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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 the European Commission, particularly its statistical aspects. Eurostat has endeavoured to guarantee a proper application of the conceptual reference framework, the European System of Integrated Economic Accounts (ESA, second edition), in order to obtain reliable and comparable statistics for evaluating convergence. 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, which is legally binding in the European Union. The aim of the present manual is to aid its application for calculating the government deficit and debt. It provides the appropriate answers to most of the statistical and accounting problems posed in the European Union during the last years.

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 (Eurostat and 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 critical. We are most grateful to them.

Having received the approval of the Statistical Programme Committee (CPS) and Committee of Financial, Monetary and Balance of Payments Statistics (CMFB), this manual is an indispensable complement to ESA95 and SNA93. 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. It has also contributed to discussion of the IMF's government finance statistics (GFS), whose present revision has brought closer to the SNA concepts.

This second edition is an important update of the manual (first edition: January 2000), enriching Part II (Privatisation in transition countries, debt rescheduling), Part IV, now entitled "Leases, licences and concessions" (including an overview of this type of transactions) and Part V (Addendum on government debt).

Now an official Eurostat publication, the ESA95 Manual on Government Deficit and Debt (second edition) will therefore be available to a wider audience, eager to understand the accounting treatments made by European statisticians in the field of government finance.

30 April 2002

Bart MEGANCK
Director

TABLE OF CONTENTS

PART I

Delimitation of the general government sector

CONTENTS

I.1 Criteria for the classification of units inside the general government sector

1. The content of the general government sector

This summary indicates the steps to be followed in order to decide if an entity is to be included in the general government sector.

1.1. Is the entity an institutional unit?

Sectorization decisions must be taken at the level of institutional units, defined in the system as units having autonomy of decision and a complete set of accounts. Producers that are not institutional units must be classified in the institutional sector to which the unit which controls them belongs. Therefore, public producers not recognised as independent legal entities are to be included in the general government sector except if they can be recognised as quasi-corporations (i.e. market entities keeping a complete set of accounts and whose economic and financial behaviour is similar to that of corporations).

1.2. Is the institutional unit private (e.g. not controlled by the general government) or public (e.g. controlled by the general government)?

Control, defined as the ability to determine general policy, is an essential criterion for sectorization. Private producers are found in all sectors, except the sector general government. In contrast, public producers are found either in the corporations sector (if they are market) or in the general government sector (if they are non-market). The sectorization of non-profit institutions (NPIs) constitutes a particular case: to be considered as public, a NPI must be both controlled and mainly financed by the general government.

1.3. Is the public institutional unit market or non-market?

When the principal function of the public institutional unit is the redistribution of national income and wealth, this unit is to be classified in the general government sector. However, when the principal function of the public institutional unit is financial intermediation, the unit is to be classified outside the general government sector, in the financial corporations sector.

In other cases, it is necessary in deciding the sector to which the public institutional unit should be allocated to check if this unit is market or non-market: in other words, are more than 50% of production costs covered by sales, or not?

The general government sector only includes 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.

2. The definition of the general government sector

The sector general government (S.13) 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.

a) General government entities (excluding 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 sectors) 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.

The general government sector comprises four sub-sectors:

a) central government (S.1311);
b) state government (S.1312);
c) local government (S.1313);
d) social security funds (S.1314).

According to this definition, 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

3. Concept of institutional unit

3.1. The rules

ESA95 paragraph 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.

3.2. Implementation of the rules

When a public unit, by virtue of special legislation, is recognised as an independent legal entity, it can be considered as an institutional unit, to be classified in the general government sector, if it is a public non-market institutional unit.

The general government sector also includes 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) it has to be combined with the institutional unit into whose accounts its partial accounts are integrated.

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.

However, a particular case occurs with entities which keep a complete set of accounts, have a market activity and whose economic and financial behaviour is similar to that of corporations. Such entities are deemed to have autonomy of decision and are to be classified, outside the general government sector, in the corporation sector as quasi-corporations.

4. Concept of public institutional unit

4.1. ESA rules

A public producer is a producer that is controlled by the general government. In the case of NPIs, a public producer is an NPI that is controlled and mainly financed by the general government. All other producers are private producers.

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.

Owning more than half the shares of a corporation are a sufficient, but not a necessary, condition for control. In addition, government exercises control over a corporation as a result of special legislation decree or regulation that empowers the government to determine corporate policy or to appoint the directors.

4.2. Implementation of the rules

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. 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.

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.

4.3. Example of schools

The general government controls a school if its approval is needed for creating new classes, making significant investments in gross fixed capital formation or borrowing; or if it can prevent the school from ending its relationship with government.

However, the 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).

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

According to the ESA95 definition of government, public institutional units which either redistribute national income and wealth or are non-market producers should be classified in the general government sector. To the extent that a decision can be made on the market/non-market nature of the activities of a public producer, this producer can be classified in the corporate sector or in the general government sector. An exception is the case of producers recognised as financial intermediaries, which must be classified in the financial corporations sector, and not in the general government sector.

5.1. The concept of "economically significant prices"

Both in the SNA 93 (paragraphs 6.45 and 6.50) and the ESA95 (paragraph 3.19), the distinction between market and non-market producers depends on whether or not prices charged 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.

Once a decision has been taken on administrative, social or political grounds about the total amount of a particular non-market good or service to be supplied, its price is deliberately fixed well below the equilibrium price that would clear the market.

The difference between a price that is not economically significant and a zero price is, therefore, a matter of degree. The price merely deters those units whose demands are the least pressing without greatly reducing the total level of 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.

Moreover, the ESA95 provides additional rules for the distinction between market and non-market producers.

5.2. The 50% rule

In the ESA95, the concept of economically significant prices is implemented on the basis of a 50% criterion: are more than 50% of production costs covered by sales?

In distinguishing market and other non-market producers by means of the 50% criterion, “sales” and “production costs” are defined as follows:

a) “sales” cover the sales excluding taxes on products but including 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.

5.3. The borderline between taxes and sales of services by general government

- The payments should be treated as sales of services by general government if general 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 clearly in proportion to the cost of providing the services.

According to ESA95 conventions, this is considered the case for driving or pilot’s licences, television or radio licences, firearm licences, museum or library admissions, garbage disposal fees.

- The payments should be treated as taxes if either of the two above conditions is not satisfied.

According to ESA95 conventions, this is considered the case for licences on the ownership or use of vehicles, boats or aircraft, and licences to hunt, shoot or fish.

5.4. Implementation of the 50% rule

If mainly financed by households, employers and private insurance companies, the public institutional unit is market and has to be classified as a public corporation.

If mainly financed by the general government according to its costs or to global budget negotiations focussing on several factors (final output, maintenance of building, 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.

In other cases, the sector classification of the public institutional unit will depend on the treatment given in the application of the 50 % rule to payments from the general government according to the actual services provided in the period by this unit. The unit will be market and classified as a public corporation if these payments are considered as corresponding to sales, and the unit will be non-market and classified in the general government sector if these payments are not considered as corresponding to sales.

In order to check the nature of these payments, it could be useful to verify if, additionally to these payments, the general government systematically covers any important deficit of public units.

Payments from general government to public institutional units in respect of actual services provided are to be treated as corresponding to sales in the implementation of the 50% rule when prices are economically significant, e.g. 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 the following: 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 a coverage of costs) in order to have a significant economic influence on the supply and on the demand.

For example, the general government can want, through prices paid for the different services, to incite public units to develop specific services that correspond to public priorities.

The price received from the general government is economically significant from the public producer's point of view if this public producer is only financed according to the volume of output it provides. Then the public producer is acting as a business subject to market forces: its remaining deficit should not be automatically covered and the logic of this situation is to close public units which can not survive on these terms.

Payments from general government to public institutional units in respect to actual services provided are not to be treated as corresponding to sales in the implementation of 50% rule when prices are not economically significant, e.g. in the following two cases:

- When prices paid by the 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 receiving such payments or do not accept to provide services on these terms, and therefore, for the same service and the same quality), 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 placed vis-à-vis the market in a position similar to what could be the position of a private unit, because the general government tends anyway to cover its remaining deficit. Therefore, the global amount of payments from the general government to the public unit remains in fact linked to the costs. In this situation, the general government decides to finance the public units in respect to 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.

5.5. Application to hospitals

Eurostat 1999 “Survey on the sector classification of public hospitals and homes for elderly in ESA95” revealed 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.

6. Key-words and references

Transaction on behalf of another unit	ESA95, §1.41
Institutional unit	ESA95, §2.12
Quasi-corporation	ESA95, §2.13f
Holding corporation	ESA95, §2.14
Market regulatory organisation	ESA95, §§2.21, 2.69
Financial intermediation	ESA95, §§2.32 to 2.38
Pension fund	ESA95, §2.64
Social security fund	ESA95, §2.74
General government sector and sub-sectors	ESA95, §§2.68 to 2.74
Control	ESA95, §§2.26 and §§3.28 to 3.29
Economically significant price	ESA95, §3.19
Non-profit institution	ESA95, §3.31
Market/non-market	ESA95, §§3.27 to 3.45
Market output	ESA95, §3.17
Non-market output	ESA95, §3.23
Public/private producer	ESA95, §§3.28, 3.29
Social insurance scheme	ESA95, §§4.88 to 4.90

I.2. Specific units

1. Pension funds

1.1. New rules of classification

In the ESA 79 as in the ESA95, non-autonomous pension funds are not institutional units and remain part of the institutional unit that sets them up.

The change in the ESA95 occurs for the classification of pension funds which are institutional units. In the ESA 79, they are to be classified in the sector insurance enterprises if for each insured person the premium is proportional to the risks, and in the sub-sector social security funds if this proportionality does not exist.

In the ESA95, the borderline between the sub-sector Insurance corporations and pension funds (S125) and the sub-sector Social security funds (S1314) is changed. According to ESA95 (paragraph 2.74), the sub-sector Social security fund includes units which fulfil each of the two following criteria:

a) By law or by regulation certain groups of the population are obliged to participate in the scheme or to pay contributions;

b) 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."

Those two requirements, which have a typical institutional character, replace the ESA79 criteria of non-proportionality, which just becomes an indication for classification. ESA95 (paragraph 2.74) adds: "There is usually no direct link between the amount of the contribution paid to an individual and the risk to which that individual is exposed".

Social insurance schemes organised by government units for their own employees are classified as private funded schemes or unfunded schemes as appropriate and not as social security funds. If the general government creates an autonomous pension fund for its own employees, this fund will be classified outside the general government sector.

If an institutional unit of the general government creates a non-autonomous pension fund, this fund is not an institutional unit and should be included in the relevant sub sector (central, state or local) of the general government sector. However, as in the case of autonomous pension funds, the assets should be treated as reserves that belong to the beneficiaries and not to the general government. The most common case is unfunded social schemes operated by the general government, which pays social benefits to its employees, ex-employees or their dependents out of its own resources.

1.2. Practical implications

Concrete examples of pension funds being classified in the insurance sector (according to ESA 79) which are now to be classified in the social security fund sector could not be provided, as all schemes managed by the general government are on a pay-as-you-go basis.

On the contrary, examples of pension funds classified in the social security funds (according to ESA79) which are now to be classified in the sub-sector Insurance corporations and pension funds (S.125) could be provided. In Italy, many units managing supplementary insurance are concerned, since they are not obligatory (so they do not fulfil the first criteria needed in the ESA95 to be classified as social security funds).

In the Netherlands, early retirement funds are concerned, since they are not managed by the general government but at a branch level in respect of the settlement or approval of the contributions and benefits (so, they do not fulfil the second criterion needed in ESA95 to be classified as social security funds).

2. Units engaged in financial activities

The content of this paragraph applies only to public units, since only those may be classified in the general government sector.

Units principally engaged in financial intermediation and/or in auxiliary financial activities are to be classified in the sector financial corporations S.12 (ESA95, §2.32)

Units engaged in financial intermediation, as defined in ESA95, §2.32 to 2.35, are to be classified in the sub-sectors S.121 (Central bank), S.122 (Other monetary and financial institutions), S.123 (Other financial intermediaries, except insurance corporations and pension funds) and S.125 (Insurance corporations and pension funds).

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).

The Monetary Financial Institutions (MFIs) comprise the sub-sector S.121 and S.122, and coincide with the Monetary Financial Institutions for statistical purposes as defined by the European Central Bank (list of MFIs in the European Union and institutions subject to the Eurosystem's minimum reserve system).

Units engaged in auxiliary financial activities, as defined in ESA95 §2.39, are to be classified in the sub-sector S.124 (Financial auxiliaries).

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 might be useful 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.

Then, sales to be compared with production costs would include commissions and FISIM (as defined in ESA95, §3.63j).

When a unit, which is engaged in financial activities, is classified as another non-market producer, then no FISIM has to be calculated. The output of this government unit is calculated as the sum of the production costs.

3. Public holdings

3.1. The rules

ESA95 paragraph 2.14 defines holding corporations as institutional units whose main function is to control and direct a group of subsidiaries.

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 respectively the production of non-financial services and financial intermediation or auxiliary financial services.

3.2. Implementation of the rules

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

Government may transfer the legal ownership, total or partial, it has of some public corporations to special public bodies created for the purpose. These bodies may have, but not necessarily, the legal status of corporations.

Can such bodies be considered as public holdings as defined in ESA95?

First, they should be institutional units, and therefore act in their own right, and not on behalf of government, in respect of the assets the legal ownership of which has been transferred to them.

Secondly, they should have an effective control and direction of the public enterprises.

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

- è For a restrictive purpose: for instance, to reorganise, even in the optimal conditions, the disposal of the ownership of the public corporations;
- è For a limited period of time.

Concerning the actual control of the public corporations of which the legal ownership has been transferred to the above-mentioned bodies, it is necessary that the appointment of the public corporations' directors are made by the bodies themselves, and not by government. Moreover, the decisions of the – total or partial – disposal of the ownership of public corporations and of equity injections in some of the public corporations have to be directly taken by these bodies' directors and not by the general government itself.

It should therefore be considered that units created in a privatisation process to hold shares in public enterprises 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 enterprises whose assets they hold, but just act in financial markets.

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 paragraph 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.

4. Government debt management offices

When debt management offices are institutional units, they should be classified in the general government sector as they act on behalf of general government (§1.41).

5. Market regulatory agencies acting on behalf of the European Community (EAGGF etc.), or other units having both a market and a redistribution activity

5.1. The rules

According to ESA §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.

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).

5.2. Implementation of the rules

Market regulatory agencies may be engaged in mixed activities, that is to distribute subsidies and to buy, hold and sell agricultural and other food products. In such cases, it should be examined if the agency can be divided into two distinct institutional units:

- è One institutional unit being in market intervention activities, classified in the non-financial corporations sector;
- è A second institutional unit distributing subsidies, classified in the general government sector.

If it is not possible to distinguish two separate institutional units, the criterion of “principal activity” has to be made operational. The operational rule is the following:

By convention, these units should be classified in the sector general government if their costs incurred in market regulation compared to the total costs are less than 80%, and in the sector non financial corporations if their costs incurred in market regulation 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, that is as the sum of intermediate consumption, compensation of employees, consumption of fixed capital, and other taxes on production less other subsidies on production.

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

- è It is difficult to imagine that a corporate enterprise (market producer) distributes subsidies;
- è In many cases the agency forms part of or are closely linked to a Ministry, and its staff is composed of civil servants;
- è In the context of the new Common Agricultural Policy the relative importance of subsidy distribution has become greater than the market intervention activity (to buy, to hold, and to sell agricultural goods);
- è A treatment ensuring stability over time for the classification of market regulatory agencies is needed.

5.3. Generalisation of the operational rule (80% convention)

Such a rule could be extended to other units having both a market and a redistribution activity.

PART II

Relations between the government and public enterprises

CONTENTS

II.1 OVERVIEW OF PRINCIPLES

II.1.1 General principles

1. Identifying the Government's role in the transaction

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.

- **supporting economic activity and social policy[1]:**
  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 disposals to fund more activity elsewhere.

- **managing its budget:**
  levying taxes and social contributions;
  carrying out transactions associated with pension obligations.

In borderline cases, when determining the classification of a transaction, it is necessary to consider which role the government is playing in the transaction. In some cases more than one 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.

[1] Sometimes quoted as "acting for public policy purposes" (see definition in footnote 7 in II.2.2)

2. Reporting economic reality over legal form

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 economic flow, and to report the economic reality. This can apply both to the classification of units and to the classification of flows. SNA93 chapter III part C discusses the question. 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; securitizing 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 II.5.2 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 re-routing) 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. Re-routing 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, or to fund loss making activities within the unit under the instructions of government as part of its economic and social policy. In these cases the payments re-routed through government are shown to be funded by payments from the public unit to government in respect of the indirect privatisation. Section II.2.2 discusses this.

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.
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.

3. Consistency

The ESA95 is an integrated system of flows and stocks accounts, aiming to ensure consistency of the whole system.

Consistency is one of the eight characteristics of the system, highlighted in ESA95 chapter one (§1.05). Indeed, §1.08 underlines the fact that internal consistency of the system is a condition to calculating relevant ratios, and gives the example of « government deficit and debt as percentages of gross domestic product ».

Two important features of this consistency requirement (in the context of an integrated system of flows and stocks accounts) should be emphasised:

1. Accounting consistency:

Transactions between two units – and between two sectors - have to be recorded in the same way, according to the same rules.

For instance, interest (D.41) must be recorded on an accruals basis in both the accounts of the debtor (government for instance) and those of the creditor sectors (financial institutions, households etc.).

2. Economic consistency:

When transactions are set-up in such a way that the legal appearance contradict the economic reality (the real economic effect of the transactions), it is preferable to report in national accounts the economic reality[2].

Indirect privatisation is a good example: an indirect sale of financial assets has the same effects on the government national accounts as a direct one and therefore must be recorded as a financial transaction[3].

In the same line of reasoning, ESA95 states that « some transactions are rearranged in order to bring out the underlying economic relationships more clearly » (possible consequences: re-routing of transactions, partitioning of units etc.).

[2] The general principle, according to which the economic and financial significance of a transaction should overcome misleading or tricky legal arrangements when determining the relevant accounting classification, is quoted in several micro-economic accounting manuals including the IASC (International Accounting Standards Committee, norm 1). This is *a fortiori* relevant in national accounts that aim to produce macro-economic significance (see also « Reporting economic reality over legal form »).

[3] The other reason is that the public holding company which gives to its owner – the government – the proceeds of the sale of public financial assets has been involved, in this process, in a partial liquidation of its assets and equity (see II.2.1: « Treatment of receipts resulting from direct and indirect sales of financial and non-financial assets »).

Limits of consistency/Possible sources of « inconsistency »

Two major factors may contradict this requirement for consistency when assessing the government deficit:

1. Financial assets versus non-financial assets

Given that, in the Protocol on the excessive deficit procedure, the deficit has been defined as the net borrowing of the general government sector, there is an asymmetry in statistical treatment between non-financial assets and financial assets.

Changes in non-financial assets (when due to transactions) are recorded in the capital account. Therefore, they modify the net borrowing/net lending, which is the balance of the capital account. On the other hand, changes in financial assets – recorded in the financial account - do not modify this balance (except for one-way changes like debt assumption and debt cancellation, when the change in liability is balanced by a capital transfer).

The consequence is particularly severe in the case of sale of non-financial assets, whether or not they are operated in a direct or in an indirect way (see II.2.1: « Treatment of receipts resulting from direct and indirect sales … »):

- A direct sale of a non-financial asset improves the net borrowing/net lending of general government, through a decrease of gross fixed capital formation (GFCF).

- Indirect sale of non-financial assets: the sale improves the net borrowing/net lending of the public holding company, but the payment of the proceeds (liquid assets – F.2) to government is a financial transaction (withdrawal of equity), a partial liquidation of assets of the holding company.

Apparently inconsistent – and really asymmetrical - in its consequences on government deficit, this treatment of the indirect sale is nevertheless logical: when giving to the government the liquid assets resulting from the sale, the public holding company reduces its assets, and is in effect partially liquidated. The assets of an enterprise cannot be distributed as income to its owners (see in this chapter: « the notions of income and dividends »), in accordance with the basic principles of wealth/company accounting, and in particular the principle of « continuity of the enterprise ».

2. The specific nature of government

Some activities are undertaken by government and never by market units: government does not act only as a manager of assets. It may also support economic activity and seek to meet social objectives (see in this chapter: « Identifying the government's role in the transaction »). The government is the only agent in a position to make massive transfers to other agents of the economy.

This might contradict a recording of flows to public enterprises and from public enterprises, for instance, in a totally symmetrical way. For example, an unrequited payment recorded as « investment grant » (« 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).

4. Notions of income and dividends

a. The notion of income

In the national accounts system, the concepts of income and saving are derived from productive activities. It means that holding gains, whether realised or not, are always excluded from income and saving: they are recorded in a specific accumulation account, the revaluation account.

Moreover, SNA93 makes an explicit link with the concept of income in the economic theory (§8.15): «[...] Income is often defined as the maximum amount that a household, or other unit, can consume without reducing its real net worth ».

In other words, it is understood that streams of payment made by an enterprise to its owners from its income should keep its net assets (or net wealth) constant.

Some consequences:

- Corporation sector: see b. « the notion of dividend »;
- Government sector: privatisation receipts, for instance, are not an income of government, but the proceeds of the sale of financial assets. This is a financial transaction (see II.2.1.);
- Household sector: sometimes, for assessing household's wealth, a broader concept of income is referred to. This broader concept interprets the above-mentioned sentence (« the maximum amount that a household can consume … ») in such a way that real holding gains would be included, when assets price (net) has increased more than the general price level.

Dealing with the relation between government and public corporations in the context of the excessive deficit procedure, we refer to a strict national accounts definition of income.

b. The notion of dividend

Dividends in national accounts are a property income (D.4). The resource available for distribution by a unit (a corporation) as dividends, and to pay current transfers such as taxes on income and wealth, is the entrepreneurial income (B.4) of the unit. This balance corresponds to « the concept of current profit before distribution and income tax, as normally used in business accounting. » (ESA95, §8.26).

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.

Re-valuing an asset is nothing else than adapting to the conditions of the market the value of this asset – and therefore the substance of the enterprise – and not the creation of any income. In order to preserve the net wealth of the enterprise, revaluation proceeds, as well as assets sale's proceeds, are not distributable as income.

Practical aspects:

- There is a large consensus among statisticians that this important principle (assets revaluation or sale proceeds are not income) is the correct treatment in national accounts, but that in practice it may be difficult to apply. Nevertheless, it is agreed that it should always be applied in cases of significant and well identified sale or revaluation of assets.
- Timing of the payment: frequently, enterprises smooth the amounts of dividends that they pay year after year. Therefore, in one given year they may put in reserve part of realised profit and distribute it the following year (or years), for the purpose of dividends smoothing. There is no difficulty in recording these sorts of payments as dividends.

The case of a large and exceptional payment out of reserves – significantly reducing the own funds of the corporation - is different. It should rather be treated as a transaction in shares and other equity (a capital withdrawal).

II.1.2 Application to ESA95 transactions

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.

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.

The reason for this definition of dividends is because in national accounts dividends are property income, distributing to the owners the profit resulting from the entrepreneurial income (see this concept in SNA93 -§2.117- and in ESA95 -§8.26).

Following this logic, dividends should neither include the proceeds of sales of assets, nor the revaluation gains. The revaluation of an asset is nothing other than adapting to the conditions of the market the value of this asset – and therefore the substance of the enterprise – and not the creation of any entrepreneurial income. In order to preserve the net wealth of the enterprise, the revaluation proceeds (the holding gains) are not distributable as income.

In practice, capital gains and asset sales might be part of the routine business of the unit and it might not be possible for statisticians to determine the extent to which they finance the payment of dividends. In such cases recording as dividends is accepted. But if a significant asset sale is undertaken in response to an initiative by government it should always be recorded as a withdrawal of equity.

Moreover, enterprises frequently smooth the amounts of dividends that they pay year after year. Thus, one given year, they may put in reserves part of realised profit and distribute it the following year (or years). There is no difficulty in recording these sorts of payments as 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.

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 paper in part IV on public infrastructure financed and operated by corporations).

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 enterprises.

This category excludes any payment conditional on the acquisition of fixed capital and payments in kind: these should be recorded as investment grants[4]. 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.

[4] except in the case of quasi-corporations (see footnote 11 in II.3.1)

II.2 SALE OF ASSETS (PRIVATISATION)

II.2.1 Treatment of receipts resulting from direct and indirect sales of financial and non-financial assets

1. Background

Privatisation has been, and still is, an important feature of the management of the public sector in many countries.

In fact, privatisation normally means giving up, by general government, control over a public enterprise by the disposal of shares and other equity on this enterprise. The scope of this note is larger: it addresses the more general case of sales, by general government, of shares and other equity it owns in some enterprises, without necessarily having control on them or, if having it, without giving up this control. These sales may be made directly or indirectly. Moreover, the case of sales of non-financial assets is also dealt with.

Four cases may be distinguished:

a. The government sells itself shares or other equity it owns in an enterprise. This sale is said direct.

b. The government owns an enterprise A (most of the time, a holding company): this enterprise sells shares or other equity it owns in an enterprise B, and pays back the proceeds of the sale to government. This sale is said indirect.

c. The government sells non-financial assets it owns. This is a direct sale of non-financial assets.

d. The government owns shares or other equity in an enterprise: this enterprise sells non-financial assets it owns, and pays back the proceeds of the sale to government. This is an indirect sale of non-financial assets.

In all cases, funds provided to government may take various forms. They generally have the form of a kind of liquidity, but they may be any type of financial asset. They may also consist in the redemption of government liabilities, such as public bonds and bills. In the following, only provision of assets is considered, but this assumption does not fundamentally change the proposed treatments.

2. Treatment in national accounts

a. Direct sale of financial assets

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).

This has no impact on the net lending/net borrowing of general government.

b. Indirect sale of financial assets

The indirect sale of financial assets has to be completely 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.

c. Direct sale of non-financial assets

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. The non-financial assets may be fixed assets, inventories, valuables, land or other non-produced non-financial assets.

d. Indirect sale of non-financial assets

The indirect sale of non-financial assets has to be completely recorded in the financial accounts of general government and of the involved enterprise (A). 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.

e. Time of recording, amounts to be recorded

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.

The amounts to be recorded are the full amounts of the proceeds of the sale, as they are paid by purchasers: they correspond to the market value of the assets, which are sold at the time of transaction.

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 parties to the transaction. They have nevertheless to be recorded as financial transactions in national accounts.

Particular attention should be paid that, in the case of partial refunding to government of the proceeds of an indirect sale, the full payment to government is treated as financial transaction[5]. In practice, such sales may require the services of financial intermediaries or other non-financial services, due to be paid by general government. This is especially true in case of privatisation.

These expenses have to be recorded as intermediate consumption. If they are actually paid out from the proceeds of the sales, an imputation has to be made in order for the total of the proceeds to be recorded in the above-mentioned transactions. 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.

The cases of indirect sales addressed here deal with sales of assets, which are of a substantial amount, 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 and/or the Parliament. However, it may happen that, in their current business, enterprises sell a few assets and thus realise some capital gains. These capital gains are then liable to be distributed to general government through dividends or specific taxation, in such a way that, finally, a part of the proceeds of the sale of assets is 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 this case, to treat these flows as financial ones.

[5] The case where a part of the proceeds of the sale is kept by enterprise A is dealt with in the following note: "Case of a public holding company keeping the privatisation proceeds".

3. Rationale of the treatment

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).

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.

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 ».

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.

NB: 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).

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.

a. Direct sale of financial assets

General government

Public enterprise

Opening balance sheet

A			L	A		L
AF.5	z				AF.5	z

Financial account

∆A			∆L	∆A		∆L
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	∆ B.90	0		∆ B.90	0

b. 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							
∆A			∆L	∆A			∆L
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	∆B.90	0			∆B.90	0

c. Direct sale of non-financial assets

General government

Opening balance sheet

A		L	
AN	z		

Capital account

ΔA		ΔL	
Disposal of AN	-x		
B.9	+x		

Financial account

ΔA		ΔL	
F.2	+x		
		B.9	+x

Closing balance sheet

A		L	
AN	z -x		
ΔAF.2	+x	ΔB.90	0

d. 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							
∆A			∆L	∆A			∆L
				AN	-x		
				B.9	+x		
Financial account							
∆A			∆L	∆A			∆L
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
∆AF.2	+x	∆B.90	0			∆B.90	0

5. Key-words and references

Privatisation	ESA95, §5.16
Shares and other equity	ESA95, §5.86
Financial transaction	ESA95, §§5.01, 5.02, 5.15
Entrepreneurial income	ESA95, §§8.26 to 29
Financial account	ESA95, §8.50
Capital account	ESA95, §8.46

II.2.2 Case of a public holding company keeping the privatisation proceeds

1. Background

In some EU Member States, holding companies have been set- up by the government to manage restructuring the public sector with the aim of making the enterprises more competitive and profitable and, in the long run, disengaging the government. In this context, their main activity is to organise the privatisation in the best possible conditions and sometimes to earmark the proceeds of the sale of shares to other public enterprises (owned by the holding company or not), through grants, loans or capital injections.

It may also happen that, in other countries where public holding companies have been existing 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[6] like development agencies.

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?

2. Treatment in national accounts

There are four possibilities:

1. Public holding 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. Public holding is a market unit and moves funds around within the group to support loss making activities as part of government economic and social policy.

   Solution: re-route transactions through government if the subsidies and grants made for non-market reasons can be clearly identified.

3. Public holding is a market unit but gives grants and subsidies to units outside the group.

   Solution: re-route the payments through government

4. Public holding is non-market.

   Solution: classify to government

[6] This could be the case of regional development agencies managing funds (including shares and other equity) due to the government or possibly to the European institutions (structural or cohesion funds).

3. Rationale of the treatment

a) 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 preponderant activity of the group (see §2.100).

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 existing group), but to restructure and change the ownership status of public enterprises, as well as channelling the funds from one to the other, redistributing income and wealth.

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 a majority of EU Member States, this is (or was) often implemented by the Treasury itself. In the present case, the Treasury uses an intermediary, which is supposed to manage public assets and to redistribute funds in a short or medium-term context.

This type of activity should be regarded as a management of assets for public policy purposes[7], taking place on behalf of the government.

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 (especially in chapter 1) allow for a statistical treatment that might be diverging 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: re-routing, partitioning and recognising the principal party to a transaction."

- §1.39: "Re-routing

[...] Another type of re-routing 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 [...]."

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".

[7] 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*.

b) Some further elaboration of these solutions:

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 enterprises...) on behalf of the government:

è To re-route 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 enterprises being recorded as government grants or whatever sort of transactions is relevant in this context.
  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.

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:

è To classify the public holding inside the government sector, regardless of its legal status[8].

NB: 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.

[8] See also the case of public holdings dedicated to the management of assets on behalf of the government in part I (Delimitation of the general government sector – Specific units, §I.2.3).

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 – an other 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		

5. Key-words and references

Holding corporation	ESA95, §§2.13e, 2.14 and 2.100
Rearranged transactions	ESA95, §§1.38 to 41
Market/non-market units	ESA95, §§3.27 to 37

II.2.3 Privatisation in transition countries

1. Background

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.

Three cases have been identified:

a. Restitution in kind

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.

b. Restitution through financial compensation

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.

c. Privatisation through the issue of vouchers

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.

2. Treatment in national accounts

a. Restitution in kind

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:

i. 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.

ii. 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 capital transfer in kind (with reverse signs 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.

b. Restitution through financial compensation

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.

c. Privatisation through the issue of vouchers

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.

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).

A distinction can be made between the following two cases depending on whether vouchers are considered as financial assets or not:

i. Vouchers are considered as financial assets when issued

In this case, the vouchers are recorded in the national accounts system at the time of their issuance.

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 enterprises is to be entirely recorded in the financial account of general government. This has no impact on net lending/net borrowing of general government.

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 enterprises 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.

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.

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.

Acquisition of financial assets

The exchange of vouchers for shares in public enterprises 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.

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.

Impact of vouchers on government debt

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.

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 V).

3. Rationale of the treatment

a) Restitution in kind:

It should be analysed in a different way in the two following cases:

1. The returned asset has not changed: 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.

b) Restitution though financial compensation:

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).

c) Exchange of vouchers:

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).

4. Accounting examples

a. 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							
∆A			∆L	∆A			∆L
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		
		∆ B.90	-100			∆ B.90	+100

ii. 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							
∆A			∆L	∆A			∆L
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		
		∆ B.90	-100			∆ B.90	+100

b. 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

c. 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 enterprises 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

∆A			∆L	∆A			∆L
		D.9	-100			D.9	+100
B.9	-100	B.10.1	-100	B.9	+100	B.10.1	+100

Financial account

∆A			∆L	∆A			∆L
		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		
		∆ B.90	-100			∆ 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							
∆A			∆L	∆A			∆L
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		
		∆ B.90	0			∆ 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							
∆A			∆L	∆A			∆L
		D.9	-100			D.9	+100
B.9	-100	B.10.1	-100	B.9	+100	B.10.1	+100
Financial account							
∆A			∆L	∆A			∆L
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		
		∆ B.90	-100			∆ B.90	+100

Acquisition of non-financial assets

General government				Households			
Opening balance sheet							
A			L	A			L
AN.11	100						
Capital account							
∆A			∆L	∆A			∆L
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		
		∆ B.90	-100			∆ B.90	+100

5. Key-words and references

Privatisation	ESA95, §5.16
Shares and other equity	ESA95, §5.86
Contingent assets	ESA95, §§5.05, 7.22
Non-financial produced assets	ESA95, §7.14
Non-financial non-produced assets	ESA95, §7.16
Financial transaction	ESA95, §§5.01, 5.02, 5.15
Financial account	ESA95, §8.50
Capital account	ESA95, §8.46
Other changes in volume of assets account	ESA95, §8.53

II.3 CAPITAL INJECTIONS

II.3.1 Capital injections in public corporations

1. Background

The case

Analysts in the media commonly refer to “capital injections” made by the government in a public corporation, when some financial support is provided.

The notion of “capital injection” as such is not defined in the SNA93 and in the ESA95. In the media, it may cover any payment from government to a public corporation having the characteristics of either a capital transfer or a financial transaction in national accounts. For example, it includes transactions that could be described in public accounts as investment grants, capital grants, commutation grants, loans, equity injections, acquisition of share capital or public dividend capital.

Such injections are more often made in cash, but can also be made in kind. The latter case is subject of a specific paper (“Capital injections in kind” – II.3.2).

The issue

Should the payment from the government (commonly referred to as “capital injection”) be recorded in the national accounts as:

- a financial transaction: it could be, in the most common example, an increase of the government equity, assuming that this payment has an automatic effect on the government’s assets (of the same amount).

- a non-financial transaction: the payment would be a capital transfer, assuming that this is an unrequited payment, having no automatic effect on the government equity (of the same amount).

2. Treatment in national accounts

The principle is the following:

- when the government, acting for public policy purposes[9], provides funds to a corporation without receiving financial assets *and* without expecting property income, the capital injection is to be recorded as a capital transfer;
- When the government, acting as a shareholder, provides funds receiving financial assets *and* expecting dividends in return, the capital injection is to be recorded as a financial transaction in shares and other equity.

1. Financial transactions

- **General principle**

A capital injection should be recorded as a financial transaction only when the government receives in return a financial asset of equal value to the payment. This is a fundamental characteristic of financial transactions[10].

- **The major case: a transaction in equity (F.5)**

It should first be the case of a *transaction* between two units, and not the case of a restructuring of assets and liabilities/reclassification of units, normally recorded as *other flows* in the other changes in the volume of assets account (ESA95, §6.30).

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 modifies the property rights of shareholders on the corporation (increasing them) and entitles the shareholders to receive dividends (even though this property income is not of a fixed or predetermined amount).

Therefore, a capital injection recorded as a transaction in equity may be considered having three characteristics:

- Funds are placed at the disposal of a corporation, which have a large degree of freedom in the way of using it
- Shareholders are entitled to receive dividends
- New shares are issued (for an amount equal to the funds placed), in the case of corporations having the legal status of incorporated enterprises

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

[9] 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*.

[10] A holding gain on shares and other equity, possibly recorded after the capital injection, is not a "financial asset received in return" (but an other flow). Financial assets to be received in return (F.3, F.4, F.5) are listed in the following paragraph.

- **Other possible cases: a loan (F.4) or purchase of bond (F.3)**

  - Loans: any payment satisfying the definition of a loan in the ESA95 (§5.69 and 70), implying a repayment to the government under contractual conditions (date of repayment, interest due), should be recorded as a transaction in F.4.
  - Purchase of bonds: if the government provides funds by purchasing bonds issued by the corporation, it has to be recorded as a transaction in securities other than shares (F.3).

  Conclusion: in (national) accounting terms, the financial transaction has no impact on the government net borrowing/net lending, as well as no impact on the net worth in the balance sheet.

2. Non-financial transactions

If we exclude the case of subsidies (D.3, see ESA95, §4.30 and following) and the one of other current transfers (D.75, see in particular ESA95, §4.139b), the transaction to be considered here is a capital transfer.

The case of capital injections in kind (transfers of fixed assets) being dealt with in the following methodological note (II.3.2), only capital transfers in cash will now be taken into consideration.

- **General principle**

A capital injection should be treated as non-financial transaction in the case of the provision of funds being an unrequited transaction, this sort of payment being recorded as a capital transfer (D.9). The government does not receive in return a financial asset of an equal value. A possible effect on the government's equity is indirect, uncertain and of a different size.

An important feature of capital transfers is that they are typically government transactions. 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.).

Two transactions of this sort are clearly defined in the ESA95:

a. Investment grants (D.92)

An unrequited payment made to a corporation under the condition of using the cash to acquire an asset should be recorded as an investment grant (ESA95, §4.146, 4.152 and following)[11].

[11] In the case of a quasi-corporation, such a payment should be recorded as a transaction in shares and other equity (ESA95, §4.61) due to the fact that the net worth of a quasi-corporation is, by convention, equal to zero (§7.03). It is different if regular payments are made to cover a persistent operating deficit as a matter of deliberate government policy: they should be recorded as subsidies (§4.61).

b. Other capital transfers (D.99)

An unrequited payment to a corporation or a quasi-corporation "to cover losses accumulated over several years or exceptional losses from causes beyond the control of the enterprise" is to be recorded as other capital transfer (D.99) (ESA95, §4.165b).

It is also the case under §4.165a, if a government payment is made for "capital goods damaged or destroyed by acts of war, other political events or natural disasters".

Conclusion: in both cases, the transfer has an impact on the government net borrowing/net lending, as well as on the net worth in the balance sheet.

3. Implementation: some criteria

- **Straightforward cases**

a. Investment grant: D.92

A capital injection that is conditional on the public corporation spending the funds on fixed capital formation should be recorded as a capital transfer – in this case an investment grant (D.92).

b. Past losses: D.99

A capital injection made to cover accumulated losses should be recorded as a capital transfer (D.99).

c. Acquisition of quoted shares: F.5

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

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

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

In certain contexts (financial defeasance, business rescuing, export insurance...), the characteristics of "loans" provided by government (the contractual obligations) should be examined closely to check the relevance of the classification 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) should be recorded as a transaction in F.3.

e. 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, should be recorded in F.5 (consistently with the rationale of ESA95, §5.16)[12].

- **Difficult areas**

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

A capital injection made to cover expected future losses, as well as to cover repetitive 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 certain that the corporation will not be profitable for a long time, due to specific conditions of activity. In the case of issuance of shares, we can assume 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 return on its investment 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, 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 on the same proportion), it might be an indication that the government, serving public policy purposes, is making an unrequited transfer, and to record - at least part of the payment - as a capital transfer.

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

A capital injection to public holding company or 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 rationale here would be that the assets are managed to maximise the return for government, and that higher dividends are expected.

- **Two additional criteria:**

  - A pattern of repetitive payments would be an indication of unrequited transfers;
  - The qualification of the payments by the European Commission (as "government grants") should be taken into consideration for the statistical treatment.

[12] This case, as well as those described in the "difficult areas", should be considered as exceptions to the rule which implies that recording a flow in the national accounts increasing the "shares and other equity" (F.5) should normally be related to actual issuance of new shares.

3. Rationale of the treatment

There are three ways of increasing a public corporation's financial assets at a given point in time:

1. To receive a gift: in national account terms, this is a capital transfer. It has the effect to change the net borrowing/net lending, and to change the net worth in the balance sheet (and therefore the own funds of the corporation).

2. To raise equity capital, by issuing shares: this is a financial transaction in shares and other equity. There is no change to the net borrowing/net lending, no change to the net worth (but a change in own funds due to equity capital).

3. To borrow loan capital: this is a financial transaction. There is no change to the net borrowing/net lending, no change to the net worth (and no change to the own funds).

- **Own funds and equity capital**

a. Own funds:

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.

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)."

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 (it has received funds), borrow some funds if necessary (creditors are reassured by the financial solvency of the corporation), and finally to make and distribute profits.

b. Equity capital:

It is not defined as such in the SNA93 and in the ESA95. Through the issuance of shares, we may view it as the financial "liability" Shares and other equity (AF.5) in the balance sheet of a corporate enterprise, to be recorded like all assets and liabilities in national accounts at market value (ESA95, §7.01, 7.25 and 7.52).

The notion is dealt with indirectly in the ESA95 through the definitions of the transactions "dividends" and "shares and other equity":

- §4.53: 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 to 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."

- §5.86: 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 of a share in the profits of the corporations or quasi-corporations and to a share in their net assets in the event of liquidation."

Some problems of assessment/valuation: 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 (as states §5.86).

As a result, assessing the equity capital of a private corporation in the national accounts should take into account the amount of shares and other equity on the liability side of the corporation's balance sheet. The only adjustment should be to value the shares at market value if, as usual, they are accounted for at historic value (or book value) in the micro-economic accounts.

The case of a public corporation might be different, particularly when its equity does not consist of shares, or consists of shares which are not tradable on the market. Assessing its equity in the national accounts often leads to taking into account the shares plus some reserves (ESA95, §7.54), ending up in practice with an equity capital which is equivalent to the own funds, especially when the net worth of this public corporation is close to zero.

- **Capital transfers (D.9)**

a. Definitions:

The notion of capital transfer is clearly defined in SNA93 (chapter 10) and in ESA95 (chapter 4 principally). Capital transfers have three main characteristics:

- they are related to *transactions*, made by mutual agreement between two units (unlike other changes of assets).
- there is *no counterpart being received in return* (no direct one, in exchange for the transfer).

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

- they involve a commensurate *change in ownership of assets* (or liabilities) between two parties, or acquisition or disposal of assets (SNA93, §10.132).

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

- *Capital transfers in cash*: cases of transfers of cash, though 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 fixed assets without counterpart[13].

[13] See the following paper "Capital injections in kind" (II.3.2)

b. Comment:

Capital transfers are typically government transactions: having public policy purposes, government is the only shareholder making 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 no 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.

4. Key-words and references

Financial transactions	ESA95, §§5.01, 5.02
Equity capital	ESA95, §4.53
Own funds	ESA95, §7.05
Net worth	ESA95, §§7.01 to 05
Shares and other equity	ESA95, §5.86
Dividends	ESA95, §4.53
Capital transfers	ESA95, §§4.145 and following

II.3.2 Capital injections in kind

1. Background

It may happen that the government transfers fixed assets (such as buildings), and/or non-produced non-financial assets (such as land), to a public corporation, already existing or created for that purpose. Thus, 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.

In some cases, the government expects to receive some benefits itself, from the transfer of the asset, in the form of property income streams (dividends, for instance).

In other cases, the government does not expect this but 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.

As a result, "the rules to be followed" may also apply to private corporations.

2. Treatment in national accounts

Two solutions are relevant:

a. A straightforward transfer of a non-financial asset, with no other rights or obligations being established, nor new units being created.

This is a gift made by government to the corporation, to be recorded as a transaction.

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).

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.

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.

b. Government transfers the non-financial asset to a public corporation in the expectation of receiving a higher economic return for itself than by directly exploiting the assets; and/or 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.

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.

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.

3. Rationale of the treatment

a. For treatment as investment grant

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.

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.

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."

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."

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 term 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).

b. For treatment in other flow accounts

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.

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)."

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."

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.

NB: **Comment on recording the event as an injection of other equity in F.5.**

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 ESA 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).

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.

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

5. Key-words and references

Capital transfers in kind	ESA95, §4.146
Non-monetary transactions	ESA95, §1.36
Changes in classification and structure	ESA95, §6.30
Corporate restructuring	ESA95, §6.30 (and SNA93 §12.58 & 59)

II.4 GOVERNMENT AND PUBLIC ENTERPRISE DEBT

II.4.1 Debt assumption and debt cancellation

1. Background

In the restructuring processes of public sectors, the assumption and redemption, by general government, of debts, which are liabilities of public enterprises, are important issues. It is first worthwhile to 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 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.

  There is debt assumption if there is a substitution of debtor, whatever the recordings in the transactors' own bookkeeping. On the contrary, there is no debt assumption if there is no change of debtor, but a substitution of one kind of liability for another, of the same amount.

- Debt cancellation is a bilateral agreement between a creditor and a debtor to cancel or to forgive part or all of a liability outstanding, the debt, incurred by the debtor to the creditor. The debt, which is cancelled, was originally on the liability side of the debtor and on the asset side of the creditor: it no longer exists after the cancellation.

- Write-off: there is write-off when a creditor recognises 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.

2. Treatment in national accounts

a. General rule

The counterpart transaction of debt assumption and debt cancellation made by mutual agreement is a capital transfer.

Thus, when government assumes a debt of a public enterprise or cancels a debt it has against a public enterprise, the counterpart transaction of the financial flows recorded in the financial accounts is a capital transfer, more precisely an other capital transfer (D.99), which has an impact on net lending/borrowing of general government.

In many cases, general government takes the initiative of debt cancellation or debt assumption. The acceptance of this action by the public enterprise, and the fact that this enterprise still exists after it, can be interpreted as mutual agreement.

b. Exceptions to the general rule

There are three exceptions to the general rule: as a result, in these cases, the debt assumption/cancellation has no impact on government net lending/borrowing.

1. Debt of a quasi-corporation

If the public enterprise is a quasi-corporation, debt assumption and debt cancellation by the general government of debts of this quasi-corporation does not 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).

2. Assumption or cancellation of debt preceding the privatisation of a public enterprise

When the government cancels or assumes debts from a public enterprise “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.

Privatisation means giving up control over that public enterprise by the disposal of shares and other equity.

This rule should only be applied when there is enough certainty that the privatisation will occur in the short-term. In any case, the simple existence of a privatisation plan is not sufficient for considering the debt assumption/cancellation “as part of an ongoing process of privatisation to be achieved in a short-term perspective”.

3. Write-off

The only case liable to give rise to a write-off by general government of claims against a public enterprise is when the debt cancellation is preceded by the liquidation of the enterprise. The liquidation should be assessed from an economic point of view, i.e. if the enterprise continues formally to exist, it should be considered as liquidated if it has lost its financial substance and its main economic function.

The write-off of bad debt is recorded as an other change in volume of assets.

c. Debt repudiation

The unilateral cancellation of a liability by a debtor, i.e. debt repudiation, is not recognised in the system of national accounts. Anyway, it is unlikely to happen in the case of public enterprises.

d. Time of recording, amounts to be recorded

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.

This is not the time at which the principle of the transaction has been decided. Moreover, the recording 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.

The amount to be recorded is the full amount of the outstanding debt, which is assumed or cancelled.

The same rules apply for debts which are written off.

3. Rationale of the treatment

The general 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).

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.

The general definition of transactions (ESA95, §1.33) gives the rule for delineating the cases when, respectively, a capital transfer or an other change in the volume of assets has to be recorded. This rule consists in the existence of mutual agreement between parties. This is why a write-off cannot be considered as a transaction, in particular in the case of the disappearance of the public enterprise.

The exception made for quasi-corporations is based on the fact that a quasi-corporation is an accounting device: it is not a full institutional unit, specially from the point of view of assets and liabilities, even if it is considered as such in the system of accounts. There is unity of wealth between a quasi-corporation and its owner. So, there cannot be a transfer of wealth between a quasi-corporation and its owner. This results in the convention that the net worth of a quasi-corporation is always equal to zero. As a consequence, every transfer of assets between a quasi-corporation and its owner is reflected in the value of its equity.

The exception made for transactions occurring as parts of an ongoing process of privatisation to be achieved in a short-term perspective is of a conventional nature. The rationale is quite the same as in the case of quasi-corporations. It stems mainly from consideration of the impact on the government's net worth of the assumption/cancellation of a public enterprise debt. The negative impact of the assumption/cancellation on this net worth is assumed to be balanced, in the short term, by the positive impact on the value of the enterprise's equity.

4. Accounting examples

a. Recording a capital transfer as the counterpart transaction of debt assumption/cancellation

In the following examples, capital transfers are assumed to result, in a first step, in an increasing of the public enterprise 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 enterprise, 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 enterprise**

Opening balance sheet

A		L	A		L
AF.5	z			AF.42/S.12	x
				AF.5	z

Capital account

∆A		∆L	∆A		∆L
	D.99	-x		D.99	+x
B.9	-x	B.10.1	-x	B.9	+x	B.10.1	+x

Financial account

∆A		∆L	∆A		∆L
	F.42	+x		F.42	-x
	B.9	-x		B.9	+x

Closing balance sheet

A		L	A		L
AF.5	z	AF.42/S.12	x		AF.42/S.12	0
		∆B.90	-x		AF.5	z
					∆B.90	+x

- **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 the long-term loan outstanding.

General government				Public enterprise			
Opening balance sheet							
A			L	A			L
AF.42/S.11	x					AF.42/S.13	x
AF.5	z					AF.5	z
Capital account							
∆A			∆L	∆A			∆L
		D.99	-x			D.99	+x
B.9	-x	B.10.1	-x	B.9	+x	B.10.1	+x
Financial account							
∆A			∆L	∆A			∆L
F.42	-x					F.42	-x
		B.9	-x			B.9	+x
Closing balance sheet							
A			L	A			L
AF.42/S.11	0					AF.42/S.13	0
AF.5	z	∆B.90	-x			AF.5	z
						∆B.90	+x

b. Recording a financial transaction as the counterpart transaction of debt assumption/cancellation

This recording applies for the case of quasi-corporations 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 enterprise**

Opening balance sheet

A			L	A			L
AF.5	z				AF.42/S.12	x	
					AF.5	z	

Financial account

∆A			∆L	∆A			
		F.42	+x		F.42	-x	
F.5	+x				F.5	+x	
		B.9	0		B.9	0	

Closing balance sheet

A			L	A			L
AF.5	z +x	AF.42/S.12	x		AF.42/S.12	0	
					AF.5	z +x	
		∆B.90	0		∆B.90	0	

- **Debt cancellation**

General government				Public enterprise			
Opening balance sheet							
A			L	A			L
AF.42/S.11	x				AF.42/S.13	x	
AF.5	z				AF.5	z	
Financial account							
∆A			∆L	∆A			∆L
F.42	-x				F.42	-x	
F.5	+x				F.5	+x	
		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	z +x				AF.5	z +x	
		∆B.90	0		∆B.90	0	

c. Recording an other change in volume of assets

This recording applies for debts of public enterprises towards government, which are written off by the latter.

General government				Public enterprise			
Opening balance sheet							
A			L	A			L
AF.42/S.11	x				AF.42/S.13	x	
AF.5	z				AF.5	z	
Other changes in volume of assets account							
∆A			∆L	∆A			∆L
K.10 on AF.42	-x				K.10 on AF.42	-x	
		B.10.2	-x		B.10.2	+x	
Closing balance sheet							
A			L	A			L
AF.42/S.11	0				AF.42/S.13	0	
AF.5	z				AF.5	z	
		∆B.90	-x		∆B.90	+x	

5. Key-words and references

Other capital transfer	ESA95, §§4.164, 4.165
Debt assumption, debt cancellation, write-off	ESA95, §§5.16, 6.27, 6.28

II.4.2 Debt rescheduling

1. Background

Debt rescheduling may be an alternative arrangement to debt cancellation; however, it may also be a step in a process leading to debt cancellation.

This transaction is often set up by government with foreign transactors, in particular from developing countries or formerly socialist countries (but may happen with public enterprises as well). Foreign transactors are usually government units themselves[14]; however, for instance through guarantee calls, they may also be non-government units. In the following, government is only used to describe the creditor government.

The issue is then the following one: 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?

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:

- in a first step, a negotiation occurs on some rescheduling of the debt;
- in a second step, the debt may be cancelled, or even sold.

Only loans are considered.

The case of credit insurance is not dealt with.

[14] This is usually the case in the Paris Club, dedicated to public debt negotiations. The London Club is dedicated to private debt negotiations.

2. Treatment in national accounts

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 II.4.1 in this Manual).

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

a. Recording of a loan

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.

Loans may take various types (see box). Nevertheless, whatever their type can be, the distinction inside annuities - i.e. the total annual payments - between principal and interest is contractually fixed, and can only be changed by contract. The foreseen series of interest flows is not recorded as a claim of the creditor.

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.

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).

In any case, possible provisions made by the creditor have not to be taken into account in national accounts records.

Box: **Recording of loans (principal and interest)**

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.

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.

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:

$$A_p = D_p + F_p$$
$$F_p = r \; V_{p-1}$$
$$D_p = V_{p-1} - V_p$$
$$V_n = 0$$

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.

Basic formulae:

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.

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:

$$V_p = \sum_{m=1}^{m=n-p} A_{p+m} \frac{1}{(1+r)^m} \quad (2)$$

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:

$$\sum_{m=1}^{m=p} F_m \qquad (3)$$

b. Rescheduling of the loan: ordinary cases

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.

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. As, usually, there is a reduction of the interest rate, it is unlikely that the schedule of annuities be unchanged.

   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.

c. Determining the new amount outstanding

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.

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,

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.

d. Cancellation of a debt following a rescheduling arrangement

It may happen that, despite a rescheduling arrangement has been implemented, the creditor government cancels the involved claim. 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.

e. Sale of a loan

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.

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).

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.

3. Rationale of the treatment

a. Recording of a loan

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).

b. Rescheduling of a loan

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.

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.

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.

c. Debt cancellation

ESA95, §4.165 f and 5.16 (see II.4.1 in this Manual).

d. Sale of a loan

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).

4. A numerical example

Common features: 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

NUMERICAL EXAMPLES 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

Caseb3: 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

II.4.3 Public enterprises debt guaranteed by the government

1. Background

In several European Union Member States, the government guarantees the debt of certain public enterprises (in particular in the sectors of transport and energy). This practice allows the public enterprises to have access to financial resources at a more advantageous cost, and moreover ensures a successful borrowing: the creditor is certain that, in case of difficulty of the debtor, the State will immediately intervene to honour the liability. The State guarantee may be given to an enterprise on a one-off basis, at the issuing of a particular debt, or concern all borrowing, by law or by specific enterprise status provisions.

Will be excluded here two cases, which, at least from the national accounts point of view, are not cases where the public enterprise debt is guaranteed by the government:

- the case where the State, simply because it is shareholder, may be considered as the ultimate guarantor of the whole liabilities of the enterprise.
- the case where the State borrows directly on the market, in its own name, but with the view of providing funds to some public enterprises.

Two relevant cases

Two distinct cases will be thus envisaged, where a liability is clearly issued by the enterprise with the guarantee of the government:

1. General case:

In the most frequent case - whether or not the guarantee concerns a specific borrowing or the whole debt - the debt is recorded solely in the balance sheet of the enterprise. The actual exercise of the guarantee depends on a call of the enterprise, facing financial difficulties or being restructured.

In the public accounts, as long as the guarantee is not called, it is a contingent liability, recorded off-balance sheet.

2. Special case:

It may happen that the guarantee is systematically exercised.

Everybody knows with certainty at the issuing of the liability by the enterprise that the government is committed to actually paying the debt - interest and principal - instead of the enterprise; this is a long-term commitment. Law usually lays it down.

In this case, it may happen that the debt is recorded simultaneously:

- in the enterprise's balance sheet
- in the government’s balance sheet (or in any other document recording the government’s liabilities, including the budget).

2. Treatment in national accounts and rationale of the treatment

1. General case: enterprise's debt

a. the government guarantee is not called

The general principle is that a guaranteed liability is that of the issuer (debtor), as long as the latter does not call the guarantee. In the national accounts, the liability is recorded solely in the enterprise balance sheet. For the government, it is a contingent liability (ESA95, §5.05). It should not be taken into account in the calculation of government debt.

In this general case, national accounts can rely on the legal and accounting aspects. The delineation of government and enterprises sector is strictly defined. It should be recalled that, as far as the national accounts and the excessive deficit procedure are concerned, government debt refers only to the government sector (S.13) and not to the public sector.

b. the government guarantee is called

The calling of the guarantee means a transfer of the liability to the government. It may concern all or part of the guaranteed debt. Exercising the guarantee amounts thus to a debt assumption by the State (by mutual agreement). Both net borrowing/net lending and debt of the government are affected:

- Government debt: by exercising the guarantee, the debt becomes government debt, for the total amount of the called guarantee. This amount must be recorded in the government financial account (under loans, F.4, for instance) and balance sheet (A.F4).

- Government net borrowing/net lending: there are two effects:

- the assumption of the liability must be recorded through a capital transfer (D.99) in favour of the public enterprise, balancing the new flow of liability (the loan), the year when the guarantee is called, for the total amount of the called guarantee.
- once the debt is assumed, the interest charge is to be recorded each year on an accrual basis (under interest, D.41), as a use in the government allocation of primary income account.

On the other hand, the repayment of the principal's annuities is only a financial transaction (a decrease in cash asset, F.2, balancing a decrease of the liability, F.4) recorded in the government financial account. This diminishes the government debt.

NB: It may happen that the government decides to repay a specific borrowing of a public enterprise (or simply the annuity of a loan, or some instalments of the enterprise), without the guarantee being called, nor the debt being taken over. In this case, the debt stays recorded solely in the balance sheet of the enterprise, the only legal debtor.

Payments from the government for this purpose must be recorded as capital transfers in favour of the enterprise (balancing the flow of cash disbursed). The government net borrowing/net lending is affected, but not the debt.

2. Special case: government's debt

Even though the liability is issued by the enterprise itself, it may be right away considered with certainty as an actual government liability if the following conditions are fulfilled:

- the law authorising issuance of the debt specifies the government's obligation of repayment.
- the budget of the State specifies each year the amount of repayment.
- this debt, issued by the enterprise, is systematically repaid by the State (interest and principal).

The liability must then be recorded directly - as soon as at issuance - in the government financial account and balance sheet, and not in the enterprise's. Its amount must be taken into account in the government debt. Interest must be recorded each year on an accrual basis as a use in the government allocation of primary income account.

When the proceeds of the debt issuance (the cash, F.2) are made available to the public enterprise, this must be recorded as a capital transfer (D.99) in favour of the enterprise in the capital account, at the time the funds are made available (ESA, §4.166). This affects the net borrowing/net lending of the government.

3. Key-words and references

Guarantees/contingent assets and liabilities	ESA95, §5.05
Other capital transfers	ESA95, §§4.164 and 4.165
Debt assumption	ESA95, §§4.165f, 5.16

II.5 GOVERNMENT AND THE FINANCIAL SECTOR

II.5.1 Gold and foreign exchange in the central bank

1. Background

In recent years, some exceptional payments have been made to general government by central banks (and other central monetary agencies) following some transactions on reserve assets, such as sales and revaluation. Such exceptional payments might still be observed in the future.

Moreover, the issue was also addressed of the content of some current payments made by central banks to general government. In the own bookkeeping system of some central banks, capital gains on reserve assets, whether realised or not, form part of the bank's profits, and are thus liable to be distributed as dividends. Given the diversity of central bank bookkeeping systems, there is also a need for harmonisation in this field.

It is worthwhile, first, to give a definition of reserve assets. Such a definition may be found in SNA93, in §11.61: « Reserve assets consist of those external assets that are readily available to and controlled by a country's authorities for direct financing of international payments imbalances, for indirect regulation of the magnitude of such imbalances through intervention in foreign exchange markets to affect their currency's exchange rate, and for other purposes. Reserve assets comprise monetary gold, Special Drawing Rights, reserve position in the IMF, foreign exchange assets, and other claims, such as non-marketable claims arising from arrangements between central banks or governments ». In the following, only monetary gold and foreign exchange assets are considered.

2. Treatment in national accounts

Three cases may be distinguished. The first two deal with exceptional transactions carried out by monetary authorities. The exceptional feature of these transactions refers, not to the size of amounts involved, but to the purpose of these transactions, which do not take place in the context of the normal activity of monetary authorities, as defined in the above-mentioned paragraph of SNA93. By contrast, the third case deals with the normal activity of monetary authorities, through intervention in foreign exchange markets.

In the following, central bank refers to the ESA95 sub-sector central bank (S.121, cf. ESA95 §2.45-2.47), i.e. the central bank itself, but also other central monetary agencies, particularly those managing foreign exchange, when they exist separately.

The expression 'capital gain' is used to mean the difference between two successive recordings of asset prices, as recorded in the internal bookkeeping of central bank: the latter price is not necessarily the market price. By contrast, 'holding gain' is used for the corresponding national accounts concept. It is the difference between the price of an asset at the beginning of the period - or at the time of entry in the balance sheet if acquired during the period - and its current market price selling price if sold during the period.

a. Payments following sales of reserve assets by central bank

It may happen that, apart from its normal activity as defined above, a central bank sells a significant part of its reserve assets to non-financial agents or the rest of the world, and pays part or all of the proceeds to government. In the past, this was likely to happen only in the case of monetary gold, but similar sales of other reserve assets may be possible in the future.

In such a case, the payment of the sale proceeds to general government has to be completely recorded in the financial accounts of general government and of central bank. It is a withdrawal of shares or other equity (F.5) from central bank, with a counterpart entry as an increase in a financial asset (most of the time, liquid assets, F.2), or, possibly, a decrease in a financial liability.

This treatment in the national accounts has to be made however the payment is named in the central bank bookkeeping or in public accounts, such as a dividend or a tax for instance.

This has no impact on the net lending/net borrowing of general government.

b. Payments linked to simple entries in the internal bookkeeping systems of central banks

The internal bookkeeping systems of central banks may differ (see in annex the presentation of the principles of the two main systems)[15]. It is worthwhile to give two examples of transactions occurring in opposing bookkeeping systems which give rise to flows constituting payments from central bank to general government:

- in one bookkeeping system of central bank, capital gains on reserve assets, whether realised or not, are, on a permanent basis recorded in a special item on the liability side of its balance sheet. At one time, a significant part of this amount is decreased and, as a counterpart, a claim of general government on central bank is increased or a claim of central bank on general government is decreased;
- in another bookkeeping system, only from time to time, a central bank carries out some revaluation of reserve assets, thus generating a profit which can be distributed to general government.

This may apply both to monetary gold and to foreign exchange assets.

In both cases, payment has to be completely recorded in the financial accounts of general government and of central bank. It is a withdrawal of shares or other equity (F.5) from central bank, with a counterpart entry as an increase in a financial asset (most of the time, liquid assets, F.2), or, possibly, a decrease in a financial liability.

This treatment has to be made whatever the payment called in the central bank bookkeeping or in public accounts, a dividend for instance.

The treatment may be extended to all other possible internal bookkeeping entries of central bank, which would be similar to the two above-mentioned examples.

This has no impact on the net lending/net borrowing of general government.

[15] The implementation of the European System of Central Banks in 1999 implies, for all countries of the Euro-Zone, a harmonisation of central banks' bookkeeping systems, including the obligation to revalue reserve assets on a regular basis.

c. Payments connected to the normal intervention of central bank in foreign exchange markets

The normal activity of central banks in foreign exchange markets, which consists of buying and selling domestic currency against international currencies, may generate capital gains which are liable to be distributed to general government. The amounts involved may sometimes be very large.

Here, too, problems of comparability arise from the diversity of the bookkeeping systems of central banks. In some systems, capital gains cannot be part of trading profits and are thus not distributed, while they can be in other systems - and, generally only capital gains increase trading profits, while capital losses does not decrease them.

In national accounts, capital gains have to be excluded from the distributed profits of central bank, at least for the part distributed to general government, when the bookkeeping of central bank allows for such capital gains to be included in the trading profits.

For this purpose, a practical method may be used, made possible for national accounts compilers due to the general availability of information. It consists of comparing the two following amounts:

- on one side, the sum of interest received - minus interest paid - by central bank and of other flows of income, from which are deducted operating costs and any capital gains realised by central bank in its intervention activity; let us call the resulting amount net revenue;
- on the other side, the amount paid to general government as part of distributed profits: let us call it the dividend.

Two situations may occur:

- if the net revenue is higher than the dividend, this means that the dividend does not include any part of capital gain: so, the total amount of the dividend has to be recorded as property income (D.4), with a full positive impact on net lending/borrowing of general government;
- if the net revenue is lower than the dividend, this means that the dividend includes capital gains: then, the difference between the dividend and the net revenue has to be excluded from the property income (D.4) paid to general government. This difference has to be recorded as a financial transaction, more precisely as a withdrawal of shares or other equity (F.5), without any impact on net lending/borrowing of general government.

3. Rationale of the treatment

The rationale of the rules needs some development since, although in complete conformity with national accounts principles, they do not explicitly appear in ESA95.

a. The specific feature of reserve assets

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. for maximising their holder's profits or wealth. They are managed for macro-economic purposes and for the public interest, in the framework of monetary policy. The role of the central bank concerning the management of foreign assets is fixed by specific legislation. Thus, these assets are not really owned by units that manage them. They are the ownership of the nation, represented in national accounts by general government.

b. The recording of foreign exchange in central bank's balance sheet

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 general government and the central bank, an equity has to be recorded, in national accounts, to express the fact that the central bank holds and manages reserve assets on behalf of the nation through general government.

The question is how to value the equity of general 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, in its balance sheet, a counterpart entry on the liabilities side to record the issuance of money.

When the market price of reserve assets acquired in this way increases, there is a holding gain. In national accounts balance sheets, the appearance of this holding gain on the asset side of the central bank's balance sheet has a counterpart on the liability side: this gives rise to an increase in the general government equity.

Thus, the value of the general government equity in the central bank's balance sheet in respect of reserve assets is measured by the accumulated holding gains on these assets, i.e. 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 minus the possible withdrawals made by government. At this stage, it is useful to make a distinction between monetary gold and foreign exchange assets.

Gold was acquired by central banks a long time ago; moreover, gold prices have greatly increased since that time. As a consequence, the government equity in respect of the holding of monetary gold is generally important insofar as central banks have kept reserve assets under this form.

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 equity is negative.

Nevertheless, all payments mentioned above, mainly in cases 1 and 2, imply a positive difference between the present market value of foreign currencies and their acquisition price; if there were not such a difference, there would be no room for payments from central bank to government. So, in the cases under consideration there is a holding gain, and in consequence the government equity in the central bank in respect of foreign exchange assets is positive.

Finally, all payments made by the central bank to general government, which stem from the fact that the central bank holds and manages reserve assets, occur because government has an equity in the central bank in respect of these reserve assets. They are thus to be treated as a withdrawal of shares and other equity (F.5).

c. The exclusion of capital gains from the dividend paid by central bank to government

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. Thus they are not a kind of income. Given the specificity of central banks and the general availability of information, they have to be excluded from income flows from central bank to government.

4. Accounting examples

a. Recording a holding gain following the acquisition of a reserve asset by the central bank

Assume that the central bank buys foreign currency (AF.2, m12) from a non-financial agent, and provides the latter with the equivalent in national currency (AF.2, m11). In the same period, the exchange rate leads to a holding gain on the foreign currency.

General government				Central bank			
Opening balance sheet							
A			L	A			L
AF.5	z					AF.5	z
Financial account							
ΔA			ΔL	ΔA			ΔL
				F.2, m12	+x	F.2, m11	+x
						B.9	0
Revaluation account							
ΔA			ΔL	ΔA			ΔL
AF.5	h			AF.2, m12	h	AF.5	h
		B.10.3	h			B.10.3	0
Closing balance sheet							
A			L	A			L
AF.5	z +h			ΔAF.2	x +h	ΔAF.2	+x
		ΔB.90	h			ΔAF.5	+h
						ΔB.90	0

b. Recording the sale of monetary gold by the central bank and the following payment of the proceeds to government

Assume that the central bank sells monetary gold to non-financial agents and pays back the totality of the proceeds to general government.

General government				Central bank			
Opening balance sheet							
A			L	A			L
AF.5	z			AF.1	y	AF.5	z
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	+x			F.1	-x	F.2/other sectors	-x
						F.2/S.13	+x
F.5	-x					F.5	-x
		B.9	0			B.9	0
Closing balance sheet							
A			L	A			L
ΔAF.2	+x			AF.1	y -x	ΔAF.2	0
AF.5	z -x					AF.5	z -x
		ΔB.90	0			ΔB.90	0

c. Recording a payment from central bank to government following the recording of a capital gain in the central bank's own bookkeeping

Assume that the capital gain recorded in the central bank bookkeeping arises only from the observation that, in the previous period, the market prices of foreign currencies (e.g. AF.2, m12) has greatly increased from the price previously used in the bookkeeping. Assume also that there is no price movement during the period: in national accounts, there is no holding gain.

General government				Central bank			
Opening balance sheet							
A			L	A			L
AF.5	z			AF.2, m12	y	AF.5	z
Financial account							
∆A			∆L	∆A			∆L
F.2	+x					F.2/S.13	+x
F.5	-x					F.5	-x
		B.9	0			B.9	0
Closing balance sheet							
A			L	A			L
∆AF.2	+x			AF.2, m12	y	∆AF.2/S.13	+x
AF.5	z -x					AF.5	z -x
		∆B.90	0			∆B.90	0

d. Recording a payment from central bank to government of a dividend including part of a capital gain

Assume that the dividend, d, as recorded in the central bank bookkeeping, includes an estimated part of a capital gain, c. Assumptions concerning capital gains and holding gains are the same as in the previous example.

General government				Central bank			
Opening balance sheet							
A			L	A			L
AF.5	z			AF.2, m12	y	AF.5	z
Current accounts							
U			R	U			R
		D.4	d -c	D.4	d -c		
B.8	d -c			B.8	c -d		
Capital account							
∆A			∆L	∆A			∆L
		B.8	d -c			B.8	c -d
B.9	d -c	B.10.1	d -c	B.9	c -d	B.10.1	c -d
Financial account							
∆A			∆L	∆A			∆L
F.2	+d					F.2/S.13	+d
F.5	-c					F.5	-c
		B.9	d -c			B.9	c -d
Closing balance sheet							
A			L	A			L
∆AF.2	+d			AF.2, m12	y	∆AF.2/S.13	+d
AF.5	z -c					AF.5	z -c
		∆B.90	d -c			∆B.90	c -d

5. Key-words and references

Central bank	ESA95, §§2.45, 2.47
Reserve assets	SNA93, §11.61
Financial transaction	ESA95, §§5.02, 5.15
Shares and other equity	ESA95, §5.86
Holding gains	ESA95, §§6.43, 6.46

Annex: Recording capital gains/losses in the central bank's bookkeeping

There are, among European countries, at least two opposing systems of bookkeeping concerning the way capital gains/losses on foreign currencies are recorded in central bank (CB) accounts. They lead to two different measures of profit. Involved are realised capital gains as well as unrealised ones:

- realised capital gains arise when some foreign currency is sold,
- unrealised capital gains arise when the existing stocks of foreign currency reserves are revalued.

First system

In the first system, there exists, on the liability side of the CB balance sheet, an item recording the impact of all currency exchange rate movements: this item, which may be called revaluation item, increases if the price of foreign currencies increases, and decreases in the opposite case.

At the same time, in this system, the price of foreign currencies held as exchange assets is generally updated in a more or less permanent way, and is always close to the market value. As a consequence, capital gains are very close to national accounts holding gains.

If, for instance, the stock of foreign exchange assets is revalued without any sale, there is only a recording in the balance sheet.

If a sale of foreign currencies occurs between two updatings, whereas the market price has become higher than the price of the previous updating, this gives rise to the appearance of a profit, but this profit is « neutralised » when recorded in the balance sheet in the revaluation item. It cannot be distributed.

Similar but opposite records are made with capital losses.

Second system

In the second system, there is no equivalent of the above-mentioned revaluation.

In general, this second system is associated with a different way of valuation of foreign currencies. Foreign exchange assets are valued in a prudent way, at a rate always below the market one, sometimes far below. This means that, when the market rate decreases, the recording rate decreases too. But things are not always symmetric when market rates increase. It is a kind of « floor rate ».

Because of the absence of a revaluation item in the balance sheet, capital gains, realised as well as unrealised, form part of profit and are thus liable to be distributed. Here, too, similar but opposite records are made with capital losses.

It has to be noted that the consequences on possible distribution of capital gains does not stem from the valuation rules, but rather from the existence of the revaluation item.

NB: The implementation of the European System of Central Banks in 1999 has led to adoption of the first system in all countries of the Euro-Zone.

II.5.2 Financial defeasance

1. Background

In recent years, there have been instances of public authorities intervening when financial institutions – banks, insurance corporations or financial groups – have faced difficulties because of their involvement in assets which proved to be of a bad quality.

Known examples involve public enterprises, but it may also happen that private enterprises are concerned.

Intervention of general government may take various forms. For instance:

- government gives its guarantee to the financial institutions: this guarantee is called when these institutions make losses on the bad assets;
- government buys directly the bad assets from the financial institutions;
- there may also be other arrangements: government creates on purpose public bodies to finance and/or to manage the sales of assets (or liability).

The two last cases may be referred to as financial defeasance.

2. Treatment in national accounts

1. Classification issues

When general government gives its guarantee to the financial institutions in case of occurrence of losses born by the latter, there is no classification issue. The involved assets stay in the financial institutions balance sheets.

Institutional arrangements concerning the organisation of the defeasance may be different according to countries. For instance, the management of the assets acquired under the defeasance and financing of the costs of defeasance may be given to two different 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, it should be classified in the general government sector. In other cases, where the management of assets is assumed by another unit, the classification inside or outside the general government sector has to be made following the general rules governing the market/non-market distinction.

2. Treatments to be followed when government is only involved by its guarantee

Government may give its guarantee to the financial institutions themselves or to specific units controlled by them, or to public units created on purpose for the management and sale of the depreciated assets, which stay classified outside the general government sector. The guarantee may be given directly or through the above-mentioned public body in charge of financing of the defeasance.

In this case, the government guarantee may be called, for instance, when the concerned units suffer losses, as the result selling the depreciated assets, or after having written-off some loans extended to bad debtors.

The call may lead to the assumption of some of the unit's debt by government, or to the cancellation of debt that government has towards the unit.

The call on the guarantee results in the recording of a capital transfer, for the amount called, from government to the involved units. On the assumption that these units do not belong to the government sector, it has a negative impact on general government net lending/borrowing.

3. Treatments to be followed when government buys the depreciated assets

Let us then assume that government buys depreciated assets. It does this directly or through specific units created on purpose that are analysed to be part of the government sector. In the following, both are referred to as government.

The assumption is made that government buys the assets at the value at which they are recorded, before provisions, in the internal bookkeeping of the seller.

The rules to be followed depend heavily on the availability of reliable information.

a. Recordings related to setting up the defeasance

As a general principle, a capital transfer should be recorded when government buys the assets from the financial institutions. The amount of this transfer, paid by government, is equal to the difference between the amount paid for buying them and their true value.

It is useful to make a distinction between different kinds of assets.

Some assets have a price, and thus a market value. This is the case for securities and for real estate; real estate may also be part of the defeasance through shares in corporations managing this real estate. It is assumed that the selling price of these assets is equal to their "gross" value – i.e. before deduction of any provision. In all these cases, the amount of the capital transfer is equal to the difference between the selling price of the assets and their market value.

- For real estate assets, it may be assumed that the financial institutions are in trouble because of their excessive involvement in real estate activity which is in general crisis, not because of their involvement in specific – bad - assets. So, a general price index for real estate, applied to their purchaser price, may be used to calculate their market value.

- For securities other than those linked to real estate, except in the case of a general stock exchange crisis, it may be hard to estimate their market value without precise knowledge of the financial institutions portfolio. This could be even harder for unquoted shares.

- The case of loans is a bit different. Loans that enter the defeasance are certainly bad ones; anyway, they are sold by the financial institutions at their redemption value (see below the definition of redemption value), and it is very hard to know what could be their true value. So, there should be no capital transfer associated with the sale of loans.

  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. Provisions that might have been previously recorded by the financial institution are not to be taken in account.

  The capital transfers have a negative impact on government net lending/borrowing, at the time this type of defeasance is implemented.

b. Recordings to be made during management of the defeasance

   Here, too, it is necessary to make a distinction among the transferred assets.

   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.

   The same holds for securities, except that their sale has no impact on government net lending/borrowing.

   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, 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.

3. Rationale of the treatment

1. Classification issues

The defeasance structures could be considered as involved in a kind of financial activity: they borrow to finance the purchase of the assets put in the defeasance.

Nevertheless, they cannot be considered as being financial intermediaries, because they do not really place themselves at risk, 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.

2. The general principle to record capital transfers

There are three cases of recording capital transfers (with an impact on general government net borrowing/net lending):

- at the time of setting up the defeasance, when government buys the involved assets at a value which is higher than their fair value;
- during 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.

In the three cases, 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.

The capital transfer is recorded at the time the transfer of wealth occurs.

3. Valuation issues for assets other than loans

The general rule for valuing these kinds of assets in national accounting is to record them at their market prices.

Generally, in the internal bookkeeping of the financial institutions, their gross value – i.e. value before amortisation or other provisions – corresponds to the price paid for their acquisition. Let us call this their accounting value.

If such assets are put in the defeasance, it is certainly because their market value has fallen far below their accounting value.

It is thus logical to record a capital transfer if they are bought at this accounting value.

The later moves in market price of these assets, when held by units classified inside general government, give rise to the recording of holding gains/losses.

4. The case of loans

Valuation of loans is referred to in ESA95 §7.51. The general rule is to record, for 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.

§§5.79 and 6.51 give further indications 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.

The question is that, in a financial defeasance, when loans are sold by the financial institutions to a government unit, the transaction value is equal to their redemption value.

Nevertheless, it is common sense to assume that the loans put in the defeasance are indeed bad loans, with a low expectation that they could be repaid for their full amounts. Generally, they are likely to have been subject to provisions for bad debt in the internal bookkeeping of financial institutions. However, ESA95 states that “ provisions for bad debt [...] do not appear anywhere in the system” (§4.165, f). The notion of “fair value”, commonly used in business and banking accounting systems, is not recognised for loans in the system of national accounts.

Practical considerations also forbid taking into account provisions because they may be subject to manipulations.

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 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.

5. Global assessment of the treatments

Defeasance, when publicly managed, leads certainly to an impoverishment of general government. There are three ways in which this occurs, according to the above rules:

- in one instance, when the 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 a government unit has bought the involved assets, for loans which have been transferred without the recording of a capital transfer[16]. This has an impact on government net lending/borrowing only for loans cancelled by mutual agreement, which is unlikely to be the general case; otherwise, the impact on government wealth is recorded through an other change in volume of assets.

However, classification inside the general government sector of units in charge of the defeasance financing may have an impact on government debt if these units borrow their funds; it has certainly an impact on net lending/borrowing of the general government sector through the financing cost.

4. Accounting treatments

The call on the guarantee is not illustrated.

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.

Accounts are compiled for the general government unit only, not for government as a whole. The government equity in the financial institution is thus not shown.

1. Setting up the defeasance

Assets transferred from financial institutions to the public unit in charge of the defeasance are the following ones:

- Securities, with a bookkeeping value of 40, and a market value of 25;
- buildings, with a bookkeeping value of 10, and a market value of 5;
- loans, with a redemption value of 50: at the time the defeasance is set up, some loans are considered as being irrecoverable, for an amount of 10.

[16] 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	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	+25	B.9	-35	F.5	-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	25	ΔB.90	-30			ΔB.90	+20

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	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	-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	+5	B.10.3	+8

Closing balance sheet

A			L
AN	0		
AF.2	x -32		
Other AF	0	Δ B.90	-2

5. Key-words and references

Financial intermediation/intermediary	ESA95, §§2.32, 2.33
Other capital transfer	ESA95, §§4.164, 4.165
Valuation of transactions	ESA95, §5.136
Valuation of assets	ESA95, §§7.33, 7.51, 7.69

Part III

Implementation of the accrual principle

CONTENTS

<u>Warning</u>: the following Council Regulation (page 123) has been approved by the European parliament on 3 October 2000 (under Amsterdam Treaty's co-decision procedure). The regulation is introduced by a short note ("general principles").

III.1 Recording of taxes and social contributions: general principles

1. <u>Background</u>

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.

The strict application of chapter 4 in ESA95 is not sufficient to achieve this objective. This is because taxes and social contributions accrued (or assessed as due) may be recorded as government resources even though a significant proportion of it might never be actually paid, due to bankruptcy of companies, lack of efficiency of the tax collecting system or other reasons.

This is the reason for the attached draft Council Regulation clarifying the ESA95 rules concerning both the time of recording and the amounts to be recorded.

2. <u>Treatment in national accounts</u>

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

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

1. 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.
2. 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.
3. 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.

3. Rationale of the treatment

This is the subject of the article 2 statement:

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.

4. Key-words and references

Time of recording	ESA95, §1.57
Taxes on production and imports	ESA95, §§4.26, 4.27
Taxes on income and wealth	ESA95, §4.82
Social contributions	ESA95, §4.96

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

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 285 thereof,

Having regard to the proposal from the Commission[1],

Having regard to the opinion of the Economic and Social Committee[2],

Acting in accordance with the procedure laid down in Article 251 of the Treaty[3],

Whereas:

(1) Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community[4] (ESA 95) contains the reference framework of common standards, definitions, classifications and accounting rules for drawing up the accounts of the Member States for the statistical requirements of the Community, in order to obtain comparable results between Member States.

(2) Article 2 of Regulation (EC) No 2223/96 sets out the conditions under which the Commission may adopt amendments to the ESA 95 methodology which are intended to clarify and improve its content.

(3) It is therefore necessary to refer the clarifications concerning the recording of taxes and social contributions in ESA 95 to the European Parliament and to the Council as these clarifications modify basic concepts.

(4) Article 2 of the protocol on the excessive deficit procedure relating to Article 104 of the Treaty states that the government deficit means net borrowing of the general government sector as defined in the European system of integrated economic accounts (ESA).

(5) The Statistical Programme Committee (SPC), set up by Council Decision 89/382/EEC, Euratom[5], the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB), set up by Council Decision 91/115/EEC[6], and the Gross National Product Committee (GNP Committee) can state their opinion on the country-specific accounting treatment of taxes and social contributions whenever they consider it relevant.

(6) The SPC and the CMFB have been consulted.

(7) The measures necessary for the implementation of Regulation (EC) No 2223/96 should be adopted in accordance with Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission[7],

[1] OJ C 21 E, 25.1.2000, p. 68.

[2] OJ C 75, 15.3.2000, p. 19.

[3] Opinion of the European Parliament of 13 April 2000 (not yet published in the Official Journal), Council Common Position of 26 June 2000 (OJ C 245, 25.8.2000, p. 1) and Decision of the European Parliament of 3 October 2000 (not yet published in the Official Journal).

[4] OJ L 310, 30.11.1996, p. 1. Regulation as amended by Regulation (EC) No 448/98 (OJ L 58, 27.2.1998, p. 1).

[5] OJ L 181, 28.6.1989, p. 47.

[6] OJ L 59, 6.3.1991, p. 19. Decision as amended by Decision 96/174/EC (OJ L 51, 1.3.1996, p. 48).

[7] OJ L 184, 17.7.1999, p. 23.

HAVE ADOPTED THIS REGULATION:

Article 1

Purpose

The purpose of this Regulation is to modify the common principles of ESA 95 as concerns taxes and social contributions so as to ensure comparability and transparency among the Member States.

Article 2

General principles

The impact on the net lending/borrowing of general government of taxes and social contributions recorded in the system 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.

Article 3

Treatment of taxes and social contributions in the accounts

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 the determination of the amount of tax) and cash tax receipt.

Article 4

Verification

1. The Commission (Eurostat) shall verify the implementation by Member States of the principles laid down in this Regulation.

2. From 2000 onwards, Member States shall provide the Commission (Eurostat) before the end of each year with a detailed description of the methods they plan to use for the different categories of taxes and social contributions in order to implement this Regulation.

3. The methods applied and the possible revisions shall be subject to agreement between each Member State concerned and the Commission (Eurostat).

4. The Commission (Eurostat) shall keep the SPC, the CMFB and the GNP Committee informed of the methods and the calculation of the aforementioned coefficients.

Article 5

Implementation

Within 6 months of the adoption of this Regulation, the Commission shall introduce in the text of Annex A to Regulation (EC) No 2223/96, pursuant to the procedure in Article 4 thereof, the changes needed for the application of this Regulation.

Article 6

Committee procedure

Article 4 of Regulation (EC) No 2223/96 shall be replaced by the following:

«Article 4

1. The Commission shall be assisted by the Statistical Programme Committee (hereinafter referred to as «the Committee»).
2. Where reference is made to this Article, Articles 4 and 7 of Decision 1999/468/EC shall apply, having regard to the provisions of Article 8 thereof.
The period laid down in Article 4(3) of Decision 1999/468/EC shall be set at three months.
3. The Committee shall adopt its rules of procedure.»

Article 7

Entry into force

1. This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Communities.*
2. Member States may ask the Commission for a transitional period of no more than two years in which to bring their accounting systems into line with this Regulation.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 7 November 2000.

For the European Parliament
The President
N. FONTAINE

For the Council
The President
L. FABIUS

III.2. Changes in due for payment dates for taxes, subsidies, compensation of employees, social contributions and benefits

1. The rules

The times of recording are 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 paragraph 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).

2. Implementation of the rules

a. For most distributive transactions

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 1st January (n) to 31st December (n), that is, amounts in respect of transactions realised during the 12 months of the year.

Example

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.

However, VAT recorded in non-financial accounts 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

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.

Taxes and social contributions recorded in the accounts can be derived from two sources: cash receipts or amounts evidenced by assessments and declarations.

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 – see part 2.b below). This adjustment can be based on the average time difference between the activity and cash tax receipts.

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 thirteen month would be neutralised.

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.

b. The exception of some distributive transactions: Ad hoc bonuses or other exceptional payments, 13th month, etc. paid by the employer to his employees; 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.

Such distributive transactions constitute exceptions to the general accrual time of recording principle. Therefore, changes in the due for payment date (for instance forward payments) could affect the government net borrowing.

Example

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

One year, 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?

Decision concerning the change in the due for payment date

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.

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.

III.3. Recording of interest

1. Background

Recording interest on an accrual basis is a major change in the new edition of the European system of national accounts (ESA95). It means that, beyond the institutional and practical arrangements, the national accounts aim to measure at any point in time the rights and commitments between economic agents.

The principle of recording interest on an accrual basis may be seen as rather simple and quite explicit in ESA95 (see main references in part 5). However, the implementation needs further consideration, in order to clarify, and possibly interpret and complete ESA95 provisions.

2. Treatment in national accounts

a. On general features

- 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.

b. On 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 saving premium)
- 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.

3. Rationale of the treatment

a. General features

- **Full coverage**

In ESA95, there is evidence that recording interest on an accrual basis should be applied in an extensive way. This basic principle covers all financial instruments bearing interest.

In the description of interest in chapter 4, all kinds of debt instruments are mentioned. §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”. §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.

From an economic point of view, initial exchange of funds is the only condition for recording interest on an accrual basis. 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.

- **"Debtor approach"**

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 his 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.

In ESA95, it seems obvious that interest is accrued from the point of view of the debtor. Paragraph 4.42 on interest specifies that it is "under the terms of the financial instrument agreed between (a debtor and a creditor)". Paragraph 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”.

The conditions prevailing at the time of the creation of the financial instrument are favoured. Changes in market rates during the life of the instrument are not mentioned (Paragraph 4.46 provides similar evidence).

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.

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).

ESA95 specifies the treatment of nominal holding gains/losses in chapter 6 only as a change in price of assets/liabilities. Thus, §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".

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. Obviously, it is not the case for a change in price during the life of a debt instrument. If the point of view of the creditor (the historical rate at purchasing time) or of the market (the present rate) were favoured, finally the cost of borrowing would be variable even in the case of fixed rate instruments.

- **Method for calculating accrued interest**

The issue is to determine which method should be used to calculate accrued interest. The choice is between simple interest, applied only on the principal outstanding amount, and compound interest that takes into account the amount of interest previously accrued.

Paragraph 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.

However, on this point, there is room for some flexibility, according to national practice as mentioned in ESA95 for various areas. It is notably the case for securities markets. Interest on zero-coupon bonds is accrued in a compound way. It is the same for all discounts or premiums treated as interest (see later).

On the contrary, it is frequent that for bonds with regular interest payments (annual or more frequent) accrued interest effectively exchanged on secondary markets (the buyer of the bond paying to the seller the amount accrued since the last payment) is determined *pro rata temporis*, according to a very simple arithmetic proportionality.

Thus, for practical reasons, it would be more convenient to stick to the market practice, avoiding some adjustment, as recording would exactly fit to the amounts effectively exchanged between investors.

Anyway, it is obvious that differences in methods should have a very small effect where markets are fully developed and so regular payments are rather well distributed during the year, or, at least, fairly equal on half-yearly period. Overestimating interest by simple method for a short period of accrual (compared to compound method) tends to be balanced by underestimating it for a longer period. Notably, it can be assumed that it is generally the case for securities issued by general government.

- **Reinvestment of accrued interest under the instrument**

ESA95 provides some guidelines in §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 §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 interest accrual is not recorded as being reinvested in the financial asset, it should be classified in sub-category F.79.”

It seems however more relevant to have a restrictive approach. In any case, the reinvestment of accrued interest should be recorded under the same item as for the underlying instrument. (This component would be identified in a memorandum sub-item under the “parent” instrument category within the ESA95 classification for financial instruments.) This treatment applies to all kinds of debt instruments.

For securities other than shares, it is based on the following arguments:

First, for zero-coupon bonds or short-term securities issued at a discount, it 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. The notion of “clean price” is not relevant in this case. 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 same reasons as in the case of a zero-coupon bond oblige the reinvestment to be recorded under the instrument. It would not be consistent to treat both components in different ways. But the same treatment should apply to all other debt securities. For analytical purposes, a comprehensive approach of securities markets seems highly preferable. It is also more "friendly" for users of financial accounts.

Secondly, as already mentioned, 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.

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 the property income.

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 he has kept this asset, the actual payment for the “full coupon”, recorded only in the financial account, is the counterpart of the initial entry in the category of the instrument and the following reinvestment of accrued interest.

A third argument is based on the difference between change in “size” and change in price, as developed in §6.52. Including accrued interest under the item “other accounts” would finally mean considering it only 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.

Finally, as a very strong argument, comparability and aggregation of data at the European Union level require a deep harmonisation. ESA95 refers to this possible flexibility in several paragraphs (5.121, 5.128, 5.129f and 5.130). The only justification seems to be to follow “national practice”. But, in this case, it is a highly questionable ground. A harmonised system of national accounts cannot be based on specific arrangements, which are necessarily different between countries and even within countries for instruments or in accounting systems used by economic agents.

Concerning non-negotiable instruments:

Concerning deposits and loans, the last two arguments are totally relevant in order to justify a similar treatment of reinvestment under the relevant instrument. Nevertheless, rules in chapter 7 about valuation in balance sheets need to be specified.

For deposits, §7.46 states that are recorded “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 is added: “the values may include accrued interest”, with a reference to §5.130.

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

In both cases, normally transactors would not 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.

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.

- **Instruments issued at a discount treated in a single way**

The question of discounted bonds is mentioned in §5.138. The provision is clear concerning the fact that the difference between the redemption value and the issue price is treated as interest, recorded normally on an accrual basis. However, it is stated in e) 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 the last provision. All bonds issued at a discount should be treated in the same way, whatever the size of the discount, for several reasons.

First, there is no definition in ESA95 of these bonds and it is not a category existing on the market. Obviously, in any definition, any provision related to the size of the discount would be rather arbitrary and without rational economic grounds.

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.

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. As a result, rather dissimilar treatments could be observed. The impact on general government deficit might be not at all negligible as a large part of general government debt is issued with small discounts that could be considered as "non significant".

Fourth, it must be stressed that general government debt is often issued in a large part under the form of "fungible bonds" (also named "linear bonds"). In this case, securities are issued under one similar line (concerning nominal interest rate, coupon payment date and final maturity) by tranches, issued generally during a rather short period but sometimes on a longer one. 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 with round figures (for instance, only one decimal).

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 paragraph 5.138b. Fungible bonds may be seen as a perfect example of instruments with two interest components: a share for the regularly paid nominal coupon and a share for the above-mentioned difference. Both are recorded on an accrual basis.

In most cases this premium or discount is on an individual basis small, rather “non-significant”. However, in some member states, where this category of instruments represents a large share in government debt, the total amount of all discounts may be significant. It would not be consistent to ignore it for accruals. In addition, the argument about comparability of data is in this case particularly reinforced.

Thus, each tranche should be identified separately in order to be in a position to estimate accrued interest from the liability side on the basis of the relevant rate of interest. This information is assumed to be easily available for compilers in the case of issues by general government. However, there is a specific difficulty for splitting the amounts of accrued interest between holders, as after issuance all tranches are “mixed” under the global line and cannot be traded separately on secondary markets and identified as such in portfolios. It is thus necessary to estimate a weighted average discount (or premium) resulting from issuing different tranches and updates at each new issue.

- **Arrears of interest recorded under the instrument**

Accrued interest may not be offset at due time by a payment in cash (or eventually under the form of another financial instrument). According to the current statement in ESA95, the nature of the claim coming from the reinvestment of accrued interest is assumed to change. 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 §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". In any case, 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”.

However, 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 said before, in ESA95 accrued interest is seen as reinvested in the instrument. It means that at this time accrued interest is assimilated to the principal, showing the same nature as a liability. As a consequence, all arrears must be recorded in the same way as the principal and so kept under the instrument.

There is also a practical argument. For some instruments such as loans and securities (but less frequently), debt may be continuously amortised and not through a final repayment. Any regular payment includes both interest and principal. Thus, in case of default by a debtor, the corresponding payment concerns 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. It may be assumed that in this case the creditor would rather classify the non-paid amount under the instrument category.

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 and would generally concern both principal and interest arrears.

b. Specific instruments or transactions

- **Stripped bonds**

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.

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. However it would be completely unrealistic from a practical point of view to take in account the rate prevailing at each issuance, as in the case of tranches of fungible bonds. Stripping may normally be reversed, by asking to convert back into the original bond from a complete set of strips. It is not at all infrequent.

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.

Stripping is a transaction concerning only the secondary market. However, strips exist on the market as such and can be traded separately. Cross-border transactions may be significant.

Stripping could be analysed as the conversion of interest payments into capital repayments, regular payments of interest being replaced by the redemption of a security. There could be a positive effect on net borrowing/net lending. However, recording interest on an accrual basis prevents such an effect. In no way must stripping changes the cost of borrowing. Stripping provides no additional funding to the issuer and there is no impact on the original cost of borrowing, fully determined at the issuance time (in case of fixed rate) or following rules that cannot be changed (in case of floating rate).

Under ESA95 framework, strips are recorded in the financial accounts at the transaction value, i.e. issue price. But strips are substituted to the market value of the original bond. Thus, the transaction is neutral on the balance sheet of the issuer. For all strips, the difference between the redemption value and the issue price must be considered as interest and accrued over the remaining maturity. Accrued interest is actuarially equal to all coupons normally paid under the previous form.

However, contrary to other zero-coupon bonds, the rate of interest used for accruing interest on strips is not the rate prevailing at the time of stripping. Only the original cost of borrowing must be taken in account. As a result, interest on strips should be accrued by reference to the underlying bond, from the point of view of the issuer, and finally stripping has no impact on the calculation of interest on an accrual basis. Compilers can continue estimating accrued interest on the basis of the original form of the bond.

In some countries, strips for interest payments may refer to coupons of several bonds, with different nominal amount, but paid at the same date. There is an adjustment for the number of securities provided in the exchange. In this case, it would be necessary to use the average nominal rate on the different underlying bonds, calculated in proportion to the share of each stripped portion of the bonds.

Another point relates to repurchases of strips by the issuer. The latter may not obtain a complete set that would allow him to reconstitute the original bond under its "conventional" form and then to offset it in his debt amount. In these conditions, gross recording seems more relevant. These repurchases would not affect the debt. For the purpose of sector allocation in the national accounts, the market price at the time of compiling outstanding amounts should be used. Under the framework of Excessive Deficit Procedure, strips held by units classified in general government may raise difficulties in the consolidation process. It would not be consistent to match the nominal value of strips with the nominal value of the underlying bond, recorded in the gross debt. The market value of the strip should be related to the market value of the bond under the original form, then to its nominal value.

- **Floating rates and assimilated issues (including saving premium)**

Treatment of floating rate debt instruments does not raise conceptual issues. References for floating rates are quite numerous and may apply in a significant number of ways. In case fixed and floating rates are combined (“mixed bonds”) two different instruments must be considered.

In the case of securities, 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”. 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.

Thus, provisional estimates of accrued interest could only be made with the risk of a difference with the effective payment. This shortcoming in the estimation of accrued interest must be corrected. The revision should be entered preferably on the last period of compilation, but considering that the discrepancy would be generally very small, for simplification, the adjustment could also be entered during the period the actual payment occurs.

In regard to loans and deposits, from a general point of view, a great number of references may be used, with a large range of spreads due to the quality of debtors/creditors and various payment practices for interest. In addition, for loans, the rate can float only under the condition of a minimum change in the index and within specific upward limits. Where compilation is not conceivable on an individual basis, only global information could 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.

Although it is generally a minor issue for general government, the question of saving premiums raises similar problems to the case of floating rates. In ESA95, this point is mentioned only for securities (5.138g) although it is currently rather exceptional within the European Union, but it may concern some non-negotiable saving instruments.

A saving premium is treated in the system as interest, clearly distinguished from the case of redemption premium, paid in any case and treated as interest but through the accrual component (difference between issue price and redemption value).

A saving premium is paid only under a certain condition, generally regarding minimum holding stability. It is an additional remuneration and not a nominal holding gain. It 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 would 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 negative entry 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. In case there are strong reasons to think that a significant share of holders behave rationally (or possibly on the basis of previous experience), the interest rate used for accruals should not take in account the premium. Nevertheless, a final adjustment would be necessary as a result is always uncertain.

- **Lottery instruments**

ESA95 mentions in paragraph 5.138g the case of securities with lottery payments, i.e. attributed by drawing. Such instruments are not at all described. At the present time, it is very infrequent that units of general government issue bonds with this feature. However, some non-negotiable instruments (time deposits, special schemes), possibly managed by general government units and held by households may also include lottery payments. This issue of accrued interest deals with debt instruments, negotiable or not, whereas a lottery consists of paying a bonus, or a set of bonuses, at specific dates (one or several), to some holders (possibly only one) chosen at random.

A lottery payment depends exclusively on chance and is not guaranteed in the initial arrangements. Each holder ignores the exact amount he can receive. In addition, only some of them (and in theory only one winner…) are granted. It is clearly different from floating rate securities (all the bonds are treated in the same way), from redemption premiums (totally known at issuance time) and from savings premiums (depending on holders' own behaviour).

It is stated in ESA95 that lottery payments are to be treated as interest and not considered as a holding gain for the holder. They do not result from a change in market valuation. All the specific arrangements (bonus, beneficial investors) are fixed in advance. Lottery payments are part of the remuneration of the instrument, of the cost of borrowing.

- **Index-linked instruments**

Some units in general government may issue debt instruments, generally under the form of bonds that include a clause specifying a link with a specific reference. 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 follow the same index.

ESA95 §4.46 covers only the case of a price index. By contrast, §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. Thus, provisions should apply to any case of linkage.

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 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.

As a result, the index should apply continuously all over the life of the bond. Any change 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.

Under these conditions, a difference may appear between the amount accrued and the sum effectively paid.

The question is clear for index-linkage related to coupon or interest. Similar to the case of a post-determined interest, the amount previously accrued should be corrected in the property income and in the financial account.

Concerning an index-linkage on the value of principal, in case of negotiable instruments, the current price would include the linkage effect. However, this specific element is not another flow, recorded as nominal holding gains or losses in the revaluation account, as for other sources of change in the price. It is considered as a financial transaction with a counterpart in distributive transactions and, so, an impact on net borrowing/net lending.

As a result, any difference between the amount effectively paid and the amount previously recorded should be treated as for variable coupons and corrected, with no adjustment entry in the revaluation account. This correction should be made at each compilation of balance sheets. Thus, the corresponding amount of interest would be adjusted, positively or negatively, until the final redemption. Note that where the index is an exchange rate index (one currency or a basket), the effect of exchange market volatility is not taken in account in the revaluation account (see further the case of instruments denominated in foreign currency) as the change in percentage of the index is only used to modify the principal amount.

This statement is supplemented by the following two provisions.

Generally, index-linked instruments include a clause for a minimum guaranteed redemption value, for instance the nominal principal amount. Thus, if the index had the effect to reduce the price under this minimum, it would not be relevant to record it in the national accounts. In this case, the amount of interest due to the linkage would be nullified. Normally, the current price of market instruments takes in account such a clause.

Where the index could lead to significant fluctuations (in absolute value, taking in account the importance of such issues), notably because of short-term volatility, it could be preferable to "smooth" in order to avoid large fluctuations in income account and net borrowing/net lending. As an exception to valuation rules, we could consider an average price during a period and not a daily one if the latter does not seem fully representative.

- **Short-term negotiable instruments**

As a reminder, 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 the treatment for recording interest on an accrual basis. Conceptually, there is no reason to use for these instruments an approach different from the case of bonds.

Instruments with an original maturity over one year raise no specific difficulty compared to the case of bonds and notes. Concerning instruments with maturity at a maximum of one year, issuance at a discount is very frequent. Most Central Governments issue Treasury Bills. All the statements relating to bonds issued at a discount are to be applied whatever the size of the discount. Generally these instruments are similar to zero-coupon bonds. If a security-by-security approach cannot be implemented, estimations based on average maturity and average rate of interest at issuance could also provide reliable figures.

- **Instruments with grace periods**

Some debt instruments may include a grace period during which no interest is paid. This case is not mentioned in ESA95 and SNA. Such arrangements are currently rather infrequent in the case of bonds. General government may be involved, notably for loans granted to developing countries or for public policy purposes.

A first case relates to instruments bearing a zero rate of interest during the grace period. No interest is to be accrued, as the cost of borrowing is really zero. During this time, the debtor has no commitment concerning interest. This statement applies even if the rate of interest applied in a second time period is adjusted so that the final yield is roughly similar to "normal" conditions over the total life of the instrument.

In other cases, interest payments are only postponed from the grace period to the remaining lifetime of the instruments. The cost of borrowing is not equal to zero. Interest is really due but is capitalised. The amount of accrued interest during the first period is paid later under various forms (added to the first coupon, spread all over the remaining period, paid with the final repayment, possibly under the form of new securities).

- **Accrued interest on instruments denominated in foreign currencies**

For these financial assets and liabilities, recording interest on an accrual basis fully follows the basic rules mentioned in point 2. The effective payment of interest should be equal to the amount previously reinvested in the financial account. However, specific attention must be given to the issue of conversion into the national currency.

As a reminder, under the framework of 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. Thus, "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) It is also specified that "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.

Recording interest on an accrual basis implies two simultaneous transactions in the property income and, as counterpart, in the financial instrument. Where interest is denominated in foreign currency, both must be converted into the national currency by the exchange rates prevailing at the time they are made. 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[17]. For these transactions, a "spot" exchange rate, observed only at a specific point of time, could be used as a proxy only in case of very low foreign exchange volatility. The effective payment of interest is another transaction, with a counterpart in another category of financial instruments (currency and deposits) and using an exchange rate appropriate to the actual date payment made. Finally, accrued interest refers conceptually to time as a "segment" and payment of interest to the time as a single point.

Under normal circumstances, an adjustment is in all likelihood needed in the revaluation account. Although perfectly equal in foreign currency, the amounts of accrued and paid interest may diverge in national currency, due to exchange volatility.

This entry is fully meaningful from an economic point of view[18]. 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.

[17] Where interest is accrued by means of a compound method, theoretically, this average should be weighted by the amounts of accrued at each point time during this period. However, a simple arithmetic average seems to be an acceptable proxy.

[18] Conceptually, the exchange rate effect is different from the case of instruments with variable interest 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.

Thus, the treatment should be the following one.

At the end of a period of compilation, there is an entry 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.

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.

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.

- **Income of mutual funds**

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.

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.

- **Early redemption of debt instruments (including exchange)**

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.

- The case of securities is *first* considered.

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 (or bills/notes) and provides in exchange a new security or a new tranche of a security previously issued.

The price may be fixed 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. General government is often involved.

A difference (possibly called 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. Where the debt is valued at face value, as currently in EDP, bigger gaps are observed.

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, and not as a separable transaction, followed by an automatic reinvestment in the same category of debt instrument. Any transaction on the secondary market normally provides holding gains or losses, recorded in the system in the revaluation account.

In the exchange, there is a strict equivalence between the amount bought back by the issuer and the new amount issued with maybe a cash payment for adjustment. For bonds with regular interest payments, there is, in addition, a payment by the issuer for the accrued coupon, except if the latter is also converted into new bonds.

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.

- *Second*, an early redemption also occurs for loans. This case may involve units within general government sector, as lenders or as borrowers. From a general point of view, the debtor may be allowed to reimburse a loan before the final maturity. In compensation, he may be forced to pay to the lender an indemnity, a lump sum. The latter cannot be considered as a capital transfer, neither as the price of levying an option held by the borrower or as a service charge. The treatment in the national accounts depends on the way the indemnity is calculated.

A first case is where it is based on the amount of principal that has been effectively provided and on the exact time of borrowing. The borrower is contractually asked to pay an additional amount for all (or part of) the time before the redemption, so that the interest rate is finally increased, through a retroactive effect. This additional payment should be treated as interest. However, as a 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.

A second case is where the indemnity is calculated as a fixed percentage over the remaining amount of principal. It should be recorded as holding gain (for the lender) and loss (for the borrower). The indemnity is added to the principal and both form the redemption value as a whole. It cannot be considered as interest as it is charged on a principal that is no more available for the borrower. Finally, this treatment would be similar to an early redemption of bonds. There would be no impact on net borrowing/net lending.

- *Third*, the case of deposits must be considered, notably because in some countries units classified in general government manage this category of instruments.

For some instruments, as 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. It might also occur where a delay is not respected for deposits redeemable at notice.

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 could be imputed on the last period of compilation.

4. Accounting treatments

a. 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 at this date, a maturity of 10 years and a redemption *in fine*. At end of year 1, the "clean" market price is 102%. At end of year 2, the market price is 105% *(In Italics, estimation with compound interest).*

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			L
		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)

b. 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

c. 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

Closing balance sheet

A		L
	F.332	95
		(EDP: 100)

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	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

d. Strips

Central government has issued the following bond: fixed rate of 15%, principal of 1000, redemption *in fine*, 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

5. Key-words and references

General accrual principle	ESA95, §1.57
Time of recording interest	ESA95, §4.50
Interest and financial transaction	ESA95, §5.17
Discounted bonds	ESA95, §§4.46, 5.138
Index-linked securities	ESA95, §§4.46, 5.138
Mutual fund shares	ESA95, §5.141
Arrears	ESA95, §§5.121, 5.131
Accrued interest and nominal holding gains	ESA95, §6.52
Instruments denominated in foreign currencies	ESA95, §6.58

III.4 Cases of Court decisions with retroactive effect

1. Background

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.

Sometimes, benefits could have been due by the government for several years and not paid because of the disagreement.

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?

2. Treatment in national accounts

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 […]”

“The claims on benefits are established” when 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 year when the Court decision occurs.

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.

NB: a simple postponement of payments by the government without that government disputing the obligation to pay should not prevent recording social benefits in cash at the time the payments are due (see III.2: “Changes in the due for payment dates”).

3. Rationale of the treatment

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).

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 §1.42)

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.

This is true also, *a fortiori*, for any penalty or interest charge awarded by the Court.

Part IV

Leases, licences and concessions

CONTENTS

IV.1 Overview (classification of some government receipts)

1. Background

Among government receipts are licence fees, tolls, administrative charges and royalties, some of which may arise under leasing contracts, concessions or franchises given by government. They cover different types of transactions in national accounts, explained in various chapters in ESA95. The purpose of this overview is to guide the reader who is not sure where to start looking in ESA95 for relevant guidance, and to expand on that guidance where necessary.

Part I of this manual considers when payments between public units can be recorded as sales of services. Part II explains 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.

2. Treatment in national accounts

a. **Receipts for goods and services (that could be supplied by other units).**

The receipts could be less than (in which case a subsidy may need to be imputed, see part II of this Manual), the same as, or more than the costs of production: it does not affect the classification.

Treatment: record as a sale - market output (P.11) (possibly incidental sales)

> Examples: sale of refreshments in a public building; payments for provision of training; fees charged for advice to businesses, or testing the ability of somebody to drive a motor vehicle.

b. **Receipt for the use of a produced asset**

The receipts could be less than, the same as, or more than the costs of production: it does not affect the classification.

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 is not part of a contract requiring payments for use over a longer period).

Treatment: record as a sale - market output (P.11) (possibly incidental sales)

> 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 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. 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 further explanation in the annex to Part IV of this manual). 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 asset by government when the purchasing unit assumes most of the risks and rewards of ownership for the period of the contract.

Operating lease: 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 government owned building for five years: record as rentals (P.11) and accrue over the five years; and record a financial asset in F.7.

Franchise payments for the right to use an intangible asset produced by government: record as P.11. Don't include payments that arise only because of government's unique power to make the law – see section d.

Finance lease: 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 would record a produced asset, of the same type as the asset sold, with a value equal to the difference between the price received under the time limited contract and the market price of the asset for whole life use (equals the government's reversionary interest in the asset).

Example: a single payment to use a building for 20 years, after which it reverts to government, and the payer assumes most of the benefits, costs, risks and rewards of ownership during that time: record as a sale of the building at the price paid (P.5).

See also IV.3 on sale and leaseback, and IV.4 on public infrastructure financed and exploited by the corporation sector.

iii) a **payment to use the asset for the rest of its economic life**

Treatment: record as sale of a produced asset (P.5).

Example: government sells a building

c. **Receipts for the use of a tangible non-produced asset**

Non-produced assets include land, sub-soil assets, and other tangible natural assets over which ownership rights have been enforced. Typically the assets would have been bought by government in an earlier period, or acquired as government property in some other way such as through an international agreement. These are tangible natural assets, which could 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 ownership is not established and it is not credible to regard government as the owner of the assets;

- payments for the use of “assets” which are not regarded as economic assets in ESA95 – see paragraph 7.12b.

Receipts for the use of a tangible non-produced asset include the following two types of payments:

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**

The tangible non-produced asset is made available by government through a lease, for a limited period of time.

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 record the prepayment as a financial advance, F.7)

Example: government receives royalties paid for the extraction of oil.

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).

ii) a payment to use the asset for the rest of its economic life

Treatment: record as the sale of a non-produced asset (K.2).

Example: government sells land.

d. **Note on intangible non-produced assets**

Transactions in intangible non-produced assets (K.22), undertaken between non-government units, are to be recorded only in certain limited 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.

It is correct to record a transaction in an intangible non-produced asset when a unit has a right to buy services at particular price (which could differ from the current market price), and sells that right to another unit (see ESA95 paragraph 6.17§d). 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.

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 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[19] (recorded under K.2, see ESA95 paragraph 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 depreciation 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 paragraph 12.34 and ESA95 paragraph 6.21§b.4).

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 e.3 below.

For the specific case of sale of mobile phone licences, see the following paper (IV.2).

[19] 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'.

e. **Receipts in return for permission to undertake an activity**

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 government passes legislation such that the activity requires permission from government, and so 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:

1. Record as **sale of a service** (market output, P.11, or incidental sales, P.13) 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.

   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 pay, intermediate consumption, capital consumption and taxes (see ESA95 paragraph 3.33).

   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.

   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 a service; other parts would be recorded as taxes (see below), if used by those other public units for activities unrelated to the payer.

   ESA95 paragraph 4.80d and footnote 5 describe this in more detail.

   Examples: passport fees, driving licences, gun licences.

2. Record as a **tax** if the conditions above do not apply.

   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.

3. 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.

   In many cases, these assets can be traded directly, or can be traded indirectly through transactions in the ownership of the units that hold the assets.

   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'. This recording is preferred to recording a transaction in government resources (say D.2, D.5 or D.7) and other flows in the unit's balance sheet. If the permission granted is time limited, the balance sheet of the unit would show falls in the value of the asset using K.6 other flows (amortisation of the asset).

   So it is proposed to treat receipts for granting permission, in cases where such permission is given exclusively to only one or a restricted number of units, as the sale by government of an intangible non-produced asset.

3. Rationale of the treatment

a) Receipts from sale of goods and services (that could be supplied by other units):

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 receipts relating to non-market output (P.13). The distinction refers to the notion of economically significant price and to the ESA95 50% criterion (see ESA95 paragraphs 3.43 to 3.45).

b) Receipts for the use of a produced asset:

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.

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.

In the specific case of concession under public law for financing and exploiting public infrastructure, see further IV.4.

c) Receipts for the use of a non-produced asset:

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 paper (IV.2).

d) Receipts for permission granted to undertake an activity:

The distinction is to be made between the recording of a tax and of sale of services (market output, P.11).

Distinction between taxes and sales of services

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."

Government acts in an economy in two ways:

Civil commercial law

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.

ESA95 paragraphs 3.38 to 3.45 explain that it is possible for government receipts to be classified as sales: either as market output or as incidental sale from a non-market unit. This is because under ESA95, a non-market institutional unit can have market output. Market output is not restricted to units classified to the corporation sectors.

ESA95 paragraph 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 paragraph 6.12 describes when to record transactions in intangible non-produced assets.

Public law

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, sells licence and impose fines.

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.

Note that ESA95 paragraph 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 output of a service or rent, not tax.

4. Key-words and references

Economic asset	ESA95, §7.10
Non-financial non-produced assets	ESA95, §7.16 and table 7.1
Time of recording	ESA95 §1.57
Output	ESA95 §§3.14 to 3.68
Rent	ESA95 §§4.72 to 4.76
Transaction in non-produced assets	ESA95 §§6.06 to 6.13
Financial leases/operating leases	ESA95 annex II
Other taxes on production	ESA95 §4.23
Other current taxes	ESA95 §§4.79 to 4.80
Economic disappearance of non-produced assets (K6)	ESA95 §6.21 (b) 4

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 have been produced 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 use for ever		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 does not greatly exceed 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)

IV.2 Allocation of mobile phone licences

FOREWORD

"The present paper reflects the current state of knowledge. In case that a consensus on substantial new insights would result from any further discussions at international level (notably at the level of the Inter-secretariat Working Group on National Accounts), the treatment detailed in the present paper could be revisited."

1. Background

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.

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.

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)[20].

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.

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:

[20] 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.

- the payment of *a rent*,
or,
- the *purchase of an asset*.

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)[21].

2. Treatment in national accounts

a) 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*.

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.

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)[22]. This improves once-for-all the net borrowing/net lending of the general government sector.

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), *ceteris paribus* increasing the net worth in the balance sheet (without impacting net borrowing/net lending).

Time of recording

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.

[21] This was also the conclusion of the member organizations 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.

[22] 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.

b) Special cases

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.

3. Rationale of the treatment

The type of assets described in this paper (spectrum, licence) is not explicitly dealt with in ESA and SNA. Therefore, the conceptual basis of Eurostat decision may still be developed and refined.

1. In the major cases, rent is not the appropriate transaction

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’ (§7.87)”

- property income (interests, dividends, rents, etc.) usually have 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.

2. Two distinct assets can be considered

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.

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).

- The licence

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.

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. [...]"

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).

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).
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[23].
- 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 happened in the E.U. that a corporation acquired the licence by acquiring another corporation.

[23] U.K. Companies have recorded the licence as an asset in their accounts for the year 2000

4. The allocation of a long-term contract by auction is similar to a sale

a) 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.

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.

b) 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.

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.

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.

4. Key-words and references

Economic asset	ESA95, §7.10
Non-financial non-produced assets	ESA95, §7.16 and table 7.1
Property income	SNA93, §§7.87 and following ESA95, §§4.41 and following
Time of recording flows	ESA95, §1.57

IV.3 Sale and leaseback

1. Background

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.

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?

Depending on the way these questions are answered, the reality of the "sale" may be questioned, and the "transaction" recorded in very different ways.

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".

2. Treatment in national accounts

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.

a. The unit is created on purpose by government

The main issue in this case is a classification issue.

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.

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 any transaction on goods and services - output and intermediate consumption - later.

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 more generally for questions of statistical opportunity. It has however to be classified in the general government sector. The creation of the unit will generally be adequately recorded in the other changes in volume of assets accounts, under changes in classification and structure. Nevertheless, if the unit finds by its own an adequate financing - in borrowing in its own right, for instance - for acquiring the assets disposed of by government, this disposal 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's units to the unit are not to be treated as payments for services, but as transfers inside general government.

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.

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.

b. The unit is an existing public corporation

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).

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).

As a result, in the context of such a restructuring of assets, there is no impact on net lending/net borrowing of general government.

c. The unit is an existing private operator[24]

In this case, a transaction on fixed assets (GFCF) will usually be recorded, improving the general government net lending/borrowing.

Nevertheless, it has to be addressed if the transaction does not correspond to a financial leasing arrangement, in which case the asset would, in national accounts, remain - or come back in a second step - in the general government balance sheet.

[24] As in the market/non market distinction the term private means « excluding NPIs ».

3. Rationale of the treatment

a. The unit is created on purpose

Particular attention should be brought to SNA93 provisions on 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."

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.

If, however, such a unit is considered as being a full institutional unit, payments made by government for renting services provided by this unit would hardly be considered as corresponding to a market output:

- 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[25].

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 does not however correspond to a market activity.

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.

[25] 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.

b. The unit is an existing public corporation

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.

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.

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).

c. The unit is an existing private operator

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.

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.

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.

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.

IV.4. Public infrastructure financed and exploited by the corporation sector

1. Background

Some governments are making increasing use of the corporation sector to finance, construct and operate public infrastructure. There can be two objectives: to use the skills and profit motivation of the corporation sector; and to spread the cost of new assets over the time they are used, so avoiding the high initial costs of government's own capital formation.

Two main types of cases are involved:

1.1 **Case 1:** government enters into a contract with a corporation for the construction of an infrastructure used to provide services which constitute government final consumption expenditure.

Examples are:

- Government requires a corporation to build a prison to a specification it decides. Government agrees to pay the corporation a certain amount for 25 years for making the prison available for its use, provided it is adequately maintained. At the end of 25 years, legal ownership of the prison is transferred from the contractor to government.
- Government enters into a contract with a corporation for the design and construction of a road, and the corporation is responsible for maintaining the road for 25 years to an agreed standard. Government pays the contractors an annual fee linked to the number of vehicles using the road.

In these cases, there are regular payments from government to the corporation.

1.2 **Case 2:** a corporation constructs and/or operates public infrastructure and finances the costs by charging users who are not the government.

For example a corporation might build a road and levy tolls on vehicles using it. There may be or not payment from the corporation to government.

The questions are as follows:

- In the balance sheets of which sector – corporation sector or general government sector – should the public infrastructure be recorded during the period of exploitation?
- how should transactions linked to the contracts be recorded, and what is their impact on government net lending/borrowing?

NB: 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. Assume that a public unit is deliberately established for the purpose of financing, constructing and operating an asset, which is made available to government for regular fees over the life of the asset. In this case it might be more appropriate to say that the fees are not sales but just transfers, and to classify the unit within government.

2. Treatment in national accounts

2.1 Case 1: Government makes regular payments to the corporation

Two situations should be distinguished:

a. Case 1 a

When the corporation is exposed to most of the risks and rewards of ownership during the period of exploitation, the infrastructure is recorded in the corporation's balance sheet.

The contract between government and the corporation has the characteristics of an operating lease. Only the regular payments by government have an impact on government net lending/borrowing (B.9).

If the infrastructure is given to government at the end of the period of exploitation, it enters government's balance sheet through a gross fixed capital formation, balanced by a capital transfer ("Other capital transfers" D.99), with no impact on government net lending/borrowing (B.9).

b. Case 1 b

When government is exposed to most of the risks and rewards of ownership during the period of exploitation, the infrastructure is recorded in the government's balance sheet.

The contract between government and the corporation has the characteristics of a financial lease.

The infrastructure built by the corporation is allocated to government's balance sheets through gross fixed capital formation (GFCF), balanced by an imputed loan (F.4) of equal value.

GFCF is recorded in government's accounts according to ESA95 rules (See §3.112): there is an impact on government net lending/net borrowing (B.9) for the value of GFCF. Government debt is increased by the amount of the imputed loan.

During the period of exploitation, annual payments should be subdivided into repayments of principal and interest payments related to the imputed loan. Interest payments have an impact on government net lending/borrowing (B.9).

Risks and rewards of ownership should be assessed according to the factors presented in the annex.

2.2 Case 2: Government does not make payment to the corporation

In these cases government makes no regular payment to the corporation in cash or in kind, either directly or indirectly. The infrastructure should be recorded in the corporation's balance sheet during the period of exploitation.

a. Case 2 a

When the infrastructure is a new one built by the corporation, it is GFCF by the corporation with no impact on government accounts.

If the infrastructure is given to government at the end of the period of exploitation, it enters the government's balance sheet through a GFCF, balanced by a capital transfer ("Other capital transfers" D.99), with no impact on government net lending/borrowing (D.9).

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). They should be recorded as taxes ("Other taxes on production" D.29) if government does not provide anything in return for the payment.

b. Case 2 b

It may happen that government transfers an existing infrastructure to the corporation. 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 part II. 3. 2 (paragraph 2.b.) of the Manual.

If the infrastructure is given back to government at the end of the period of exploitation, it enters government's balance sheet through the other changes in volume of assets account, with no impact on government net lending/borrowing (See chapter II.1.2 of the Manual: "Payments by public corporations to government", F.513).

If payments are made by the corporation to the government during the contract, they should be recorded as dividends (D.421).

3. Rationale of the treatment

3.1 Case 1: Government makes regular payments to the corporation

ESA95 annex II applies. It explains how to distinguish between case 1 a (operating lease) and case 1 b (financial lease). The criteria in the annex give some practical guidance on how to interpret ESA95 annex II.

a. Case 1 a

It is the corporation which provides a service to government: this production is carried out with the infrastructure. It is thus relevant to record the infrastructure in the corporation's balance sheet during the period of exploitation. The service constitutes government final consumption expenditure.

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 could be thus balanced either by property income (D.4) or by another current non-financial transaction. However, it is proposed to balance GFCF by a capital transfer ("Other capital transfers" D.99) as the operation is exceptional.

b. Case 1 b

It is government which provides a service by means of the infrastructure. Government acquires the infrastructure through a financial leasing contract with the corporation which built the asset. The service constitutes government final consumption expenditure.

3.2 Case 2: Government does not make payment to the corporation

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.

a. Case 2 a

The infrastructure is a new one built by the corporation.

Possible payments from the corporation to government can arise because:

- Government provides something in return:
  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 rents (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 paragraph 4.23 (e) refers.

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 could be thus balanced either by property income (D.4) or by another current non-financial transaction. However, it is proposed to balance GFCF by a capital transfer ("Other capital transfers" D.99) as the operation is exceptional.

b. Case 2 b

It may happen that government transfers an existing infrastructure to the corporation. 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 part II. 3. 2 (paragraph 2.b.) of the Manual.

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.

Reversion of the infrastructure to government is recorded by symmetry to the initial transfer: exchange of non-financial asset for a financial one (AF.5) shown in the other changes of volume in assets account.

4. Accounting examples

Accounting treatments related to the four 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.

4.1 Case 1 a

- the infrastructure is built by the corporation (GFCF=1 000)
- government makes regular payments to the corporation during the period of exploitation and the infrastructure is recorded in the corporation's balance sheets: operating leasing (payments are 100 for 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 of the infrastructure

General government				Enterprise			
Non-financial accounts							
U/ΔA			R/ΔL	U/ΔA			R/ΔL
P.3	100			P.51	1 000	P.12	1 000
B.9	-100					P.11	100

Reversion of the infrastructure to government at the end of exploitation

General government				Enterprise			
Capital account							
ΔA			ΔL	ΔA			ΔL
P.51	200	D.99	+200				
B.9	0						
Closing balance sheet							
A			L	A			L
AN.11	200						

4.2 Case 1 b

- the infrastructure is built by the corporation (GFCF=1 000)
- government makes regular payments to the corporation during the period of exploitation and the infrastructure is recorded in the government's balance sheet (financial leasing).

Construction of the infrastructure allocated to government

General government				Enterprise			
Non-financial accounts							
U/ΔA			R/ΔL	U/ΔA			R/ΔL
P.51	1 000					P.11	1 000
B.9	-1 000						
Financial account							
ΔA			ΔL	ΔA			ΔL
		F.4	1 000				
		B.9	-1000				
Closing balance sheet							
A			L	A			L
AN.11	1 000	AF.4	1 000				

First year of exploitation of the infrastructure

P.13 = D.1 (=60) + K.1 (=40)
P.3 = P.13
D.41 = 50
F.4 = - 20

General government				Enterprise			
Current accounts							
U			R	U			R
D.1	60	P.13	100				
D.41	50					D.41	50
P.3	100						
K.1	40						
B.8 net	-150						
Capital account							
ΔA			ΔL	ΔA			ΔL
K.1	-40	B.8 net	-150				
B.9	-110	B.10.1	-150				
Financial account							
ΔA			ΔL	ΔA			ΔL
F.2	-130	F.4	-20	F.2	70	F.4	-20
		B.9	-110			B.9	-50
Closing balance sheet							
A			L	A			L
AN.11	960	AF.4	980				
ΔAF.2	-130	ΔB.90	-150				

4.3 Case 2 a

- 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				
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						

4.4 Case 2 b

- 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 (it is not the situation of 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						

Annex Factors influencing the distinction between operating and finance leases

ESA95 annex II is brief in describing the factors that determine whether an operation is a financing lease or an operating lease. It is proposed that the following questions should be considered when making the decision. It could of course be the case that answers to some questions will suggest an operating lease, but others suggest a finance lease. In such cases the relative importance of each question has to be judged for the particular case.

1. Who is responsible for the maintenance and insurance of the asset?

Assume government organises and pays directly for the insurance and maintenance of the asset.

This suggests a finance lease since government is bearing the risk of variations in such costs.

2. Who repays finance on early termination of a contract?

Assume the government is responsible for repayment of the corporation's debt in the event of early termination of the contract.

This suggests a finance lease since the government is bearing that risk.

3. Who determines the nature of the asset?

Assume the corporation has significant and ongoing discretion on how to fulfil the contract; makes the key decisions on the design and construction of the asset; and decides and how it is operated and maintained in order to provide the service required by the purchaser.

This suggests an operating lease.

4. Who bears the demand risk?

Demand for services provided by the asset might be greater or less than expected. Assume the corporation's income is affected by the demand for the asset, such that government or other customers only pay for the amount of service consumed.

This suggests an operating lease.

5. Are there any third party revenues?

Assume the corporation uses the asset to provide services to customers other than just government, and that government is not exposed to the variability of third party demand, and that these revenues are a significant part of the total income from the asset.

This suggests an operating lease.

6. Does government pay less if the quality of service is not good enough?

Assume government payments are reduced when the service provided by the corporation is not up to the required0 standard, even if this is because of problems with the asset rather than how it is operated.

This suggests an operating lease.

7. Does government pay more if the corporation's costs increase?

Assume government does pay more if there is an increase in the corporation costs related to the asset. For example the corporation might have to undertake more maintenance than expected.

This suggests a finance lease.

8. Who bears the residual value risk?

Assume government has the option, at the end of the contract, to buy the asset at the current market price, and that it is not obliged to buy the asset at a pre-agreed price if it does not need it nor if the asset is not in good condition.

This suggests an operating lease.

Part V

Addendum on government debt

CONTENTS

V.1. The calculation of general government debt

The definition of government debt in the excessive deficit procedure is coherent with the provisions of ESA95 concerning the definition of the government sector and of the financial liabilities (but excluding Other accounts payable and Financial derivatives). However, its valuation differs from ESA95 valuation rules.

1. Definition and valuation rules

a. ESA95

There is no specific definition of government debt in the ESA95, but general provisions on institutional sectors (including the general government, see Part I) and on financial liabilities and their *valuation rules*.

§1.51: « 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)

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 and to a very small extent, shares and other equity (AF.5) and insurance technical reserves (AF.6).

Stock of debt (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)

b. Protocol on the excessive deficit procedure

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 the revised Council Regulation 3605/93 (see appendix) specifying the components of government debt with reference to the definitions of financial liabilities in ESA95.

The nominal value

In the Council Regulation 3605/93, the nominal value is considered equivalent to the face value of liabilities. It is therefore equal to the amount (contractually agreed) that the government will have to refund to creditors at maturity. In principle, interest accrued on a liability is not accounted for in the valuation of this liability.

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) and available for withdrawal
- 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
- Zero-coupon bonds: 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[26]
- 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 under financial leasing

[26] 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 in part III, « Recording of interest », III.3, §3.b)

NB: the case of interest arrears

On an accrual basis, interest is recorded when accruing. Therefore, whether or not it is actually paid, accrued interest affects the net borrowing/net lending.

For government debt under EDP (at nominal value, not including accrued interest) interest due but not paid is to be recorded under Other accounts payable (F.79), as long as it is not paid (ESA95, §5.131). In the EDP, interest arrears under Other accounts payable are not accounted for in the government debt.

Debt in foreign currency

Liabilities denominated in foreign currencies shall be converted into the national currency at the representative market exchange rate prevailing on the last working day of each year.

The revised Council Regulation 3605/93 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 (see chapter V.2), 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 (see chapter V.2).

The stock of government debt (at nominal value)

It should be recalled that:

- for practical reasons of measurement, other accounts payable (AF.7, including trade credits) are not presently accounted for in government debt.
- government debt must be consolidated: those liabilities the corresponding financial assets of which are held by the sub-sectors of general government must be eliminated from the calculation.

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

2. The change in government debt

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 questionnaire

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 (B.9 in ESA95) and the change in government debt. Analytically, an increase in government debt should be viewed as due to two main factors:

1. the net borrowing of general government (B.9, the balance of the capital account);
2. 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).

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[27]).

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)

[27] One has to pay attention to 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.

V.2 Debt in foreign currency (currency swaps on debt instruments)

1. Background

This paper describes 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).

The last three paragraphs of article 1.5 of the Council Regulation No 475/2000, amending article 1.5 of Council Regulation 3605/93 'on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community' (see Appendix of the Manual) indicate 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."

Consequently, and as a result of discussions with government debt managers in the course of preparing the Amendment, it was decided to take account (in the calculation of government debt for the purpose of the EDP) of the above-described liabilities denominated in, or exchanged from and/or in foreign currency.

It has to be noted that ONLY the treatment of these liabilities denominated in, or exchanged from and/or in foreign currency is described. Other related issues, hereafter listed (see the *'Clarification' Box* on next page), are not concerned by what is stated in this paper.

CLARIFICATION

The treatment of the liabilities denominated in, or exchanged from and/or in foreign currency described in this paper is a **separate issue from**:

1. The treatment of **currency swaps in general** (or similar forward rate agreements) for the purpose of the calculation of government debt under the EDP.
   This paper only concerns currency swaps based on existing liabilities (i.e. swaps 'against the book' directly linked to actual underlying debt instruments. However, the aim of these swaps - complete or partial hedging of a given debt instrument, general coverage from exchange rate exposure, speculation and/or anticipation on exchange rate variations - is of no importance).
   Currency swaps based on non-existing liabilities (i.e. swaps not linked to any actual underlying debt instrument) are not concerned by this paper.
   Under the amended ESA95 rules (where streams of interest payments under swaps are to be recorded as Financial Derivatives[28]) and for the purpose of the EDP, streams of interest payments under currency swaps based on non-existing liabilities should be excluded from the calculation of government debt.
   This exclusion is pursuant to the second paragraph of article 1.5 of the Council Regulation No 475/2000, amending article 1.5 of Council Regulation 3605/93 'on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community':
   "Government debt is constituted by the liabilities of general government in the following categories: currency and deposits (AF.2); securities other than shares, excluding financial derivatives (AF.33); and loans (AF.4), as defined in ESA95."
   The reason for this exclusion is that, in the case of financial derivatives, as defined in ESA95, there is no nominal value identical to that for other debt instruments.

2. The treatment of swaps for the purpose of the calculation of government **deficit** under the EDP.
   It is specifically mentioned in the Regulation amending the treatment of swaps in ESA95[28], that this amendment does not affect the treatment of streams of interest payments under swaps agreements for the purpose of the calculation of government deficit under the EDP.
   For the purpose of the calculation of government deficit under the EDP - and in this case only - streams of interest payments under swaps agreements will continue being recorded at market value as property income (D.41 interest), following the original ESA95 rule and having an impact on the general government net borrowing/net lending (B.9).
   A specific B.9 item (respectively a specific D.41 item) - codified EDPB.9 (resp. EDPD.41) and differing from the revised ESA95 concept of B.9 (resp. D.41) - will be distinguished for the purpose of the EDP.

3. The treatment of swaps **under amended ESA95**[28] (in line with amended SNA93[29]). Amended ESA95 (where articles 4.47, 5.67 and 5.139 have been modified) states that streams of interest payments under swaps agreements are to be recorded at market value as financial derivatives (F.34), without any impact on the general government net borrowing/net lending.

[28] See "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" included at the end of this chapter.
[29] Completed on 8 February 2000 at the ISWGNA (Inter-Secretariat working Group on National Accounts) level.

2. Treatment in national accounts

As a basic principle, similar to ESA95 provisions (6.58), 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 the total amount of government debt. Currently this compilation occurs only at the end of each year. Thus, the "representative market exchange rate prevailing on the last working day of each year" is to be used.

The amended Regulation 3605/93 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".

Note that a similar effect may result from using other kinds of derivatives, like futures or options contacts. In any case, the conversion into national currency should be based on similar approach.

The amended Regulation also states that where a debt instrument denominated in foreign currency is swapped into another foreign currency, and not into the national currency, a "two-step" approach has to be implemented.

First, the debt instrument is converted into the currency received at inception of the swap contract and provided in the subsequent payments, 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.

The amended Regulation covers also the specific case where covering/modifying an exchange risk exposure is not the motive for writing a swap. For example, debt originally denominated in national currency might be swapped into foreign currency thereby creating a currency exposure.

The provision is in this case to consider the debt 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.

In the amended Regulation, and as long as the currency swap is based on an existing debt instrument, there is no restriction for applying the above mentioned provisions, notably:

- A derivative contract is not necessary written at the time of the underlying debt instrument issuance. It may be implemented at any point of time and for any maturity (yet, within issuance and maturity of the underlying debt instrument).
- A derivative contract may set an exchange of settlements inferior (thus, not superior) to the flows of principal and interest resulting from the underlying instrument.
- 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.
- More complex cases could also be observed.

Thus, the new Regulation covers all cases where a derivative contract offsets an initial risk exposure or changes the currency, in which this risk is borne, including the case where the risk was initially nil.

3. Rationale of the treatment

The conversion of debt instruments denominated in foreign currencies is needed in order to be in a position to aggregate figures and estimate the total amount of "consolidated gross government debt."

The conversion at one point of time must be based on a rate of exchange.

It does not mean that a debt would be necessarily reimbursed for the amount resulting from the conversion because, in case of marketable instrument, one should take into account the price of the instrument at time of the transaction. But it is a general practice in accounting systems. In addition, it is consistent with the valuation rules under EDP at nominal value. There would be no sense referring to the exchange rate prevailing at time the new liability incurred.

However, where an original debt instruments denominated in foreign currency is swapped into the national currency, flows of settlements are fixed upon 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 totally matched, the government unit will regularly paid an amount in national currency and received in exchange an amount in foreign currency. The later will be immediately 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 more exchange risk exposure concerning payments for the original instruments. It has no need to go 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 may impact the debt instrument that is now insensitive to exchange market trends and volatility.

Finally, for the part covered by a currency swap agreement[30], 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.

[30] Or possible by any other derivative instrument with the same effect.

However, debt managers do not use financial derivatives only to suppress any exchange risk resulting from the initial incurrence of a new liability. They act also with the aim of reducing the final "burden" of the debt, the borrowing cost.

Under these conditions, they may enter in 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 that for swaps into national currency should apply. The currency denomination of the debt is changed. First, the rate of exchange agreed upon the contract has to be used, from the "original" currency to the "new" one. Second, the market rate of exchange has to be used, as usual, for the currency on which an exchange risk is borne.

In some cases, currently rather infrequent, debt managers may initialise a kind of "chain" of currency swaps. They exchange proceeds denominated in one currency resulting from a swap into another foreign currency. Several similar transactions may be implemented. In this case, through the different exchange rates included in the contracts, 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.

In some occasions, debt managers may swap a debt initially denominated in national currency into a foreign currency. They may have strong rationale grounds in order to take an exchange risk exposure (and in addition a new counterpart risk) whereas the issuance of the debt instrument was fully neutral on this point. In fact, due to some market configuration, they may hope as a final result a lower cost of borrowing.

It could be argued that for a debt originally denominated in national currency there is no need to apply the same rule based of successively use of two exchange rates, contractual and current. The transaction in financial derivative could be seen as a "pure" "treasury" management, fully detached from the underlying instrument.

However, the swap may change the total amount in national currency to be paid by the debtor, compared to a "straight" indebtedness transaction. In addition, such treatment is coherent with the new approach in the amended Regulation. Finally, using rates agreed upon the derivative contracts provides a best measure of the risk exposure.

4. Accounting examples[31]

1) Debt denominated in foreign currency swapped against the national currency

-Nominal value of debt instrument: 100 $.

-Swap dollar against Euro: 100$/95.24 € (exchange rate in the swap agreement: 1 € = 1.05 $).

-Valuation of the debt instrument according to the amended Regulation: 95.24 €.

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 95.24 € with certainty.

2) Debt denominated in foreign currency swapped against another foreign currency

-Nominal value of debt instrument: 100 $.

-Swap dollar against yen: 100$/10500 ¥ (exchange rate: l $ = 105 ¥).

-New nominal value of the debt: 10500 ¥.

-Valuation of the debt instrument according to the amended Regulation: 95.45 €
(on the basis of a market exchange rate: 1 € = 110 ¥)

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 was originally 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 €/105 $ (exchange rate 1 € = 1.05 $)

-New nominal value of the debt: 105 $

-Valuation of the debt instrument according to the amended Regulation: 98.13 € (on the basis of a market exchange rate: 1 € = 1.07 $)

Comments: the liability is no more in national currency but in foreign currency as, finally, 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 1.87 Euro.

[31] In the following examples, the national currency is assumed to be the Euro (€).

4) "Chain" of swaps

-Nominal value of debt instrument: 100 $

-Swap dollar against yen: 100$/10500 ¥ (exchange rate: 1 $ = 105 ¥)

-Swap yen against Swiss franc: 10500 ¥/168 CHF (rate of exchange: 100 ¥ = 1.6 CHF)

-Final nominal value of the debt: 168 CHF

-Valuation of the debt instrument accorded to the amended Regulation: 93.33 € (on the basis of a market rate of exchange: 1 € = 1,8 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 in 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$/47.62 € (exchange rate in the swap agreement: 1 € = 1.05 $).

-Valuation of the debt instrument according to the amended Regulation: 96.69 €, of which

* for the half which was not swapped:	49.07 €
(on the basis of a market exchange rate: 1 € = 1.07 $)	
* for the half which was swapped:	+ 47.62 €

Comments: the rate of exchange of the swap contact is more appropriate than the market rate for reflecting the cost of the part of the debt swapped against the national currency.

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)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 285(1) thereof,

Having regard to the proposal from the Commission[(1)],

Having regard to the opinion of the European Central Bank[(2)],

Acting in accordance with the procedure laid down in Article 251 of the Treaty[(3)],

Whereas:

(1) Council Regulation (EC) No 2223/96 of 25 June 1996 on the European System of national and regional accounts in the Community[(4)] contains the reference framework of common standards, definitions, classifications and accounting rules for drawing up the accounts of the Member States for the statistical requirements of the European Community, in order to obtain comparable results between Member States.

(2) In ESA 95, as in SNA 93, swaps are defined (5.67) as «contractual arrangements between two parties who agree to exchange, over time and according to predetermined rules, streams of payments on the same amounts of indebtedness» and it is specified that «the two most prevalent varieties are interest rate swaps and currency swaps».

(3) In original versions of ESA 95 and SNA 93, interest flows exchanged between two counterparts under any kinds of swaps and under forward rate agreements have been considered as non-financial transactions, recorded in property income, under the item interest.

(4) Problems have been raised by this statement and the Commission thus considers that it is necessary to exclude these interest flows from property income, in a manner similar to revised SNA 93.

(5) It is therefore appropriate to record these flows in financial transactions under the item financial derivatives, included in ESA 95 in F3 entitled «Securities other than shares».

(6) A specific treatment of these flows should be defined for the data transmitted under the excessive deficit procedure.

(7) The Committee on the statistical programmes of the European Communities, established by Decision 89/382/EEC, Euratom[(5)], and the Committee on Monetary, Financial and Balance of Payments Statistics, established by Decision 91/115/EEC[(6)], have each been consulted in accordance with Article 3 of the said Decisions,

HAVE ADOPTED THIS REGULATION:

Article 1

Annex A of Council Regulation (EC) No 2223/96 shall be amended in accordance with the Annex to this Regulation.

(1) OJ C 116 E, 26.4.2000, p. 63.

(2) OJ C 103, 3.4.2001, p. 8.

(3) Opinion of the European Parliament of 15 March 2001 (not yet published in the Official Journal) and Decision of the Council of 8 November 2001.

(4) OJ L 310, 30.11.1996, p. 1. Regulation as last amended by Commission Regulation (EC) No 995/2001 (OJ L 139, 23.5.2001, p. 3).

(5) OJ L 181, 28.6.1989, p. 47.

(6) OJ L 59, 6.3.1991, p. 19. Decision as amended by Decision 96/174/EC (OJ L 51, 1.3.1996, p. 48).

Article 2

This Regulation shall enter into force on the day of its publication in the *Official Journal of the European Communities.*

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 3 December 2001.

For the European Parliament
The President
N. FONTAINE

For the Council
The President
F. VANDENBROUCKE

ANNEX

Annex A of Council Regulation (EC) No 2223/96 is amended as follows:

1. In Chapter 4, paragraph 4.47 is replaced by the following:

   "4.47. No payment resulting from any kind of swap arrangement is to be considered as interest and recorded under property income. (See paragraphs 5.67(d) and 5.139(c) relative to financial derivatives).

   Similarly, transactions under forward rate agreements are not to be recorded as property income. (See paragraph 5.67(e))."

2. In Chapter 5:

   (a) in paragraph 5.67, points (d) and (e) are replaced by the following:

   "(d) swaps, but only if they have a market value because they are tradable or can be offset. Swaps are contractual arrangements between two parties who agree to exchange, over time and according to predetermined rules, streams of payment of the same amount of indebtedness. The most prevalent varieties are interest rate swaps, foreign exchange swaps and currency swaps (also named cross-currency interest swaps). Interest rate swaps involve an exchange of interest payments of different character, such as fixed rate for floating rate, two different floating rates, fixed rate in one currency and floating rate in another, etc. Foreign exchange swaps (including all forward contracts) are transactions in foreign currencies at a rate of exchange stated in advance. Currency swaps involve an exchange of specified amounts of two different currencies with subsequent repayments, which include both interest and repayment flows, over time according to predetermined rules. None of the resulting payments is considered as property income in the system and all settlements are to be recorded in the financial account;

   (e) forward rate agreements (FRAs), but only if they have a market value because they are tradable or can be offset. FRAs are contractual arrangements in which two parties, in order to protect themselves against interest rate changes, agree on an interest to be paid, at a settlement date, based on a notional amount of principal that is never exchanged. The payments are related to the difference between the agreement rate and the prevailing market rate at the time of settlement. These payments are not considered as property income in the system but are to be recorded under the item financial derivatives."

   (b) in paragraph 5.139, points (c) and (d) are replaced by the following:

   "(c) any explicit commissions paid or received from brokers or intermediaries for arranging options, futures, swaps, and other derivatives contracts are treated as payments for services in the appropriate accounts. The parties to a swap are not considered to be providing a service to each other, but any payment to a third party for arranging the swap should be treated as payment for a service. Under a swap arrangement, where principal amounts are exchanged the corresponding flows are to be recorded as transactions in the underlying instrument; streams of other payments (excluding commissions) are to be recorded under the item financial derivatives (F.34). While the premium paid to the seller of an option can conceptually be considered to include a service charge, in practice it is usually not possible to distinguish the service element. Therefore, the full price is to be recorded as acquisition of a financial asset by the buyer and as incidence of a liability by the seller;

(d) where swap contracts involve an exchange of principal amounts, for example as occurs with currency swaps, the initial exchange is to be recorded as a transaction in the underlying instrument exchanged and not a transaction in financial derivatives (F.34). Where contracts do not involve an exchange of principal, no transaction is recorded at inception. In both cases, implicitly, a financial derivative with zero initial value is created at that point. Subsequently, the value of a swap will be equal to:

1. for principal amounts, the current market value of the difference between the expected future market values of the amounts to be re-exchanged and the amounts specified in the contract;

2. for other payments, the current market value of the future streams specified in the contract.

Changes in the value of the derivative over time should be recorded in the revaluation account.

Subsequent re-exchanges of principal will be governed by the terms and conditions of the swap contract and may imply financial assets being exchanged at a price different from the prevailing market price of such assets. The counterpart payment between the parties to the swap contract will be that specified within the contract. The difference between the market price and the contract price is then equal to the liquidation value of the asset/liability as it applies on the due date and should be recorded as a transaction in financial derivatives (F.34). On the contrary, other flows under a swap arrangement are recorded as a transaction in financial derivatives for the amounts effectively exchanged. All transactions in financial derivatives must match the total revaluation gain or loss throughout the duration of the swap contract. This treatment is analogous to that set out with respect to options, which proceed to delivery (see point (a)).

For an institutional unit, a swap or a forward rate agreement is recorded under the item financial derivatives on the assets side where it has a net asset value, positive net payments increasing the net value (and conversely). Where the swap has a net liability value, it is recorded on the liabilities side, negative net payments increasing the net value (and conversely)."

3. The following Annex is added:

"ANNEX V

DEFINITION OF GOVERNMENT DEFICIT FOR THE PURPOSE OF THE EXCESSIVE DEFICIT PROCEDURE

For the purpose of the Member States' reports to the Commission under the excessive deficit procedure laid down in Council Regulation (EC) No 3605/93[(1)], "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 EDPB9. For this purpose, interest includes the abovementioned flows and is codified as EDPD41.

(1) OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 475/2000 (OJ L 58, 3.3.2000, p. 1)."

COMMISSION REGULATION (EC) No 351/2002

of 25 February 2002

amending Council Regulation (EC) No 3605/93 as regards references to ESA 95

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community[1], as amended by Regulation (EC) No 475/2000[2], and in particular Article 7 thereof,

Whereas:

(1) The definitions of «government», «deficit» and «investment» are laid down in the Protocol on the excessive deficit procedure annexed to the Treaty and in Regulation (EC) No 3605/93, by reference to the European system of national and regional accounts in the Community (hereinafter referred to as «ESA 95») established by Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community[3], as last amended by Commission Regulation (EC) No 113/2002[4].

(2) Regulation (EC) No 2223/96 contains the reference framework of common standards, definitions, classifications and accounting rules for drawing up the accounts of the Member States for the statistical requirements of the European Community, in order to obtain comparable results between Member States.

(3) 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[5] has changed the classification of interest flows under swap contracts and forward rate agreements (FRAs) from income property to financial account while stating at the same time the need for a specific treatment of these flows for the data transmitted under the excessive deficit procedure.

(4) Regulation (EC) No 3605/93, should therefore be amended accordingly.

(5) In order to avoid confusion concerning the application of the new references to ESA 95, the measures provided for in this Regulation should apply with effect from 1 January 2002,

HAS ADOPTED THIS REGULATION:

Article 1

Article 1(3) of Regulation (EC) No 3605/93 is amended as follows:

1. the code «B.9» is replaced by «EDP B.9»;

2. the code «D.41» is replaced by «EDP D.41».

Article 2

This Regulation shall enter into force on the day of its publication in the *Official Journal of the European Communities*.

This Regulation shall apply from 1 January 2002.

[1] OJ L 332, 31.12.1993, p. 7.
[2] OJ L 58, 3.3.2000, p. 1.
[3] OJ L 310, 30.11.1996, p. 1.
[4] OJ L 21, 24.1.2002, p. 3.
[5] OJ L 344, 28.12.2001, p. 1.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 25 February 2002.

For the Commission
Pedro SOLBES MIRA
Member of the Commission

V.3. Repurchase agreements

1. Background

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. It is not for this reason that this issue is included in the Manual. Units classified in this sector may enter into such contracts, either as liquidity provider or as cash borrower.

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). 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).

ESA95 provides specific recommendations on this item, although it includes no precise definition for this financial instrument.

SNA 1993 (11.32) 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 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").

2. Treatment in national accounts

a. Basic treatment in ESA95 (reminder)

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 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 5.46 (f), 5.64 (a), 5.81 (d). 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. In ESA95, 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” (5.75).
- 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. In no way is there a 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.

b. Additional rules

Some questions relating to repos are not mentioned in ESA95. The basic treatment needs to be supplemented.

- 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 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 to repurchase it under conditions agreed at inception.

- 5) An effective delivery of securities used in a repo, notably through electronic depository systems, has no effect on the conceptual treatment.

- 6) In the case an economic agent resells an asset "acquired" under a repo arrangement, a negative entry is recorded in his balance sheet.

- 7) Only securities lending with cash may be treated in a similar way to repos.

3. Rationale of the treatment

a. Maturity

This rule is based on experience. Most repos are engaged for very short-term maturity, frequently overnight. Obviously, 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 simplification is seen as an acceptable approximation.

b. Valuation

Repurchase agreements are considered as loans or deposits. 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. 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.

c. Underlying assets

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. 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. However, obviously, except transactions with the Central Banks (that do not concern units in general government) repos are in all likelihood linked to securities.

d. Repurchasing clause

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.

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. 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, the rule about firm commitment should be applied in a rather restrictive way. National compilers should implement exceptions only 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.

e. Delivery of securities

According to national regulations and market practice, it is rather frequent that securities are effectively 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. 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. 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.

f. Sale of asset during a repo arrangement

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. For a short while, it may first result in a negative value in the portfolios of some economic agents. Identifying such transactions may be difficult, notably in the case of cross-border flows.

g. Securities lending

In some countries, securities lending is largely used by investors on securities markets for many reasons such as covering short-term positions or for derivatives position management.

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. 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.

The treatment is quite in line with ESA95. The last sentence in 5.64(a) 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.

On the contrary, securities lending without a flow in cash (generally without collateral and for very short maturity) should not be treated as a repurchase agreement. This case is not specified in ESA95 (or SNA). It is in fact a kind of "loan in materials" that is not recognised as a financial instrument. ESA 5.69 specifies that there is a loan "...when creditors lend funds to debtors". No transaction should affect the financial accounts (stocks and flows).

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, it would be better classifying the latter transaction under "other accounts receivable/payable" and not 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. It may be assumed that only a minority of these transactions is cash-free. Thus, in absence of reliable data, a "repo-like" treatment could be applied for the whole.

4. Effect on debt

The effects on general government debt of this category of financial instruments may be as follows.

Where a unit in general government is "assignor", temporary seller or "cash receiver", there is an impact on gross debt as the item "loans" (F4) is increased in counterpart to the borrowed funds. But, if the counterpart is another unit classified in general government, the effect is nil at a consolidated level.

Where a unit is "assignee", providing funds to an economic agent classified in another sector, namely a monetary financial institution, there is no impact on the debt at gross and consolidated level. If a unit classified in general government (like Treasury agency) previously managed the funds there is a positive impact on gross debt.

It must be stressed that the impact is quite different 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. There is an impact on government debt only when a unit classified in general government lends or borrows public securities with a counterpart classified outside general government sector, as consolidated debt is respectively increased (decrease in assets) or reduced (increase in assets). There is no impact for transactions on other securities with a similar counterpart or, whatever the instruments involved, with a unit classified in general government.

5. Accounting treatments

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

Financial Account

ΔA			ΔL
F.22	-100		
F.29	+100		
		B.9	0

Bank

Financial Account

ΔA			ΔL
F.22	+100	F.29	+100
		B.9	0

2) At the maturity date (if no early redemption)

General government unit

Non financial account

U			R
		D41	1
B.9	+1		

Financial account

ΔA			
F.22	+101		
F.29	-100		
		B.9	+1

Bank

Non financial account

U			R
D41	1		
B.9	-1		

Financial account

ΔA			
F.22	-101	F29	-100
		B.9	-1

Appendix

COUNCIL REGULATION (EC) No 475/2000
of 28 February 2000
amending Regulation (EC) No 3605/93 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community

(OJ L 58, 3.3.2000, p.1)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular the third subparagraph of Article 104(14),

Having regard to the proposal from the Commission[1],

Having regard to the opinion of the European Parliament[2],

Whereas:

(1) The definitions of "government", "deficit" and "investment" are laid down in the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community and in Regulation (EC) No 3605/93[3] by reference to the European System of Integrated Economic Accounts; Regulation (EC) No 2223/96[4] replaced that system with the European System of National and Regional Accounts in the Community (hereinafter referred to as "ESA 95");

(2) The definition of "government debt" laid down in the Protocol on the excessive deficit procedure and in Regulation (EC) No 3605/93 needs to be further amplified by a reference to the classification codes of ESA 95; in the case of financial derivatives, as defined in ESA 95, there is no nominal value identical to that for other debt instruments; therefore, financial derivatives must not be included with the liabilities making up government debt for the purposes of the Protocol on the excessive deficit procedure; for liabilities which are subject to agreements fixing the exchange rate, this rate should be taken into account in the conversion into national currency;

(3) ESA 95 provides a detailed definition of gross domestic product at current market prices, which is appropriate for the calculation of the ratios of government deficit to gross domestic product and of government debt to gross domestic product referred to in Article 104 of the Treaty;

(4) Consolidated government interest expenditure is an important indicator for monitoring the budgetary situation in the Member States; interest expenditure is intrinsically linked to government debt; government debt to be reported to the Commission by the Member States has to be consolidated within the government sector; the levels of government debt and of interest expenditure should be made mutually consistent; the methodology of ESA 95 (point 1.58) recognises that, for certain kinds of analysis, consolidated aggregates are more significant than overall gross figures; the way in which the figures on interest expenditure are to be provided to the Commission by the Member States should be clarified;

(5) The definitions and classification codes of ESA 95 may be subject to revision in the context of the necessary harmonisation of national statistics or for other reasons; revisions of ESA 95 or amendments to its methodology are decided by the Council or the Commission in accordance with the rules on competence and procedure laid down in the Treaty and in Regulation (EC) No 2223/96;

(6) Article 8(2) of Regulation (EC) No 2223/96 stipulates that the former European System of Integrated Economic Accounts was to continue to be used for the purposes of Member States' reports to the Commission under the excessive deficit procedure during a transitional period until the reporting exercise of 1 September 1999,

HAS ADOPTED THIS REGULATION:

[1] OJ C 376 E, 28.12.1999, p.18.
[2] Opinion delivered on 17 February 2000 (not yet published in the Official Journal).
[3] OJ L 332, 31.12.1993, p.7.
[4] OJ L 310, 30.11.1996, p. 1.

Article 1

(not reproduced, see amended version of Council Regulation N° 3605/93)

Article 2

This Regulation shall enter into force on the day of its publication in the *Official Journal of the European Communities.*

It shall apply from 1 January 2000.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 28 February 2000.

For the Council

The President

J. PINA MOURA

COUNCIL REGULATION (EC) No 3605/93
of 22 November 1993
on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community

(OJ L 332, 31.12.1993, p.7)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular the third subparagraph of Article 104 (14) thereof,

Having regard to the proposal from the Commission[1],

Having regard to the opinion of the European Parliament[2],

Whereas the definitions of 'government', 'deficit' and 'investment' are laid down in the Protocol on the excessive deficit procedure by reference to the European System of Integrated Economic Accounts (ESA)[3]; whereas precise definitions referring to the classification codes of ESA are required; whereas these definitions may be subject to revision in the context of the necessary harmonization of national statistics or for other reasons; whereas any revision of ESA will be decided by the Council in accordance with the rules on competence and procedure laid down in the Treaty;

Whereas the definition of 'debt' laid down in the Protocol on the excessive deficit procedure needs to be amplified by a reference to the classification codes of ESA;

Whereas Council Directive 89/130/EEC, Euratom of 13 February 1989 on the harmonization of the compilation of gross national product at market prices[4] provides an adequate, detailed definition of gross domestic product at market prices;

Whereas, pursuant to the terms of the Protocol on the excessive deficit procedure, the Commission is required to provide the statistical data to be used in that procedure;

Whereas detailed rules are required to organize the prompt and regular reporting by the Member States to the Commission of their planned and actual deficits and of the levels of their debt;

Whereas, pursuant to Article 104 (2) and (3) of the Treaty, the Commission is to monitor the development of the budgetary situation and of the stock of government debt in the Member States and to examine compliance with budgetary discipline on the basis of criteria relating to government deficit and government debt; whereas, if a Member State does not fulfil the requirements under one or both criteria, the Commission must take into account all relevant factors; whereas the Commission has to examine whether there is a risk of an excessive deficit in a Member State,

HAS ADOPTED THIS REGULATION:

SECTION 1

Definitions

*Article 1**

1. For the purposes of the Protocol on the excessive deficit procedure and of this Regulation, the terms given in the following paragraphs are defined according to the European System of National and Regional Accounts in the Community (hereinafter referred to as "ESA 95"), adopted by Regulation (EC) No 2223/96[5]. The codes in brackets refer to ESA 95.

2. "Government" means the sector of "general government" (S.13), that is "central government" (S.1311), "state government" (S.1312), "local government" (S.1313) and "social security funds" (S.1314), to the exclusion of commercial operations, as defined in ESA 95.

The exclusion of commercial operations means that the sector of "general government" (S.13)

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[1] OJ No C 324, 1. 12. 1993, p. 8; and OJ No C 340, 17. 12. 1993, p. 8.
[2] OJ No C 329, 6. 12. 1993.
[3] Statistical Office of the European Communities, European System of Integrated Economic Accounts (ESA), second edition.
[4] OJ No L 49, 21. 2. 1989, p. 26.

* Articles 1, 2, 4, 5 and 7 as amended by Council Regulation N° 475/2000 (OJ L 58, 3.3.2000, p.1).
[5] Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community (OJ L 310, 30.11.1996, p. 1).

comprises only institutional units producing non-market services as their main activity.

3. "Government deficit (surplus)" means the net borrowing (net lending) (B.9) of the sector of "general government" (S.13), as defined in ESA 95. The interest comprised in the government deficit is the interest (D.41), as defined in ESA 95.

4. "Government investment" means the gross fixed capital formation (P.51) of the sector of "general government" (S.13), as defined in ESA 95.

5. "Government debt" means the total gross debt at nominal value outstanding at the end of the year of the sector of "general government (S.13), with the exception of those liabilities the corresponding financial assets of which are held by the sector of "general government" (S.13).

Government debt is constituted by the liabilities of general government in the following categories: currency and deposits (AF.2); securities other than shares, excluding financial derivatives (AF.33) and loans (AF.4), as defined in ESA 95.

The nominal value of a liability outstanding at the end of the year is the face value.

The nominal value of an index-linked liability corresponds to its face value adjusted by the index-related change in the value of the principal accrued to the end of the year.

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 upon 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 upon 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 upon in those contracts.

*Article 2**

For the purposes of the Protocol on the excessive deficit procedure and of this Regulation, gross domestic product means gross domestic product at current market prices (GDP mp) (B.1*g), as defined in ESA 95.

Article 3

1. Planned government deficit figures mean the figures established for the current year by the Member States consistent with the most recent decisions of their budgetary authorities.

2. Actual government deficit and government debt level figures mean estimated, provisional, half-finalized or final results for a past year.

SECTION 2

Rules and coverage of reporting

*Article 4**

1. As from the beginning of 1994, Member States shall report to the Commission their planned and actual government deficits and levels of government debt twice a year, the first time before 1 March of the current year (year n) and the second time before 1 September of year n.

2. Before 1 March of year n, Member States:

- shall report to the Commission their planned government deficit for year n, an up-to-date estimate of their actual government deficit for year n-1 and their actual government deficits for years n-2, n-3 and n-4,

- shall simultaneously provide the Commission for years n, n-1 and n-2 with their corresponding public accounts budget deficits according to the definition which is given most prominence nationally and with the figures which explain the transition between this public accounts budget deficit and their government deficit. The figures explaining this transition which are provided to the Commission shall include, in particular, the figures for net borrowing of the subsectors S.1311, S.1312, S.1313 and S.1314,

- shall report to the Commission their estimate of the level of actual government debt at the end of year n-1 and their levels of actual government debt for years n-2, n-3 and n-4,

- shall simultaneously provide the Commission for years n-1 and n-2 with the figures which explain the contributions of their government deficit and the other relevant factors contributing to the variation in the level of their government debt.

3. Before 1 September of year n, Member States shall report to the Commission:

- their updated planned government deficit for year n and their actual government deficits for years n-1, n-2, n-3 and n-4 and shall comply with the requirements of the second indent of paragraph 2,

- their actual level of government debt for years n-1, n-2, n-3 and n-4, and shall comply with the requirements of the fourth indent of paragraph 2.

4. The figures for the planned government deficit reported to the Commission in accordance with paragraphs 2 and 3 shall be expressed in national currency and in budget years.

The figures for actual government deficit and actual government debt level reported to the Commission in accordance with paragraphs 2 and 3 shall be expressed in national currency and in calendar years, with the exception of the up-to-date estimates for year n-1, which may be expressed in budget years.

Where the budget year differs from the calendar year, Member States shall also report to the Commission their figures for actual government deficit and actual government debt level in budget years for the two budget years preceding the current budget year.

*Article 5**

Member States shall, in accordance with the procedure laid down in Article 4 (1), (2) and (3), provide the Commission with the figures for their government investment expenditure and interest expenditure (consolidated).

Article 6

Member States shall provide the Commission with a forecast of their gross domestic product for year n and the actual amount of their gross domestic product for years n-1, n-2, n-3 and n-4, under the same timing conditions as those indicated in Article 4 (1).

*Article 7**

In the event of a revision of ESA 95 or of an amendment to its methodology to be decided on by the Council or the Commission in accordance with the rules on competence and procedure laid down in the Treaty and in Regulation (EC) No 2223/96, the Commission shall introduce the new references to ESA 95 into Articles 1, 2 and 4.

Article 8

This Regulation shall enter into force on 1 January 1994.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 22 November 1993.

For the Council

The President

Ph. MAYSTADT

Framework for the **Reporting of Government Deficit and Debt Levels** in accordance with Council Regulation (EC) N° 3605/93, as amended by Council Regulation (EC) N°475/2000, and the Statements contained in the Council Minutes of 22/11/1993.

- Reporting before […] -

Please mention data sources and whether the data supplied are confidential or publicly available

Table 1: Reporting of government deficits and debt levels and provision of associated data in accordance with the definitions and rules laid down in Council Regulation (EC) No 3605/93, as amended by Council Regulation (EC) No 475/2000.

Member State: …… Data are in … (units of currency) Date: …/…/ 20..	ESA 95 codes	Year 20.. (1), (2)	20.. (1), (2)	20.. (1)	20.. (1)	20... 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					
General government consolidated gross debt						forecast (3)
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					
Gross fixed capital formation	P.51					
Interest (consolidated)	EDP D.41 (uses)					
Gross domestic product at current market prices	B.1*g					

(1) Please indicate status of data: estimated, half-finalised, final.
(2) Data for sub-sectors to be provided in accordance with an agreement reached in the Expert Group "Comparison of Budgets".
(3) Forecast of level of government debt to be provided by the Member States in accordance with statement No 7 to the Council Minutes of 23/11/1993.

Table 2: Provision of the data which explain the transition between the public accounts budget deficit and the government deficit in accordance with article 4 (2), second indent, of Council Regulation (EC) No 3605/93, as amended by Council Regulation (EC) No 475/2000

Member State: …… Data are in … (units of currency) Date:…/…/ 20..	Year 20.. (1)	20.. (1)	20.. planned	Specifications
Net balance to be financed (-) by the State				**Please specify what is the departing balance in this table**
(public accounts)				
Financial transactions included in the budget				
Loans, granted (+)				
Loans, repayments (-)				
Equities, acquisition (+)				
Equities, sales (-)				
Other financial transactions (+/-)				
Other accounts receivable (+) and payable (-)				
Difference between interest paid (+) and interest accrued (-)				
Net borrowing (+) or net lending (-) of State entities not part of central government				
Net borrowing (-) or net lending (+) of other central government bodies				
Other adjustments (+/-)				
Net borrowing (-)/lending(+) of central government (S.1311)				
(ESA 95 accounts)				
Net borrowing (-) / net lending (+) of				
state government (S.1312)				
local government (S.1313)				
social security funds (S.1314)				
Net borrowing (-)/lending (+) of general government (S.13)				

(ESA 95 accounts)
(1) Please indicate status of data: estimated, half-finalised, final.

Table 3: Provision of the data which explain the contributions of the government balance and the other relevant factors to the variation in the government debt level in accordance with Article 4 (2), fourth indent, of Council Regulation (EC) No 3605/93 and the Statement No 7 to the Council Minutes of 22/11/1993.

Member State: …… Data are in … (units of currency) Date: …/…/ 20..	Year 20.. (1)	 20.. (1)	 20..	Specifications
Net borrowing (+)/lending (-)(B.9) of general government				
(ESA 95 accounts)				
Net acquisition of financial assets (consolidated)				
Currency and deposits (F.2) (+/-)				
Securities other than shares (F.3) (+/-)				
Loans (F.4)				
Granted (+)				
Repayments (-)				
Shares and other equity (F.5)				
Acquisitions (+)				
Sales (-)				
Other financial assets (F.1, F.62 and F.7) (+/-)				
Adjustments (consolidated)				
Net incurrence of liabilities in financial derivatives (F.34) (-/+)				
Net incurrence of other liabilities (F.62 and F.7) (-/+)				
Appreciation(+)/depreciation(-) of foreign-currency debt*				
Issuances above(-)/below(+) par				
Difference between interest accrued (EDP D.41)(-), and interest paid (+) and capital uplift (+/-)				
Redemptions of debt above(+)/below(-) par				
Changes in sector classification (K.12.1**) (+/-)				
Other volume changes in financial liabilities (K.7**, K.8**, K.10**) (-)				
Statistical discrepancies				
Discrepancy between financial and capital accounts(+/-)				
Other (+/-)				
Change in government gross debt (2)				

Please note that the sign convention for net borrowing / net lending is different from tables 1 and 2.

* Due to exchange-rate movements and to swap activity.

** Only concerning liabilities AF.2, AF.33 and AF.4. At face value.

(1) Please indicate the status of the data: estimated, half-finalised, final.

(2) A positive entry in this row means that nominal debt increases, a negative entry that nominal

(3) Forecast change in government debt to be provided in accordance with statement N° 7 by the Member States to the Council minutes of 23/11/1993.

Table 4: Provision of other data in accordance with the statements contained in the Council minutes of 22/11/1993.

Statement Number	Member State: Data are in … (units of currency) Date:…/…/ 20..	Year 20.. (1)	20.. (1)	20.. (1)	20.. (1)	20.. 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-finalised, final.
(2) Data to be provided in particular when GNI (also known as GNP) is substantially greater than GDP.

Index