EUROPEAN COMMISSION
EUROSTAT

Directorate D: Government Finance Statistics (GFS) and quality

27 November 2014

Eurostat Guidance Note

TREATMENT OF CLAW-BACK CLAUSES IN THE SALES OF ASSETS BY GOVERNMENT IN NATIONAL ACCOUNTS (ESA 2010)

Executive Summary

This note provides guidance on the treatment of claw-back clauses which can be observed in contracts of sales of assets by government units. Such clauses entitle a government, over a pre-determined period, to receive all or part of the proceeds resulting from the subsequent resale of assets by the initial purchaser.

The existence of claw-back clauses should not, as such, be sufficient to consider that a sale has not effectively taken place. This note defines the circumstances in which claw-back clauses in sale contracts would prevent the recognition of a "true sale" (a transfer of economic ownership) in national accounts.

The note defines as well the recording of the proceeds transferred to government in case the claw back clause is activated (if the purchaser resells the asset).

Under certain conditions, discussed in the note, the proceeds from the subsequent resale of assets with a claw-back clause can be recorded in government accounts as a capital transfer with a positive impact on government net lending/borrowing. However, in other cases, the proceeds from the resale are to be treated as a financial transaction with no impact on government net lending/borrowing.

1. Introduction

In some contracts concerning the sale of assets by government units, there may be specific "claw-back" clauses which, during a pre-determined period of time, allow the selling unit the right to all or to part of the proceeds which the buyer of the assets from government could make in case of resale of the asset, at its own initiative. The proceeds would be equal to the difference between the new and the initial selling price. However, contracts frequently

foresee that any cost which would have resulted from a refurbishment expenditure on the asset made by the purchaser from government, would be deducted from such proceeds.

Such claw-back clauses generally relate to assets having particular features – it is frequent that the new purchaser has the obligation to undertake work either for facilitating its own activities, or in order to be in a position to resell these assets more easily. Some refurbishment expenditure may also result from the poor condition of the assets due to insufficient maintenance in the past.

The claw-back clauses are notably, but not exclusively, observed in the case of sales of real estate assets. When it comes to financial assets, such clauses seem to be rather exceptional. They are observed only in the cases involving the privatisation of public corporations when governments, for various reasons, require the new shareholders to hold a specific equity stake, at least during a pre-determined period. Although their frequency, nature and extent vary significantly across the EU Member States, claw-back clauses are generally justified by governments because of the uncertainty on the valuation of some assets, which can be due to specific architectural features, constraints on the use of the assets, geographical reasons, etc. In such cases, the gap between the common methods[1] for determining the value of the asset could be relatively wide, notably in the case of real estate.

In addition, the market for such government assets (particularly when they have been designed for specific public use) is generally very narrow, which might lead to significant volatility of their price even over a short period. When markets are not very deep and liquid, the notion of an exact market price could be in itself questioned[2].

The existence of a claw-back clause in a sale contract indicates that the government, either wants to avoid the risk of not receiving an appropriate price at the time of sale, or wants to take a share of any additional proceeds which could be realised from future sales of the asset in the future should the price of the asset increase considerably over time.

In some cases, Courts of Auditors and/or Parliamentary reports have strongly recommended, if not imposed, the inclusion of claw-back clauses in some sale contracts, as there have been cases where there was a significant increase in the price of an asset when a resale transaction was carried out a few years after the initial sale by the government.

2. Applicable rules in ESA 2010

It might be argued that the sale of assets with claw-back clauses does not comply with one of the basic principles in national accounts, that is, that the sale of an asset is an outright transaction which implies that all risks and rewards are definitively (and irrevocably) transferred from one agent to another.

[1] Valuations assessments based on costs, sale comparisons, income capitalisation approaches, etc.

[2] Assets may not be homogenous and therefore not substitutable, so that each transaction would show an intrinsic significant "singularity" component. There is frequently, in this regard, a difference between non-financial and financial assets. For financial assets, prices are usually regularly observable, transactions are easily undertaken, transaction costs are low, etc. In addition, for financial assets, a "fundamental value" can be assessed with a certain degree of reliability. On the other hand, the valuation of some non-financial assets may be less precise. Finally, the risk of change in valuation for non-financial assets cannot be usually hedged through various types of derivatives.

ESA 2010 7.16 specifies that "*the economic benefits consist of primary incomes such as operating surplus, where the economic owner uses the asset, or property income, where the economic owner lets others use it. The benefits are derived from the use of the asset and the value, including holding gains and losses that are realised by disposing of the asset or terminating it*".

In addition, ESA 2010 7.17 states that "*the economic owner is the institutional unit entitled to claim the benefits associated with the use of the asset by virtue of accepting the associated risks*".

From this, it could be inferred that if, after the sale of the asset with a claw-back clause, the acquiring unit (purchaser) is not in the position to dispose of the asset at its own initiative and gain the full benefit in terms of bearing all the rewards associated with the further resale of the asset (or if the asset is excluded from the net assets in case of liquidation), the economic ownership is deemed to remain in the balance sheet of the previous asset owner (in this case, the government).

The issue here is the degree to which the above arguments could apply to those cases where the contract requires that a part of the proceeds from a possible resale (or even the whole amount) are to be returned to the original seller (the government).

Another possible issue with claw-back clauses is that their existence can be seen as evidence of the government's worry that it might not have carried out the transaction under the best conditions and that it would like, therefore, to share the possible future profits resulting from the resale of the asset.

However, in general the seller of the asset can never be fully sure that it has received a good price at the moment in which it decided to dispose of the asset. Market conditions change with time and this is an intrinsic feature of market economies.

It should also be underlined that the party acquiring the asset is fully aware, at the time of purchase, that an existing claw-back clause could limit its potential future proceeds in case of resale.

3. Treatment of the initial sale of assets with the claw-back clause

If government maintains an "interest" in the asset after its transfer to the other unit, the initial sale of the asset by the government may not be recognised as a "true sale" of a non-financial asset[3] in national accounts, meaning that the actual transfer of economic ownership did not take place. In this case, there is no negative gross fixed capital formation (GFCF) recorded for government and thus no impact on government net lending/borrowing (B.9).

However, the existence of claw-back clauses should not, as such, be sufficient to consider that a sale has not effectively taken place. This is because the "market paradigm" is not applicable in all cases. There are imperfections and shortcomings in the functioning of markets (notably as far as price setting is concerned) for some (specific) non-financial assets.

[3] This section is not relevant for financial assets, for which the sale never has an impact on government net lending/borrowing (B.9). However, in some cases, the proceeds of the sale of financial assets could first be recorded as other accounts receivable (F.89), if the full economic ownership of the asset was not transferred at the same time.

It also must be stressed that the size of the potential complementary proceeds may be variable, either because the contract could stipulate that a rather small proportion of the proceeds be returned to the government, or because the proceeds may be small compared to the original price.

Nevertheless, there are some circumstances in which claw-back clauses in sale contracts prevent the recognition of a "true sale" (a transfer of economic ownership) in national accounts. In this case, the amount received by the government is recorded as borrowing under loans (AF.4). The sale will be recognised, and thus the loan reimbursed, in case of activation of the claw-back clause (for the initial amount plus the additional payment) or when the claw-back clause expires. The value of the asset has to be adjusted through the revaluation account.

Any of the following features should be considered as sufficient to indicate that a true sale (i.e. transfer of economic ownership) has not taken place:

1. The government has the right to the proceeds generated by the possible future rental of the asset by the purchasing unit or from any other arrangement;

2. The government holds a call option allowing it to repurchase the asset at a pre-agreed price;

3. The government still uses all, or part of the asset, after the sale (notably through lease-back agreements);

4. The government is involved in the financing of any refurbishment operation;

5. The government has a direct or indirect say in the resale decision (notably in cases where the purchaser is a public entity), particularly as regards its timing and/or the sale price agreed with the new purchaser;

6. The original sale price included in the contract has not been assessed by a full independent body on the basis of common business valuation methods.[4]

4. Recording of the claw-back clause after the initial sale

At inception (the moment of the original sale), there is uncertainty about the future existence of actual proceeds of the new sale (if any) to be given back to the government. Due to the fact that such future proceeds are triggered by an event which is not certain, the claw-back clause should be considered as a contingent asset (see ESA 2010 5.08), as long as the claw-back clause is in force and/or there is no resale by the original purchaser of the asset.

[4] In the context of securitisation arrangements undertaken by government, Eurostat decided, in 2007 (see also the Manual on the Government Deficit and Debt chapter V.5 Securitisation operations undertaken by general government), that the existence of a Deferred-Purchase-Price (difference between the market value and the transaction price, with the aim to mitigate the risk borne by the unit acquiring the asset) prevented considering the transaction as a "true sale". In the case of claw-back clauses, on the contrary, the price must not be deliberately set below the estimated market value, while the new owner of the asset would be fully affected by any losses resulting from a resale at a lower price than the original one.

Contingent assets are not recognised in national accounts, in the sense that they are not included in balance sheets under the ESA framework. They may, however, be recognised as financial assets, under the category of financial derivatives, but only if they are transferable and if it is possible to make a reliable valuation (ESA 2010 5.10 (b)).

5. Treatment in the case of activation of the claw-back clause

If the asset is resold before the extinction of the claw-back clause and at the same time the original sale of the asset by the government was treated as a true sale in national accounts, the issue is to determine how to record the possible proceeds paid back to the government, i.e. whether they should be recorded as a non-financial or financial transaction.

First of all, it is not possible to record the supplementary sale of the non-financial asset in capital accounts, because, at the time of the resale, the government is no longer the economic owner of the asset.

Secondly, recording the amount paid back to the government as a tax is not appropriate. Although it could be possibly argued that this is a kind of exceptional tax on profits related to the sale of an asset, a capital tax, or a tax on a specific transaction, it would not meet the normal features of a tax, according to the national accounts concepts.

Finally, it seems inappropriate to consider that government holds some kind of non-financial non-produced asset representing the right to receive possible (contingent) supplementary proceeds. First of all, it would be difficult to identify in which category of ESA 2010 assets this could be included. Furthermore, and more fundamentally, such an asset is not transferable (and it would be also difficult to make a reasonable estimate of its value).

The proceeds paid back to government should, therefore, be recorded as a capital transfer (D.9), although the transfer in this case is not undertaken on a voluntary basis but due to a contractual obligation of the new owner which had previously (voluntarily) agreed to transfer part of the proceeds in case of a resale of the asset, through a claw-back clause, during a determined period.

ESA 2010 4.165 (g) specifies that other capital transfers (D.99), include "*that part of realised capital gains (or losses) which is redistributed to another sector.*"

Thus, the proceeds from the resale of an asset with a claw-back clause received by government may have an impact on government revenue at the time the resale takes place, improving the government's net lending/borrowing (B.9), but only when they originate from a resale of non-financial assets, such as real estate. Any proceeds resulting from a resale of a financial asset would be considered as having the same (financial) nature as the initial transaction (although in another financial asset category).[5]

[5] The transferability of a financial asset is normally easier than for a non-financial asset, due to the frequent existence of accessible markets on which prices are regularly observed. Such a clause would indicate that the financial asset had not been sold deliberately at its market price. The number of transactions of an asset may be very high and, thus, the activation clause would be more likely in the short term. Moreover, transactions concerning financial assets have no impact on government net lending/borrowing (B.9) and it would not be appropriate if, at later stage, due to the existence of a claw-back clause, part of the proceeds of a financial transaction would be treated as government revenue.

However, the proceeds of a resale of a non-financial asset for which a claw-back clause has been initially agreed with a public entity, are treated as a case of indirect privatisation, i.e. all such proceeds will be recorded as a withdrawal of equity (F.5) in the financial accounts.

This should also apply in cases when the public corporation has been privatised (i.e. no longer under government control) since the original sale of the asset (provided that the clause has not been cancelled)[6]. In addition, one can argue that, due to former government control, the public entity could have had less freedom to agree on the clause than a private purchaser.

6. Conclusions

The sales of assets by government units in the context of contracts with claw-back clauses are recognised in national accounts as "true sales" (i.e. as an actual transfer of the economic ownership) only if some conditions are met. In case of a sale of a non-financial asset, this means that a positive impact is recorded on the government net lending/borrowing (B.9) (negative GFCF). However, when the conditions are not met, the transaction is treated as government borrowing.

When the clause is “activated”, the government is entitled to receive some proceeds from the subsequent resale of the non-financial asset (initially sold by the government). A capital transfer (D.99) with a positive impact on government net lending/borrowing (B.9) could be recorded in government accounts, but only in case of a resale of non-financial assets.

When the original sale was not regarded in national accounts as a true sale and thus booked as government borrowing, the sale will be recognised (and thus the loan reimbursed), either when the claw-back clause is activated (for the initial amount plus the additional payment) or when the claw-back clause expires.

Finally, if the original purchaser of the government asset was a public entity, any proceeds from a resale of this asset, which are returned to the government, are to be treated as a withdrawal of equity (F.5), with no impact on government net lending/borrowing (B.9).

[6] See the Manual on Government Deficit and Debt, Part V, Sale of assets, and, in particular, chapters V.2 Sales of financial and non-financial assets and V.3 Privatisation proceeds from public corporations.