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Luxembourg

Comments and Questions to the *Comments on "Accrual of Earnings on Equity in the SNA: Capital Injections, Superdividends, and Reinvested Earnings" (August 11, 2004)* by Brooks Robinson and and Tim Dobbs (BEA)

By **Philippe de Rougemont**

Thank you very much for those inspiring and extremely useful comments on the draft Executive Summary to the Team 1 paper circulated on July 22, 2004.

In summary, your comments would seem to express broad support for recognizing gains/losses of public corporations as property income of government at time they accrue, instead of at time they are distributed or settled (as currently the case in the 1993 SNA). The comments emphasize that this is because the relationship of government is not at arms'length, rather than because of the need for a wider and truer measure of property income on equity.

I refer below to the structure of the BEA comments.

Question 1.
#1. This will be noted.
#2. I take it from this para that the BEA method for compiling government accounts involves (1) adding the "surplus of government enterprises" and (2) ignoring inflows (superdividends or generally all dividends) or outflows (injections, notably in cash) between government and public corporations. Is it correct? Useful clarifications would be whether the surplus is after dividend or before (if before, then all dividends are disregarded under (2)), whether "surplus" also covers losses and can be negative (although probably not likely in aggregate), whether "surplus" is included in the "government total revenue" (if published).

It would seem that the BEA accounts would then already apply accrued income for public corporations. **Is it a correct characterisation of the BEA practice?**

Question 2.
The reference to "capital transfers" is seemingly contradictory with the advocating of "treating superdividends and capital injections as financial transactions".
Perhaps the use of **capital transfers** was meant by reference to accumulation accounts, and in fact referring to capital equity (which we should call, in SNA parlance, "transaction in equity" – F.5). **Am I correct?**

Question 3.
#2 could usefully be clarified. It would seem necessary to record a transaction at time of (super)dividend or capital injection. The question to my mind is then whether that transaction is financial or non financial. However, a separate issue is: in case the treatment is financial, should we in addition record prior to that transaction another, distributive (nonfinancial), transaction? The last sentence would seem ambiguous. Is it meant to take only a position on the first issue? Or on both (i.e., suggesting no prior distributive/nonfinancial transaction)? Or was the term "financial transaction" used loosely here?

If one treats (super)dividend or capital injection as financial transactions but without prior distributive transactions, then we risk minimizing property income of government over the long run but also, more problematically, government expense.

Question 4.
The fall in value of shares at time of distribution seems not an OCV: agree. However, note that the second sentence seems difficult to understand (*as a transaction in the "OCV account")*. Secondly, the **distribution of dividends leads automatically to a fall in value of the share position whether unquoted or not** – and this fall is even more directly established for unquoted equity than for quoted equity. In the case of unquoted equity, the valuation of equity is often made on the basis of the SNA "own funds" (so that the SNA net worth, B.90, is always zero); this is the case for quasicorporation according to SNA, but also generally for unquoted public corporations according to GFSM 2001 (7.119). In the case of quoted shares, this automatic effect is complicated or blurred by other value changes (in this case: price changes) due to changes in market conditions. Hence, a distribution of dividend, just like a share buyback, triggers a fall in the value of equity, with a choice between a revaluation or a transaction.

A Microsoft story

Microsoft recently indicated[1] a change in strategy in relation to its cash management and distribution policy. It has mentioned its intention of paying $32 billion as superdividend in 2004-Q4 (or more than 1% of quarterly GDP of the USA!). **It would seem interesting to know how BEA quarterly accounts will reflect this event.** In addition, Microsoft will buy back a further $30 billion in the following 4 years. Would it be a concern that both events would be treated differently? It also decided to double its yearly dividend to $3.5 billion yearly. To put those figures into perspective, Microsoft sales are about $40 billion a year, profit $8 billion a year, liquid assets $60 billion and market value about $300 billion. Microsoft did not distribute dividends until 2003. Interestingly, in the last 3 years, Microsoft bought back $6 billion in stock a year, issued $1.5 billion a year, and provided stock option employee compensation for a fair value of $3.5 billion per year (15%-20% of costs).

And what about "my employee stock options"?
It is worth noting that in recognition that the superdividend (in contrast to buybacks, which are theoretically neutral) will create an apparent fall in share price, the Microsoft board [2] decided to adjust the reference prices (strike prices) of its employee shares programs. This would seem to be an indication that the fall in value is not viewed by professionals as a price change but as another type of change (a volume change).

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[1] http://www.microsoft.com/presspass/press/2004/jul04/07-20BoardPR.asp

[2] "Because the company's employee stock plans did not contemplate a one-time special dividend , the board has approved adjustments, subject to shareholder approval, that will protect employees as the share price declines due to the one-time special dividend. Mathematically, after a company makes a large one-time distribution, the overall value of the company declines by the amount of the distribution, which in turn reduces the stock price by a similar amount. If amendments to Microsoft stock plans authorizing the adjustments are not approved by shareholders this fall, the special dividend would not be made, and the board and management would consider other alternatives."

Question 5.
#1 could seemingly be read as a prescription regarding legal arrangements or adequate financial practices governing the relationship between the shareholder and the company. It is likely it was not the intention of this paragraph, which instead simply wishes to underline the fact that "shareholders value corporate managers' decisions to distribute or retain" and to question why statisticians would like overriding that aspect.
First, it is worth noting that accountants also already override the distribute/retain delineation in case of associates. Second, showing D.42 separate from D.43 in effect already informs, in the SNA accounts, of the distribution policy followed by companies; which arguably has some economic relevance.

The issue of "dividends that never materialize" is, to my mind, essentially solved because losses are also "distributed".

Question 6.
The point made by the paper, outlining the SNA intention for distinguishing the treatment of the property income of life insurance/pension funds and of mutual funds, is well taken. It would seem, more precisely, that some contracts incorporate explicit commissions (mutual funds, defined contribution pensions) and others not (defined benefit pensions, withprofit life insurance policies), with a need to indirectly measure output.

Indeed, the conventional view is that, as statisticians remarked that applying the SNA68 (?) formula led to very low or even negative insurance output, there was a need to boost premium by a "supplement" – set equal to the property income received on the assets.

This in turn leads me to two remarks:

(1) The formula for measuring output crucially refers to "changes in reserves [meaning provisions] arising from transactions". However, this change in reserve arising from transactions could either refer to the "property income receivable" on assets backed by the reserves/provisions, or alternatively to another delineation, such as the one followed by accountants/actuaries (IAS19…), where reserves/provisions themselves generate a kind of property income (based on the bond rate times the outstanding amounts) separate from other changes: actuarial changes (a type of revaluation).
Hence, it is arguable that the reference to "change in reserves arising from transactions" is *in fine* circular and <u>is not a true constraint for the measurement of output</u>.

(2) In addition, the current SNA interpretation, that for pension funds the property income payable = that receivable, supposes to know how to compile that property income payable. For bonds, this would seem easy (although some would like to record interest using the creditor principle), as we apply the accrual principle: we recognize property income even for zero coupon bonds. But what is the best measure for accrued income on shares? The dividend distributed or the earning of the firm? It is clear that dividend yields are only a part of the expected return on equity and has remained much below bond yields over the past 40 years. Is it sound to record as income only that part (the dividend) that is paid?

Lets' return to Microsoft. Its shares are held by households (a), mutual funds (b), pension funds (c) and other investors (d). Recording the superdividend as income would boost households' income in 2004-Q4 in case of (a) and (b), but not in case of (c). Is it normal? In turn, GDP will provably be impacted (blip up) because of the SNA rule on pension funds' output. Alternatively, recording the superdividend as financial transactions, without accruing profits as income would lead with a situation where $32 billion will never be recorded as income. Similarly, pension fund output and GDP would there remain systematically underestimated.

Finally Question 6 #2 refers to “guaranteed earnings” – which could perhaps be defined. **It is clear that the intention of “accrual of earnings” cannot be to incorporate holding gains/losses “ups and downs” into income. The intention would simply be to delineate, within the change in value of assets, a part that arises from price changes (revaluation) and a part that arises from volume changes (income), for amounts that seem more sensible than currently is the case**.

One serious cause of concern is cases where mutual funds capitalize instead of distribute their income/earnings (particularly money market mutual funds), with the effect of becoming a black hole to income (it comes in, but never goes out). The disturbance created led the ESA1995 to rule in favour of applying a transparency mechanism.

The fact that “operating surplus can be offset by losses before distribution” is true but not a concern as those losses are also to be accrued, as negative income. Over the long run (assuming liquidation) amounts of property income would be the same, but the timing may be superior in the case of “accrual of earnings”.