**July 22, 2004**
**Paris**
***By philippe de Rougemont***

# Accrual of earnings on equity in the SNA

***Capital injections, Superdividends and Reinvested earnings***

# EXECUTIVE SUMMARY

**Dividend recording in SNA and reinvested earnings**

1. The *1993 SNA* recognises as revenue (or more exactly as "resources") of the investor, the dividends paid by the investee (SNA 7.113), instead of the prorated share of the (operating) profit/loss of the investee that accrues on the equity holdings of the investor. However, the *1993 SNA* makes an exception to this principle for the Rest of the World Accounts (following the preexisting treatment in the Balance of Payment statistics), in the case of direct investment relationship — that is, when the investor has "control or influence" in the investee (or more than 10% equity stake; SNA 14.152) —, where the part of the profit not distributed, called "reinvested earnings", is recorded as a property income (D.4) of the investor, and deemed to be reinvested (SNA 7.120).

2. The rationale for the "reinvested earnings" treatment is that "*since a direct foreign investment enterprise is subject to control or influence by a foreign direct investor…, the decision to retain some of its earnings within the enterprise must represent a conscious deliberate investment decision on the part of the foreign direct investor*" (SNA 7.121). This rationale was not extended to other direct investment links in the SNA.

**GFS implications of the *1993 SNA***

3. The non-application of the accrual of earnings to direct investments of general government or of the public sector leads to difficulties for establishing proper fiscal data, with many cases where public corporations pay lump sums to governments that exceed their operating profits for the year in question ("superdividends"), or, in contrast, receive "capital injections" in cash or in kind (including via debt assumption/cancellation), notably to cover past losses or with no expectation of future profits. Under *1993 SNA*, what should be the criteria for expensing or revenue recognition of such events (i.e. classify those as financial or non-financial transactions)?

4. Recording superdividends paid by public corporations as government revenue allows government to pilot deficit at will, conveniently tapping the vast pool of their accumulated reserves. It is worth noting that superdividends are net worth neutral, and does not seems to meet the general Revenue criteria as laid down in *GFSM 2001* (GFSM 5.1). In addition, the time of recording seems not appropriate, because the true economic underlying event of the income is the profit made, not its distribution – which is clearly a financial choice, at least for controlled entities. Furthermore, government revenue should be demand contracting: superdividends are not, while the profit generated by the corporation ultimately was.

5. Conversely, while capital injections are net worth neutral, and should therefore logically be treated as financial in nature, fiscal experts often wish booking those as expense (capital transfers), at least when they are deemed to cover past (or even future) losses, because otherwise quasi-fiscal operations would not score in the government deficit. This is also seemingly foreseen in SNA 10.141b. However, the booking of such expense is also controversial, as they are not demand expanding (while the losses of the corporation were).

***Question 1. Is the recording of superdividends and capital injection a serious difficulty in GFS (Q.1.1)? Have you observed or can you fear cases where governance issues are at stake (Q.1.2)?***

## Pragmatic approach of *GFSM 2001* and Eurostat Manual on Government Deficit and Debt

6. To alleviate the severe difficulties associated with the proper accounting of superdividends and capital injections, the *GFSM 2001* and more clearly Eurostat's *ESA 1995 Manual on Government Deficit and Debt* (MDD) have developed a pragmatic jurisprudence that wishes to expand on the existing *1993 SNA* or ESA 1995. The main elements are:

- Recorded dividends should not noticeably exceed the income of the period (this excludes holding gains and losses), aside from legitimate smoothing (GFSM 5.87; MDD II.1.1.4.b and II.1.2.1). Hence, distributions of superdividends, or other lump sum payments, should be reclassified as financial transactions, otherwise governments would be able to manipulate the timing of their revenues, irrespective of the time of the underlying event (the profit accrued).
- Conversely, capital injections should (generally) not be booked as financial transactions (even though they are always net worth neutral for the corporation in question and also for government). These transactions should be expensed where they cover past, or even perhaps future losses, of public corporations (MDD II.3.1.2; GFSM 6.57 and 6.60; SNA 10.141), as their losses are not accrued in the first place as expenses in the books of government at time they are made, even where shares are issued (MDD II.3.1.2.3). Only injections realized in a commercial context, with expectations of a reasonable return on investment, would be classified as transactions in equity (MDD II.3.1.2).

7. One important case is the capital injections in the form of debt operations, instead of cash: debt assumptions, debt cancellation (debt forgiveness), or debt write-off. Recording guidance in *GFSM 2001* Annex II and ESA 5.16 seems not completely aligned and not necessarily coherent in between debt operations. Interestingly, for debt assumptions, *GFSM 2001* emphasizes the notion of acquisition of an effective claim[1]; and in case the beneficiary disappeared, GFSM Appendix II # 6 envisages recording a transfer, while ESA 5.16 foresees an other change in volume.

8. To some extend, the jurisprudence established by Eurostat and the *GFSM 2001* has been reasonably successful in starting sketching broad principles designed to avoid undue fiscal beautification. Arguably, the SNA review should, at the very least, be the occasion to incorporate those pragmatic guidance (unless the accrual of profits would be generalized to the general government – and other domestic sectors; see below).

[1] However, it may be noted that a debt assumption without effective claim could be conceived as a debt assumption with effective claim followed by a cancellation or a write-off; hence a need for internal consistency.

***Question 2. Is the orientation of the GFSM 2001 or Eurostat MDD guidance on superdividends and capital injection broadly right (Q.2.1)? Would it be important, <u>as a minimum</u>, to obtain that similar guidance be added in a reviewed SNA (Q.2.2)?***

9. However, this has not been an unmitigated success. A charge can be made of asymmetric bias and cherry picking:

a. <u>Asymmetry</u>: the distributed profits are booked as revenue if distributed during the period of earning—"too bad" for earlier undistributed profits. Injections are in contrast booked as expense more systematically and for the whole amount, but often long time after the underlying event (the loss). Injections in the form of debt operations are even recorded in various ways, opening the gates to substantial adverse statistical incentives.
b. <u>Cherry picking</u>: injections are to be classified according to the expected performance, a judgment for which the statisticians may be ill-equipped.

***Question 3. Do you judge the orientation of the GFSM 2001 or Eurostat MDD insufficient overall (Q.3.1)? Do you consider asymmetry a serious weakness (Q.3.2)? Do you consider cherry picking a serious weakness (Q.3.3)?***

**Accrual of earnings**

10. Another serious charge is that such pragmatic rules do not tackle head-on two large deviations to key principles of the system: accrual principle and the net worth neutrality of revenue/expense:

a. Expense and revenues are defined as transactions that change the net worth (*GFSM 2001*). But dividends from, and capital injections in, public corporations are net worth neutral: they are fundamentally in the nature of a financial transaction, decreasing (or increasing, respectively) the public corporation liquidity to the advantage (or to the disadvantage) of the government liquidity; they are not in concept government revenue/expense.

b. The accrual principle suggests recording amounts at the time the underlying event occurs: dividends are distributions of profits, and superdividends are simply distributions of mainly past periods' profits, that ideally ought to be recorded at time of profit earned (instead of at time of distribution). In the same vein, capital injections deemed to cover for past losses ought to be booked at time losses were incurred, not at time of recapitalization.

***Do you consider that the deviation from the revenue/expense criteria for dividends and capital injections to be a serious weakness (Q.3.4)? Do you consider that dividends and capital injections recording deviates from accrual recording (time of recording) and is a serious weakness (Q.3.5)?***

11. It is well-known on the market that the distribution of dividends is associated with a matching fall, on same day, of the value of the share in question. It is doubtful why such falls should be recorded as revaluations, as is the case now (although *1993 SNA* is silent on this issue). Instead, such falls in value on dividend distribution may be better captured as a volume change: a transaction in equity, similar to the SNA recording of the payment of coupons on bonds (which is not treated as property income but as a redemption in bond). Symmetrically,

the increase during the year of the value of shares for that part due to the accruing of profits should better be conceived as volume changes, instead of price changes.

***Question 4. Do you consider that the recording under revaluation of the fall in value of shares at time of dividend to be a serious weakness (Q.4.1)?***

12. Accruing the earnings of investees (subsidiaries, affiliates) as revenue of the investors (the parents) would not eliminate all entries in the revaluation account in shares and other equity for direct investment, but would merely reclassify, from revaluations to transactions, that part of the change in value observed between two balance sheets that is originating from operational or entrepreneurial profits (exclusive of holding gains/loss and net of dividends paid). Hence, some revaluation entries would remain, capturing the change in equity stakes due to holding gains/losses on the investee's assets or liabilities, including (in case of quoted shares) those reflecting the optimist or pessimist market perception for the share in question.

13. Recording the earnings of investees as resources of the investors, at time those are earned would be an improvement in accrual accounting implementation. For this reason, it is suggested to call this method or option: "accrual of earnings".

**Public accounting : IPSAS**

14. It is worth noting that accounting rules have long recognized the need to distinguish, for deciding the recording rules of equity stakes and their returns, whether there is control or influence, or whether there is not.

15. In case of "control", IPSAS 6 prescribes consolidating the investee in the accounts of the investor; in case of "significant influence" (e.g., stake of more than 20%), IPSAS 7 prescribes accounting the equity stake in the investee using the equity method. In both cases, the profit/loss and the net worth of the investee are immediately recorded in that of the investor (pro-rata). This contrasts with the accounting of other minority stakes, where the revenue and net worth of the investor is impacted only at time and for the amount actually distributed by the investee.

16. IPSAS explicitly indicates that the equity recording is necessary in case of significant influence, because it would not be meaningful to allow dividends to be recognized as income. IPSAS 7 # 19:

> *"The recognition of revenue on the basis of distributions received may not be an adequate measure of the revenue earned by an investor…. As the investor has significant influence over the associate, the investor has a measure of responsibility for the associate's performance and, as a result, the return on its investment. The investor accounts for this stewardship by extending the scope of its consolidated financial statements to include…"*

17. To the extend that the equity method in accounting is analogous to the "accrual of earnings" (or reinvested earnings) in statistics, its application to general government in SNA would promote additional convergence of statistical standards with accounting standards.

***Question 5. Would accrual of earnings pave the way to convergence with IPSAS (Q.5.1)? Should it be a main consideration (Q.5.2)?***

**Extension of the accrual of earnings in the SNA**

18. An issue is to what extent, the accrual of earning should be generalized in the SNA.

- in terms of sector coverage;
- in terms of threshold of ownership.

19. Already, all residents—non residents direct investment relationships apply accrual of earnings. The proposed further extension of all government—corporations direct investment relationships would leave, in the economy, two main families of links candidate for extension: (1) the financial corporation—non financial corporations links and (2) the links internal to each of the sectors (financial corporations; non financial corporations), which are massive but possible candidate for consolidation. It is worth noting that the (2)-types leave unchanged the saving of each sector.

***Question 6. Do you consider that accrual of earnings should be applied consistently across national accounts, or could be only extended to government accounts / public sector accounts (Q.6.1.0)? Should it be extended to type (1) (Q.6.2.1) and/or type (2) (Q.6.2.2)?***

20. In terms of thresholds, the accrual of earnings seems hard to contest in case of 100% ownership, where the parent can engage in transactions which are not at arm's length. The 50% threshold corresponds more neatly to control. The 20% threshold would ensure consistency with accounting standards. The 10% threshold would correspond to the traditional BOP threshold.

***What should the relevant threshold be (Q.6.2)?***

21. The case of the 0% threshold is interesting to note: it supposes recording all property income on shares on an accrual of earnings basis. Such an approach has the appealing aspect of relying more on the notion of volume-price delineation (than on the notion of control/influence), and of purifying the definition of the revaluation account. It would be argued that the increase in value due to the capitalization of profits must be interpreted as an increase in the volume or size of the company (presumably to invest more than otherwise would have been the case and boost further revenue and staff), not as a price change. The trend increase in stock price reflects in part this increase in size, in sympathy with the trend increase in GDP. Shareholders expect the value of their shares to increase by that amount, and it seems those expected changes in value do not meet the implicit definition of the revaluation account[2].

***Do you think that the threshold could usefully be lowered to 0% (Q.4.2)?***

22. More and more companies pass distributing dividends and instead redistribute cash via share buy-backs, notably for tax reasons; this risks distorting income data across the economy under the *1993 SNA* recording. In particular, many mutual funds (not to mention pension funds and life insurance) do not actually distribute their income and instead capitalize them: it

[2] SNA 12.63 and more neatly ESA 6.36 define holding gains and losses by reference to change in prices of assets. However the delineation within value between price and volume is largely conventional, and there is a risk of circularity when relying only on those two paragraphs. As an example, the increase in value of a zero coupon bond due to time passing is clearly assimilated in the system as a "quantum or volume change" (i.e., an increase in "size"), just as a wine ageing is gaining quality (SNA 12.110 and ESA 6.52). It is hence suggested that the SNA revaluation account captures **changes in value that were not expected**, either at time of contract (debtor principle) or at beginning of the accounting period (creditor principle).

would be unreasonable not to "fictitiously" distribute them to equity holders; this fictitious distribution prevents noticeable distortions of households' saving ratio. Already *1993 SNA* foresees such a distribution for insurance technical reserves in life insurance and pension funds—with the transaction D.44 (SNA 7.124 and 7.127). In addition, ESA 1995 wisely extends such a distribution to mutual funds shares (ESA 4.49b, 4.54b).

***Do share buybacks create a risk of distorting income series (Q4.3)? Do you think accrual of earnings should be extended to mutual fund shares, as in ESA 1995 (Q.4.4)?***

**Definition of the applicable earnings and treatment of losses**

23. Another technical decision is what should be the earnings to accrue. The SNA uses the entrepreneurial income (i.e., gross operating surplus plus net property income received/paid) net of current transfers received/paid (SNA 7.122). One issue is whether capital transfers should also be considered, as well as some other changes in volumes, such as those on impaired loans (very relevant for public banks). Another issue is how to deal with the possible circularity in case of cross-ownership.

***What should be the definition of earnings to accrue (Q.6.3)?***

24. Another technical decision is the treatment of losses: should they be recorded as negative revenue/property income in the books of the parent, or should they be expensed? Subsidies are in principle only government expenses; a rule may be applied where losses of 100% government owned corporations would be expensed, while losses in other cases would be booked as negative revenue.

***What should be the treatment of losses (Q.6.4)? Could 100% government owned entities be treated differently (subsidies) from other cases (Q.6.4.1)?***