Comments on "Accrual of Earnings on Equity in the SNA: Capital Injections, Superdividends, and Reinvested Earnings"

by Brooks Robinson, Bureau of Economic Analysis, United States of America

The following are comments on the July 22, 2004 version of the Task Force on Harmonizing Public Sector Accounts (TFHPSA) paper entitled, "Accrual of Earnings on Equity in the SNA: Capital Injections, Superdividends, and Reinvested Earnings." We provide answers to questions posed in the paper and highlight specific points of disagreement with the ideas expressed.

Question 1: It is important to state at the outset that, based on the nature of the U.S. economy and the role of government in it, we believe that superdividend and capital injection transactions between general government and government enterprises (public corporations) are not pervasive in the United States.

The U.S. National Income and Product Account (NIPA) estimates of "Surplus of government enterprises" are based on individual financial statements or on aggregate tabulations of financial statements, which generally do not reflect superdividend and capital injection-type transactions.[1] Currently, there are only fifteen Federal or central government enterprises in the United States, and it is feasible to monitor their transactions closely; however, there are thousands of state and local government enterprises, and it is not feasible to monitor their financial records at the detailed level to identify transactions of the superdividend and capital injection variety. However, the definitions in play for calculating "net income" for these enterprises exclude superdividend and capital injection-type flows.

Question 2: Ideally, the nature of the relationship between general government and public sector enterprises should be "arms-length"; consequently, it appears appropriate to treat superdividends and capital injections as financial transactions, specifically as capital transfers, except in the case of capital injections that are intended to cover past losses and expected future losses.

Questions 3: It stands to reason that asymmetric treatment of superdividends and capital injections and "cherry picking" can become problematic in national accounting if strict standards are not established. As expressed in our response to question 2, these two types of transactions should be treated primarily as financial in nature, given the one exception. Also, the "net worth neutrality" of superdividends and capital injections, the "non-demand contracting" nature of superdividends, and the "non-demand expanding" nature of capital injections are strong criteria for identifying these transactions as financial in nature.

[1] "Government enterprises" are the NIPA analogue to SNA or GFS public sector corporations. The operating surplus of these enterprises are derived primarily from financial reports in the case of central government enterprises and from tabulations of financial reports of thousands of state and local governments enterprises.

Sound accounting standards emphasize the importance of time consistency in recording transactions; i.e., on an accrual basis. However, if superdividends and capital injections are viewed as financial transactions, then these transactions are no longer directly linked to economic production and the incomes generated by that production. Hence, accrual of earnings accounting in the sense of recording superdividends during the period public corporations earn surpluses, or of recording capital injections at the time public corporations incur expenses, becomes less important. These financial transactions should simply be recorded when the distributions or injections occur.

Question 4: In our opinion, changes in share value upon the issuance of dividends should be accounted for in the "revaluation account." Changes in share value do not meet the criteria for classification as a transaction in the "Other changes in volume of assets account" (see System of National Accounts, 1993 (SNA), ¶ 1.9). Notably, we are not aware of U.S. government enterprises whose shares are traded publically and would be susceptible to reductions in value following dividend distributions.

Question 5: Accrual of earnings would create greater consistency between IPSAS and the SNA/GFS; however, we do not believe that this should be a main consideration. In our view, there are advantages to adopting parallel treatments for the public and private sectors whenever possible. There are no requirements that private corporations distribute dividends to domestic investors immediately upon earning them. Retained earnings (dividends) can be used to grow a private or public corporation, or they may be lost during operations. Given the history of retained earnings, investors must be very comfortable with this arrangement, and value corporate managers' decisions to distribute or to retain these earnings. If there were a requirement that investors record dividends earned by the corporations that they own at the time of earning, but the corporations did not distribute the dividends and subsequently incurred operating losses, then investors would have recorded dividends that were never realized. Therefore, accrual of earnings probably should not be imposed for investors in domestic private corporations.

However, given the special relationship between governments and public corporations, it appears appropriate to impose accrual of earnings for these two institutional units.[2] As stated earlier, the NIPAs, through estimates of the "Current surplus of government enterprises," impose this accounting convention.

[2] The special relationship being alluded to here is that most, if not all, government enterprises (public corporations) in the U.S. are solely owned by government. As noted in your paper, these two types of institutional units experience net worth neutrality with respect to earnings and losses. Consequently, accrual accounting of earnings and losses for governments and their enterprises is likely to produce fewer accounting distortions and will be less problematic than would be accrual accounting of earnings and losses for private owners of private domestic corporations. These two types of owner-agent relationships operate under very different forms of governance and may warrant different treatment.

Question 6: The IPSAS 20 percent stake and BOP Manual 10 percent stake for foreign owners of corporations and the related accrual of earnings standard appears appropriate. However, the accrual of earnings standard should not be imposed broadly across the national accounts for the reasons given in our response to question 5.

We do not believe that share buybacks create a risk of distorting income series.

Also, we do not agree that accrual of earnings should be extended to mutual funds. It is important to remember that the accrual of earnings standard that is imposed in the SNA for insurance technical reserves results from the fact that the reserves are linked to the cost of insurance services. Mutual fund earnings do not raise or lower the cost of the financial service offered by the funds. Given prospects for recording unrealized earnings when the accrual of earnings standard is imposed, the standard should only be imposed in the case of "guaranteed" earnings, such as "interest" earnings. Because operating surpluses and non-interest property income can be offset by losses before distribution, it is probably inappropriate to impose the accrual of earnings standard on these types of income.

Generally speaking, we believe that the losses of government enterprises should be treated as negative revenue by the parent/owning government.

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