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GOVERNMENT DIVIDENDS AND CAPITAL TRANSACTIONS WITH PUBLIC CORPORATIONS IN THE UPDATED SNA

by Task Force on Harmonisation of Public Sector Accounting

GOVERNMENT DIVIDENDS AND CAPITAL TRANSACTIONS WITH PUBLIC CORPORATIONS IN THE UPDATED SNA

Executive summary

Shareholders in a private corporation expect (or hope) to receive regular dividends based on their shares and to have the value of their shares increase over time as the net worth of the corporation increases. The SNA accounts show dividends as a distribution of entrepreneurial income but in fact there is no strict connection between them. Some entrepreneurial income may be retained for investment or other purposes. Sometimes dividends may be paid from previous retained earnings because the corporation wishes to smooth the size of dividends paid from year to year. In general, shareholders of private corporations do not determine the size of the dividends because the shareholders are numerous, may have different objectives as regards the size of dividends and the preferability of capital growth to income and may in any case not be able to exercise sufficient control over the corporation to influence the decision on dividends.

Public corporations and even more so public quasi-corporations are in different positions from private corporations because government controls the institution and is able to determine the payments to be made by the corporation or quasi-corporation to government. Further, government may be obliged to provide funds to corporations or quasi-corporations on either a regular or exceptional basis when entrepreneurial income is low or has been persistently low or negative for some years.

The SNA specifies that regular payments from public corporations to government are dividends and that payments from quasi-corporations are withdrawals from entrepreneurial income. It further specifies that regular payments to both public corporations and quasi-corporations are subsidies.

There is an asymmetry in treatment of exceptional payments, in both directions, as between public corporations and public quasi-corporations. Exceptional payments from a public corporation are recorded, as are regular payments, as dividends. Exceptional payments from public quasi-corporations are recorded as withdrawals from equity, recognising that the payment is not made from current entrepreneurial income but from accumulated reserves or sales of assets. It is recommended that the treatment of exceptional payments from public corporations should be changed and also recorded as withdrawals from equity because these also must be made from accumulated reserves or sales of assets

Exceptional payments from government to public corporations are recorded as capital transfers. Exceptional payments from government to pubic quasi-corporations are recorded as additions to equity. It is recommended that similar recording should apply for both public corporations and quasi-corporations. When the government makes the payment in a commercial context, receiving an asset in exchange (shares or other equity), the payment should be recorded for both types of corporation as additions to equity. More frequently, though, exceptional payments by government are simply intended to cover accumulated losses. Government is unlikely to make payments to corporations making regular losses as an investment and so the characterisation of an addition to equity is inappropriate. Such payments should be treated as capital transfers for both public corporations and public quasi-corporations.

The TFHPSA considered a more radical solution which was to follow the same principle for public bodies as for non-resident units in recording reinvested earnings exactly matching current entrepreneurial income. However, this is not being proposed for adoption at the present time but is recommended as an item for the research agenda expected to be included in the updated SNA.

Questions for the AEG:

1. Does the AEG agree to record exceptional payments by public corporations to government, funded from accumulated reserves or sale of assets, as withdrawals of equity?

2. Does the AEG agree to record exceptional payments by government to public corporations and to public quasi-corporations intended to offset accumulated losses as capital transfers? (This is a change in the SNA as far as public quasi-corporations are concerned.)

3. Does the AEG agree to record exceptional payments by government to public corporations and to public quasi-corporations for commercial reasons and leading to increases in government's claim on shares or other equity in the unit as addition to equity? (This is a change in the SNA as far as public corporations are concerned.)

4. Does the AEG agree to recommend that the "reinvested earnings" approach to payments between governments and public corporations and public quasi-corporations be added to a research agenda?

GOVERNMENT DIVIDENDS AND CAPITAL TRANSACTIONS WITH PUBLIC CORPORATIONS IN THE UPDATED SNA

1. It is commonly agreed that the present SNA does not provide sufficient guidelines to record in a relevant and consistent way some transactions of government with its public corporations, like dividends, withdrawals of equity, capital transfers, and acquisitions of equity. This issue has been put forward as issue 34 by the AEG.

Background, including the 1993 SNA position, and main reasons for change

2. According to SNA paragraphs 7.113 and 7.114, "Dividends are a form of property income to which shareholders become entitled as a result of placing funds at the disposal of corporations…dividends must also be understood to cover all distributions of ***profits*** by corporations to their shareholders or owners, by whatever name they [the corporations] are called." Key points are that the term "profits" does not have a specific meaning within the SNA and the period in which the profits must be earned is not specified. One can surmise from the placement of dividends in the allocation of primary income account that first the profits must be part of the operating surplus and second that the operating surplus is that earned from production in the same period. An alternative interpretation is first that profits include holding gains/losses, and, second, refer to profits that could have been earned in previous periods, with dividends recorded as declared regardless of their sources.

3. Paragraphs 7.115 to 7.118 may be used as guidance on the above as they describe the treatment of withdrawals from income of quasi-corporations (which are treated as if they were dividends but considered a separate category of property income because it is not possible for quasi-corporations to pay dividends). In this case, however, the withdrawals are identified as coming from the income earned in the same period: "The amount of income which the owner of a quasi-corporation chooses to withdraw will depend largely on the size of its ***entrepreneurial income***, i.e., its operating surplus plus property income receivable on any assets owned by the enterprise minus any interest or rents payable on its liabilities, land or other tangible non-produced assets." The description of withdrawals of income is more extensive than the description of dividends, as paragraph 7.118 states that "withdrawals of income from a quasi-corporation do not, of course, include withdrawals of funds realized by the sale or disposal of the quasi-corporation's assets: for example, the sale of inventories, fixed assets or land or other non-produced assets. Such sales would be recorded as disposals in the capital account of the quasi-corporation and the transfer of the resulting funds would be recorded as a ***withdrawal from the equity*** of quasi-corporations in the financial accounts of the quasi-corporation and its owner(s). Similarly, funds withdrawn by liquidating large amounts of accumulated retained savings or other reserves of the quasi-corporation, including those built up out of provisions for consumption of fixed capital, are treated as withdrawals from equity."

4. Drawing from the parallel of corporate dividends with quasi-corporation withdrawal from income, one can infer that "profits" refer to ***entrepreneurial income*** (operating surplus plus property income receivable on any assets owned by the enterprise minus any interest or rents payable on its liabilities, land or other tangible non-produced assets); that dividends are from the current profits; and that dividends from profits accumulated in previous periods are withdrawals of equity. Despite the general parallel of withdrawals from income of quasi-corporations with dividends, at a minimum, a clarification is necessary.

5. There is a similar lack of clarity regarding funds transferred from a government to a corporation controlled by that government. Paragraph 7.78(c) is clear that regular transfers paid to public corporations and quasi-corporations that are intended to compensate for persistent losses on their productive activities are subsidies. The situation with large, infrequent payments is less clear. In the section on capital transfers, paragraph 10.137 describes investment grants as a ***capital transfer*** "in cash or in kind made by governments to other resident or non-resident institutional units to finance all or part of the costs of their acquiring fixed assets." Paragraph 10.141 states: "transfers from government units to publicly or privately owned enterprises to cover large operating deficits accumulated over two or more years" also are ***capital transfers***. In the section of the Financial Account chapter describing transactions in shares and other equity, paragraph 11.87 states: "***net additions to the equity*** of quasi-corporate enterprises are the net additions that owners of such enterprises make to the funds and other resources of these enterprises. The owners make these additions for purposes of the capital investment of the quasi-corporate enterprise…Included under proprietors' net additions are the net results of actual additions to, and withdrawals from, the capital of quasi-corporations. The capital consists of funds for use by the enterprise in purchasing fixed assets, accumulating inventories, acquiring financial assets or redeeming liabilities." Similarly, paragraph 7.118 states: "any funds provided by the owner(s) of a quasi-corporation for the purpose of acquiring assets or reducing its liabilities should be treated as ***additions to its equity***." These quotes appear to apply a treatment that differs between quasi-corporations (equity) and corporations (capital transfer) on transactions that are the same in substance. This ambiguity suggests that a clarification is necessary.

6. The extension to government and public corporations of the current treatment of reinvested earnings of direct foreign investment, as described in paragraphs 7.119 to 7.122, suggests a change in substance rather than a clarification.

- According to those paragraphs, the saving or retained earnings of a direct foreign investment enterprise are treated as if they were distributed and reinvested. The rationale behind this treatment is that the decision to retain or distribute the earnings of the enterprise must represent a conscious deliberate investment decision on the part of the foreign direct investor(s). It is obvious that if a government controls a public corporation, then the decision to retain or distribute the earnings of the corporation is also a conscious deliberate decision of the government and the retained earnings could be treated as if they were distributed and reinvested just as with a direct foreign investment.

- In case of losses by public corporations, the mirror image of imputed distributions of retained earnings would be an expense (subsidy) in the government accounts, and a withdrawal of equity investment in the public corporations. The existing SNA treatment is to treat losses as government current expenses (subsidies), only if the government makes regular payments to compensate the corporation for its losses(as described in paragraph 7.78(c) quoted above); and as capital transfers, if the government makes one large payment after several years to compensate for the accumulated losses. Using the retained earnings approach, this lack of important analytical information would be remedied as a subsidy would be imputed along with a withdrawal of equity to account for ongoing losses, whether or not the government makes regular or irregular payments to cover the losses.,

The TFHPSA approach towards a solution

7. It was agreed in the last meeting of the Task Force on Harmonisation of Public Sector Accounting (TFHPSA) that the alternatives to improve the situation are:

I. <u>The "improved/amended SNA approach</u>": keep the conceptual approach of the present SNA, but amend the SNA to clarify the uncertainties cited above, taking on board some developments and recommendations put forward by the *ESA95 Manual on government deficit and debt (EMGDD)* and the *Government Finance Statistics Manual 2001 (GFSM 2001).*

II. The "D.43 / reinvested earnings approach": move towards a new approach, extending to the government and to public corporations the recording of foreign direct investment in the present SNA (reinvested earnings, D.43). This would amount to recording the retained earnings or losses of publicly owned corporations as accruing in the government accounts and then reinvested in - or withdrawn from - the equity of the corporation (through a financial transaction in F.5). A consequence is that most other related flows between the government and the corporation –capital injections, payment of dividends and of super-dividends, debt assumptions etc. – would be recorded as financial transactions. As a result, only the accruing profit or loss has an impact on the net borrowing / net lending of the general government.

8. The TFHPSA opinion was quite shared, but finally expressed a preference for the "improved/amended SNA approach". However, it asked to keep the second approach on the research agenda (the Robinson-Dobbs paper will be improved to feed the reflection). The remainder of this issues paper describes the two approaches and the pros and cons of each.

The two alternative treatments

I. Improved/amended SNA approach (as developed by the *EMGDD* and the *GFSM 2001*)

9. Dividends paid by public corporations and withdrawals of income from quasi-corporations are property income (D.4). They are paid out from the entrepreneurial income derived primarily from the productive activity of the corporation (as currently defined in SNA paragraph 7.117). In principle, they should not include proceeds of sales of assets nor revaluation gains. Payments made from sales of assets or revaluations should be recorded as withdrawal of equity.

- This principle may be difficult to apply to all cases in practice. Nevertheless, it should always be applied in case of significant and well identified sales or revaluations of assets.

- Dividends may be smoothed from one period to the other, notwithstanding the variations of the entrepreneurial income. (Resources earmarked to these smoothed payments will usually be put in a special reserve, not accounted for in the own funds of the corporation.)

10. Large and exceptional payments to government based on accumulated reserves, or sales of assets, are to be treated as withdrawals of equity.

Should this include the seldom case of irregular and large dividends, which occur when a corporation does not pay dividends for several years and then pays a single large-dividend to the shareholders? It may be argued that such a payment is different from the case of "smoothing dividends" where a corporation puts in a special reserve, not part of the own funds, a limited part of the realised profits to smooth the amount of dividends paid year after year to the shareholder. Smoothed dividends are of the same nature as dividends. In the case of irregular and large dividends paid to government by 100% owned corporation, the close relationship between the government and the public corporation – the government control - creates a very specific context, and in this context, such payments should be viewed as the "large and exceptional payments" mentioned above. Therefore, it should be treated in national accounts as a withdrawal of equity.

11. Capital injections

The term "capital injections" is not used in the SNA, but commonly referred to in the media. It may cover any large and exceptional payment – or transfer of funds - made by the government to a public corporation (possibly described in the public accounts as capital grant, equity injection, loan etc.). This provision of funds may be recorded in national accounts either as a financial transaction, or as a capital transfer. We

will consider here the main case: the transfer of funds in cash by the government to the public corporation (not subject to reimbursement as a loan). Principles and recommendations to record these government payments to public corporations are as follow:

- To record a financial transaction, in shares and other equity, when the government payment is made in a commercial context - government acting as a shareholder - , and when the government receives in exchange an asset of the same value (the shares and other equity). The decrease in cash in the government financial accounts is offset by the increase in equity; or

- To record a non-financial transaction, normally a capital transfer , when this is an unrequited payment ("something for nothing"), made for public policy purposes, having not the automatic effect to increase the government's equity assets (or the effect is not immediate and not of the same amount). Capital transfers are the right treatment in national accounts for capital injections aimed at covering accumulated losses ("capital injections for losses").

12. In the context of relationship between government and public corporations, it may be expected that most capital injections will be in practice "capital injections for losses" and recorded as capital transfers (D.99). It should be the case every time payments are made to corporations that have low profitability and have accumulated losses. Usually, as an indicator, these corporations never pay dividends. Providing in exchange a simple piece of paper called "share" would not be sufficient to characterise the payment as a "transaction in shares and other equity" in the national accounts. It is expected that this type of treatment would apply to most 100% owned corporations.

13. However, it cannot be excluded that some capital injections made to public corporations - usually incorporated - are made in a more commercial context. In this context, the capital injection recorded as a transaction in shares and other equity should have the following three usual characteristics:
- Funds are placed at the disposal of the corporation, which has a large degree of freedom in the way of investing them.
- New shares are issued for an amount equal to the funds placed (in the case of incorporated enterprises).
- Shareholders, inclusive of the government, are entitled, and do expect, to receive dividends.
As an indicator of the commercial context and of the fact that government acts as a shareholder, a special emphasis should be put on the corporation's profitability and, in practice, on the payment of dividends – or the realistic expectation of dividends to be paid - by the corporation.

<u>Pros and Cons of this approach</u>

14. Pros:
- It provides a pragmatic "updating" approach, with no conceptual change to the present SNA;
- It preserves the consistency of the SNA institutional sector general government and leaves open the possibility (already planned in the SNA) to calculate relevant aggregates and balances for the consolidated public sector to provide complementary views of public finance;
- Dividends remain recorded as property income (D.4) in national accounts, and in the same year as in corporations' accounts, i.e. "when declared" (that is are payable);
- It is easy to implement since statisticians are used and trained to the present recommendations.

15. Cons:
- Recommendations to record capital injections are sometimes considered not clear enough: they rely on assessments from economists / statisticians to consider if these injections are made in a commercial context, with an asset in exchange and a valid expectation of a return in the form of dividends, etc. If not, the injections are to be expensed (capital transfers). This assessment has material impact on the net borrowing /

net lending calculation, and is sometimes seen as leaving some room for manoeuvre or manipulation of the net borrowing / net lending.
- Recording large and irregular dividends has appeared to be problematic: are they of the nature of deferred dividends (property income), capital transfers or withdrawal of equity? Recommendations in the *EMGDD* are not crystal clear. In the case of public corporations, it should be made clear now that SNA recommends "withdrawal of equity".
- The time of recording dividends (that are accrued in the sense that they are recorded when declared as due) may be viewed as not being linked to the time of production, that is when income is generated, contradicting another level of accrual principle.
- It keeps the present boundary – and difference of treatment of capital injections - between the public quasi-corporations and 100% owned public corporations (if the recording of these transactions between government and public quasi-corporations is not clarified in the updated SNA).

II. Reinvested earnings (D.43) approach

16. The reinvested earnings approach takes inspiration from the present SNA treatment of "reinvested earnings on foreign direct investment (D.43)" (see SNA1993, §7.119 and 7.120). The rationale is based on the fact that owners who control corporations can decide upon the distribution and allocation of the income. It is thus proposed to extend to 100% government-owned corporations the treatment that was recommended for direct investment of foreign equity holders. It also takes inspiration from the "equity method" from the private accounting guidelines.

17. The result (see the Robinson-Dobbs paper) is that:
- Current profits - or losses - of the public corporations are accrued in the government account, impacting the saving and the net borrowing / net lending of the general government the year when they are earned. These accrued earnings (D.43) are to be immediately reinvested in the equity (F.5).
- All subsequent flows of payments to the owner - dividends, including large and irregular dividends, and other exceptional payments - are to be recorded as financial transactions (increase of F.2, decrease of F.5 in the financial accounts of government)
- All capital injections to the public corporations are recorded as financial transactions (increase of government F.5).

Pros and cons of this approach

18. Pros:
- Providing a view of the government accounts in a *consolidated* way (in the sense of consolidation of earnings with the public corporations) may be considered relevant from an economic analysis point of view or for a sound public finance point of view. Moreover it converges with the "whole-of-government" approach favoured in IFRS and IPSAS reflection and recommendations.
- It is consistent with a full accruals basis of recording the earnings from equity (in the year the income is earned)
- It leaves less room for manoeuvre to manipulate a key fiscal measure (the net borrowing / net lending)
- Capital injections and payment of large irregular dividends may be seen as net worth neutral, and therefore better recorded as financial transactions (in F.5)
- The recording under financial transactions in F.5 of other related flows in capital (including debt cancellations and assumptions, as initially stated for this approach) would appear simpler in all cases.

19. Cons:
- Is such an approach for the accounts of the government sector conceptually consistent with recommendations for the other institutional sectors? Doesn't this blur the boundary between the general government sector and the public sector?

- Is it really similar to the equity method (for associates) referred to in IFRS and IPSAS? This point needs more explanations.
- The recording of debt assumption and debt cancellation in favour of public corporations is problematic: if it would be only financial transactions, it would contradict the present recommendations for recording debt operations (see EMGDD, GFSM2001 and other papers presently discussed), recommendations now widely agreed on in the statisticians' community. If it would be also capital transfers, wouldn't it introduce an inconsistency with the recording of all capital injections as financial transactions?
- Numerous imputations of flows in F.5 category may be seen as disconnecting the value of AF.5 in national accounts from the assessment of the equity capital in the corporation's balance sheet.
- Coverage of public corporations: to what extent would the recommended treatment be applied to all government owned corporations? The relevant threshold is proposed at 100%. Any threshold introduces dissymmetry between sectors and/or within corporations (according to the threshold).
- This treatment may be a source of practical difficulties since the "income" of public corporations may not necessarily reflect the income in the SNA sense, making it difficult to have the data to make the necessary adjustments.
- The treatment may be difficult to apply since statisticians may not be familiar with it.

20. Nota Bene: In the context of the improved / amended SNA approach, an option was proposed at the OECD Working Party on National Accounts (12 October 2005): One paragraph in the chapter of the updated SNA could summarise the D.43 approach as a conceptual reference (not as a guideline). This reference would be relevant to the specific relationship between government and public corporations, when 100% owned. It is proposed to ask the agreement of the AEG for such a paragraph (see below, Questions to the AEG).

Appendix 1: ESA95 Manual on Government Deficit and Debt (EMGDD) provisions

1. Dividends and large payments from public corporations to government

The EMGDD has not explicitly dealt with the case of "super-dividends". It has meant to clarify the boundary between income, and property income, on one hand and capital withdrawal (or withdrawal of equity) on the other hand. In part II (II.1 Overview of principles), one can read:

See in II.1.1 "General Principles: 4.b The notion of dividend"

"Dividends in national accounts are a property income (D.4). The resource available for distribution by a unit as dividends and to pay current transfers is the entrepreneurial income (B.4) of the unit. (…) Following this logic, the resources from which dividends have to be paid should neither include the proceeds of sales of assets nor the revaluation gains.(…) In order to preserve the net wealth of the enterprise, revaluation proceeds as well as assets sale's proceeds are not distributable as income.

Practical aspects:
- There is a large consensus among statisticians that this important principle (assets revaluation or sale proceeds are not income) is the correct treatment in national accounts, but that in practice it may be difficult to apply. Nevertheless, it is agreed that it should always be applied in cases of significant and well identified sale or revaluation of assets.
- Timing of the payment: frequently, enterprises smooth the amounts of dividends that they pay year after year. Therefore, in one given year, they may put in reserve part of the realised profit and distribute it in the following year (or years), for the purpose of dividends smoothing. There is no difficulty in recording these sorts of payments as dividends.

The case of a large and exceptional payment out of reserves – significantly reducing the own funds of the corporation – is different. It should rather be treated as a transaction in shares and other equity (a capital withdrawal)."

This is confirmed in II.1.2 "Application to ESA95 transactions: D.421 Dividends".

Comment:

The notion of dividend as property income is clearly defined. The possibility of smoothing dividends is recognised (still as property income). Quite differently, "the case of a large and exceptional payment significantly reducing the own funds of a corporation" is also dealt with in substance, and is analysed as "a capital withdrawal" (a transaction in F.5).

Does this cover the case of a corporation that would not pay dividends during 5, 6 or more years, that would place the money in a special reserve, not accounted for in the own funds of the corporation, and paying a super-dividend to the shareholders (and being not out of proportion with the sum of yearly unpaid dividends)? A clarification is proposed on this above, taking into consideration the very close relationship between the government and the public corporations.

2. Capital injections

In its chapter II.3, "Capital injections" the EMGDD has provided clarification of principles and guidance to record capital injections of government in public corporations in the SNA/ESA framework.

Considering the main case – providing funds in cash to a corporation – the issue is defined in the following way:
- Either to record a financial transaction, in shares and other equity, when the government payment is made in a commercial context (government acting as a shareholder), and when this payment has an automatic effect on the government's assets, immediate and of the same amount
- Or to record a non-financial transaction, normally a capital transfer, when this is an unrequited payment, made for public policy purposes, having no automatic effect on the government's assets, immediate and of the same amount.

Therefore a capital injection recorded as a transaction in shares and other equity is considered having three characteristics:
- Funds are placed at the disposal of the corporation, which has a large degree of freedom in the way of investing it
- Shareholders, including the government, are entitled to receive dividends
- New shares are issued for an amount equal to the funds placed (in the case of incorporated enterprises).
A special emphasis has been placed, to characterise the commercial context and the fact that government acts as a shareholder, on the realistic expectation of dividends to be paid by the corporation.

A contrario, a capital injection will be recorded as a capital transfer every time it is made to corporations that make losses and that never pay dividends. A simple piece of paper called "share" would not be sufficient to characterise a "transaction in shares and other equity" in national accounts.

Appendix 2: GFS Manual 2001 provisions

1. Dividends and large payments to government

This is dealt with in §5.86 and 5.87 of the GFSM2001. (The rationale is the same as in the EMGDD.)

- §5.86: "(…) Dividends include all distributions of profits by corporations to their shareholders or owners, including profits of central banks transferred to government units (…)".
- §5.87: "(…) Dividends are payments a corporation makes out of its current income, which is derived from its ongoing productive activities. A corporation may, however, smooth the dividends it pays from one period to the next so that some periods it pays more than it earns from its productive activities. Such payments are still dividends. Distributions by corporations to shareholders of proceeds from privatisation receipts and other sales of assets and large and exceptional one-off payments based on accumulated reserves or holding gains are withdrawal of equity rather than dividends."

2. Capital injections

As in the SNA, the term "capital injections" is not used in the GFSM2001. A couple of paragraphs are relevant to the subject:
- §6.60 (subsidies): Government payments in favour of public corporations to cover losses accumulated over two or more years are classified as capital expense (miscellaneous capital expense)
- §6.87 (Miscellaneous other expense) confirms that are recorded as capital transfers (to market enterprises) transfers "to cover large operating deficits accumulated over two or more years, to cancel a debt by mutual agreement with the debtor, or to assume a debt."
- §9.36 clarifies the case of quasi-corporations: "Additions to the funds and other resources of a quasi-corporation, including in-kind transfers of non-financial assets, are treated as purchases of shares and other equities by the owner of the quasi-corporation."