1610
2	8 990	539	1 071	1610
3	7 919	475	1 135	1610
4	6 783	407	1 203	1610
5	5 580	335	1 276	1610
6	4 305	258	1352	1610
7	2 952	177	1433	1610
8	1 519	91	1 519	1 610
Total		2 883	10 000	12 883

Case b2: change in rate of interest

The loan at 6% is transformed into a loan at 4%

1. Loan with a final repayment

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	400	0	400
2	10 000	400	0	400
3	10 000	400	0	400
4	10 000	400	0	400
5	10 000	400	10 000	10 400
Total		2 000	10 000	12 000

2. Loan with constant amortisation

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	400	2 000	2 400
2	8 000	320	2 000	2 320
3	6 000	240	2 000	2 240
4	4 000	160	2 000	2 160
5	2 000	80	2 000	2 080
Total		1 200	10 000	11 200

3. Loan with constant annuities

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	400	1 846	2 246
2	8 154	326	1 920	2 246
3	6 234	249	1 997	2 246
4	4 237	169	2 077	2 246
5	2 160	86	2 160	2 246
Total		1 231	10 000	11 231

Case b3: Grace period

Three years of grace period are agreed for the principal (with interest capitalised)

1. Loan with a final repayment

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	(600)	0	0
2	10 600	(636)	0	0
3	11 236	(674)	0	0
4	11 910	714	0	714
5	11 910	714	0	714
6	11 910	714	0	714
7	11 910	714	0	714
8	11 910	714	11 910	12 624
Total		3 570	11 910	15 480

2. Loan with constant amortisation

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	*600*	0	0
2	10 600	*636*	0	0
3	11 236	*674*	0	0
4	11 910	715	2 382	3 097
5	9 528	572	2 382	2 954
6	7 146	429	2 382	2 811
7	4 764	286	2 382	2 668
8	2 382	143	2 382	2 525
Total		2 144	11 910	14 054

3. Loan with constant annuities

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	*600*	0	0
2	10 636	*636*	0	0
3	11 236	*674*	0	0
4	11 910	715	2 113	2 827
5	9 797	588	2 240	2 827
6	7 558	453	2 374	2 827
7	5 184	311	2 516	2 827
8	2 667	160	2 667	2 827
Total		2 227	11 910	14 137

Case c1

The new interest rate is 4%. The new schedule of annuities is available. We derive the new principal that is unknown

1. Loan with a final repayment (four first annuities = 300)

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	7 500	300	0	300
2	7 500	300	0	300
3	7 500	300	0	300
4	7 500	300	0	300
5	7 500	300	7 500	7 800
Total		1 500	7 500	9 000

Capital transfer recorded at the time of the new agreement: 2 500

2. Loan with constant amortisation (total annuities = 9 000)

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	8 036	321	1 607	1 929
2	6 429	257	1 607	1 864
3	4 822	193	1 607	1 800
4	3 214	129	1 607	1 736
5	1 607	64	1 607	1 671
Total		964	8036	9000

Capital transfer recorded at the time of the new agreement: 1 964

3. Loan with constant annuities (total annuities = 9 000)

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	8 013	321	1 479	1 800
2	6 534	261	1 539	1 800
3	4 995	200	1 600	1 800
4	3 395	136	1 664	1 800
5	1 731	69	1 731	1 800
Total		987	8 013	9 000

Capital transfer recorded at the time of the new agreement: 1 987

Case c2

The new interest rate is unknown. The new schedule of annuities is available. We derive the new principal which is unknown by using the original rate of 6%.

1. Loan with a final repayment (four first annuities = 415)

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	6 923	415	0	415
2	6 923	415	0	415
3	6 923	415	0	415
4	6 923	415	0	415
5	6 923	415	6 923	7 338
Total		2077	6 923	9 000

Capital transfer recorded at the time of the new agreement: 3 067

2. Loan with constant amortisation (total annuities = 9 000)

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	**7 627**	458	1 525	1 983
2	6 102	366	1 525	1 891
3	4 576	275	1 525	1 800
4	3 051	183	1 525	1 708
5	1 525	92	1 525	1 617
Total		1 373	7 627	9 000

Capital transfer recorded at the time of the new agreement: 2 363

3. Loan with constant annuities (total annuities = 9 000)

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	**7 582**	455	1 345	1 800
2	6 237	374	1 426	1 800
3	4 811	289	1 511	1 800
4	3 300	198	1 602	1 800
5	1 698	102	1 698	1 800
Total		1 418	7 582	9 000

Capital transfer recorded at the time of the new agreement: 2 418

VII.4 Government guarantees

VII.4.1 Background to the issue

1. In several European Union Member States, government guarantees the debt of certain corporations, mainly but not exclusively public corporations and notably those operating in the transport and energy industries. This practice allows the corporations to borrow at a more advantageous interest rate, and in some cases allows borrowing where otherwise it would not happen. This is because the creditor is reassured that, if the debtor experiences difficulty, the guarantor will settle the liability. Government guarantees may be given to corporations on a one-off basis, for specific borrowing, or cover all the borrowing it incurs.
2. Although this chapter concerns the guaranteed debt of public corporations, it is also relevant to private sector corporations, including financial corporations.
3. This chapter does not consider the case where, although there is no formal guarantee, government is viewed as an effective guarantor. This perception may arise because of government's role as shareholder, or because the economic activity is integral to the economy, that it is assumed that government would intervene to prevent a failure.
4. The chapter provides guidance on when to impute government borrowing, and how to record guarantee calls[11] and guarantee fees.

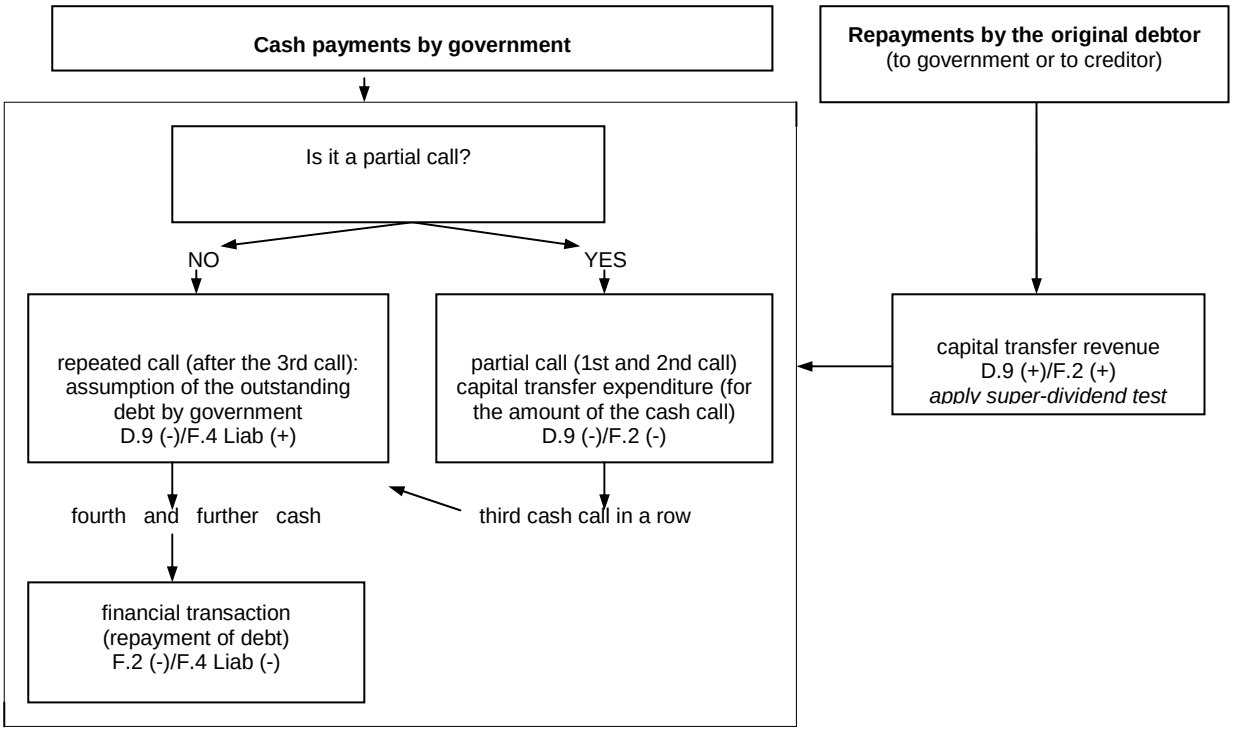
VII.4.2 Treatment in national accounts

VII.4.2.1 General case

5. In the general case, the guaranteed debt is recorded solely as the borrowing of the corporation, whether or not the guarantee concerns specific borrowing or the whole corporate debt. For the government, it is a contingent liability.
6. If the guarantee, or part of it, is called, then government takes over the debt through "debt assumption", which is recorded as a capital transfer (D.99) from government to the corporation for the amount called. The capital transfer is offset by a financial transaction, the financial liability transferred from the corporation to government. Government may, either immediately or subsequently, enter into further transactions where it repays the debt outstanding, both principal and interest, to the creditors.
7. In the public accounts, the guaranteed debt will usually not be recorded in the core accounts until the guarantee is activated. However, it is expected that information is made publicly available on government guarantees.
8. The case of "partial call" of the guarantee – sometimes also referred to as "cash call" - must be specified: this is when government pays only one instalment. The actual payment by government is recorded as a capital transfer (D.99), balanced by a decrease in cash and deposit (F.2) (see also the decision tree diagram). In case of "repeated calls", see the following section (VII.4.2.3).

[11] A "call" on a guarantee may also be referred to as "activation" or "exercising" the guarantee.

Decision tree for guarantee cash calls



VII.4.2.2 Where it is known government will repay the debt

9. In some cases it is known with certainty that, despite the borrowing being legally carried out by the corporation, it will be government that repays the borrowing. This may occur for newly issued debt or for existing debt which government had started to guarantee.

10. In straightforward cases, evidence is provided in legal documents, or a government liability is recognised in the public accounts or similar documents, such as the budget. In such cases the debt is considered to be sequentially first issued by the corporation and then assumed by government. This assumption may happen immediately, for example in the case where it is obvious at inception, so that, in national accounts, the debt may never be recorded in the balance sheet of the corporation in any accounting period. The debt assumption is recorded as described in VII.4.2.1.

VII.4.2.3 Where it is judged that government is repaying or will repay the debt

11. In other cases, documented evidence may not be available to show that government has assumed the debt but other indicators point to the *de facto* situation being that government has assumed it. Evidence of this case includes:

    - government is observed to be repaying the debt each year, either directly or through payments to the corporation;

    - a provision is recorded in public accounts (or similar documents) that shows that the probability that government will repay the debt is very high.

12. In this case the outstanding amount of debt, or the relevant part of it, is assumed by government in the time period it is judged to have assumed it.

13. Specific examples where judgement is needed include where there are repeated calls on the guarantee (or where equivalent payments - like repeated capital injections - are made to the corporation to prevent a call being necessary). In the latter case government effectively repays the debt even though it has no legal requirement to do so.

14. As practical guidance, if government repayments of the debt occur in three consecutive years, and this situation is expected to continue, then the debt is to be considered assumed, normally in its entirety (or for the proportion government is expected to repay, if there is evidence of that). The debt assumption should be recorded at the time the event that triggered the economic judgement of debt assumption occurs, for example the time of the third annual payment. The debt assumption is recorded as described in VII.4.2.1.

VII.4.2.4 Where assumption of liability includes a financial asset on a third-party

15. When government assumes debt through a guarantee call, it may also acquire a financial asset. This financial asset is a liability of a third party and previously an asset of the guaranteed corporation. This is common in export credit insurance carried out by a dedicated unit and guaranteed by government.

16. Another case of existing assets transferred to government results from guarantee exercised over a financial institution having provided loans to students or to other households (mortgage loans). In these cases, the financial asset is to be recorded in the balance sheet of government at market value (probably inferior to nominal value), reflecting the real recoverability of the claim.

17. When the guarantee is called, a debt assumption (or a cash call) is recorded as usual for government exercising its guarantee (capital transfer expenditure). Simultaneously, a second capital transfer is recorded, an expenditure of the guaranteed corporation and a revenue of government, reflecting the transfer of effective claims to the government. This second capital transfer should be for the market value of the assets claimed - this value will often be less than the value of the liability assumed - resulting in a net capital transfer from government. The second capital transfer is offset by a financial transaction, where government acquires the financial asset on the third party.

18. Another possibility is that the claim acquired by government is a non-financial asset rather than a financial asset, such as a real estate property (financed by a guaranteed mortgage loan). Here, if the loan defaults, the government assumes the debt to repay the bank and also takes ownership of the underlying property. The recording is identical to above except that the offsetting transaction is a non-financial one rather than a financial transaction and hence has an impact on government net borrowing (for example through an increase of GFCF). If government immediately disposed of the asset at market value, in order to repay the liability, the impact on government net lending / net borrowing will be identical in both the non-financial and financial asset cases.

VII.4.2.5 Where assumption of liability includes a claim on the corporation

19. It may happen that government assumes debt through a guarantee call, and also records, in the public accounts, a claim on any recoveries that it can subsequently make (a liability of the guaranteed corporation). As government provides its guarantee to the corporation's borrowing, the situation is different from the case of a pre-existing financial asset as described above

20. Where government exercises guarantee vis-à-vis a corporation facing a difficult situation, it is a debt assumption (capital transfer expenditure), and it is considered in national accounts that any new claim possibly recorded in this context has a very hypothetical value. In the most common case, the corporation benefitting from such a

guarantee activation will be a public corporation. In national accounts, no such claim should be recorded (what implies no simultaneous capital transfer revenue for government). In case of later repayments from the corporation, these would be recorded as capital transfer revenue of government (see also below in VII.4.2.6).

VII.4.2.6 If circumstances change

21. When a judgement is made that government has economically assumed debt it guaranteed (see VII.4.2.3), it may happen that the financial performance of the company will improve to the extent that it can resume its legal obligation for the liability. Here, the economic judgement from earlier has been reassessed and the corporation assumes the debt from government. This is recorded as a capital transfer from the corporation to government, offset by a financial transaction where the liability transfers from government to the corporation.

22. However, when the recovering corporation is a public one, the transaction recorded in favour of the government should be subject to the super-dividend test: if the payment would be larger than the liability, this part of the payment in excess would then be recorded as a capital withdrawal (F.5).

23. To avoid instability in government debt statistics, a debt assumed in anticipation should remain as a liability of government until payments from the debtor corporation to government or to the creditor occur, and there is evidence that it will continue in the future.

VII.4.2.7 On-lending

24. If government borrows on the market, in its own name, in order to specifically allocate the funds to corporations that are contractually obliged to repay government for both principal and interest, the debt is recorded as government debt at issuance and a corresponding loan is recorded to the corporations. The loan is analysed according to rules on "Capital injections into public corporations" (see chapter III.2). Therefore it may, or may not, have an impact on the government net lending / net borrowing according to the capital injection test.

25. If government creates an entity, which it guarantees, in order to borrow to finance corporations engaged in large public works and/or infrastructure (for example the *ISPA* case in Italy) then government debt should be recorded at issuance. If the entity is recognised as an institutional unit the borrowing is rerouted so that government borrows and lends to the entity. If the entity is not recognised as an institution unit, then the borrowing is recorded as direct government borrowing, with the proceeds used for lending to the corporations engaged in the infrastructure work.

VII.4.2.8 Guarantee fees

26. Any fees that government receives in its role as guarantor are classified as service fees (P.131 non-market output). It should be spread over the life of the guarantee (accruing principle).

VII.4.3 <u>Rationale of the treatment</u>

VII.4.3.1 General case

27. The general principle is that such guarantees of payments granted by third parties are considered as contingent assets/liabilities. This means that at least one condition must be fulfilled before a transaction due to the guarantee, and involving the guarantor, takes place and before economic value is transferred (SNA93 11.25).

28. ESA states that, "In the system, a contingent asset is a financial asset in case where the contractual arrangement itself is tradable or can be offset on the market. Otherwise a contingent asset is not recorded in the system" (ESA95 5.05).

29. As a result, contingent liabilities are not recorded in the ESA balance sheet and are excluded from government debt. In the general case they are recorded only when activated. This leads to debt assumption. In debt assumption the amounts recorded are the “payments in fulfilment of guarantees which free defaulting debtors from their obligations” (ESA95 4.165f).

30. Any call of a guarantee, which may cover all or part of the debt guaranteed, is thus equivalent to a debt assumption by government.

VII.4.3.2 Where it is known government will repay the debt

31. In the case of new debt where it is certain that government will repay, this is the economic equivalent to government borrowing directly from the creditor, and hence taking on the obligation to service the debt. If the proceeds are then used to fund the corporation, as government does not expect to receive anything in return from the corporation, this transaction is not a loan and should be recorded as a distributive transaction, such as a capital transfer, with impact on government net lending / net borrowing.

32. In the case where existing debt is guaranteed and it is known with certainty that government will repay it, this is equivalent to debt assumption from the corporation.

33. In cases where government is judged the economic debt holder at inception, the debt is briefly allocated to the corporation and then assumed. This is necessary to prevent different effects on government net borrowing for the cases where government is viewed as debt holder at inception and that where it assumes the debt a very short time afterwards.

VII.4.3.3 Where it is judged that government is repaying or will repay the debt

34. This case is effectively an informal call of the guarantee. The recording reflects the concept of economic substance being recorded rather than legal form (ESA95 1.38). In such cases government is viewed as having assumed the debt from the corporation.

35. Cases where government makes debt payments every year without any formal call of a guarantee have been observed and must be carefully analysed to judge whether they are an effective call of the guarantee. In practice, there is often some evidence that this debt has a special status, is recorded in a special account, and that government is expected by observers and analysts to assume the debt. Recording the liability as government debt is the result of judgement that the economic reality is that government will continue to assume the liability on an annual basis.

36. For the purpose of national accounts, economic reality must always prevail over legal form. An ambiguous situation where a further reclassification of the debt could occur in future should be avoided.

VII.4.3.4 Where assumption of liability includes a financial asset on a third-party

37. A major issue, especially in the case of export credit insurance, when a government guarantee is called, is the recording of the claim (usually a financial asset) that government retains, to the extent of its value, if it is an effective claim. The notion of "effective claim" is referred to in several commercial accounting texts (notably in IPSAS19) as well as in the IMF’s *GFSM2001*.

VII.4.3.5 Where assumption of liability includes a claim on the corporation

38. An economic analysis is made of the corporation and an assessment of the effectiveness of the claim. A parallel may be made with the rationale in the "capital injection test", which records a financial transaction in case the injection is made in a market competition context with the expectation of a sufficient rate of return, and a capital transfer where the injection benefits a loss-making corporation, with no such valid expectations. It is expected that corporation requiring government guarantees to borrow will have some financial difficulties, which may be due to regular losses, so future performance must be assessed to determine expectation of a return on the asset.

39. If the claim recorded in the public accounts is on a public corporation that is owned by government, then the case for viewing the financial transaction as a loan is questionable, since it may instead be an injection of equity, a subsidy or a capital transfer if the public corporation faces financial difficulty and is unlikely to repay the loan. This is a factor that weakens the effectiveness of the claim. Its real value is zero or close to zero.

40. A similar rationale applies for corporations in difficulty where government is not the owner. Here, the option of an equity injection would probably be inappropriate but the transaction may still be a subsidy or capital transfer rather than a loan.

VII.5 Keywords and references

Debt assumption, debt cancellation, write-off	ESA95 5.16, 6.27, 6.28
Other capital transfer	ESA95 4.164, 4.165
Contingent asset / liability	ESA95 5.05, SNA93 11.25

VIII

Measurement of General Government debt

Part VIII Measurement of General Government debt

VIII.1 Overview

1. There is a specific definition of government debt for the Excessive Deficit Procedure in the Maastricht Treaty (1992). It is coherent with ESA95 concerning the definition of the government sector and of the liabilities. However, its valuation differs from ESA95 valuation rules in that it is measured at nominal value and not market value as in national accounts.
2. It is a gross measure in the sense that no financial assets are netted-off. It is consolidated, both at the level of the sector and at the level of the sub-sectors, so that any liabilities of general government units that are assets of other general government units do not add to the total.
3. Mainly for practical reasons of measurement, other accounts payable (AF.7, including trade credits) are not accounted for in government debt. Similarly, financial derivatives are not included because there is no satisfactory way to define a nominal value for such instruments consistent with the same concept for instruments included in the debt.
4. The following chapters present some issues relating to swaps because they need specific consideration as regards deficit and debt (chapters 3 to 5). In addition, a box at the end of chapter 2 is devoted to the treatment of interest under swaps (and FRAs) for EDP purpose, different from ESA95 provisions.
5. The main classes of derivatives are swaps, options and futures, but there are many types of derivatives in each class and even products made up of combinations among the classes. (For their treatment in national accounts, see chapter V in ESA95 and chapter 11 in SNA2008). Here the accent is put on swaps (see the ESA95 definition, notably 5.67.d). See box 1 below.
6. Swaps are used by many governments as a financial tool for risk management purposes. Concerning debt such management means essentially hedging exchange rate risks when the debt is issued in a foreign currency, and minimising the cost of the debt on the basis of the current and anticipated yield curve (change in all short/long-term interest rates). Government debt managers may decide to use the best suitable debt management tools according to their objectives and constraints. It is frequent to distinguish "micro-hedging", attached to a particular debt instrument, from "macro-hedging" linked to a more global risk exposure coming from a set of debt instruments. Risk management may also cover the assets side, notably when government units place at risk exposure for liquidity investments. As regards risk management, in substance, public debt managers in Ministries of Finance or in dedicated agencies do not act differently from financial/treasury corporate managers.
7. In this part of the Manual, provisions on currency swaps, only applicable for EDP purpose, are explained in chapter VIII.3 as they have an impact on the measurement of government debt. Chapter VIII.4 covers the specific issue of swap cancellations for which a treatment has been set by Eurostat. Chapter VIII.5 relates to a specific design of flows under swaps (so called "off-market swaps"), such that they do not show a nil market value and that a loan component must be extracted. In both case a "spreading approach" is the basis of the treatment to apply.
8. Finally, chapter 6 covers financial transactions named "repurchase agreements" and "securities lending" that, under certain circumstances, may have an impact on government debt.

Box 1

Elements of definition on swaps

A swap is a legal agreement between two parties to exchange periodic payments over a defined period in the future, so that one party may escape from the risk of a change in an uncontrollable variable such as an interest rate or exchange rate.

A common type is "interest rate swaps" (IRS), where parties agree to exchange flows of interest. In many contracts, one party agrees to pay to the other a fixed rate of interest in exchange for a variable rate of interest (plus a constant spread depending on market conditions). The payments may be on any timescale, but are commonly semi-annual or annual; they may be different for each leg of the swap and net settlements are frequent where applicable. At inception, obligations due by both parties are quite balanced but over the life time of the contract, one party may make a net gain and the other a net loss, depending on the effective trends on markets. Thus, the swap would show a negative value (often referred to as "out of the money") for one party and a symmetrical positive value ("in the money") for the counterpart. Swaps position can be actively managed - through "mirror swaps" or cancellations - depending on the change in the value of the position and market rates expectations.

A great number of interest rate swaps contracts cover an exchange "fixed-for-floating" in the same currency (often referred to as "vanilla swaps" as it is the standard type of transaction). During the last two decades, many other types of swaps have appeared on markets, such as "basis swap" ("floating-for-floating"), inflation swaps (payments in one leg depending on change in a price index), amortising swaps (declining notional amount), asset swaps (conversion of cash flow from an underlying instrument), constant maturity swaps (periodical rest of interest on one leg), total return swaps (exchange of revenue and risks on assets), etc. The various types just listed (as illustrative) do not seem to be used by government units on a large scale, notably by managers of central government debt or treasury. In addition there was a huge development of swaps related to credit risk (Credit default swaps), with various degrees of complexity and specific features.

A currency swap (and close transactions – see chapter VIII.3) operates similarly, very often connected to underlying loans or securities, in that parties exchange flows denominated in different currencies. There are different types of currency swaps that differ by the time of exchange of principal and the nature of involved interest rate ("fixed-for-fixed", "fixed-for-floating"). The more common currency swap, with exchange of principal both at inception and at termination date, allows a borrower in one currency to fully hedge the underlying exchange risk, as if the original currency denomination has been shifted into another one. It is frequently observed that government units, even in the euro area with deep and large financial markets, issue a minor part of debt in a foreign currency (namely in USD, JPY, GPB or CHF) for various reasons, such as enlarging the basis of investors or benefiting from a final lower cost of borrowing under some markets conditions.

VIII.2 The calculation of general government debt

VIII.2.1 Measurement in National Accounts

1. There is no specific definition of government debt in the ESA95, but there are general provisions on institutional sectors (including the general government see Part I) and on financial liabilities and their *valuation rules*. The relevant ESA95 paragraphs are:

   1.51: « …stocks are measured according to their exchange value, i.e. the value at which they could be exchanged for cash. Market prices are ESA's basic reference for valuation ».

   7.01: « The stock of the assets and liabilities recorded in the balance sheet is valued at the market prices prevailing on the date to which the balance sheet relates ».

   As a result of these general provisions, the stock of government liabilities should be recorded in the national accounts at their *market value* at the end of the accounting period, in the closing balance sheet of the general government sector.

   The stock of government debt under ESA95 (at market value, where applicable)

2. It would be equal to the sum of all liabilities of the general government sector (S.13): currency and deposits (AF.2), securities other than shares (AF.3) including financial derivatives (AF.34), loans (AF.4) and other accounts payable (AF.7), as well as, in some_cases of specific units classified in the government sector, shares and other equity (AF.5) and insurance technical reserves (AF.6).

Stock of debt under ESA95		
(at the end of year N)	=	AF.2
	+	AF.3 (including AF.34)
	+	AF.4
	+	AF.7
	+	AF.5 (if any)
	+	AF.6 (if any)

VIII.2.2 Measurement in the Excessive Deficit Procedure

3. For the purpose of the Excessive Deficit Procedure (EDP) in the Economic and monetary union (EMU), as well as for the Growth and Stability Pact, the Protocol annexed to the Treaty on European Union (Maastricht, 1992) provides a complete definition of government debt: «Debt means total gross debt at *nominal value* outstanding at the end of the year and consolidated between and within the sectors of general government. »

   This definition is supplemented by Council Regulation 479/2009 specifying the components of government debt with reference to the definitions of financial liabilities in ESA95.

VIII.2.2.1 The nominal value

4. In Council Regulation 479/2009, the nominal value is considered equivalent to the face value of liabilities (article 1). In this context, it is equal to the amount, contractually agreed, that the government will have to refund to creditors at maturity. It is also on this amount that the interest is calculated.

5. It should be specified that:

   – Deposits (including non-negotiable notes): the nominal value includes interest accrued when it is actually credited to the holder (as a result of a legal obligation), added at principal, bearing interest and available for withdrawal at any time (and not only in case of total cancellation)

   – Index-linked bonds: the nominal value corresponds to the face value adjusted by the index-related capital uplift accrued to the end of the year (with often a guaranteed minimum redemption value)

   – Zero-coupon bonds (Treasury Bills for example): the nominal value is the redemption value (face value)

   – Bonds with capitalised interest: the nominal value is the issue value (face value, but not the same as redemption value)

   – Stripped bonds: stripping of coupon and principal does not modify the nominal value of the original bond. When a government unit intervenes on the secondary market and buys separately a stripped coupon or a stripped principal (from a bond issued by the general government), the consolidation process requires a specific valuation of the strip based on the nominal value of the original bond (see sub-section II.4.3.8)

   – Financial derivatives are not included in the government debt as there is no nominal value identical to that of other debt instruments

   – Financial leasing: debt includes the imputed loan equal to the gross fixed capital formation.

VIII.2.2.2 Interest arrears

6. In national accounts, interest is recorded when accruing. Therefore, whether or not it is actually paid, accrued interest affects the net borrowing/net lending. Accruing interest is added to the value of the instrument in the balance sheet. That value is reduced when the interest is actually paid. Under the EDP rules government debt is measured at nominal value, here defined as the face value, and accrued interest is not recorded under the corresponding debt instrument (with the exception of instruments issued with a discount where the face value included de facto the interest). In table 3 of the notification tables, an adjustment item reconciles flows of accrued interest with the change of debt at nominal value.

VIII.2.2.3 Debt in foreign currency

7. Liabilities denominated in foreign currencies shall be converted into the national currency at the representative spot market exchange rate prevailing on the last working day of each year. However, Council Regulation 479/2009 states that, if a liability denominated in foreign currency is exchanged through contractual agreements to one or more other foreign currencies, it shall be converted into the other foreign currencies at the rate agreed upon in those contracts and then converted into the national currency according to the general rule (stated in the previous paragraph). The same principle applies in the case of debt denominated in national currency swapped into a foreign currency. This principle implies that liabilities denominated in a foreign currency and exchanged through contractual agreements to the national currency shall be converted into the national currency at the rate agreed upon in those contracts.

VIII.2.2.4 The change in government debt

8. The stock of government debt in the excessive deficit procedure is equal to the sum of liabilities of the general government sector (S.13) in the following categories: currency

and deposits (AF.2), securities other than shares (AF.3) excluding financial derivatives (AF.34), and loans (AF.4):

Stock of debt (at the end of year N)	=	AF.2
	+	AF.3 (excluding AF.34)
	+	AF.4

9. The change in government debt between two points in time (end of year N and end of year N-1) is equal to the issuance in year N of new liabilities (in F.2, F.3, and F.4) – minus redemption - and to other changes in volume (K.10 and K.12 in liabilities), as well as other valuation effects due to the EDP definition.

The EDP notification tables

10. In the EDP questionnaire filled in by the EU Member States, sent twice a year to the European Commission, a table (table 3) aims to describe the link between the government net borrowing/net lending (EDPB.9) and the change in government debt. Analytically, an increase in government debt should be viewed as due to two main factors:

- the net borrowing of general government (B.9, the balance of the capital account);
- the net acquisition of financial assets (F.2, F.3, F.4, F.5 and F.7) by general government (flows recorded in the financial account).

11. Some adjustments have to be made to obtain the final change in government debt:

- to other flows (other changes in volume K.10 or K.12 in liabilities, holding gains and losses in particular due to foreign currency debt);
- to the EDP definition: consolidation, exclusion of accounts payable and of liabilities in financial derivatives, corrections from interest accrued to interest paid and, for securities, from transaction value to face value. That is the difference between the issue or redemption price and nominal value, taking account of the fact that the redemption price may include the payment of accrued interest. So the difference with the nominal value must be calculated after deducting from the redemption price the part corresponding to the payment of accrued interest.
- Finally, a statistical discrepancy should be identified, mainly due to the discrepancy between the financial and non-financial accounts.

Net flow of debt	=	net borrowing
	+	net flow of financial assets (F.2+F.3+F.4+F.5+F.7)
	+	adjustments (to other flows and to EDP definition of debt)

Box 2

Recording of interest under swaps for EDP purpose

The recording of interest under EDP is different from the ESA treatment.

- Under the initial version of the SNA93, which was mirrored in ESA95, streams of interest payments under interest rate swaps and payments were to be considered as property income, similarly to any kind of interest related to a financial instrument. The net flows thus affect the government deficit.

- The SNA93 was revised in 2000, after worldwide discussion amongst national accountants, to change the recording rules for swaps. The rationale was that settlement flows on markets for a predominant part were not implemented by reference to financial instruments, held or issued, but in order to take advantage of anticipated market trends. In other words, "pure hedging" was rather secondary compared to arbitrage and speculative operations. Thus, in most cases, flows under swaps do not match interest accrued on debt instruments. In addition, more technically, it was put forward that property income could only come from effective acquisition/issuance of debt instruments, together with some considerations on valuation rules.

- As a consequence, any flow under swaps should be considered of financial nature and not as income. Thus, ESA95 4.47 was amended (in Regulation 2558/2001) to record all settlement flows as transactions in financial derivatives, with a clear statement that: "*No payment resulting from any kind of swap arrangement is to be considered as interest and recorded under property income".*

- However, the change in recording of swaps in the SNA93/ESA95 gave rise to debate, since the change in the swap recording would have automatically led to a change in the definition of the EDP deficit. Debt management officials, with a strong support from many finance ministries, argued that no change should occur in order to reflect the actual costs of debt servicing they were trying every day to reduce for the benefit of tax payers.

- Finally, Regulation 2558/2001 added a new annex to ESA95 which specified that:

  For the purpose of the Member States' reports to the Commission under the excessive deficit procedure laid down in Council Regulation (EC) No 479/2009, "Government deficit" is the balancing item "net borrowing/net lending" of General Government, including streams of interest payments resulting from swaps arrangements and forward rate agreements. This balancing item is codified as ***EDP B9****. For this purpose, interest includes the abovementioned flows and is codified as* ***EDP D41****.*

VIII.3 Currency swaps

VIII.3.1 Background to the issue

1. Under this generic term, this chapter covers several categories of derivatives transactions which have in common the exchange of capital amounts in different currencies. A foreign exchange swap contract consists of a spot sale/purchase of currencies and a simultaneous commitment to a forward purchase/sale of the same currencies. A forward foreign exchange contract consists in a commitment to transact, at a designated future date and agreed-upon exchange rate, in a given amount of specified foreign currencies.
2. Currency swaps (also referred to as "cross currency interest rate swap", hereafter CCS) are the most traded types of transaction for exchange rate purpose by government units. In these contracts, parties exchange also flows denominated in different currencies, both for principal and for interest. There are different types of currency swaps that differ by time of exchange of principal and nature of involved interest rate ("fixed-for-fixed", "fixed-for-floating"). A common case, with exchange of principal both at inception and at termination date allows a borrower in one currency to fully hedge the underlying exchange risk, as if the original currency denomination has been shifted into another one. This is frequently observed for government units that, even in the euro area where financial markets are deep and large, issue a minor part of their debt in a foreign currency (namely in USD or JPY) for various reasons, such as enlarging the basis of investors or benefiting from a lower cost of borrowing
3. The two contracts mentioned in §1 above have to be accounted as financial transactions both in national accounts and in the EDP context. For CCS contracts, regarding the periodic interest payments paid/received, the specific treatment under the EDP has to be applied. As far as the debt stock measurement is concerned, for the EDP purpose, all the three types of contracts are subject to the 479/2009 Regulation provisions examined in details in the following paragraphs". It is understood that for the first two contracts, the amount in foreign currency initially exchanged comes from the proceeds of a given debt instrument whereas the amount in foreign currency received at the term of the contract is actually used for redeem a given debt instrument.

VIII.3.2 Treatment of debt in foreign currency under EDP

4. It is worth describing how liabilities denominated in, or exchanged from and/or in foreign currency are to be treated for the purpose of the calculation of government debt under the Excessive Deficit Procedure (EDP).

   Council Regulation No 479/2009 indicates that:

   "Liabilities denominated in a foreign currency, or exchanged from one foreign currency through contractual agreements to one or more other foreign currencies shall be converted into the other foreign currencies at the rate agreed on in those contracts and shall be converted into the national currency on the basis of the representative market exchange rate prevailing on the last working day of each year.

   Liabilities denominated in the national currency and exchanged through contractual agreements to a foreign currency shall be converted into the foreign currency at the rate agreed on in those contracts and shall be converted into the national currency on the basis of the representative market exchange rate prevailing on the last working day of each year.

Liabilities denominated in a foreign currency and exchanged through contractual agreements to the national currency shall be converted into the national currency at the rate agreed on in those contracts."

5. These conversion rules only concern currency swaps based on existing liabilities, i.e. swaps "against the book"' linked to actual underlying debt instruments. Currency swaps that would not refer to existing liabilities should be recorded under AF34[12]. However, in many countries, debt managers, at least at central government level (the largest part of government debt), are not allowed (by law or other regulations) to enter into currency swaps with no reference to existing liabilities. If any, currency swaps based on non-existing liabilities have no impact on the existing stock of public debt as they are not accounted for the calculation of government debt (except in exceptional cases – see VIII.3.4 below).

6. Actually, the impact of currency swaps on the debt may occur only through rates of exchange. Effectively, as a basic provision ESA95 6.58 states, in a trivial way, that any debt instrument denominated in foreign currency has to be converted into national currency at the current exchange rate prevailing at time of compilation of balance sheets on the basis of the "representative market exchange rate prevailing on the last working day of each year"[13]. Regulation 479/2009 added that where a debt instrument denominated in foreign currency is swapped into national currency the conversion into the latter should be based on the "rate agreed upon in those contracts". As a consequence, in the absence of specifications, this rate of exchange could be different from the spot market rate prevailing at time of the transaction. The Regulation also states that a debt instrument denominated in foreign currency may be swapped into another foreign currency, and not into the national currency. This has been effectively observed in some cases, however, not so frequent. A "two-step" approach has to be implemented:

   – first, the debt instrument is converted into the currency received at inception of the swap contract, on the basis of the cross-exchange rate for both foreign currencies agreed upon the contract;

   – then, the conversion into national currency is based on the current exchange rate prevailing at the end of the year for the currency resulting from the first conversion.

7. The Regulation also covers the specific case – that is certainly very restricted in many countries, again at least at central government – where covering/modifying an exchange risk exposure is not the motive for writing a swap but would on the contrary create a currency exposure. A debt originally denominated in national currency might be swapped into foreign currency. In this case, the debt must be treated as if it were denominated in the foreign currency, on the basis of the exchange rate within the contract. For the required conversion into the national currency, the current exchange rate must be used, so that the final amount in national currency should come from the original proceeds from the issuance.

8. It is important to take note that, as long as the currency swap is based on an existing debt instrument, the Regulation, at least under the interpretation agreed at this time, does not impose strong restrictions for applying the above mentioned provisions, notably:

   1. A derivative contract is not necessary written at the time of the underlying debt instrument issuance but may be implemented at any point of time; however,

[12] As regards interest rate swaps, the mention of existing liabilities would, of course, not be relevant. In theory debt managers could take a full risk exposure. However, in practice, they enter such swaps by reference to the interest exposure resulting from their market liabilities, often on a global basis (macro-hedging). For instance, in a context of curve steepening, they may use IRS for reducing the duration of the debt. IRS may also be used for treasury management purposes.

[13] It is recalled that from 2005 onwards, Member States must also compile an EDP debt on a quarterly basis, although the EU fiscal surveillance remains legally on data at the end of the year.

some debt managers are for regulatory reasons obliged to hedge exchange risk very shortly after an issuance.

2. A derivative contract may have any maturity within issuance and maturity of the underlying debt instrument.

3. A derivative contract may set an exchange of settlements inferior to the flows of principal resulting from the underlying instrument.

4. Such contracts may also refer to a "book" of debt instruments and not to a specific one, covering a risk exposure bearing on several debt instruments.

VIII.3.3 Rationale of the treatment

9. The conversion of debt instruments denominated in foreign currencies is needed in order to aggregate figures and estimate the total amount of "consolidated gross government debt." Any conversion at one point of time means the use of a given rate of exchange. It does not mean that a debt would be necessarily reimbursed for the amount resulting from the conversion at this point of time because of possible change in the future exchange rate, in a volatile environment. Thus, there would be no sense referring to the exchange rate prevailing at time the new liability incurred.

10. However, where original debt instruments denominated in foreign currency is swapped into the national currency, flows of settlements are fixed upon in the contract between parties, i.e. the government unit, on the one hand, and one or several bank counterparts, on the other hand. In the simple case where amounts and maturity of debt instrument and swaps are fully matched, the government unit will regularly pay an amount in national currency and received in exchange an amount in foreign currency. The latter will be used for paying interest or principal to the creditors/holders of the underlying debt instruments. Under these conditions, it is obvious that the government has no longer exchange risk exposure concerning payments for the original instruments. It has no need to use the exchange market in order to get the currency amounts linked to the debt service of the original debt. A rate of conversion has been implicitly fixed. In this case, the exchange rate agreed in the contract is more relevant than the current one as the latter would in no way impact the debt instrument that is now insensitive to exchange market trends and volatility. Finally, for the part covered by a currency swap agreement, the debt can be considered as transformed into national currency. It is similar to the case the debt would have been originally issued in national currency, for the principal amount set in the contract.

11. Moreover, debt managers may not use financial derivatives only to suppress any exchange risk resulting from the initial incurrence of a new liability. They also try reducing the final cost of borrowing. Under these conditions, they may enter swap contracts where they will modify, but not suppress, the exchange risk exposure. According to their anticipations, they can swap the proceeds in one currency resulting from debt issuance into another foreign currency. In this case, the same reasoning is valid for swaps into national currency should apply. The currency denomination of the debt is changed.

    Firstly, the rate of exchange agreed upon in the contract has to be used, from the "original" currency to the "new" one.

    Secondly, the market rate of exchange has to be used, as usual, for the currency on which an exchange risk is borne.

    Moreover, in some cases, currently rather infrequently, debt managers may initialise a kind of "chain" of currency swaps. In this regard, the final currency in which the debt is denominated has first to be determined. Then, the conversion into the national currency is based on the current exchange rate.

12. One can also examine the case where debt managers would swap a debt initially denominated in national currency into a foreign currency, for various reasons, taking an exchange risk exposure. It could be argued that for a debt originally denominated in national currency there is no need to apply the same rule based on successive use of two exchange rates, contractual and current, as there is no uncertainty about the amount of principal due to creditors at maturity. The transaction in financial derivatives could be seen as a "pure" "treasury" management, fully detached from the underlying instrument. However, the swap may change the total cost of the borrowing to be paid by the debtor, compared to a "straight" indebtedness transaction. In addition, such treatment is coherent with the approach of the Regulation. Finally, using rates agreed upon in the derivative contracts provides a best measure of the risk exposure, whatever the original denomination of the debt.

VIII.3.4 Accounting examples

1. *Debt denominated in foreign currency swapped against the national currency*

   – Nominal value of debt instrument: 100 $.

   – Swap dollar against Euro: 100$/74.07€ (exchange rate in the swap agreement: 1 € = 1.35 $).

   – Permanent valuation of the debt instrument according to the Regulation: 74.07€.

   Comments:

   The rate of exchange of the swap contact is more appropriate than the market rate for reflecting the cost of the debt in national currency. At maturity for receiving 100 $ from the swap counterpart (used for the repayment to the holder of the instrument), the issuer has to provide 74.07 € with certainty.

2. *Debt denominated in foreign currency swapped against another foreign currency*

   – Nominal value of debt instrument: 100 $.

   – Swap dollar against yen: 100$/10000¥ (exchange rate: l $ = 100 ¥).

   – New nominal value of the debt: 10000¥.

   – Valuation of the debt instrument in euro according to the Regulation: 90.1 €

     (On the basis of a market exchange rate: 1 € = 111 ¥)

   Comments:

   The swap has changed the exchange risk. The valuation of the debt instrument depends now on the evolution of the €/¥ rate and no longer on the €/$ rate. The debt is in fact treated as if it has originally been issued in yen. At the end of each year, the debt is converted into the national currency on the basis of the market exchange rate €/¥, as the risk of exchange in yen is not covered.

3. *Debt denominated in national currency swapped against foreign currency*

   – Nominal value of debt instrument: 100 €

   – Swap Euro against dollar: 100 €/135 $ (exchange rate 1 € = 1.35 $)

   – New nominal value of the debt: 135 $

   – Valuation of the debt instrument according to the Regulation: 96.43€ (on the basis of a market exchange rate increased to: 1 € = 1.40 $)

Comments:

The liability is no longer in national currency but in foreign currency as the debtor has only to make a payment in foreign currency. Using the market exchange rate shows the effective cost of the dollars he will have to buy (or borrow) on the market. In the example, the appreciation of the national currency reduces this cost for 3.58 €.

4. *"Chain" of swaps*

- Nominal value of debt instrument: 100 $
- Swap dollar against yen: 100$/10000 ¥ (exchange rate: 1 $ = 100¥)
- Swap yen against Swiss franc: 10000 ¥/120 CHF (rate of exchange: 100 ¥ = 1.2 CHF)
- Final nominal value of the debt: 120 CHF
- Valuation of the debt instrument accorded to the Regulation: 83.92 € (on the basis of a market rate of exchange: 1 € = 1.43 CHF)

Comments:

a. The relevant denomination of the debt in foreign currency is the final currency received at each swap inception by the issuer under a "chain" of swaps.

b. Within the "chain", the Euro may be used in one leg of a swap. If it is at the end of the chain, then the debt instrument should be valued as in case 1 (exchange rate agreed in the swap contract). If not the case, the debt is converted into Euro on the basis of the market exchange rate of the currency received at inception of the last swap agreement. The rate of exchange against Euro agreed on an intermediate swap contract is not relevant.

5. *Swaps on a "partial" amount (this case may be combined with any other case - case 1 is used in this example)*

- Nominal value of debt instrument: 100 $ (half of which is swapped against the national currency and half of which is not).
- Swap dollar against Euro: 50$/37.04 € (exchange rate in the swap agreement: 1 € = 1.35 $).
- Valuation of the debt instrument according to the Regulation: 72.74 €, of which

  * for the half which was swapped: 37.04 €

  * for the half which was not swapped: + 35.71 €

  (on the basis of a market exchange rate: 1 € = 1.40 $)

Comments:

The rate of exchange of the swap contract is more appropriate than the market rate for reflecting the cost of the part of the debt swapped against the national currency.

VIII.4 Swap cancellations

VIII.4.1 Background to the issue

1. As mentioned above, a book of swaps is generally actively managed (notably in case of negative value and unfavourable market anticipations). Thus, it is frequent that one party wishes to annul the effect of an on-going swap contract. One solution is to contract a matching swap that would fully (or nearly) offset the effect of the initial swap. Another solution is to agree with the original counterpart to cancel the contract but in this case the market value of the swap has to be paid by the "losing party" to the "winning party". This takes the form of a one-off lump sum payment releasing the canceller from any future obligations.

2. Swaps are recorded on the balance sheet at market value, on the basis of the present value of expected future streams of payments. The difference between the present values of the streams to be paid on each leg of the swap provides the market value, positive for one party and symmetrically negative for the other. In national accounts, such lump sum payments on swap cancellations raises no specific issue as all flows under swaps are recorded as financial transactions in F.34. For EDP purpose, some settlements of swaps are recognised as interest and have an impact on deficit/surplus. In this respect, the lump sum seems of a similar nature. Debt managers, in case of hedging, generally consider that a lump sum cancellation affect the cost of borrowing of the underlying instrument. This rather pleads for spreading the lump sum over the remaining life time, had it not been cancelled, but one can also argue that the instrument does not exist any more, so that the calculation of interest is artificial. Therefore, debt managers show a strong preference to consider it a one-off payment of interest, which is often reflected in their own accounting system, although some international norms recommend spreading.

VIII.4.2 Treatment in national accounts

3. The following clarification was agreed (see the March 2008 guidance note on the Eurostat website):

    1. Any lump sum paid or received by government for swap cancellations does not enter the specific EDP correction for its total amount at the time of cancellation and, thus, the total amount has no impact on government deficit at that time.

    2. The whole amount of the lump sum must be spread over the theoretical remaining life time of the swap, with an impact on government deficit over this period.

    3. In the year of the cancellation, the EDP correction includes both the net interest flows accrued to the date of cancellation and the part of the lump sum that is accrued over this year since the cancellation.

    4. This applies to all kinds of swaps, whatever their purpose such as hedging arbitrage or pro-active market anticipations.

VIII.4.3 Rationale of the treatment

4. In the EDP context (in ESA95, such flows are F.34) there is no question about the fact to consider the lump sum as an interest flow in substance. Conceptually, it could not be considered a financial transaction that would be neutral for the net borrowing/net lending. The cash may effectively be used for any expenditure and is not a simple change in the structure of balance sheet liability. Thus, the main point is the decision to spread its effect over the remaining maturity, which is in line with the basic principle of ESA95 to record interest on an accrual basis, of course fully applied in the case of

interest under swap in the EDP context. In effect, the lump sum recorded as a one-off transaction might have given rise to specific operations, such as for instance cancellations followed by origination of new swaps, with an artificial net effect on deficit/surplus. In addition, it must be stressed that spreading allows full consistency, homogeneity of treatment, between swap cancellation and initiating a reverse swap, as mentioned above. Both active management tools should effectively have the same impact on the deficit/surplus at the time they are used.

VIII.4.4 Accounting example

An interest rate swap has been agreed on 1rst of July with the following conditions:

- Maturity: 10 years
- Notional principal amount: 100
- Fixed payment by a bank counterpart: 5.%
- Floating payment by a government unit counterpart: Euribor 12 M + 1

After 5 years, trends in market conditions result in a positive value of 10, excluding accrued interest for the government unit.

At a payment date (here on an annual basis), the government unit agrees with its bank counterpart to write off the swap.

The following payments take place:

- Net accrued interest paid by the government unit (half a year): (5 – 3)/2 = 1 (on the basis of Euribor 12M = 2%)
- Lump sum for cancellation paid by the counterpart: 10

Impact on government finance:

- On the year of cancellation, deficit decreases by 1 (accrued interest) + 1 (accrued lump sum).
- On each of the following four years: deficit decreases by 2 (spread of the favourable lump sum over the remaining maturity of the original swap contract).
- On the fifth year, deficit decreases by 1.
- There is no entry in government non-financial accounts for the lump sum, but the EDP correction would be balanced each year by an adjustment for the difference interest accrued/paid as there is by nature no impact on debt after the year of cancellation.

VIII.5 "Off-market" swaps

VIII.5.1 Background to the issue

1. In the context of EU fiscal position monitoring, because of the existence of the specific treatment of interest under swaps, a fundamental issue is whether the swap (whatever its category as this is a specific design of the flows exchanged) is conducted on market terms or is of an “off-market” nature. Such "off-market" swaps may concern both interest rate swaps and currency swaps.

   - In the case of a swap on market terms, at inception, the present value of the sum of the payments due by each party is strictly equivalent. The conditions agreed upon reflect the prevailing market conditions. Thus, the swap has a zero market value at inception. Such swaps are also named "par swaps" or "at the money". Afterwards, the impact on parties, fully symmetrically, will reflect the change in present value of the streams of payments for each leg in link with trend in market conditions.

   - In the case of a swap on “off-market” terms, the conditions have been agreed by parties very specifically[14] thus ensuring that, at inception of the swap, the terms are unbalanced in the favour of one party. The market value is not nil. In the case of a swap on “off-market” terms, the conditions have been agreed upon at inception a "loser" and a "winner" in the transaction. This is the main feature of "off-market swaps". Therefore, the benefiting party provides to the other compensation in order to re-balance the deal. In almost all the cases, this compensation takes the form of a lump sum paid in cash by the counterpart "in the money". However, it may happen that this compensation takes other forms and is subject to specific agreements (instalments payments, writing off of liability, transfer to other parts of complex arrangements, etc.). In any case, the loan component should be clearly identified.

2. In the Regulation, similarly to ESA95 and the two first editions of the current Manual, there is no explicit mention at all of such "no standard" swaps. This, of course, does not make it easy to know whether these operations comply with precise guidelines. However, even in the absence of an official explicit statement, there was a rather clear understanding at the beginning of the present decade that swaps were used in the context of "pure risk management" and had a nil value at inception of the contract.

VIII.5.2 Treatment in national accounts

3. In the same context as for swap cancellation, Eurostat has completed the methodological framework (see the March 2008 Guidance note on the Eurostat website). Thus, an off-market swap should be divided into two parts (a and b).

   a. A swap based on the prevailing spot market conditions, with nil market value at inception and recorded according to the usual rules (notably streams of interest included in the EDP correction); this is the "par or "at the money" component, similar to a "standard swap".

      There is no impact on government debt either at inception or later. Any change in the value of the swap is a financial transaction, recorded under AF34 (on asset side if positive, on liability side if negative).

[14] In other terms (but it is as such not a sufficient condition) the contract is not based on the prevailing spot market conditions at the time of signature, or in case of hedging an underlying instrument, the swap does not refer to some conditions similar to those of the underlying instruments.

b. The net amount exchanged generally at the start of the swap contract that is treated as loan, amortised over the life of the instrument and on which interest should be imputed; this is the "loan component".

Where government is the receiver of the initial net amount, there is at inception an increase in government debt (loan classified in AF.4). There is no entry in the EDP correction for interest, but over the life of the contract the latter will record the stream of interest payments under the swap with the exception of the amortisation of the loan, recorded as a financial transaction. Actually, this amount exchanged at inception includes the interest to be paid for the loan component. As a matter of principle, there cannot be interest charge in addition to the effective regular flows under the swap contract. Also, there cannot be any amortisation of the loan in the absence of exchange of settlements under the swap contract. Therefore, would the swap be cancelled, the loan, for the remaining outstanding amount, should be considered as fully redeemed. This part of the cancellation could not be treated according to the rules mentioned in VIII.4 and would have no impact on the deficit.

It may happen that during the lifetime of the swap contract, the counterparts agreed on a substantial change in the terms and conditions of the original contract (amendments or revisions). For instance, the maturity of the contract is increased or the notional amount is significantly changed. This must be seen as a cancellation/new origination which implies that the current value of the loan component has to be revised. Similarly, if a new non-government counterpart is substituted ("novation"), the observed transfer value would also be taken into account for revaluating the remaining outstanding amount of the loan component. As a consequence, any possible future revision that would fall under the above-mentioned criteria could result in an upward or downward adjustment of the nominal outstanding amount of the loan.

VIII.5.3 Rationale of the treatment

4. From a conceptual point of view, it must be stressed that the initial one-off payment comes from an unbalance in a swap. Should have been designed in market way, only regular payment would have been observed with a net effect spread over the whole life of the contact. Therefore, the existence of the lump sum that, again, is just the way to re-balance the swap and neutralise the disequilibrium, is intrinsically linked to the swap itself. It is why the effects are to be measured on strictly the same maturity. As regards the classification as a loan, it is a logical result of the analysis of such contracts. The counterpart of the lump sum received by one party at inception is an increase of its obligations all over the life of the swap, as a repayment of the lump sum. In national accounts, very simply, where a cash amount is reimbursed over a period of time, this is called a loan. (It is assimilated to a non-marketable instrument as the regular flows are calculated from a principal amount).

5. Similarly to swap cancellations described above, the crucial point is that government might benefit from large one-off cash payments, used to finance expenditure without generating new debt or to reimburse debt, including through buy-backs. As such, it is not an issue considering that government may benefit from exceptional significant transactions (for instance, sales of real estate, privatisations, etc.). But it appeared also through these "specific" transactions governments could achieve some arbitrage between debt and deficit. For instance, the swap may be structured such that the debt might be significantly lowered (increased) compensated by a spreading cost (gain) in terms of deficit/surplus. This would blur the analysis of the fiscal position that would not result from its specific role in the economy, the management of its property and, at a lesser extent, the effect of market trends.

6. Thus, off-market swaps might give to some government units the opportunity for specific operations implemented for other purpose than risks management (often

referred to as "window-dressing"). These arrangements affect the level of the debt because, as mentioned in chapter 2, the EDP definition of the debt does not include liabilities in derivatives. But the analysis above clearly shows that there is in such transactions an evident loan component that must be recorded in government debt under AF.4.

VIII.5.4 Accounting example

a. The case of an IRS

An interest rate swap has been agreed with the following conditions:

- Maturity: 10 years
- Notional principal amount: 100
- Fixed payment by a bank counterpart: 4.5%
- Floating payment by a government unit counterpart: Euribor 12 M + 5.50%

It is clear that such arrangement is very obviously unbalanced and the bank counterpart would be net receiver all along the contract (even if the 6M rate would fall to zero).

On the basis of the spot market conditions the par value of the swap (again so that at the inception it would be equal for both parties) can be evaluated and the "off market" component may be deducted.

Assume that in this case, the present value of the net payments is estimated at 50. The bank counterpart must pay this sum to the government unit.

The impact on EDP data would be as follows:

- At inception, there is no impact on deficit as the lump sum is not recorded as revenue.
- At inception, there is an increase in the debt by 50 as the lump sum is recorded as a loan (AF.42) that is amortised over the life of the swap, here 10 years.
- Each year over the lifetime of the swap there is a negative impact on the deficit as the government unit is net payer in the swap for an amount depending on the level of the 12 months rate.
- Part of these cash interest payments under the swap contract is to be recorded as amortisation of the loan – financial transaction; therefore, the amount recorded as interest expenditure is lower except for the part relating to the interest charged on this loan, with an impact on the deficit.
- Eurostat recommends to use the following method:
    - The loan is at a fixed, and not revisable, interest rate;
    - The interest rate is derived from the paying leg by the government unit;
    - It is the level of the fixed rate or of the floating reference rate (without spread) as observed at the start of the swap contract (trade date);
    - The loan gives rise to payment of constant instalments (annual or semi-annual) that are split between redemption of the principal and payment of interest on the basis of the fixed rate as mentioned above;
    - The interests on the loan must be recorded on an accrual basis; they are no longer part of the difference between D.41 (ESA95) and EDPD.41.

- The impact on the deficit progressively increases as the share within the constant instalments of the principal redemption is growing until maturity, depending on the maturity of the contract and the level of the interest rate used for the loan component, according to usual financial mathematics.

– Each year over the lifetime of the swap, there is a positive and constant impact on the debt as the liability incurred at inception of the swap is progressively extinguished until the final maturity date of the loan component.

– In this example, on the basis of Euribor 12M at 3% after one year, the following transactions would be recorded:

Initial AF.4 (L): 50

Loan annuity: 6

Net exchange of interest: +4.5 – 8.5 = -4

Amortisation of principal: 4

EDP D.41 par swap: -2.5

D.41 loan interest charge: -2

EDP B.9: 0

F.2 (A): -6

F.4 (L): -4

Final AF.4 (L): 46

b. <u>The case of a currency swap</u>

Assume that a government unit has issued a long-term bond at fixed rate denominated in euro for a nominal value of 100.

At a point of time, the remaining maturity is 10 years.

For various reasons, this government would like to reduce its nominal debt figures.

The following arrangement could take place:

The government unit might enter a currency swap EUR/USD (here fixed/floating) where the exchange rate agreed in the contract would be EUR/USD = 1 whereas the spot market exchange rate would be EUR/USD = 1.25 (or USD/EUR = 0.8).

At inception, the government unit would exchange €100 and receive USD100 from its counterpart (and not 125 at the prevailing spot market exchange rate).

At the end of the swap contract (if no early cancellation takes place), the government unit will return these USD100 and get back €100 that could be used for redeeming the underlying bond.

Due to the use of the less favourable rate of exchange for the euro, this arrangement would effectively result in a reduction of the debt[15] as, under EDP methodology, the conversion would be as follows:

€100 = USD100 (at 1=1, contractual rate) = €80 (at EUR/USD = 1.25, market spot rate)

The cash flows on the currency leg would be adjusted so that the government unit will repay USD125 over the life of the swap.

[15] In the case of a swap from a bond issued in foreign currency to a bond in domestic currency, the reduction of the debt needs a more favourable rate of exchange for the domestic currency.

In market terms, the swap would be unbalanced, with a market value of USD25 (€20), in favour of the counterpart (that has provided only USD100 in the swap initial exchange). Under these conditions, it would have to pay an equivalent lump sum of USD25 (€20) to the government unit at inception.

In the absence of the Eurostat rules, at the signature of the contract the government unit would benefit form a reduction of its debt (conversion) and a "one-off" improvement of its deficit (lump sum).[16]

As a counterpart, this unit would pay more net interest payments during the lifetime of the contract (offsetting the initial positive effect) and, moreover, would have taken an exchange risk exposure. It has changed the original debt in domestic currency into a foreign currency debt, the value of which is sensitive to adverse market movements (here a depreciation of the domestic currency).

Under the Eurostat rules on off-market swaps, such an arrangement would not help this government to meet its initial objective as:

- The currency swap would be split into a "par/at the money swap", on the basis of the prevailing market rate of exchange at the start of the contract (EUR/USD = 1.25) and a loan in foreign currency (recorded in AF.4) for the amount of the additional cash payment received by government;
- The loan, denominated in foreign currency, would be amortised, over a period of 10 years, by the regular interest net payments during the contract, following the method described in the previous example of off-market IRS.

Thus, it appears clearly that the "favourable" effect on the debt resulting from the use of a non-market rate of exchange is totally offset by the entry of a loan liability.

[16] Other swap arrangements, more or less complex, could have a similar effect on the outstanding amount of the debt, for instance based on an exchange foreign currency/domestic currency. In any case, they would use interest and exchange rates different from the prevailing spot market conditions, or/and rather significant spreads on floating leg(s).

VIII.6 Repurchase agreements

VIII.6.1 Background to the issue

1. Repo transactions have taken a large importance in most European countries and may be used in both money markets and securities markets. Securities issued by general government are often used in repo transactions in which they can represent the main vehicle, as it is common due to various considerations on liquidity and risk for securities issued by (namely central) government. However the crucial point here is that units classified in this sector may enter into such contracts, either as liquidity provider or as cash borrower.
2. Under these conditions, repos may have an impact on the calculation of general government debt, directly where a general government unit is "cash receiver" in such transactions (recording of a new liability). As a reminder, where two units included in this sector are involved, there is no impact because of the consolidation rule, except in the case of a resale of the asset by the assignee (see further in 3f). In addition, it must be pointed out that repos are frequently used by government debt mangers in the context of the investment of the funds that may be available generally for short-term period.
3. Contrary to ESA where no definition is provided, SNA93 11.32, quite copied in SNA 2008, specifies that: "Repurchase agreements are arrangements whereby an institutional unit sells securities at a specified price to another unit. The sale is made under a commitment to repurchase the same or some similar securities at a fixed price on a specified future date (usually very short-term, e.g. overnight or one day) or at a date subject to the discretion of the purchaser." It is also stated: "its economic nature is similar to that of a collateralised loan in that the purchaser of the securities is providing to the seller advances backed by the securities for the period of the agreement and is receiving a return from the fixed price when the repurchase agreement is reversed." Thus, a repo is a sale and repurchase agreement in which there is a firm commitment - and this is a fundamental feature, not a simple promise - for one counterpart. Effectively, at maturity or before where the contract makes provision for it, the temporary "purchaser" (or assignee) is obliged to return the security (or an equivalent one) to the original "seller" (or assignor) that is engaged to buy it back at the price fixed in the contract. Generally, national regulations require identifying separately in a portfolio the securities used in a repurchase agreement. In addition, on some markets, more complex features may be observed (such as "margining").

VIII.6.2 Treatment in national accounts

VIII.6.2.1 Treatment in ESA95

4. ESA95 specifies clearly the treatment of repos, in line with SNA and BOP 5th Manual. The main point is that a new financial instrument appears in a repo transaction. A repo creates a new relationship between two counterparts. There is clearly a new set of reciprocal claims and liabilities. For the seller, there is an increase in the balance sheet for the cash received and available for any purpose, on the asset side, and for its counterpart, on the liability side. For the purchaser, there is no increase but only a substitution on the asset side from cash to another item. The treatment of repos is clarified in ESA95 5.46f, 5.64a, 5.81d. It is based on a double distinction according first to the maturity of the repurchase agreement and second to the nature of the original holder of the security.

- ESA95 5.46 states that “short-term repurchase agreements, which are liabilities of monetary financial institutions”, are classified in F.29 (other deposits). For instance, a monetary financial institution “temporarily” sells securities to investors and receives in counterpart liquidity for a period of time. The nature of this operation is in fact very close to a time deposit, except that the investor holds a guarantee.

- In practice repo arrangements for more than one year are not very frequent. This instrument is generally used from overnight to three months maturity.

- ESA95 5.81 states that “short-term repurchase agreements, which are liabilities of institutional units other than monetary financial” are recorded in short-term loans (F.41). In this transaction, the exchange of cash concerns institutional units that do not manage deposits.

- ESA95 5.95 adds that "By convention short-term deposits accepted by institutional units other than monetary financial institutions, resident or non-resident, are normally classified in sub-category short-term loans (AF.41).

- In any case, whatever the nature of one counterpart, when the repurchase agreement is not engaged for a short period, the transaction is considered as a long-term loan (F. 42).

- ESA95 5.64a specifies that the “sub-position” F.332 (“Long-term securities other than shares, excluding financial derivatives”) does not include “transactions in securities as part of repurchase agreements. [...] The stock lent or subject to repurchase does not change the balance sheet and remains classified in AF.332.”

- According to these provisions, no transaction is recorded in securities.

5. The rationale is that there is no change of ownership for the underlying security from an economic point of view that prevails in ESA95 on legal arrangements. Effectively the seller is exposed to change in market valuation of the underlying asset. Under a repo, the underlying assets are kept in ESA within the accounts of the original holder. As no change in ownership is recognised, no transaction can be recorded in securities (5.02). The underlying security is not directly the purpose of a repo. It is not a means of investing on financial markets. It is clearly shown by the associated rate of interest, based on the maturity of the engagement.

VIII.6.2.2 Additional rules

6. Some questions relating to repos are not explicitly mentioned in ESA95. Therefore, there is a need for the following supplements:

   1. In case the information on maturity is not available for repos engaged with banks, it would be acceptable to consider repos as short-term financial instruments and thus record them in deposits.

   2. The difference between the selling price and the repurchasing price should be recorded as interest, on an accrual basis, and included in property income.

   3. Provisions about repos apply to any asset used in a similar transaction (thus relating to any kind of collateral) and not only to securities.

   4. The treatment specified in ESA95 for repos is applicable only in the case the original seller of the asset has an unquestionable commitment (and not only an option or a commitment subject to some conditions) to repurchase it under conditions agreed at inception.

5. The case of an effective delivery of securities used in a repo, notably through electronic depository systems, has no effect on the conceptual treatment.

6. Would an economic agent resell an asset "acquired" under a repo arrangement, a negative entry should be recorded in his balance sheet.

7. Securities lending with cash, and only them, should be treated in a total similar way to repos.

VIII.6.3 Rationale of the treatment

VIII.6.3.1 Maturity

7. Most repos are engaged for very short-term maturity, frequently overnight. It is not an instrument for investing liquidity in the long-term. Its flexibility, as a basic feature, explains also the development of short-term transactions. Under these conditions, the proposed treatment, in case of absence of information, as deposits (in the case of bank counterparts) seems to be an acceptable approximation.

VIII.6.3.2 Valuation

8. Repurchase agreements are considered as loans or deposits, recorded in national accounts at nominal value. Thus, the value is based on original funding. In other words, the cash amount exchanged at the beginning of the period is the value of the new financial instrument. There are no holding gains as in the case of outright transactions in securities. Accrued interest is also included in the price of the transaction. However, there might be a need for adjusting the amount recorded as interest:

   – firstly in order to exclude commissions or fees recorded as service charge (but from a practical point of view, where very negligible, the amount could be ignored),

   – secondly for transactions in assets denominated in foreign currencies;

     - in this case, the change in the value of the asset due to a possible effect of the change in the exchange rate is not imputed on the remuneration of lending/borrowing of funds;
     - the repurchasing price should be estimated on the basis of the original rate of exchange and any difference recorded as nominal holding gains or losses in the revaluation account;
     - for practical reasons, it may be easier to start from the amount of holding gains or losses (provided that the effect of the change in the exchange rate is rightly identified) and to deduct the interest on repos by using an estimate based on an average maturity.

VIII.6.3.3 Underlying assets

9. ESA95 and SNA deal only with repos backed by securities, generally government bonds and Treasury bills because of their deep and liquid markets. In some countries other assets can also be used, namely loans to non-financial agents according to some criteria, and even real estate assets. Treatment as repos should also apply. Thus, the ESA95 definition of repos should be enlarged to cover any arrangement concerning the provision of cash for a given period of time to an economic agent that, in counterpart, “supplies” as collateral any asset he holds with a repurchase engagement.

VIII.6.3.4 Repurchasing clause

10. As aforementioned, for the original seller (assignor/borrower of funds) there must be a firm commitment to repurchase the securities. From a legal point of view, there exists an unquestioned claim held by the buyer or assignee. At the maturity date, automatically, the initial position would be offset by a reverse transaction, whatever the new conditions on the market. Where contracts stipulate that the seller has only an option to buy back the securities, the treatment of repos should not be implemented. The arrangement includes only a kind of promise. The expression “spurious repurchase agreements” is sometimes used in this case. This may also be observed in sale/buy back transactions where there are strong similarities with repos concerning the economic nature of the transaction but also some technical differences. Sale/buy backs should however be treated as repos where the original holder has a strict obligation to buy back and the assignee an unquestioned claim to get back liquidity. Therefore, the transactions should be recorded in the same way and, if necessary, the sources used for compilation should be corrected, notably in the respective portfolios.

11. Where the original seller does not have a firm commitment to repurchase the asset(s), it should be considered as an effective transfer of ownership. As a consequence, for securities, a change in both contracting parties’ portfolios should be recorded, with no increase in the balance sheet of the seller. As a reminder, the contingent asset corresponding to the possible resale should not be included at all in the financial account, according to ESA95 provisions in 5.05. In some cases, the repurchasing transaction, even if not firmly legally based, is in fact quite certain because of the nature of the parties. For instance, repo is undertaken by two units classified in general government. However, it is recommended here to apply the rule about firm commitment in a rather restrictive way, i.e. in limited situations where there is very strong evidence that in case of conflict the commitment would be certainly recognised by legal or arbitration authorities. Some very infrequent "conflicting" cases were observed and resulted generally in the obligation to repurchase.

VIII.6.3.5 Delivery of securities

12. According to national regulations and market practice, securities may effectively be delivered to the buyer. It is notably the case where it needs only an adjustment in the book-entry depository system via efficient electronic delivery-payment organisation. Fundamentally, this feature does not change the nature of the operation as a repo from an economic point of view. But, obviously, it adds, however, some complexity in the compilation process and may be the source of discrepancy as mentioned later. As the transaction is recorded in loans/deposits instruments and the assignee is supposed not to have bought securities, the purchaser's portfolio must be corrected if the asset has been entered. It may be the same in the portfolio of the original holder so that he keeps the asset in his portfolio, in addition to the new instrument representing the temporary cash lending. Even in the case of delivery, it is assumed that the “seller” keeps his right of property on the securities he has transferred. The main point is that he assumes risks, for instance when the value of the securities would be less than the repurchase price due to change in market conditions. More, in case of default from the issuer of the security, he would have to repay the fixed sum to the lender. Normally, the seller continues to receive benefits (as interest or dividend) associated with the securities. It means that if such payment occurs during the contractual period, the temporary buyer has to repay it.

VIII.6.3.6 Sale of asset during a repo arrangement

13. It may happen that the buyer ("assignee"/liquidity provider) sells the asset received under the repo transaction before the second "leg" of the transaction. In this case, a negative entry is to be recorded in the purchaser’s portfolio in counterpart to the cash

taken from the sale. However, the initial relationship resulting from the repo does not disappear and is not at all changed by the second transaction. The temporary purchaser has a liability to provide back a “comparable” security. This is the reason why his balance sheet has to show a negative asset. This entry also shows that the purchaser is now theoretically exposed to a market risk, which was not the case before the resale. However, this treatment may raise some difficulties that are not, nevertheless, specific to the transactions undertaken by general government units but is a general issue for repos. Identifying such transactions may in addition be particularly difficult in the case of cross-border flows.

VIII.6.3.7 Securities lending

14. Securities lending may also be largely used by investors on securities markets for various reasons such as covering short-term positions (as in he case of short selling) or for derivatives position management.

15. Where there is an effective flow of cash, it is clear, from an economic point of view, that the case is very similar to a repurchase agreement transaction. Effectively, there is no definitive change of ownership and there is a firm commitment concerning the reverse transaction on securities. Thus, the transaction should be recorded in loans or deposits, according to the general rules mentioned above. Although securities lending is not explicitly mentioned as such in ESA95, this treatment is quite in line with it. The last sentence in 5.64a states that “the stock lent or subject to repurchase does not change the balance sheet and remains classified in AF. 332” (for the case of long-term securities, but it is similar in the case of short-term ones). In this case, a negative entry is also required in the purchaser’s portfolio.

16. On the contrary, securities lending without a flow in cash (generally for very short maturity) should not be treated as a repurchase agreement, but this case is not at all specified in ESA95 (or SNA, even in the 2008 edition). From an economic point of view, it may be seen as a kind of “loan in materials” that is not recognised as a financial instrument in national accounts. ESA95 5.69 specifies that there is a loan “...when creditors lend funds to debtors". Therefore, no transaction should affect the financial accounts (stocks and flows).

17. Generally, in the accounting system of the contracting parties there is no effect on the balance sheet but possibly an entry in the “off-balance sheet” in order to record the forward reverse transaction. But in some countries, portfolios reflect directly the transaction. Two cases should be distinguished:

    – Where the distinction between securities lending with cash and without cash is available, for lending without cash, the counterpart in the balance sheet of parties should be preferably classified under “other accounts receivable/payable” (for consistency reasons no entry under deposits or loans).

    – Where the distinction is not available, the treatment would depend on the estimated share (through specific information) of each kind of transaction within the global figures. However, a good proxy seems to consider that only a few transactions are cash-free and, thus, to apply a “repo-like” treatment for the whole.

VIII.6.4 Effect on government debt

18. There may be different effects on general government debt of this category of financial instruments:

    - Where a unit in general government is "assignor", temporary seller of securities and "cash receiver", there is an impact on gross debt as the item "loans" (F4) is increased in counterpart to the borrowed funds. Of course, if the counterpart is

another unit classified in general government, the effect is nil at a consolidated level.

- Where a unit is "assignee", placing liquidities and providing funds to an economic agent classified in another sector, namely a monetary financial institution, there is no impact on the debt at consolidated level, but a change in the structure of its assets.
- Where the transaction is not recognised or else treated as a repo (see 3d), without a firm commitment concerning the reverse transaction, there is in this case a change in ownership of the assets. Government debt would be changed only when a unit classified in general government lends or borrows public securities with a counterpart classified outside general government sector.

  The latter effect comes from the consolidation rules. Thus, consolidated debt is increased when the government unit is lender (decrease in assets) or reduced when the government unit is borrower (increase in assets). There is no impact for transactions on securities with a unit classified in general government, whatever the instruments involved.

VIII.6.5 Accounting examples

*A unit in general government enters into a **repurchase agreement** (on Treasury bonds) for a value of 100 with a bank. The original maturity is 3 months. The repurchase price is 101.*

1. At the date of inception

General government unit				Bank			
Financial Account							
ΔA			ΔL	ΔA			ΔL
F.22	-100			F.22	+100	F.29	+100
F.29	+100						
		B.9	0			B.9	0

2. At the maturity date (if no early redemption)

General government unit				Bank			
Non financial account							
U			R	U			R
		D41	1	D41	1		
B.9	+1			B.9	-1		
Financial account							
ΔA				ΔA			
F.22	+101			F.22	-101	F29	-100
F.29	-100						
		B.9	+1			B.9	-1

VIII.7 Keywords and references

Financial assets and liabilities	ESA95 7.20 and following
Valuation of financial assets and liabilities	ESA95 7.44 and following
Financial derivatives (F.34)	ESA95 5.65 and following
Interest under Interest rate swaps and FRAs	ESA95 4.47
Index-linked securities	ESA95 5.62f
Zero-coupon bonds	ESA95 5.62g
Financial leasing	ESA95 3.112, 3.133, 5.81g
Repurchase agreements	ESA95 5.46f, 5.64, 5.81d

Annex 1

Legal texts (references and links)

Annex 1 **Legal texts** (references and links)

They can be found here

http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/legal_instruments

European System of Accounts 95 (ESA95)

Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community

ESA95 has been subsequently amended by the following instruments:

- Classification of SWAPS

Regulation (EC) No 2558/2001 of the European Parliament and of the Council of 3 December 2001 amending Council Regulation (EC) No 2223/96 as regards the reclassification of settlements under swaps arrangements and under forward rate agreements (Text with EEA relevance

http:/eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:021:0003:0009:EN:pdf

- Taxes and social contributions

Regulation (EC) No 2516/2000 of the European Parliament and of the Council of 7 November 2000 modifying the common principles of the European system of national and regional accounts in the Community (ESA) 95 as concerns taxes and social contributions and amending Council Regulation (EC) No 2223/96

Commission Regulation (EC) No 995/2001 of 22 May 2001 implementing Regulation (EC) No 2516/2000 of the European Parliament and of the Council modifying the common principles of the European system of national and regional accounts in the Community (ESA95) as concerns taxes and social contributions

- Revised classification of expenditure

Commission Regulation (EC) No 113/2002 of 23 January 2002 amending Council Regulation (EC) No 2223/96 with regard to revised classifications of expenditure according to purpose (Text with EEA relevance)

The following instrument draws on ESA95 definitions to establish a harmonised definition of government expenditure and revenue:

- General Government expenditure and revenue

Commission Regulation (EC) No 1500/2000 of 10 July 2000 implementing Council Regulation (EC) No 2223/96 with respect to general government expenditure and revenue

Data transmission programme

Regulation (EC) No 1392/2007 of the European Parliament and of the Council of 13 November 2007 amending Council Regulation (EC) No 2223/96 with respect to the transmission of national accounts data

Excessive Deficit Procedure - Statistics

Council Regulation 479/2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community

Council Regulation (EU) No 679/2010 of 26 July 2010 amending Regulation (EC) No 479/2009 as regards the quality of statistical data in the context of the excessive deficit procedure

Other documents

Code of best practice

Administrative arrangements

Annex2

EDP Notification tables

Annex 2 EDP Notification tables

Reporting of Government Deficits and Debt Levels

in accordance with Council Regulation (EC) N° 479/2009
and the Statements contained in the Council minutes of 22/11/1993

Set of reporting tables as endorsed by the CMFB on 06/08/2009.

Member state: XXXX
Date: XX/XX/2010

The information is to be provided in the cover page only

Table 1: Reporting of government deficit/surplus and debt levels and provision of associated data.

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Table 4: Provision of other data in accordance with the statements contained in the Council minutes of 22/11/1993.

Yellow cells: compulsory detail; green cells: automatic compilation; blue cells: voluntary detail.

Not applicable: M ; Not available: L

Table 1: Reporting of government deficit/surplus and debt levels and provision of associated data

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	ESA 95 codes	Year 2006	2007	2008	2009	2010
		(1)	(1)	(1)	(1)	planned
Net borrowing (-)/ net lending (+)	EDP B.9					
General government	S.13					
- Central government	S.1311					
- State government	S.1312					
- Local government	S.1313					
- Social security funds	S.1314					
		(1)	(1)	(1)	(1)	planned
General government consolidated gross debt						
Level at nominal value outstanding at end of year						
By category:						
Currency and deposits	AF.2					
Securities other than shares, exc. financial derivatives	AF.33					
Short-term	AF.331					
Long-term	AF.332					
Loans	AF.4					
Short-term	AF.41					
Long-term	AF.42					
General government expenditure on:						
Gross fixed capital formation	P.51					
Interest (consolidated)	EDP D.41					
p.m.: Interest (consolidated)	*D.41 (uses)*					
Gross domestic product at current market prices	B.1*g					

(1) Please indicate status of data: estimated, half-finalized, final.

Table 2A: Provision of the data which explain the transition between the public accounts budget balance and the central government deficit/surplus

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year 2006	2007	2008	2009	2010	
Working balance in central government accounts						
Basis of the working balance	(1)	(1)	(1)	(1)	(1)	
Financial transactions included in the working balance						
Loans, granted (+)						
Loans, repayments (-)						
Equities, acquisition (+)						
Equities, sales (-)						
Other financial transactions (+/-)						
of which: transactions in debt liabilities (+/-)						
Detail 1						
Detail 2						
Non-financial transactions not included in the working balance						
Detail 1						
Detail 2						
Difference between interest paid (+) and accrued (EDP D.41)(-)						
Other accounts receivable (+)						
Detail 1						
Detail 2						
Other accounts payable (-)						
Detail 1						
Detail 2						
Working balance (+/-) of entities not part of central government						
Net borrowing (-) or net lending (+) of other central government bodies						
Detail 1						
Detail 2						
Other adjustments (+/-) (*please detail*)						
Detail 1						
Detail 2						
Detail 3						
Detail 4						
Detail 5						
Net borrowing (-)/lending(+) (EDP B.9) of central government (S.1311)						

(ESA 95 accounts)

(1) Please indicate accounting basis of the working balance: cash, accrual, mixed, other.
Note: Member States can adapt tables 2A, B, C and D to their national specificity according to the established practice

Table 2B: Provision of the data which explain the transition between the working balance and the state government deficit/surplus

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year 2006	2007	2008	2009	2010	
Working balance in state government accounts						
Basis of the working balance	(1)	(1)	(1)	(1)		
Financial transactions included in the working balance						
Loans (+/-)						
Equities (+/-)						
Other financial transactions (+/-)						
of which: transactions in debt liabilities (+/-)						
Detail 1						
Detail 2						
Non-financial transactions not included in the working balance						
Detail 1						
Detail 2						
Difference between interest paid (+) and accrued (EDP D.41)(-)						
Other accounts receivable (+)						
Detail 1						
Detail 2						
Other accounts payable (-)						
Detail 1						
Detail 2						
Working balance (+/-) of entities not part of state government						
Net borrowing (-) or net lending (+) of other state government bodies						
Detail 1						
Detail 2						
Other adjustments (+/-) (*please detail*)						
Detail 1						
Detail 2						
Detail 3						
Net borrowing (-)/lending(+) (EDP B.9) of state government (S.1312)						

(ESA 95 accounts)

(1) Please indicate accounting basis of the working balance: cash, accrual, mixed, other.

Note: Member States can adapt tables 2A, B, C and D to their national specificity according to the established practice

Table 2C: Provision of the data which explain the transition between the working balance and the local government deficit/surplus

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year 2006	2007	2008	2009	2010	
Working balance in local government accounts						
Basis of the working balance	(1)	(1)	(1)	(1)		
Financial transactions included in the working balance						
Loans (+/-)						
Equities (+/-)						
Other financial transactions (+/-)						
of which: transactions in debt liabilities (+/-)						
Detail 1						
Detail 2						
Non-financial transactions not included in the working balance						
Detail 1						
Detail 2						
Difference between interest paid (+) and accrued (EDP D.41)(-)						
Other accounts receivable (+)						
Detail 1						
Detail 2						
Other accounts payable (-)						
Detail 1						
Detail 2						
Working balance (+/-) of entities not part of local government						
Net borrowing (-) or net lending (+) of other local government bodies						
Detail 1						
Detail 2						
Other adjustments (+/-) (*please detail*)						
Detail 1						
Detail 2						
Detail 3						
Net borrowing (-)/lending(+) (EDP B.9) of local government (S.1313)						

(ESA 95 accounts)

(1) Please indicate accounting basis of the working balance: cash, accrual, mixed, other.
Note: Member States can adapt tables 2A, B, C and D to their national specificity according to the established practice

Table 2D: Provision of the data which explain the transition between the working balance and the social security deficit/surplus

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year 2006	2007	2008	2009	2010	
Working balance in social security accounts						
Basis of the working balance	(1)	(1)	(1)	(1)		
Financial transactions included in the working balance						
Loans (+/-)						
Equities (+/-)						
Other financial transactions (+/-)						
of which: transactions in debt liabilities (+/-)						
Detail 1						
Detail 2						
Non-financial transactions not included in the working balance						
Detail 1						
Detail 2						
Difference between interest paid (+) and accrued (EDP D.41)(-)						
Other accounts receivable (+)						
Detail 1						
Detail 2						
Other accounts payable (-)						
Detail 1						
Detail 2						
Working balance (+/-) of entities not part of social security funds						
Net borrowing (-) or net lending (+) of other social security bodies						
Detail 1						
Detail 2						
Other adjustments (+/-) (*please detail*)						
Detail 1						
Detail 2						
Detail 3						
Net borrowing (-)/lending(+) (EDP B.9) of social security (S.1314)						

(ESA 95 accounts)

(1) Please indicate accounting basis of the working balance: cash, accrual, mixed, other.

Note: Member States can adapt tables 2A, B, C and D to their national specificity according to the established practice

Table 3A: Provision of the data which explain the contributions of the deficit/surplus and the other relevant factors to the variation in the debt level (general government)

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year 2006	2007	2008	2009	
Net borrowing(+)/lending(-)(EDP B.9) of general government (S.13)*					
Net acquisition (+) of financial assets [2]	0	0	0	0	
Currency and deposits (F.2)					
Securities other than shares (F.3)					
Loans (F.4)					
Increase (+)					
Reduction (-)					
Short term loans (F.41), net					
Long-term loans (F.42)					
Increase (+)					
Reduction (-)					
Shares and other equity (F.5)					
Portfolio investments, net[2]					
Shares and other equity other than portfolio investments					
Increase (+)					
Reduction (-)					
Other financial assets (F.1, F.6 and F.7)					
Adjustments [2]	0	0	0	0	
Net incurrence (-) of liabilities in financial derivatives (F.34)					
Net incurrence (-) of other liabilities (F.5, F.6 and F.7)					
Issuances above(-)/below(+) nominal value					
Difference between interest (EDP D.41) accrued(-) and paid[4](+)					
of which: interest flows attributable to swaps and FRAs					
Redemptions of debt above(+)/below(-) nominal value					
Appreciation(+)/depreciation(-)[3] of foreign-currency debt [5]					
Changes in sector classification (K.12.1)[5] (+/-)					
Other volume changes in financial liabilities (K.7, K.8, K.10)[5](-)					
Statistical discrepancies					
Difference between capital and financial accounts (B.9-B.9f)					
Other statistical discrepancies (+/-)					
Change in general government (S.13) consolidated gross debt [1, 2]					

***Please note that the sign convention for net borrowing / net lending is different from tables 1 and 2.**

(1) A positive entry in this row means that nominal debt increases, a negative entry that nominal debt decreases.
(2) Consolidated within general government.
(3) Due to exchange-rate movements.
(4) Including capital uplift
(5) AF.2, AF.33 and AF.4. At face value.

Table 3B: Provision of the data which explain the contributions of the deficit/surplus and the other relevant factors to the variation in the government debt level and the consolidation of debt (central government)

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year 2006	2007	2008	2009	
Net borrowing(+)/lending(-)(EDP B.9) of central government (S.1311)*					
Net acquisition (+) of financial assets [2]	0	0	0	0	
Currency and deposits (F.2)					
Securities other than shares (F.3)					
Loans (F.4)					
Increase (+)					
Reduction (-)					
Short term loans (F.41), net					
Long-term loans (F.42)					
Increase (+)					
Reduction (-)					
Shares and other equity (F.5)					
Portfolio investments, net[2]					
Shares and other equity other than portfolio investments					
Increase (+)					
Reduction (-)					
Other financial assets (F.1, F.6 and F.7)					
Adjustments [2]	0	0	0	0	
Net incurrence (-) of liabilities in financial derivatives (F.34)					
Net incurrence (-) of other liabilities (F.5, F.6 and F.7)					
Issuances above(-)/below(+) nominal value					
Difference between interest (EDP D.41) accrued(-) and paid[4](+)					
of which: interest flows attributable to swaps and FRAs					
Redemptions of debt above(+)/below(-) nominal value					
Appreciation(+)/depreciation(-)[3] of foreign-currency debt [5]					
Changes in sector classification (K.12.1)[5] (+/-)					
Other volume changes in financial liabilities (K.7, K.8, K.10)[5](-)					
Statistical discrepancies					
Difference between capital and financial accounts (B.9-B.9f)					
Other statistical discrepancies (+/-)					
Change in central government (S.1311) consolidated gross debt [1, 2]					
Central government contribution to general government debt (a=b-c) [5]					
Central government gross debt (level) (b) [2, 5]					
Central government holdings of other subsectors debt (level) (c) [5]					

***Please note that the sign convention for net borrowing / net lending is different from tables 1 and 2.**

(1) A positive entry in this row means that nominal debt increases, a negative entry that nominal debt decreases.
(2) Consolidated within central government.
(3) Due to exchange-rate movements.
(4) Including capital uplift
(5) AF.2, AF.33 and AF.4. At face value.

Table 3C: Provision of the data which explain the contributions of the deficit/surplus and the other relevant factors to the variation in the debt level and the consolidation of debt (state government)

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year 2006	2007	2008	2009	
Net borrowing(+)/lending(-)(EDP B.9) of state government (S.1312)*					
Net acquisition (+) of financial assets [2]	0	0	0	0	
Currency and deposits (F.2)					
Securities other than shares (F.3)					
Loans (F.4)					
Increase (+)					
Reduction (-)					
Short term loans (F.41), net					
Long-term loans (F.42)					
Increase (+)					
Reduction (-)					
Shares and other equity (F.5)					
Portfolio investments, net[2]					
Shares and other equity other than portfolio investments					
Increase (+)					
Reduction (-)					
Other financial assets (F.1, F.6 and F.7)					
Adjustments [2]	0	0	0	0	
Net incurrence (-) of liabilities in financial derivatives (F.34)					
Net incurrence (-) of other liabilities (F.5, F.6 and F.7)					
Issuances above(-)/below(+) nominal value					
Difference between interest (EDP D.41) accrued(-) and paid[4](+)					
of which: interest flows attributable to swaps and FRAs					
Redemptions of debt above(+)/below(-) nominal value					
Appreciation(+)/depreciation(-)[3] of foreign-currency debt [5]					
Changes in sector classification (K.12.1)[5] (+/-)					
Other volume changes in financial liabilities (K.7, K.8, K.10)[5](-)					
Statistical discrepancies					
Difference between capital and financial accounts (B.9-B.9f)					
Other statistical discrepancies (+/-)					
Change in state government (S.1312) consolidated gross debt [1, 2]					
State government contribution to general government debt (a=b-c) [5]					
State government gross debt (level) (b) [2, 5]					
State government holdings of other subsectors debt (level) (c) [5]					

***Please note that the sign convention for net borrowing / net lending is different from tables 1 and 2.**

(1) A positive entry in this row means that nominal debt increases, a negative entry that nominal debt decreases.
(2) Consolidated within state government.
(3) Due to exchange-rate movements.
(4) Including capital uplift
(5) AF.2, AF.33 and AF.4. At face value.

Table 3D: Provision of the data which explain the contributions of the deficit/surplus and the other relevant factors to the variation in the debt level and the consolidation of debt (local government)

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year 2006	2007	2008	2009
Net borrowing(+)/lending(-)(EDP B.9) of local government (S.1313)*				
Net acquisition (+) of financial assets [2]	0	0	0	0
Currency and deposits (F.2)				
Securities other than shares (F.3)				
Loans (F.4)				
Increase (+)				
Reduction (-)				
Short term loans (F.41), net				
Long-term loans (F.42)				
Increase (+)				
Reduction (-)				
Shares and other equity (F.5)				
Portfolio investments, net[2]				
Shares and other equity other than portfolio investments				
Increase (+)				
Reduction (-)				
Other financial assets (F.1, F.6 and F.7)				
Adjustments [2]	0	0	0	0
Net incurrence (-) of liabilities in financial derivatives (F.34)				
Net incurrence (-) of other liabilities (F.5, F.6 and F.7)				
Issuances above(-)/below(+) nominal value				
Difference between interest (EDP D.41) accrued(-) and paid[4](+)				
of which: interest flows attributable to swaps and FRAs				
Redemptions of debt above(+)/below(-) nominal value				
Appreciation(+)/depreciation(-)[3] of foreign-currency debt [5]				
Changes in sector classification (K.12.1)[5] (+/-)				
Other volume changes in financial liabilities (K.7, K.8, K.10)[5](-)				
Statistical discrepancies				
Difference between capital and financial accounts (B.9-B.9f)				
Other statistical discrepancies (+/-)				
Change in local government (S.1313) consolidated gross debt [1, 2]				
Local government contribution to general government debt (a=b-c) [5]				
Local government gross debt (level) (b) [5]				
Local government holdings of other subsectors debt (level) (c)[5]				

***Please note that the sign convention for net borrowing / net lending is different from tables 1 and 2.**

(1) A positive entry in this row means that nominal debt increases, a negative entry that nominal debt decreases.
(2) Consolidated within local government.
(3) Due to exchange-rate movements.
(4) Including capital uplift
(5) AF.2, AF.33 and AF.4. At face value.

Table 3E: Provision of the data which explain the contributions of the deficit/surplus and the other relevant factors to the variation in the debt level and the consolidation of debt (social security funds)

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year 2006	2007	2008	2009	
Net borrowing(+)/lending(-)(EDP B.9) of social security funds (S.1314)*					
Net acquisition (+) of financial assets [2]	0	0	0	0	
Currency and deposits (F.2)					
Securities other than shares (F.3)					
Loans (F.4)					
Increase (+)					
Reduction (-)					
Short term loans (F.41), net					
Long-term loans (F.42)					
Increase (+)					
Reduction (-)					
Shares and other equity (F.5)					
Portfolio investments, net[2]					
Shares and other equity other than portfolio investments					
Increase (+)					
Reduction (-)					
Other financial assets (F.1, F.6 and F.7)					
Adjustments [2]	0	0	0	0	
Net incurrence (-) of liabilities in financial derivatives (F.34)					
Net incurrence (-) of other liabilities (F.5, F.6 and F.7)					
Issuances above(-)/below(+) nominal value					
Difference between interest (EDP D.41) accrued(-) and paid[4](+)					
of which: interest flows attributable to swaps and FRAs					
Redemptions of debt above(+)/below(-) nominal value					
Appreciation(+)/depreciation(-)[3] of foreign-currency debt [5]					
Changes in sector classification (K.12.1)[5] (+/-)					
Other volume changes in financial liabilities (K.7, K.8, K.10)[5](-)					
Statistical discrepancies					
Difference between capital and financial accounts (B.9-B.9f)					
Other statistical discrepancies (+/-)					
Change in social security (S.1314) consolidated gross debt [1, 2]					
Social security contribution to general government debt (a=b-c) [5]					
Social security gross debt (level) (b)[2, 5]					
Social security holdings of other subsectors debt (level) (c)[5]					

***Please note that the sign convention for net borrowing / net lending is different from tables 1 and 2.**

(1) A positive entry in this row means that nominal debt increases, a negative entry that nominal debt decreases.
(2) Consolidated within social security.
(3) Due to exchange-rate movements.
(4) Including capital uplift
(5) AF.2, AF.33 and AF.4. At face value.

Table 4: Provision of other data in accordance with the statements contained in the Council minutes of 22/11/1993.

Statement Number	Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year 2006 (1)	2007 (1)	2008 (1)	2009 (1)	2010 forecast
2	**Trade credits and advances (AF.71 L)**					
3	**Amount outstanding in the government debt from the financing of public undertakings**					
	Data:					
	Institutional characteristics:					
4	**In case of substantial differences between the face value and the present value of government debt, please provide information on**					
	i) the extent of these differences:					
	ii) the reasons for these differences:					
10	**Gross National Income at current market prices (B.5*g)(2)**					

(1) Please indicate status of data: estimated, half-finalized, final.
(2) Data to be provided in particular when GNI is substantially greater than GDP.

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European Commission

Manual on Government Deficit and Debt - Implementation of ESA95

Luxembourg: Publications Office of the European Union

2010 — 352 pp. — 21 x 29.7 cm

ISBN 978-92-79-13835-5
ISSN 1977-0375
Doi:10.2785/34596
Cat. No KS-RA-09-017-EN-N

Theme: Economy and finance

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