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Eurostat Guidance on accounting rules for EDP[1]

Classification of public holding corporations and their subsidiaries in national accounts

This note gives guidance on the appropriate accounting treatment under ESA 1995 and excessive deficit procedure (EDP) for the classification of public holding corporations and their subsidiaries, in the light of ESA 1995/SNA 1993 principles and rules and of the further elaboration of the Manual on Government Deficit and Debt (MGDD), with the aim to ensure an appropriate measurement of the government deficit and debt and the consistency of treatment across Member States.

I. The issue

1. During several EDP dialogue visits in different Member States, the question has emerged whether, in a group of public companies, a subsidiary or the holding corporation itself could be classified to different institutional sectors in national accounts.

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. Recent examples show that the question is not simply academic. In particular, public transportation and public infrastructure units often make losses and provide typical examples of possible borderline sector classification cases.

II. Accounting references

Holding corporations as institutional units

4. According to ESA 1995 paragraph 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,*

[1] This Guidance note is released under the responsibility of Eurostat. Member States have been consulted within the framework of the Financial Accounts Working Group (FAWG), where this Guidance note received broad support.

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.

5. ESA 1995 paragraph 2.13 (c): "*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.

6. 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?

Classification of the holding corporation

7. ESA 1995 paragraph 2.13 (e) 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*".

8. SNA 1993 paragraphs 4.36 and 4.37 also introduce the notion of holding corporations. The SNA 1993 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*." (SNA 1993 paragraph 4.36). The second type of parent company, called "holding company" or "holding corporation" in SNA 1993, 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*." (SNA 1993 paragraph 4.37). This may somehow give a more restricted notion of a holding company than ESA 1995 paragraph 2.13 (e).

9. Moreover, SNA 1993 paragraph 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.

10. The MGDD also mentions public holding corporations, quoting ESA 1995 paragraph 2.14. The MGDD emphasizes the role of public holding corporations in privatisation and their classification (see MGDD Part I. I.2.3.). If the public holding corporation is redistributing income and wealth, and "*if the major part of the public holding activity consists of acting for public policy purposes (privatising, supporting public enterprises), on behalf of the government*", the guidance in the MGDD is "*to classify the public holding inside the government sector, regardless of its legal status*." This case includes not only activities of simply channelling government funds through the holding corporation but also other activities such as when this company has a role of actively implementing public policies.

Classification of subsidiaries

11. According to ESA 1995 paragraph 2.13 (e) and SNA 1993 paragraph 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.

12. SNA 1993 defines the notion of subsidiaries in paragraph 4.32. Beyond this, SNA 1993 paragraph 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 which 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. 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, SNA 1993 explicitly says that subsidiaries – if they are not ancillary corporations – shall be assessed individually.

13. SNA 1993 paragraph 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 SNA 1993 paragraph 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.

14. The MGDD, part IV.3 *Sale and lease-back*, section 2.a, explicitly refers to these ancillary units provisions and indicates: "*The unit is created on purpose by government*: (…) *if its activity is only devoted to provide services to the government units which created it, it has to be considered as engaged in a kind of ancillary activity (see SNA 1993 paragraph 4.40-4.44 and paragraph 5.9-5.16). It is thus not considered as a unit which would be separate from its parent unit and no specific accounts have to be compiled for it*."

Notion of control

15. 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? ESA 1995 gives some guidance on this. ESA 1995 paragraph 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 fora and statistical or accounting manuals.

III. Analysis

Classification of the holding corporation

16. It may be useful to distinguish three cases.

Case 1. The holding corporation is purely a "shell", meaning that it has no genuine autonomy of decision and/or that it acts as a government agent (channelling subsidies etc.) in the group.

Case 2. The controlling corporation is a "mother" or "parent" company (and not merely a holding corporation), not only exercising effective control over its subsidiaries, but also having own production or other profit seeking activities (SNA 1993 paragraph 4.36.).

Case 3. The holding corporation is not a shell but is a real holding corporation, with staff and offices, whose main activity is exercising the management of the group (SNA 1993 paragraph 4.37.).

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

a. the "shell" is not a genuine institutional unit according to the ESA 1995 definition, and is instead an ancillary corporation providing services to the unit that controls it.

b. 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. See MGDD, part I.1, *Delimitation of the general government sector*: "*The sector S.13 includes all institutional units which are other non-market producers…and/or all institutional units principally engaged in the redistribution of national income and wealth.*", and part II. *Relations between the government and public enterprises*, especially II.2, the case where a public unit is engaged in a *"type of activity that should be regarded as a management of assets for public policy purposes, taking place on behalf of the government*".

Standard government activities (e.g. taxation, distributing subsidies) performed by a market body as a secondary activity would generally not lead to the unit being classified as non-market; instead the government activity can be rearranged through the government accounts.

c. the "shell" is an institutional unit but it is acting on behalf of government, such as in the case of privatization agencies (MGDD, part I.1 *Delimitation of the general government sector*, section 3.2).

d. it fails the market test.

18. 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.

19. 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 ESA 1995 paragraph 2.23 (e) (non-financial corporations) and paragraph 2.40 (e) (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"*.

Classification of subsidiaries

20. 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.

21. 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.

22. If the subsidiary of a public holding corporation is recognized 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.

23. 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 ESA 1995 paragraphs 1.38-1.41.

Equity liability of government

24. 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 recognizing 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.

25. 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.

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

IV. Guidance

27. Eurostat recommends classifying holding corporations according to their nature. When the holding corporation is a shell or acts as a government agent (such as a privatization agency), it should be classified inside government (Case 1). 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 assessment criteria (Case 2). When the holding corporation is none of the above, but is a genuine holding corporation, its market/non-market classification should be assessed at the group level (Case 3).

28. 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 recognizing equity liabilities of general government. Accounts of subsidiaries not being institutional units, such as ancillary units, should be combined with the corporation that controls them.

Eurostat Unit C.3