METHODS AND NOMENCLATURES

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Capital injections (Part II, chapter 3)

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II.3 Capital injections

II.3.1 Capital injections into public corporations

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1. Background

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

The notion of a “capital injection” as such is not defined in the SNA93 or in the ESA95. In the media, the term is used for many types of payment from government to a public corporation which in national accounts have to be classified under quite different headings as capital transfers or as financial transactions. For example, it includes transactions that might 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 most often made in cash, but can also be made in kind. The latter case is the subject of a later part of this chapter (“Capital injections in kind” – II.3.2).

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

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

- a non-financial transaction: assuming that this is an unrequited payment, it would be a capital transfer, having no automatic effect (aside from any revaluation effect) on the government equity.

2. Treatment in national accounts[1]

2.1 General principle

The principle is the following:

When the government, acting in the same capacity as a private shareholder, provides funds while receiving financial assets in return and expects to earn a future return on its investment (in the form of dividends or a higher value of the financial instrument which represents government's property rights on the corporation), the capital injection is to be recorded as a financial transaction in shares and other equity.

When, on the other hand, the government, acting for public policy purposes[2], provides funds to a corporation without receiving financial assets and without expecting a future return on the investment, the capital injection is to be recorded as a capital transfer.

[1] This guidance covers only the case of a *transaction*, i.e. an economic flow that results from the interaction between two institutional units by mutual agreement (or an action within an institutional unit that it is useful to treat as a transaction - see ESA95 §1.33). Therefore, it excludes the case of a restructuring of assets and liabilities or reclassification of units (both of which are normally recorded as *other flows* in the other changes in the volume of assets account -ESA95, §6.30).

[2] 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*.

2.2 Recording a financial transaction

(*See the annex for further detail).*

a. Transactions in equity

In the majority of cases, the financial instrument concerned is equity (F.5). A transaction in equity in this context is the action of “placing funds at the disposal of a corporation” (ESA95, §4.53), increasing the equity capital.[3] This is to be recorded in national accounts as a financial transaction, in shares and other equity (F.5). In accordance with ESA95, §4.53 and 5.86, this transaction increases the property rights of shareholders of the corporation. Thus, the investment must be made predominantly for market purposes and not for public policy purposes.

Additionally, a capital injection that is made as part of a privatisation process within a short term perspective (less than one year), such that government expects to get its money back, is always recorded in F.5 (consistently with ESA95, §5.16)[4].

A capital injection that results in government acquiring quoted shares of equal value is a straightforward case. The fact that the shares are quoted means that the shares may be traded on market by private investors (as defined in ESA95 chapter 2) and therefore that the corporation is respecting some minimum market requirements in the long run.

However, the private investors should not be crowded out by the government's share acquisition (which reduces their participation to a level where they could not exercise influence). They must also bear strictly similar risks and rewards to those borne by government notably as regards their rights on the net assets of the corporation in case of liquidation (case of issuance of shares with specific features).

Where the capital injection is given to an unlisted public corporation, the capital injection should be recorded in F.5 only if government has the objective of increasing its future wealth, under the form of dividends or a higher value of the financial instrument received in counterpart (or at least equal to the amount injected, under an ongoing process of privatisation).[5]

Normally, a condition is that the public corporation has not accumulated net losses as recorded according to generally accepted accounting standards and, for instance, evidence being given by the trend of own funds. However, even in such cases, any part of the capital injection used for investment in profitable areas of activities with an evident and long-term profitability may be recorded as financial transaction (typically in F.5).

[3] In some cases, the injection can take the form not of cash funding but of "a contribution in kind" (productive assets). The Manual recommends recording this exchange of non-financial assets against financial assets as another change in volume. (See further, II.3.2.2.b)

[4] This case, as well as others described in this chapter, 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.

[5] The application of this principle to the specific case, observed in some Member States, of public corporations that, due to statutory provisions, is not allowed to make profits (and, thus, to distribute dividends), but must not show losses, needs special attention. Strictly speaking government cannot expect a positive return, as defined above, in such cases. Nevertheless, it is still appropriate to classify the injection as a financial transaction if the value of the injected funds is expected to be maintained in the form of an increase value in government's holding in the corporation, evidence given for example by an addition to the fixed assets of the corporation.

A capital injection should also be recorded as a financial transaction in two specific cases:

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

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

b. Transactions in other financial instruments

Not all financial transactions take the form of acquisition of equity: other possibilities are the making of a loan (F.4) or the purchase of bonds. (F.3)

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

One exception is where government grants a loan to a loss-making public corporation, in a context where it is very likely that the corporation would not be in a position to repay the loan (because of recurrent losses and with no expectation of restoring profitability before the maturity date(s)). In this case, the funds transferred to the corporation by government are recorded as a non-financial transaction for their full amount.

In addition, in certain specific contexts (financial defeasance, business rescue, export insurance...), the characteristics of "loans" provided by government (the contractual obligations) should be examined closely to check whether it is correct to classify them in F.4.

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

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

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

<u>Conclusion</u>: *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.*

2.3 Recording a non-financial transaction

(*See the annex for further detail).*

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

The case of capital injections in kind (transfers of fixed assets) will be dealt with in the following part of this chapter (II.3.2), and only capital transfers in cash will be considered here.

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

a. <u>Investment grants (D.92</u>)

A capital injection that is conditional on the public corporation spending the funds on fixed capital formation, but does not commit the recipient any further, such as in making future payments, should be recorded as a capital transfer – in this case an investment grant (D.92).[6]

b. <u>Accumulated losses or other capital transfers (D.99)</u>

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

However, there are some exceptions (investment of private shareholders, specific investment in a profitable activity carried out by the corporation, fundamental restructuring that are described in the annex, at the end of this chapter.

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

[6] 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).

Conclusion: in both cases, a capital injection recorded as a non financial transaction has an impact on the government net borrowing/net lending, as well as on the net worth in the balance sheet.

3. Rationale of the treatment

3.1 Types of capital injections into a public corporation

Government may increase a public corporation's holdings of financial assets (generally cash) at a given point in time in three ways.

It matters in national accounts to clearly distinguish them as they result in different treatments, according to the classification of transactions and assets provided by ESA95:

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

   An important feature of capital transfers is that they are transactions which are usually undertaken only by governments. Acting this way, the government expects no return on its investment in the form of dividends (most of the time the enterprise receiving such transfers does not pay dividends) or of value of government assets that could be realised in a privatisation. Of course, government is acting for precise public policy purpose and is expecting some economic or social results from the use of the funds but he is not requiring any result in any form specifically from the amount transferred to the receiver.

2. Raising 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 and no change to the net worth (but there is a change in own funds due to equity capital).

   In providing equity capital to the corporation, the government acts similarly to a private shareholder, with the strong expectation of a return on investment. In this regard the actual payment of dividends to the shareholder, or the positive trend in the value of the shares would be important criteria for treating the injection as equity.

3. Borrowing 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).

   As a lender, government is expecting that the public corporation, as a borrower, would be in a position to redeem the funds, according to a schedule agreed at inception, and would be rewarded by an amount of interest of which all conditions are fixed at inception and that would depend on various factors, among them risk is predominant.

3.2 Own funds and equity capital

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

The instrument "Equity capital" is not defined as such in the SNA93 or 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 are to be recorded - like all assets and liabilities in the national accounts - at market value (ESA95, §7.01, 7.25 and 7.52).

- **§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 by borrowing.* In contrast to loan capital, however, equity capital does not give rise to a liability that is fixed in monetary terms and it does not entitle the holders of shares of a corporation to a fixed or predetermined income."

- **§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 to a share in the profits of the corporations or quasi-corporations and to a share in their net assets in the event of liquidation." 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 (ESA95, §5.86).

A transaction in equity may be considered having three characteristics:

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

As a result, in national accounts, shares and other equity must be valued at a market value that reflects the expectations of return, whereas in balance sheets of the issuers they are usually accounted for at historic value (or book value). Where shares are listed on a market, their value is the observed price. Where equity does not consist of shares, or consists of shares that are not tradable on a market - as it is frequently the case for a public corporation - a proxy market value must be implemented in national accounts (see ESA95, §7.54 and next).

3.3 Capital transfers (D.9)

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.*

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

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

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

- *Capital transfers in cash*: these consist of transfers of cash that one party has raised by disposing of an asset (other than inventories) or that a second party is required to use by acquiring an asset (other than inventories). 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[7].

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

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

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

[7] See the following paper “Capital injections in kind” (II.3.2)

Annex: operational guidance[8]

Government is injecting capital into a public corporation under the legal form of new shares or similar instruments representing property rights on corporations.

The following key questions must be examined:

-Is government injecting capital into an existing corporation or into a corporation that either is set up at this time or starts completely new activity, or is acquiring new kinds of productive assets for large amounts)[9]?

-Does the public corporation have accumulated net losses as recorded according to generally accepted accounting principles (and, for instance, with evidence in the trend of the corporation's own funds)?

-Is government acting alone (possibly together with one or more public corporations, for a minor part) or jointly with private shareholders (as defined in ESA95 chapter 2)?

¦ I It is an existing corporation that is not changing its activity

¦ I.1 The corporation has accumulated net losses

¦ I.1.1 There are no private shareholders

As a general rule, the capital injection is treated as a non-financial transaction for its full amount.

With the following exceptions:

1) where a capital injection exceeds the net amount of accumulated losses and government can provide evidence that this excess is specifically used to make further investment in already profitable operational areas of the corporation's activity, with an evidence in past results and that government aims an obvious return from the new injection of funds (evidence given in some cases by a clear intention to privatise the business):

the capital injection is treated as a non-financial transaction up to the limit of the accumulated losses and as a financial transaction beyond this amount.

[8] In a large part, the following provisions can only be implemented through on a case-by-case analysis, based on the assessment of the information available. Therefore, the classification of the capital injection is made by the Member State competent institutions, without prejudice to the role of Eurostat and CMFB, as is provided for in the 2003 Code of best practice.
[9] In the latter two cases, a condition is that all relating expenditure and revenue can be separately identified in the accounting system of the corporation.

2) where there is an obvious fundamental restructuring of the corporation, in order to prevent the occurrence of new losses after the complete implementation of the new business plan, the treatment will depend on a specific examination of various indicators[10]:

> either, there is evidence that government will in a rather high likelihood benefit from a return on its new investment[11],
>
> > the capital injection is treated as <u>financial transaction for its full amount,</u>
>
> or, if the positive return on new investment is still uncertain[12], such that it would take time to offset the accumulated losses,
>
> > the capital injection is treated as <u>a non-financial transaction up to the limit of the accumulated losses, and as a financial transaction beyond this amount</u>.

¦ I.1.2 <u>There are private shareholders participating in the capital injection</u>

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

Where the private investors:

(i) take a significant share in equity,

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

(iii**)** bear similar risks to government as regards their rights on the net assets in the event of liquidation (ESA95 5.86)

The capital injection is treated as <u>a financial transaction for its full amount</u>.

Where the private investors do not fulfil one of the conditions mentioned above, the capital injection should be closely examined to determine whether it should be treated according to rules specified in the cases where there are no private shareholders.

¦ I.2 <u>The corporation has not accumulated net losses</u>

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[10] As main operational guidance they might be the rating (or change in) of the debt (notably long term debt), the significance of downsizing in staff and structure, the shift to new activities, the reorganization of management, etc.

[11] In other words, there is a large consensus on considering that the restructuring may be efficient.

[12] The restructuring plan is largely considered as insufficient as regards the main sources of losses and/or restoring profitability depends substantially on factors not under the control of the corporation.

Normally, this means that the corporation makes profits, regularly distributed or reinvested, even if in some cases statutory provisions impose only a strict coverage of total costs.

Where government is obviously acting similarly to a private shareholder, meaning that it provides funds, receives in return financial assets and is expecting a future return on the investment (in the form of dividends or higher value of the financial instrument representing the government's property rights in the corporation),

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

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

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

¦ II **It is a new corporation or new activity/assets**

The treatment will depend on the specific examination based on the various indicators as usually used in investment analysis. The presence of private investors could also be a key indicator.

In any case, it should be obvious that government does not intend to use the new unit largely for public policy purposes.

As a result:

> Either, the conditions support the conclusion that, after a "normal" period of losses (as usually observed for similar investments), the corporation would be structurally profitable,
>
> > the capital injection by government is treated as a financial transaction for its full amount.
>
> Or, on the basis of various factors (an uncertain economic environment, non-compensation of some costs imposed by government, the consensus opinion of independent experts in different areas like accountancy, economics and financial analysis, etc.) there are doubts on the long-term profitability of the project,
>
> > the capital injection is treated as a non-financial transaction for its full amount.