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Calculating the Accrual of Interest on Tradeable Debt Securities

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Summary of the discussion of the OECD Working Party on Financial Statistics

The Background

1. Accrual accounting is one of the major changes of the revised *System of National Accounts 1993* (SNA93) and the *Balance of Payments Manual, 5th edition* (BPM5). However, there is some confusion in the interpretation and the application of the principle to the various types of statistics compiled at the national level. This issue was raised at the October 1999 session of the OECD Working Party on Financial Statistics (WPFS) where participants agreed that further work would be necessary in order to clarify the theoretical concepts and their application.

2. Following from that recommendation, an agenda item was devoted to the subject in November 2000. The Working Party considered a report by two experts[1]: 'Calculating the accrual of interest on tradable debt securities' [DAFFE/MC/STAT(2000)15]. The report is the first version of an extensive study which includes conclusions making recommendations for a preferred method to record the accrual of interest.

3. The report discusses mostly the conceptual framework but does not question the principle of accrual accounting recommended by international manuals. What is questioned by the authors is rather how the principle should be applied. In addition to the conceptual framework, the study also provides some examples for recording interest on an accrual basis for securities that are subject to price changes. The ultimate objective is to agree on a common methodology to achieve consistency not only across countries but also between different types of statistics, namely the national accounts, balance of payments, government finance statistics and money and finance statistics. In conclusion, the authors of the study recommend the use of the market price principle applied by the creditor approach as opposed to the debtor approach or the acquisition approach.

4. The Working Party devoted sufficient time to discuss this important issue. The present document does not intend to repeat the arguments included in the study or to relate the entire discussion. It will only attempt to relate the main arguments and comments raised during the session.

General remarks and conclusions of WPFS

5. Delegates welcomed this excellent report which discusses the conceptual framework for calculating the accrual of interest in the most objective way. The document makes it very clear that the market value approach is the only approach which provides the grounds for a valid and consistent treatment across all the statistics.

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1. The views expressed by experts, Chris Wright from the Bank of England and John Joisce from the IMF, are in their personal capacity.

6. This study is very timely as many compilers have been raising the practical application of accrual accounting. The adoption of fair value accounting by the business community is in line with the statistical standards.

7. The Working Party congratulated the authors for this very comprehensive document and encouraged them to follow-up this difficult and complex task which is extremely useful for national compilers. Although the study includes some practical examples, the focus is mostly on the theoretical framework. Thus, Delegates recommended that the practical application of the concepts be further developed in future versions. The Working Party expressed a keen interest in reviewing future versions of the document for comments and recommendations.

8. The Working Party also recommended that the final version of the report be submitted to the Intersecretariat Working Party on National Accounts.

Different approaches

9. The principles set out in the international manual have led to some confusion which adds to the complexity of the interpretation and the practical application of interest accrual:

- Debtor approach relates to the historical price, i.e. the rate that was applicable when the security was issued. Although SNA93 does not clearly recommend or discuss a specific approach to use, some consider (or interpret) the SNA93 recommendation to be in line with the debtor approach.

- Creditor approach is the preferred approach of the authors and is in line with the principles set out in the *Balance of Payments Compilation Guide* and *Balance of Payments Textbook*. Conceptually, it relates to the current market price. The yield at the time of issue of the security is not relevant but rather the current yield is relevant, i.e. the yield at the time when the flow is measured. This approach is, in principle, in line with the national accounts as it is based on the market value.

- Acquisition approach relates to the rate required by the asset holder. It does not apply to the debtor at the time of purchase of the security but could relate to any time after the date of issue of the security. This approach is more in line with the recommendations as stated in BPM5.

10. The SNA is a conceptual construction and is a closed system where all elements must have an interpretation and a counterpart. Therefore, all the accounts must be balanced. The document provides several numerical examples in Tables 1 to 4. One could not argue that debtor and creditor approaches are fundamentally different. The logic of the system is the same for both debtor and creditor approaches, i.e. the market price determines the interest flows. However, the authors demonstrate that the debtor approach requires a balancing item to fulfil the requirements of the system while the statistics will be balanced naturally when applying the creditor approach.

11. In the debtor approach the balancing item is ‘other revaluations’ to ensure consistency between closing and opening statements. Conceptually speaking, this recording corresponds more to a ‘reconciliation’ item rather than revaluation. Its interpretation does not have an analytical meaning. On the other hand, by using the creditor approach all elements are absorbed and can be explained.

12. As an example of practical application, it was indicated that some countries would follow the example described in Table 3 of the report with some minor differences: the amounts recorded under 'other revaluations' in years 4 and 5 will appear under 'market revaluations'.

13. The argument against this presentation is that one cannot use market revaluation while there has been no change in the market price. The change is due to an accumulation of interest which has not yet been compensated by some other payment , e.g. in the form of coupon payment. Consequently, it should not appear under market revaluation which, according to SNA93 and PBM5 would indicate revaluations due to price changes in the recording period.

14. The lack of coherence in the debtor approach can be demonstrated by an example of a bond issue which has changed its value following the change in the market value. The issuer buys back the bond at a different price than the issue price. Afterwards, he reissues the bond at the purchase price which is the market rate. Within the debtor approach, the future stream of the bond will be different than what it would have been if it was not bought back and reissued.

Suggestions for the revision of the report

15. The report should be expanded to include more practical information and practical examples.

16. With regard to the boundary between interest and capital gains or losses, there is no confusion between the concepts. However, the document could usefully provide additional clarifications..

17. The debtor could choose to buy-back or not to buy-back the security. In the past, there has been little buying back of issued debt. However, the trends indicate a change in the behaviour of issuers. A practical example is the government debt mangers. These examples could be further elaborated.

18. In paragraph 54 of the document one reads ' .. but the market rate of the bond has now increased …' This statement indicates a change in the market price and, thus, justifies the use of the post 'market revaluation'. The text will need further clarification to indicate that the change is due to the accrual of interest but is not a revaluation change resulting from a price change.

19. The authors use the words 'interest' and 'yield' almost indifferently. This may be a matter of language only but could be usefully clarified to improve the text. The SNA93 refers only to 'interest' but not to 'yield'.

20. The balancing items used in the numerical examples for a better comprehension of the arguments.

21. The treatment of variable rates, indexed interest rates, etc. could be further elaborated (from the creditor approach).

22. The report deals with financial derivatives but does not explore fully these instruments as much as they deserve.

23. The section devoted to sectoral and national savings is rather short and could be developed further on the practical aspects.

24. With regard to business accounting, the issue is more complex and the wider use of fair value accounting may take much longer than what is indicated in the paper. Some further exploration is recommended.

25. The report could usefully include further discussions on the interpretation of the statistics. The users will have to be educated to take into account the accrual accounting as opposed to cash based concepts. Users will have to adopt a wider approach to statistics rather than limiting themselves to certain compartments. They will have to look at the system as a whole, i.e. to take into account the relations between different accounts (e.g. the impact of changes in the current account on the financial account, etc.).