

Manual on Government Deficit and Debt

Implementation of ESA10

2013 edition

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PREFACE

In May 2013, the legislative process for adopting the new European system of national and regional accounts in the European Union (referred in this Manual to as “ESA10”) was completed and this new ESA will be legally enforceable (Regulation 549/2013) from 1st of September 2014 onwards.

In the context of the Excessive Deficit Procedure (EDP), defined by the Maastricht Treaty (Article 104) and in force in the European Union since 1994, Eurostat has been given the mission to guarantee a proper application of the conceptual reference framework, the European System of Accounts (ESA), in order to obtain reliable and comparable statistics across the EU.

The aim of the Manual on government deficit and debt is to assist the application of the ESA legally in force for calculating Government Deficit and Debt data. It provides the appropriate treatment to statistical issues raised in the European Union regarding government financial statistics. It consolidates Eurostat decisions on methodological issues, as provided for by Article 10.2 of Regulation 479/2009, as amended.

The Manual is the result of a collective work, under the supervision of Eurostat, which saw the participation of experts in Government Finance Statistics and national accounts from EU Member States, the Commission (the Directorate General for Economic and Financial Affairs) and the European Central Bank. It is an indispensable complement to the ESA. It is an important tool for statisticians and specialists of public finance issues not only in the European Union but also beyond. It may also help the general public to understand the methodology applied to government finance data in the context of the Excessive Deficit Procedure.

This new edition of the Manual, whose first edition was published in 1999, will be the reference in the context of the new ESA10, which shows several significant changes from the previous ESA95. It is to be underlined that the new ESA10 has taken on board in a dedicated chapter 20 (“The government accounts”) most of the interpretations and complements which were progressively introduced in the Manual, at the initiative of Eurostat but also, in some cases, following requests for advice by Member States.

The main new methodological provisions in ESA10 have been integrated in this Manual, such as the sector classification of some entities under government control, the recording of transfer of pension obligations to government and the treatment of standardised guarantees. In addition, the drafting of some chapters has been further improved for a better understanding by readers.

This Manual is structured similarly to the previous editions, through parts and chapters which generally follow a standard presentation.

This edition does not yet include the part VIII “Measurement of General government Debt” which refers to a specific EDP legislation partly independent from ESA which has not been definitively approved at the time of this publication. However, the reader may refer for this part to the previous edition of 2012, notably for the current recording of some swap derivatives, repos and securities lending, which treatment should not be changed in substance in a next complete future edition foreseen in the first months of 2014.

This new edition has been prepared by Eurostat unit D1 in cooperation with experts of a dedicated Task Force (chaired by Luca Ascoli and which secretariat was assumed by Denis Besnard), to which Eurostat is very grateful for their participation. For any further information, please contact the D1 Secretariat ESTAT-D1-SECRETARIAT@ec.europa.eu.

November 2013

François LEQUILLER
Director

INTRODUCTION: SCOPE AND DEFINITIONS

The Excessive Deficit Procedure (EDP)

The Maastricht Treaty, which foresaw the creation of the Euro, organised the way that multilateral fiscal surveillance would be conducted within the European Union. This surveillance is based on the EDP which sets out schedules and deadlines for the Council, following reports from and on the basis of opinions by the Commission and the Economic and Financial Committee, on how to judge whether an excessive deficit exists in a Member State.

The Treaty obliges Member States to comply with budgetary discipline by respecting two criteria: a deficit to GDP ratio and a debt to GDP ratio not exceeding reference values of 3% and 60% respectively, as defined in the Protocol on the EDP annexed to the Treaty.

Council Regulation 479/2009, as amended by Council Regulation 679/2010, requires that Member States report EDP-related data to Eurostat twice per year at end-March and end-September. The data are reported in harmonised tables (see Annex 2). These tables are designed specifically to provide a consistent framework, with a link to national budgetary aggregates and between the deficit and changes in the debt. They should be fully consistent with GFS data supplied through the ESA10 Transmission Programme.

The latest EDP Notification Tables for each Member State, for all biannual reports since September 2005, and a brief explanation of their contents, can be found [here](#). Further information on Government Finance Statistics is [here](#).

Statistical Methodology

These reference values for Deficit and Debt are based on concepts defined in the European System of Accounts (ESA10). The government deficit is the net lending / net borrowing of general government as defined in ESA10 adjusted for the treatment of interest relating to swaps. The government debt is defined as the total consolidated gross debt at nominal value in the following categories of government liabilities (defined in ESA10): currency and deposits, securities other than shares excluding financial derivatives, and loans.

ESA10 is derived from, and almost entirely consistent with the worldwide manual for national accounts (SNA2008). ESA10 is a legislative text which can be found [here](#) in a user-friendly form. Since ESA10 is a conceptual framework, it has been necessary for Eurostat to supplement it with additional guidance in the form of this ESA10 Manual on Government Debt and Deficit, Eurostat Decisions, and bilateral advice to Member States.

Eurostat's decisions and advice take account of the views of national experts. Eurostat, statisticians from the Member States and other interested parties meet several times per year in the National Accounts Working Group and Financial Accounts Working Group to discuss methodological and practical issues relating to national accounts. The Committee on Monetary, Financial and Balance of Payments Statistics ([CMFB](#)) is a high-level advisory group composed of officials from National Statistical Offices and Central Banks. It provides opinions to help Eurostat clarify the interpretation of ESA10 for the purpose of compiling Government Deficit and Debt statistics. The guidance in this manual is influenced by those committees.

Key concepts for measuring Government Deficit and Debt

ESA10 is a system for producing economic statistics. As such, it records the economic reality of transactions rather than their legal form. This can involve looking through complex financial operations to understand who bears the financial risks and who has control over the rewards, irrespective of how the contracts have been constructed. In the

context of measuring Government Deficit and Debt, this search for the economic reality affects such matters as the following.

- The classification of units: is a unit inside or outside the Government sector? The Government Deficit and Debt is primarily affected by units classified to the Government sector. This is determined by considering whether or not a unit is public (performs a government function, or controlled by another public unit), and by whether it is market (financed by its own sales) or non-market. Market institutional units are not in the Government sector.
- The timing of transactions: ESA10 records transactions when the economic activity takes place, rather than when the cash is paid if different. Such differences might be large, and therefore significant for the deficit, in the case of some taxes and the purchase of capital assets.
- The nature of a transaction: non-financial transactions such as consumption, wages and salary, subsidies and grants to cover losses directly affect the deficit, whereas others do not such as the acquisition of financial assets or the repayment of debts.

Structure of the manual

The following terms are used when referring to text within the manual, based on the hierarchical structure shown in the table of contents on the next page.

- I. Part
- I.1 Chapter
- I.1.1 Section
- I.1.1.1 Sub-section

Each of the eight parts starts with an overview and ends with keywords and references. The links to legal texts are shown in Annex 1. An index can be found at the end of the book.

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I

Delimitation of the general government sector

Part I Delimitation of the general government sector

I.1 Overview

1. Government Deficit and Debt statistics report on the activity of the General Government sector (S.13) as defined in national accounts. According to ESA10 2.111, as a general definition of main features, this sector "consists of institutional units which are non-market producers whose output is intended for individual and collective consumption, and are financed by compulsory payments made by units belonging to other sectors, and institutional units principally engaged in the redistribution of national income and wealth." This does not exclude that, as a minor part, government units may have other kind of resources (such as property income and sales of goods and services, but the key distinctive point is the existence of the capacity of levy.¹ In this regard, ESA10.02 insists also on "the power to raise taxes and to pass laws affecting the behaviour of economic units." ESA10 20.06 also adds that "government units are legal entities established by political process which have executive legislative, judicial authority over other institutional units within a given area." However, this definition fits totally only for the units which are designed as "primary" units in ESA10 20.10 but other kind of entities may be established in order to carry out some specific activities. If they meet the criteria of institutional units (see below), they must be considered as separate government units.
2. The qualification of institutional units as non-market producers, i.e. units "providing all or most of their output (goods and services) free of charge or at prices that are not "economically significant."(ESA10 20.19) is fundamental for the proper delimitation of the general government sector. As a consequence, the general government sector excludes all government-controlled units (as defined on the basis of different criteria - see ESA10 20.307) that are considered as market producers ("public corporations"). The public sector consists of all general government units and public corporations outside government sector (ESA10 20.303).
3. Under ESA, the general government sector is divided into four sub-sectors. It may also be relevant, notably for practical reporting purpose, like in ESA10 chapter 20, to make a distinction between the "core" or "primary" units (such as "budgetary central government" or "regional/local authorities budgets") and the other government entities with separate legal identities and various degree of autonomy which are part of the sub-sector as controlled by the core units and frequently mostly financed by transfers from them.
 - a) Central government (S.1311): includes all administrative departments of the State (such as ministries, boards, authorities, etc.) globally considered as a single unit² and other central bodies whose competence (made of legislative,

¹ ESA10 chapter 2 specifies in addition that such units may be engaged in other types of "non-market production" which covers cases of sales of goods and services on "pseudo-markets" but such that the corresponding income does not cover the production costs.

² Notably because they operate collectively, dependent on a single budget, under the responsibility of the Ministry of Finance, which in addition to "controlling" most of the revenue, allocates to "line ministries" (spending departments with generally no autonomous public accounts) their expenditure limits.

- b) judicial, taxation and executive powers) extends normally over the whole economic territory (as defined in ESA10 2.05-06.)³ Non-Profit Institutions (NPIs) which are non-market producers and are controlled by central government with a competence on the whole economic territory are part of this sub-sector; the central government sub-sector is itself divided into two components, “budgetary central government” and “other central government bodies” (ESA10 20.62);
- c) State government (S.1312): consists of separate institutional units exercising some of the functions of government at a geographical level below that of central government and above that of the local government (see footnote 4); these government units have a full and exclusive competence (in the areas specified in Constitution or Fundamental Law) on a state or regional territory; normally the existence of significant legislative power is an element as to identify this sub-sector level which may also include other dependent bodies and controlled Non-Profit Institutions (NPIs);
- d) Local government (S.1313): is made of public administration whose competence (frequently small from legislative and judicial points of view) extends to only a local part of the economic territory (see footnote 4); ESA10 20.65 specifies that “statistics for local government cover a wide variety of government units” and it also mentions that there is frequently overlapping of different local government on the same geographical area, based on their respective functional responsibilities; a great number of non-market producers, of various statutes, may also be attached and they can control also numerous NPIs;⁴
- e) Social security funds (S.1314): includes all central, state and local institutional units whose principal activity is to provide social benefits and which fulfill each of the following two criteria⁵:
- by law or by regulation certain groups of the population are obliged to participate in the scheme or to pay contributions;
 - general government is responsible for the management of the institution in respect of the settlement or approval of the contributions and benefits independently from its role as supervisory body or employer. (ESA10 2.117)
4. Statistical authorities frequently encounter units for which the sector classification is not straightforward and represent borderline cases. This chapter, gives guidance on how to resolve such problems with the aim to ensure full comparability of Government finance statistics across the European Union, by examining whether an unit is:
- a separate institutional unit
 - controlled by Government
 - market or non-market producer.
5. The sector classification of units matters particularly because the deficit and debt of units classified to General Government sector add to general government deficit

³ Except for the administration of social security funds, which have their own sub-sector.

⁴ ESA10 20.64 stresses that there should be a distinction between units that are fully dependent on central government but act locally and units part of the state and local sub-sectors that are not subject to central government (for instance they have their own funding, discretion on expenditure, ability to appoint officers, etc.).

⁵ This sub-sector is only relevant if “an institutional unit is organized separately from the other activities of government units, holds its assets and liabilities separately, and engaged in financial transactions on its own account.” (ESA10 20.12)

and debt, as defined by Council Regulation⁶, for the purpose of the "Excessive Deficit Procedure".

⁶ See Part VIII.

I.2 Criteria for classifying units to the general government sector

I.2.1 The definition of the general government sector

1. The general government (S.13) sector includes all institutional units which are non-market producers, whose output is intended for individual and collective consumption, and are financed by compulsory payments made by units belonging to other sectors; it also includes institutional units principally engaged in the redistribution of national income and wealth, which is an activity mainly carried out by government. It includes:
 - a) General government entities which exist through a legal process to have judicial authority over other units and administer and finance a group of activities, principally providing non-market goods and services, intended for the benefit of the community;⁷
 - b) Non-market public enterprises, corporations or quasi-corporations controlled by a government unit if its output is mainly non-market;
 - c) Non-profit institutions recognised as independent legal entities which are non-market producers and are controlled by general government;
 - d) Pension funds, recognised as separate institutional units (“autonomous”) where there is a legal obligation to contribute, and where government manages the funds with respect of the settlement or approval of contributions and benefits.⁸
2. The general government sector comprises four sub-sectors, as mentioned above, although the State Government sub-sector applies only in a minority of the EU Member States. It excludes market public producers (public corporations, quasi-corporations or, by virtue of special legislation, entities recognised as independent legal entities), which are classified in the non-financial or financial corporation sectors.
3. In order to decide whether an entity should be classified to the general government, it is necessary to determine whether:
 - a) it is an institutional unit
 - b) it is a government-controlled institutional unit
 - c) it is a non-market institutional unit

These criteria are discussed in detail below.

I.2.2 Concept of an institutional unit

4. ESA10 2.12 sets out the rules according to which an entity can be considered as an institutional unit:

"A resident unit is regarded as constituting an institutional unit in the economic territory where it has its centre of predominant economic interest if it has decision-

⁷ Classification of statutory regulators follows specific rules.

⁸ This is the definition of SSFs in ESA10 2.117c. ESA10 4.89a also specifies that social security schemes are “covering the entire community, or large sections of the community, that are imposed, controlled and financed by government units.” This means that resources of such schemes take the form of compulsory levies (social contributions or taxes) and that government is obliged to cover any gap between the resources and the benefits, including using its power to change some parameters.

- making autonomy and either keeps a complete set of accounts, or is able to compile a complete set of accounts."
5. In order to be said to have autonomy of decision in respect of its principal function, a unit must be:
 - a) "entitled to own goods or assets on its own right; it will be able to exchange the ownership of goods or assets in transactions with other institutional units;"
 - b) "able to take economic decisions and engage in economic activities for which it is responsible and accountable at law;"
 - c) "able to incur liabilities on its own behalf, to take on other obligations or further commitments and to enter into contracts;"
 - d) "able to draw up a complete set of accounts, comprised of accounting records of covering all its transactions carried out during the accounting period, as well as balance sheet of assets and liabilities."⁹
 - If the entity does not keep a complete set of accounts or, if it is not possible to compile it, its partial accounts are to be integrated with the institutional unit's accounts.
 - If an entity, while keeping a complete set of accounts, has no autonomy of decision in the exercise of its principal function, it should be part of the unit that controls it.
 - Individual entities part of a group and keeping a complete set of accounts are considered as institutional units even if a central body (head office), recognised as institutional unit, is responsible for the general direction of the group. (see below 1.7)
 - Entities, keeping a complete set of accounts, that do not have a separate legal status, but have an economic and financial behaviour comparable to that of corporations (i.e. market producers) that is different from that of their government owners are deemed to have autonomy of decision and are classified as quasi-corporations in the corporations sector outside the general government sector.
 6. In general the entire activity of an institutional unit is classified to one sector. The exceptions are, for instance:
 - when part of a non-market institutional unit can be recognised as a quasi-corporation;
 - when a public financial institution is managing special purpose funds on behalf of government;
 - certain types of pension funds (see below 1.3);
 - some market regulatory agencies (see 1.4);
 7. It must be stressed that the ESA10 classification criteria about entities are not based on the legal form of a body as entities may be judged not to have the required autonomy of decision, which is not automatically evidenced by a legal status.

⁹ The unit is able to compile both flows accounts, showing net income and cash flows statements, and balance sheets showing its patrimonial situation. ESA10 specifies that the publication of such accounts is not a condition for being considered as an institutional unit. Only their (even potential) existence matters. This condition is not formally required for households

I.2.3 Concept of a government-controlled institutional unit

8. A public producer is a resident institutional unit which is directly or indirectly controlled by resident general government units. All other resident producers are private producers.
9. Public producers (excluding financial intermediation and services) are classified either in the corporations sector (if they are market) or in the general government sector (if they are non-market). The only exception is for certain financial institutions either supervising or servicing the financial sector, which are classified as public financial corporations irrespective whether they are market or non-market (ESA10 20.307).
10. Control over an entity is defined as “the ability to determine the general policy or programme of that entity” (ESA10 20.18). A set of indicators are to be considered (See more detail on each criterion in ESA10 20.309):

*Rights to appoint remove, approve or veto a majority of officers, board of directors, etc.*¹⁰

Rights to appoint, veto or remove key personnel

Rights to appoint, veto or remove a majority of appointments for key committees of the entity

*Ownership of the majority of the voting interest*¹¹

Rights under special shares and options

Rights to control via contractual agreements

Rights to control from agreements/permission to borrow

Control via excessive regulation

*Other*¹²

11. It is important to note that the criteria 1, 2 and 4 (and in some cases 3 if these committees have been delegated significant decision related to the strategy of the corporation) in the above list are by themselves sufficient to determine the existence of control. It is only if none of them should be conclusive that, in rather infrequent cases, the other criteria should be considered. A number of separate indicators may collectively indicate that there is control. Thus, a case-by-case approach may be required.
12. This notion of control is also applicable to NPIs and similarly covers the ability to determine the general policy or programme of the NPI. ESA10 20.15 indicates that the following five criteria should be considered: a) appointment of officers, b) other provisions of the enabling instrument (such as the specific obligations in the statute of the NPI), c) contractual agreements, d) degree of financing¹³ and e) risk exposure¹⁴ In some cases, one indicator can be sufficient to establish control but it

¹⁰ This is considered in aggregate (jointly) when these rights are held by several public units. For instance, a corporation with 30% ownership by central government and 40% by a public corporation, which itself is 75% central government-owned and 25% privately-owned, is considered as 70% public-sector controlled (here indirectly by central government). In most cases, a corporation with less than 50% public sector ownership would not be part of the public sector based on ownership, but could nevertheless be if other above-listed control criteria were met.

¹¹ This is usually referred to as “voting rights”, as there may be multiple voting rights attached to some shares.

¹² This criterion covers various elements, notably restrictions on some operations, change in status needing an ex-ante approval, financing (“fully, or close to fully, by the public sector” in ESA10 309i).

¹³ ESA10 20.15 does not specify this degree. However, there must be consistency with ESA10 309i (“fully or close to fully”) related to public corporations. It is very likely that, as a counterpart of significant financing, in most cases, government would closely monitor its use and impose rather strict rules.

¹⁴ This indicator is not explicit in ESA10. It seems to refer to various possible commitments taken by government in order to ensure the continuity of the activity carried out by the NPI and judged essential for public policy purpose.

is most frequently necessary to consider collectively a number of indicators and would be frequently "judgmental in nature".

13. As many schools are Non-profit Institutions they represent a practical example for applying the ESA10 control criteria mentioned in the later paragraph. General government unquestionably controls a school if government's approval is needed to create new classes, make significant investments in gross fixed capital formation, borrow or if it can prevent the school from ending its relationship with government. However, general government does not control the unit only supervises the quality of education any school has to provide (for instance, fixing general programmes or the maximum number of pupils per class). As far as financing is concerned, government could be deemed to exert control on a school if it provides a large part (far above 50%) of its resources under various forms (subsidies, purchases of goods and services, investment grants, etc.) or, even, directly takes over some expenses (such as teachers' salaries). This would be reinforced if the school would not be able to substitute other resources, notably through parents. Therefore, if government is predominantly and permanently financing the school, this could lead to a judgment of control.

I.2.4 Concept of a market or a non-market institutional unit

14. When the principal function of a public institutional unit is the redistribution of national income and wealth, it is to be classified by definition in the general government sector.
15. When the principal function of a public (government-controlled) institutional unit is financial intermediation activity, as defined in ESA10 2.57, it must be classified outside the general government sector in the financial corporations sector, i.e. the market test (see below) is not relevant to apply (ESA10 20.34). However it must be checked whether the entity is effectively carrying out financial intermediation (managing/acquiring financial assets and incurring liabilities in its own account) and/or auxiliary financial activities (see ESA10 2.95 and 2.96). If it is not the case, the unit would be classified in the general government sector.
16. In other cases, it is necessary to check whether the unit is market or non-market: in other words, if the unit finances its operational activity by sales of goods and services at economically significant prices then it is a market producer. Market producers are classified to the corporations sectors. This is referred at as the "market/ non-market test".
17. The general government sector includes only public non-market institutional units. When these non-market institutional units have some residual market activity, it is the case of secondary local kind-of-activity units (KAUs) which are not recognised as quasi-corporations and must be included in the general government sector. (See ESA10 2.144 and following).

I.2.4.1 The concept of "economically significant prices"

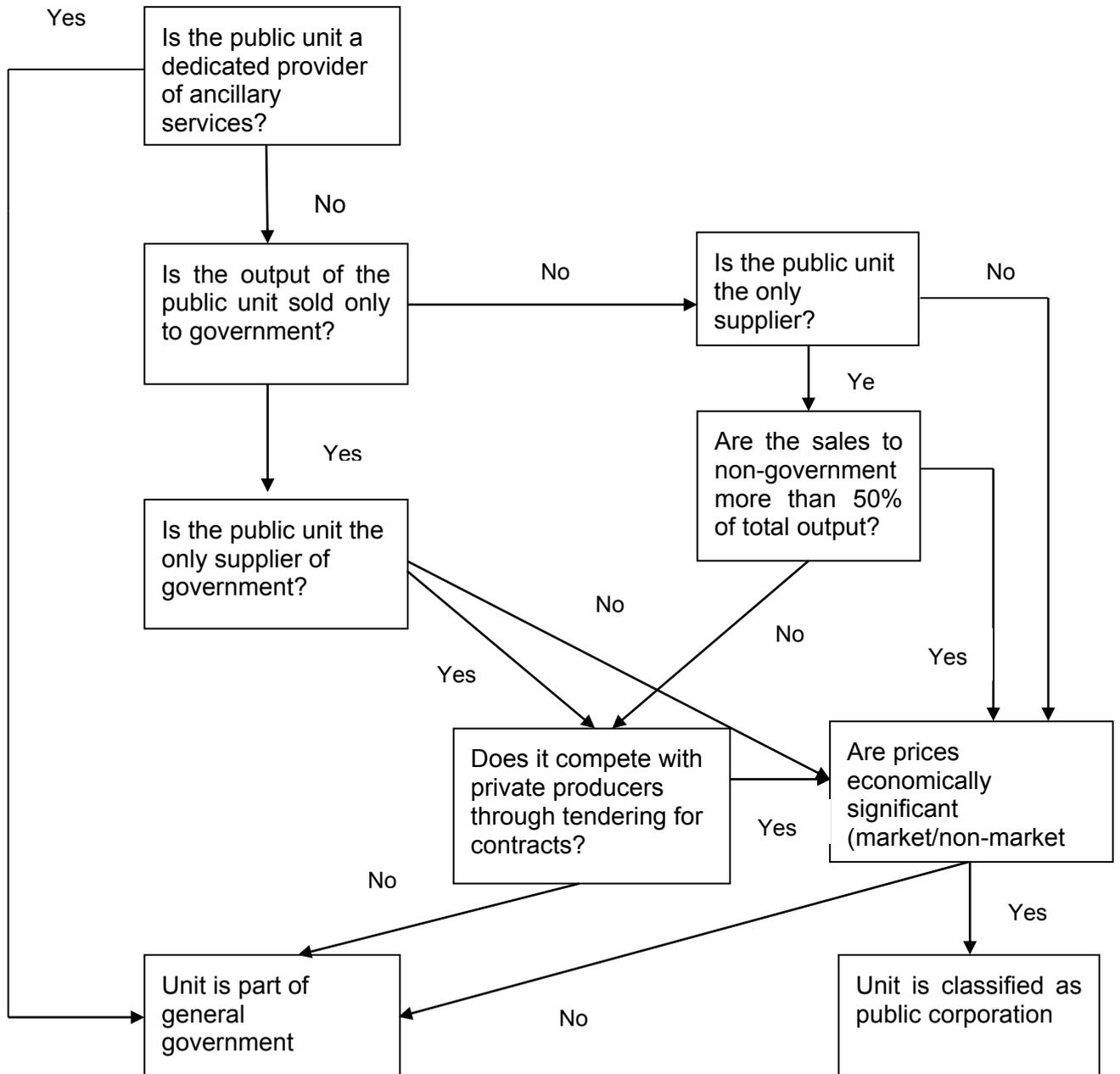
18. ESA10 states that the distinction between market and non-market producers depends on whether or not prices charged for sales of goods and services are economically significant. (see ESA10 20.19 and following paragraphs) A price is said to be economically significant when "it has a substantial influence on the amounts of products the producers are willing to supply and on the amounts of products that the purchasers wish to acquire." The capacity of producers and consumers to react to economic "signals" is fundamental as to assess market behaviour. Conversely, a price is said to be not economically significant when it has little or no influence at all on how much the producer is prepared to supply and

have only a minor influence on the quantities demanded. It is thus a price that does not determine the observed levels of supply or demand.

19. Market producers sell their output at economically significant prices. Non-market producers are typically providing their output free of charge or at prices that are not economically significant. A public market producer will act as a business unit subject to market forces such that it might have to close down if it cannot survive at those prices without the permanent support of government or it would be subject to restructuring.¹⁵

¹⁵ From a general point of view, normally a private market producer cannot incur losses in the long run as this would mean a negative return of equity (with possible exceptions for some entities within a group). The case of a public market producer is different in the sense that in many cases one can assume that government would provide support for public policy reasons. Usually, the ROE requirements would not apply in similar conditions for the private sector whereas, frequently, events triggering bankruptcy (such as negative equity) are not applicable to these entities. In terms of public finance, any government support to public market producers has an impact on government net lending/net borrowing and possibly its debt. However, generally, government would decide corrective measures or restructuring plans when the burden becomes too heavy on public finances.

Decision tree



I.2.4.2 Specific cases of producers

20. Independently of the results from the quantitative test described below, there may be cases, expected to be rather exceptional needing specific analysis as the producer would not be “by nature” considered as a market producer. This is relevant for public producer. In the case of private producers (those not controlled by a government as described above), the price is by definition deemed to be economically significant because of profit constraints.¹⁶ For their part, public enterprises (mainly corporations) may be set up for public policy purpose, with various degree of support which may influence the price of their output. Their market/non-market nature has to be considered through the quantitative test below but in a few cases the result should not be considered as relevant criterion. The involved units may generally identified by the specific nature of their activity and it is assumed that the relevant information could be easily available for statisticians.¹⁷

a) The public producer is not an institutional unit

The distinction between market/non-market makes sense only if the producer is an institutional unit and is not a dedicated provider of ancillary services to government, as defined in ESA10 3.12. If it is the case, the entity is servicing government and so has to be integrated into the government unit it depends on.

b) The public producer sells its output both to government and other customers (corporations, households, no-residents)

However, if the public producer is the only supplier of these goods and services, it would be presumed to be a market producer if more than 50% of its output is sold to non-government units (under the same conditions as for government), or if, for its part of the sales (whatever its size), government purchases goods and services through a tender procedure. In such cases, government is deemed to be fully “price taker”.

If government represents a significant part of the output of the producer (such as more than 50%) and if there are several suppliers (i.e. also private producers in the country or abroad), the public producer is considered a market producer if the contracting process with government takes place in an actual open competition.

c) The public producer sells its output only to government

In this case government may be in dominant position (monopsony). This situation must call for a close examination by national accountants as government could have a significant influence on the level of the prices (de facto “price maker”).

If the public producer is the only supplier of government for this kind of good or service, it will be considered as a non-market producer except if this producer competes with private producers, which may notably be evidenced by a tendering procedure for initial selection. If such competition exists¹⁸, it means

¹⁶ In some cases, this must be considered at the level of a private group because of non market-based transfer pricing between entities of the group.

¹⁷ This means that when assessing the coverage of the production costs by the sales, it is important to identify the share of government units among buyers, where relevant. It must also be rather well known cases of production exclusively (or almost) dedicated to government's use.

¹⁸ This competition must be assessed not only by the presence of different firms on the domestic market but also by the degree of openness of the market to new producers.

that the position of the public producer is deemed not to be definitive as the contract is normally renewed after a given period.¹⁹

If this producer is not the only supplier to government and is in real competition with other producers, its market/non-market nature is checked through the quantitative test.

1.2.4.3 The quantitative market/non market test

21. To determine whether a producer is market, it must sell its products at an economically significant price which, in practice, would be assessed if the sales of the producer cover a majority of the production costs. In distinguishing market and other non-market producers by means of this “50% test”, “sales” and “production costs” are defined as follows:

- a) “sales” (equal to the market output increased by payments for non-market output, if any) exclude taxes on products (D.21) but include all payments made by general government or the Institutions of the European Union²⁰ and granted to any kind of producer in this type of activity. Other sources of revenue, such as holding gains, dividends, investment grants, other capital transfers, are excluded from the notion of sales.²¹
- b) “Production costs”, for the purpose of this test, are the sum of intermediate consumption (P.2), compensation of employees (D.1), consumption of fixed capital (P.51c), other taxes on production (D.29) and the net interest charge²². For this criterion other subsidies on production (D.39) are not deducted. To ensure consistency between the concepts of sales and production costs when applying the 50% test, the production costs exclude all imputed costs made for own-account capital formation.
 - The 50% test should be applied by looking over a range of years on an individual unit basis (even when entities are part of a group): only if the test holds for several years (at least 3 years) or if, in some cases where the unit had previously passed the test, is observed for the present year and is strongly expected to hold for the near future, should it be applied strictly. Minor fluctuations (or deemed to be one-off exceptional case) in the size of sales from one year to another do not necessitate a reclassification of

¹⁹ As a reminder there are some rules at the level of the EU concerning public procurements based on open competition.

²⁰ See more detail on the treatment of EU grants/subsidies in chapter II.3.

²¹ In order to be assimilated to sales, these payments (to which any producer of the same service should be entitled) must be directly linked to the volume or value of the output, and not only because the producer is engaged in such production. For example, in respect of public transport, government could choose to pay subsidies based on the number of tickets sold, such that the subsidies paid vary directly with usage and cover the gap between the price charged to users (generally controlled by government) and the costs for the corresponding output. On the contrary, payments made irrespectively of the actual amount of tickets sold to final users, under the form of a global lump sum to cover operating deficit resulting from the insufficient coverage of costs by pricing, would not be added to the sales for the 50% test. In practice, the payments included in the extensive notion of “sales” are labelled “subsidies on products” (D.31), defined in ESA10.4.33 as “payable per unit of a good or service produced or imported”. ESA10 3.33, however, specifies explicitly that “the payments made by general government to cover an overall deficit of public corporations and quasi-corporations” that “constitute part of other subsidies on products as defined in ESA10 4.35c” are not considered sales. For their part, “other subsidies on production” (D.39) (ESA10 4.36) and other transfers from government are not taken in account. Therefore, any subsidy for which the total amount to be paid has been fixed ex-ante (possibly already partially or totally paid before the whole activity has been carried out), generally in the context of global budget negotiations focusing on factors such as maintenance of buildings, investment in technical equipment, payment for compensation of employees, are excluded from “sales” when applying the market quantitative test.

²² ESA10 3.33 mentions “net interest payments”, which is in contradiction with the accrual principle (and also inconsistent with other components of sales which are on an accruals basis). The categories underlying the expression “net interest charge” (D41 -uses- minus D41 -resources-), in ESA10 20.31, are to be used instead.

institutional units (and their local KAUs and output), similarly to exceptional costs.

- The 50% test decides also when a government unit can be treated as a quasi-corporation (owned by the government): a quasi-corporation can be created only if the identified entity is market.
- In case of new public enterprises the test may be difficult to apply immediately due to lack of results and/or because of a progressive gearing up.²³ The classification should be based on the business plan and special attention should be given to check whether the unit becomes a market producer in a short period of time. In some cases, where the new unit is a merger of previous units, the results of previous periods can be estimated as an indication of future performance.
- In case of liquidation of a market producer²⁴, the quantitative test is no longer relevant as there is no new output and no sale. As a rule, if the test has confirmed the classification of a public unit outside the government sector just before the liquidation, no reclassification should incur during the liquidation process which may take time. However, in most cases, the liquidation process occurs after a period where the unit has shown strong difficulties and it is frequent that the unit would have no longer satisfied the test (with a consequent reclassification within government) before it was decided to irrevocably enter the liquidation process.

I.2.4.4 Specific case of hospitals

22. There are important differences among Member States concerning the way the payments are made by the general government to public hospitals:

- i. Directly according to their costs;
- ii. According to a negotiation (global budget) between general government (social security funds, central government or at a geographical sub-level) and each hospital. These negotiations focus on several factors (final output, maintenance of building, investment in technical equipment, payments for compensation of employees);
- iii. According to a system of pricing applied only to public hospitals;
- iv. According to a system of pricing applied to both public and private hospitals, covering most of the activities of the public hospital (which must compete with private hospitals) resulting from negotiations between government and hospitals and not unilaterally decided and imposed by government.²⁵

23. Only payments made under iv) can be considered as sales on the basis of the comparable situation between public and private hospitals provided that an actual competition is observed for the main part of the activity of both entities. However, for the implementation of the market test, qualitative aspects should also be considered. In some cases public hospitals are not acting in a competitive environment, notably because they do not provide all the same services than private hospitals. They may also be subject to a specific regulatory framework, acting under a narrow control of government which goes beyond the definition of

²³ This is notably the case for new units which needs in a first step significant capital expenditure and will start to sell services until after the completion of the works.

²⁴ This does not cover the specific case of "defeasance structures" related to problematic assets held by financial institutions. (See chapter IV.5)

²⁵ Government may entrust public hospitals with specific tasks, in addition to medical care, such as emergencies, education and research. The payments for these tasks are not considered as sales.

the general policy of the hospital and limits the scope of their of decision power in the conduct of their daily activities.

I.2.4.5 The borderline between taxes and sales of services

24. In assessing whether a unit is market or non-market, it is necessary to check whether a unit's income from non-government sources should be classified as sales or as something else. For example, payments made for permissions to carry out a given business or personal activity (usually evidenced by a license), should be treated as sales of services only if the revenue is used to organise some proper regulatory function associated with the permission (such as checking the competence or the qualification of the person concerned, suitability or safety of the business premises, reliability or safety of the equipment employed, quality or standard of goods and services produced), and if the payments does not significantly exceed the cost of providing the services. However, the degree of obligations for the payers should also be considered as there may be situations where the economic agents cannot carry out a given activity without holding a specific permission, so that the price should in no way influence the number of bid and asked permissions. Such payments should be treated as taxes if either of those conditions is not satisfied (see ESA10 4.79 d) and, therefore, the unit classified within general government or, in some cases, the payments routed via government since only government has the power to levy taxes. Chapter VI (Overview) provides more guidance on this. (TV, radio)

I.3 Pension institutions

I.3.1 Background to the issue

I.3.1.1 Main definitions

1. Pension schemes provide an income after retirement from work and a survivor's pension to a surviving spouse in most cases. Some further risks might occasionally be insured under a pension scheme as well (sick leave, disablement). They can take the form of "social insurance schemes", which includes both "social security schemes" and "employment related social insurance schemes other than social security schemes". Protection against these risks could also be insured on a private insurance policy and through other (long-) term savings instruments arranged by individuals on their own initiative. The entities managing social security schemes would normally be classified in the general government sector (S.13) whereas the entities managing the other employment related social insurance schemes would normally be classified in the subsector "Insurance corporations" (S.128), "Pension funds" (S.129) or the employer's sector (S.11, S.12, S.13 or S.14). Entities managing private insurance policies would be classified in the subsector "Insurance corporations" (S.128). Entities managing savings instruments will predominantly be allocated in the financial corporations' sector (S.12). Occasionally, depending on the country's legislation, they might also act as the insurer of an "employment related social insurance schemes other than social security schemes".

In national accounts, social insurance means collectively organised protection against a list of "social risks or needs" such as, in the case of retirement pensions, the risk of not having an adequate income when being old. The main flows under a social insurance scheme are "social contributions" (payments to the scheme) and "social benefits" (payments by the scheme).

I.3.1.2 Social assistance

2. In national accounts, social insurance differs from social assistance. ESA 2010 says that social assistance payments "meet the same needs as social insurance benefits but which are not made under a social insurance scheme requiring participation usually by means of social contributions" (see ESA10 4.105) and they "are not conditional on previous payment of contributions and which are generally linked to an assessment of available income" (see ESA10 4.85).

I.3.1.3 Unfunded and funded pension schemes

3. In discussing the accounting of social insurance schemes, a distinction between "unfunded" and "funded" schemes should be made.
4. Unfunded schemes, frequently referred as to "pay as you go schemes", are schemes where the unit responsible for the scheme is not or only partially recognising in its accounts the outstanding liabilities to pay pension benefits in future. The pension benefits due during a year are primarily financed out of the pension contributions earned during the same year.
5. Funded schemes are arrangements where the unit responsible for the scheme is fully recognising the outstanding pension entitlements. The balance sheet will show a separate entry reflecting the "pension entitlements". Also, the balance sheet will include earmarked investments to finance future pension benefits. The pension contributions earned during a year combined with interest flows from the

investments will serve to supplement the "pension entitlements" for the active participants (and for the participants with postponed pension entitlements) and the pensioners in the scheme. The amount of the earmarked investments will increase accordingly.

Generally, the value of the earmarked assets will be well over the value of the "pension entitlements"; the difference serving as a buffer to accommodate the effect of any risks that might occur (especially from price risks on the financial markets, from interest rate changes or from the longevity risk). Supervisory authorities might set limits to the minimal amount of these buffers.

Short-term shortages, where the value of the earmarked investments is below the outstanding amount of the "pension entitlements" (probably increased by the amount of the mandatory buffers), might not endanger the classification of the scheme as being funded. Maintaining the classification as a funded scheme would occur under the precondition that the employer and sometimes the active participants will inject additional pension contributions and/or that pension benefits will be reduced to restore the minimal level of the buffers.

If the scheme becomes underfunded, meaning the mandatory buffers become too small or even negative and the employer funds into it, this is to be recoded as an employer's contribution.

Social insurance schemes that are partially funded by design, so the earmarked investments are significantly below the scheme obligations, are classified as unfunded schemes.

The participants in a pension scheme, whether unfunded or funded, do not own directly the assets that are collectively held and managed (similarly to mutual funds) but they hold an individual claim on the pension entity (the pension entitlement).

I.3.1.4 Defined-Defined contribution and defined-defined benefit schemes

6. With defined-defined contribution schemes, the individual pension benefits depend on the value of the accumulated assets at or after retirement. Therefore, the individual households bear the financial risk of the performance of the earmarked assets: they are facing uncertainty concerning the level of the future pensions. Regularly (but this is not a required condition), the participants in the scheme may have some individual choice in the orientation of the investment of their funds in one or more market segments and/or of the investment manager. The accumulation of the assets and the attribution to the individual participants is very similar to investing via a mutual fund. Normally, participants in the scheme cannot dispose of their holdings before retirement. (See also ESA10 17.54.) With the aim of mitigating the risk from developments on the financial markets on the level of the pension benefits the asset mix for participants – either on an individual or on a vintage basis – might be shifted to less volatile instruments some years before retirement.

Normally, a defined-defined contributions scheme is funded though unfunded defined-defined contributions schemes may exist. In the latter option, the scheme would use a financial market index as the yard stick to calculate the individual pension rights at retirement.

7. With defined-defined benefit schemes, the benefits are calculated according to a scheme-specific formula. Often the number of years in service and the salary are the main ingredients of this formula (final pay, average pay). The outcome of this formula, sometimes in combination with a guaranteed minimum amount was solely decisive on the benefits to be granted in the past. The employer was obliged to supplement any deficit with the scheme in many cases. This means that if the value

of the investments was less than the amount of the pension entitlements plus (part of) the buffers, the employer should pay an additional employer's contribution. However, increasingly the employers stepped down from being solely responsible to supplement when needed in recent years. Accordingly, the scheme's formula was amended and/or the unconditionality of the pension promise to the participants was mitigated: a promise according to the formula often changed into a conditional entitlement. So the formula reflects the envisaged entitlement without – circumstance driven – being legally enforceable. (See also ESA10 17.57)

These defined benefit schemes should have a clear surplus of the value of the earmarked assets over the pension entitlements according to supervisory regulations in many cases. This mandatory buffer might be up to over 30% of the pension entitlements. One could fancy, a defined-defined benefit scheme being unfunded. Present accounting regulations, however, make the existence of unfunded defined-defined benefit schemes fairly unlikely in the corporations' sector; most applicable accounting directives prescribe all obligations of the corporation to be included in its balance sheet. Accordingly, unfunded defined-defined benefit schemes would mainly be seen with government.

Some social insurance schemes have characteristics from both defined contribution- and defined benefit schemes. These schemes are treated as defined benefit schemes in national accounts and government finance statistics.²⁶

I.3.2 Treatment in national accounts

8. ESA 2010 draws a line between social insurance and any other personal protection against social risks or needs (see ESA 2010 4.84). In order for an individual policy to be treated as part of a social insurance scheme, the eventualities or circumstances against which the participants are insured shall correspond to the risks or needs listed in ESA 2010. In addition, one or more of the following conditions shall be satisfied:
 - a) participation in the scheme is obligatory either by law or under the terms and conditions of employment of an employee, or group of employees;
 - b) the scheme is a collective one operated for the benefit of a designated group of workers, whether employees, self-employed or non-employed, participation being restricted to members of that group;
 - c) an employer makes a contribution (actual or imputed) to the scheme on behalf of an employee, whether or not the employee also makes a contribution.

I.3.2.1 Sector classification of the unit responsible for the management of a social insurance scheme

9. Social insurance institutions should be classified according to their characteristics.
 - a) A government unit is judged to be responsible for the management and scope of a scheme if participation is imposed by law or specific regulation and if it is controlled and financed by government units, the level of the main flows by setting (or approving in last resort) the rules. (Note that this role of managing, control and financing differs from the role government might have in supervising institutions to ensure they are run according to prudent principles; see ESA10 4.89a).

²⁶ See also IAS 26 §12.

Such schemes qualify as “social security schemes” (ESA10 2.117, 4.89.a). The government department managing such schemes, where clearly identifiable, is classified within the sub-sector “Social security funds”. If the department unit is no separate (quasi) institutional unit, it should be classified into the subsector of government where the larger unit is classified.

This classification applies independent of the scheme being funded or unfunded. An unfunded scheme often relates to the state pension scheme where the pension benefits normally are of a “flat rate” nature, possibly only dependent of the number of participating or contributory years. However, funded defined contribution pension schemes and private institutions managing the scheme’s investments are not classified within the general government sector (see para 14, 15 and 37).

The financial investments that are held in the context of an unfunded scheme – predominantly a liquidity buffer – are recorded as assets of the scheme’s entity and not of the beneficiaries.

b) The employment related social insurance schemes other than social security schemes (including the scheme(s) for civil servants) could be organised within:

- the unit of the employer;

In this case the employer organises the scheme exclusively for its own staff (or part of them in some cases), manages the scheme directly and is fully responsible for all underlying flows (some might be imputed flows in national accounts).

These schemes qualify as “non-autonomous employer pension schemes”; if funded often also named “book-reserve system” (ESA10 2.106).

All flows, assets and liabilities are allocated to the unit and sector of the employer. In other words, such schemes can be classified in all institutional sectors except households.

The unit managing the scheme for government employees normally is assumed constituting a separate (quasi) institutional unit – contrarily to those with corporations – which should be classified as a pension fund (see next bullet).

- a separate and dedicated unit (a pension fund);

If the employer organises the scheme exclusively for the own staff (or part of them in some cases) or jointly with other employers, managed via a separate and dedicated entity outside the employers’ unit this entity is called a pension fund. The pension fund is fully responsible for all underlying flows and stocks.

These schemes qualify as “autonomous employer pension schemes”. All flows, assets and liabilities are allocated with the associated pension funds in the corresponding subsector (S.129).

- an insurer.

In this case the employer organises the scheme exclusively for the own staff (or part of them in some cases) or jointly with other employers, through an insurance contract with a life insurer who is fully responsible for all underlying flows and stocks. These flows and stock are part of the life

insurer's flows and stocks. All flows, assets and liabilities are reported in the insurance corporations' subsector (S.128).

The role of pension funds and life insurers should be distinguished from the role of most other classes of institutions that might manage pension schemes on behalf of employers²⁷. These other institutions would most often organise the scheme without being responsible and accountable for the scheme's obligations: they are the administrator and perform auxiliary activities and should be classified as such. Especially, insurers, banks and dedicated pension auxiliaries perform these activities. The pension entity itself should be classified separately. Occasionally, depending on a country's legislation, these other classes of institutions might be responsible and accountable for the scheme's obligations. The pension scheme's transactions should be reported with the institutional sector of those institutions.

10. In recent years, some countries have set up funded defined contributions pension schemes where government imposes or encourages participation, possibly collects contributions from employers/employees/self-employed and it may pay pension benefits to retirees. Also government would might fix the level of contributions and maybe possibly decide on the applicable the rules. Government has often outsourced the investment management to private sector managers (banks, insurers and brokers). Under funded defined contributions pension schemes such schemes, the pension benefits predominantly depend on the accumulated assets. Under these conditions, not all the ESA 2010 criteria for classifying such schemes as social security schemes are fulfilled, as government is not fixing the level of the pension benefits and it does not "control and finance" the scheme.

Moreover, as the full investment risk is with the policyholders/beneficiaries, these schemes are comparable to an investment fund. This implies that the entity managing such a pension scheme, constituting a separate institutional unit, should be classified as a financial institution in the appropriate sub-sector.

If government would guarantee the level of the benefits under a funded defined contributions pension scheme, implying that government would bear part of the risks, this as such is not a sufficient condition for classifying it as a social security scheme. This would only apply if the scheme is under a recurrent call during several years from which it is clear that the government guarantee is not for exceptional and temporary reasons. That situation might motivate government to take full control of the scheme and adjust the levels of contributions and benefits. This reclassification might also occur before a call on the guarantee has been made but where sufficient evidence exists that such a call would be inevitable in the near future. Reclassification would be at stake only if government participation in the benefits from a funded defined contribution scheme would be over the payment from the scheme's own resources.

11. Therefore, in the absence of government guarantees, the flows of contributions and benefits under funded defined contribution schemes are not recorded as government revenue or expenditure and do not have an impact on government deficit or surplus.

²⁷ These other institutions should record insurance technical reserves (provisions) to reflect the pension obligations for which they are responsible. These reserves would not otherwise exist for these institutions.

I.3.2.2 Government guarantee to a funded scheme

12. Even where government is not responsible for the management of a scheme that is not classified as social security scheme, it may have a “strong interest” in the sustainability of the scheme, as part of its social protection policy. Government might closely follow the performance of non-government pension schemes notably, to ensure that nobody within the population would be left without an adequate pension.
13. In this context, where government considers that the degree of uncertainty for participants in a non-government pension scheme is not acceptable, for example because of operational risks, insufficient level of accumulated reserves, market collapse, the government may grant an explicit guarantee to protect the participants. Government acts as payer of last resort to ensure that benefits reach a level considered as satisfactory.
14. The existence of a government guarantee, in conditions mentioned above, to a funded scheme that is not classified as a social security scheme, does not as such imply that the beneficiary pension scheme should be reclassified as a social security scheme.
15. The government guarantee must be considered as a one-off guarantee (a contingent liability), not recorded in national accounts as a government liability according to the general ESA 2010 principles. In this respect the risk borne by government is only a potential one as it depends on the occurrence of certain specific events. As a result, neither a government expenditure nor a government revenue is recorded as long as the guarantee is not called.
16. Government may support a scheme for exceptional and temporary reasons, for instance a short-term shock on financial markets (such in 1987, 1994, or 2008) such that the government intervention is limited in time and/or amount. This does not imply reclassifying the scheme as a social security scheme, unless government takes control of the scheme and directly adjusts the levels of contributions and benefits. This means that, in a first stage, any government support, although affecting government surplus / deficit would not have the automatic effect of reclassifying the scheme.
17. If government’s support for the scheme is not implemented for exceptional and temporary reasons but is observed frequently and assumed to be permanent, national accountants should closely examine whether government has obtained some controls over the scheme such that conditions for classifying it as a social security scheme are fulfilled.
18. In the case of a defined-defined contributions funded scheme, this reclassification as a social security scheme should be implemented only when the government is effectively ensuring the payment of benefits for an amount higher from than the one payable from the assets accumulated in the fund.
In the case of a funded defined benefit scheme, this reclassification as a social security scheme should be implemented only when the government is effectively ensuring the payment of benefits for an amount higher than 50% of the actuarial value of the pensions from its own resources.

I.3.3 Rationale of the treatment

19. The level of pensions depends on the value of the accumulated assets that are invested on the market with a defined contributions funded scheme. Therefore,

government is not controlling the level of the individual pension benefits because it has no direct influence on the market performance of the assets.

20. All pension funds where the participants bear the financial risk should be treated in the same way, whatever the nature – public or private – of the unit managing the scheme, or even the obligatory or voluntary nature of the scheme. They are savings accumulated by households. Managing assets on behalf of other units is a financial intermediation activity that is not normally a function of government. When managing such schemes, government is not acting for public policy purposes but is acting in a similar way to a financial institution.
21. Classifying a funded defined contributions funded scheme into the sub-sector of the managing entity, often S125 "insurance corporations" S.128 or and "pensions funds" (S.129) but possibly (depending on the country's legislation) another (sub-)sector means that, although on the one hand the liability relating to the future pensions is not recorded as government liability and on the other that, the government securities held by the managing entity on behalf of the pension scheme pension fund should be are rightly recorded in government debt (not consolidated). Under these conditions, the structure of the entity's portfolio of the pension fund has no influence on the recording of government debt.

I.3.4 Transfer of pension entitlements from the second pillar

22. Occasionally, pension entitlements that are accumulated in the second pillar are transferred to the first pillar of the country's pension system, accompanied by the transfer of associated assets. The transfer might be voluntary, encouraged by government or compulsory. The treatment in the MGDD will depend on the exact features of such transfers at inception, which are not yet fully known: future role of individual accounts, calculation of the future value of the accounts, etc. The MGDD will be completed in further editions after more clarity will be available on this issue.
23. The starting point of the recording would be an identical value of the transferred entitlements and the associated assets. Under this assumption, the transaction is financial in nature. Accordingly, the transfer has no impact on government net lending / net borrowing. However, government debt may be indirectly affected through the consolidation of the government bonds that are amongst the assets.

I.4 Market regulatory agencies in agriculture

I.4.1 Background to the issue

1. This section discusses the sector classification of market regulatory agencies²⁸ and the treatment of their inventories, when these agencies operate within the domain of agriculture. The rules could also apply for market agencies intervening in other markets such as raw materials (this is not currently observed in EU).²⁹
2. These are national agencies acting on behalf of the European Union or other units having both a market and a redistribution activity. They mainly concern agricultural products. Institutional arrangements vary between countries. Typically their activities include the purchase and storage of agricultural products; giving direct subsidies to farmers, levying charges on producers and imports; giving subsidies for exports; giving grants for capital equipment and environmental improvements.³⁰
3. The Eurostat 2005 decision on the accounting treatment of transfers between the EU budget and Member States specifies that EU transfers should have no impact on government deficit/surplus, as government is considered to act "on behalf" of the EU. The Eurostat decision focused on the recording of some ESA transactions, such as subsidies or investment grants. As noted above, market regulatory agencies buy and sell products, in most cases on behalf of the EU, with the aim to stabilize prices by setting up inventories or buffers. From a national accounts point of view, general governments are not the economic owners of these inventories. However, allocating to the EU (S.2 Rest of the world) the changes in inventories would imply recording market regulatory agencies' purchases/disposals as exports/imports with the EU institutions, which would not be the relevant solution both from a conceptual and an accounting point of view.
4. For more information, refer to the document released by Eurostat paper on 20 November 2008 at this address:
http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/MARKET_REGULATORY_AGENCIES.pdf

I.4.2 Treatment in national accounts

5. ESA10 2.114 makes a clear distinction between "market regulatory organisations" which are either or principally distributors of subsidies and those which are exclusively or principally engaged in buying, holding and selling agricultural or food products.
6. Market regulatory agencies channeling subsidies are classified in the general government sector (sub-sector central government). Market regulatory agencies engaged in transactions on markets are classified in non-financial corporations sector.
7. However, market regulatory agencies may be engaged in a mixture of both activities mentioned above. In such cases, ESA10 20.54 states that the agency

²⁸ Also referred to in ESA10 as market regulatory organisations (MRO);

²⁹ As far as other regulatory bodies (which do not intervene directly on markets through "buffer stocks"), such as national authorities for energy, telecommunications, transportation, etc., are concerned, the classification within the general government sector would depend on their significant role in the design of the framework of the activities together with the judicial power they are entitled to. Should the above conditions not be fulfilled, it would be necessary to look at the nature of their resources, which may largely take the form of taxes.

³⁰ However, in the context of the current EU Agricultural policy, the regulation of output prices has decreased to a rather minor activity, observed only for a restricted number of products.

may be split into two institutional units, which may be implemented when there is evidence that one part of the activity of one unit is fundamentally different from another part (for instance in the case of quasi-corporations): the institutional unit being in market intervention activities is classified in the non-financial corporations sector. The second institutional unit distributing subsidies is classified in the general government sector.

8. When it is not possible to distinguish two separate institutional units (notably for accounting reasons or no clear management separation), the following rule should be applied to determine the "principal activity". Units should be classified to the general government sector if their costs incurred in market regulation compared to the total costs are less than 80% and to the non-financial corporations sector if their costs incurred in market intervention compared to the total costs are more than 80%.
9. The costs incurred are measured in the same way as the value of output of non-market services, i.e. as the sum of intermediate consumption, compensation of employees, consumption of fixed capital, and other taxes on production less other subsidies on production, while interest payments are not included. (See ESA10 3.49)
10. However, where a market regulatory agency acting on behalf of the EU (i.e. in the context of EU common policies) is classified inside general government, the creation of a quasi-corporation, rather than a notional unit, in the corporations sector (S.11) is recommended in order to capture the changes in agricultural inventories, and to avoid that such changes in inventories are recorded in national government accounts (as changes in government inventories, with an impact on the government deficit/surplus, or in the rest of the world accounts (as exports and imports).
11. This recording would be mainly based on the view that the EU has economic ownership of those inventories, and not the national government, and that the market regulatory agencies are in fact acting on behalf of the EU: the EU exercising control and assuming risks and rewards associated to these inventories. Such a treatment is also in line with the convention of sector classification of market regulatory agencies (in S.11) stated in ESA10.

I.4.3 Rationale of the treatment

80% criteria

12. The main reasons for fixing the threshold at the high level of 80% are the following:
 - It is not a "normal" activity of for an enterprise (market producer) to distribute subsidies;
 - In many cases the agency has a public legal status;
 - In the context of the Common Agricultural Policy, the subsidy distribution significantly prevails on market interventions;
 - A treatment ensuring stability over time for the classification of market regulatory agencies is needed.

Economic ownership of the inventories

13. Given that a market regulatory agency would be "acting on behalf of the EU" and thus would not use these inventories in its own production process, this institutional unit does not seem to be the economic owner of those inventories arising from its

interventions on the market. The EU should be considered the economic owner of such inventories.

14. Nonetheless, in this case, the recording of exports/imports relationships with the EU does not seem desirable or plausible because this would entail recording export and import flows each time the agency buys or sells, inflating totals with limited analytical value. In addition, market interventions of regulatory agencies, although acting "on behalf" of the EU, are made at national level, i.e. in the national markets
15. It is important to analyse the economic ownership of the inventories constituted by market regulatory agencies. In the case of public interventions on markets, the Commission bears all the financial risks including all the losses derived from the intervention in the market, as the aim of the EU common agricultural policy in this field is to avoid any financial impact on the Member State resulting from market interventions. The opposite situation also occurs when prices go up, the Member State repaying in full the difference to the Commission (gain on sale). In addition, the Member State is responsible for taking all necessary measures for its good conservation but, at the same time, has no control over these goods as the buying and reselling decisions are in the hands of the EU instances.

Classifying the inventories in the corporate sector:

A notional unit or a quasi-corporation?

16. In national accounts, a possible solution (to avoid recording exports and imports upon each addition to or removal from inventories) would be to allocate the recording of such agricultural inventories (P.52) to the non-financial corporation sector (S.11). This would be consistent with the reasoning that general government is not the economic owner of the inventories resulting from market interventions. This approach would follow to some extent the convention stated in ESA10 2.114 mentioned above.
17. The above view would imply that an artificial unit would be created to capture transactions in inventories within S.11, in those cases where the market regulatory agencies are classified inside central government (S.1311).
18. One possibility would be to recognize a notional resident unit owned by the EU. The creation of a notional resident unit seems broadly in line with the ESA10 2.29, which explains that notional resident units, even if they keep only partial accounts and may not always enjoy autonomy of decision, are treated as institutional units, by convention. Such a notional resident unit would hold inventories and it would be regarded as transacting in those. This implies the EU being the owner of the entity in national accounts.
19. Another possibility would be to recognize a quasi-corporation in national accounts, having the same purpose as a notional resident unit mentioned above (i.e. to capture transactions in inventories in case that a market regulatory agency is classified inside central government). Normally, under ESA a complete set of accounts should be available. This is not ensured but, to the extent that the EU makes up for the losses arising from the holdings of inventories, relevant and comprehensive information is deemed to be available. This implies government being the owner of the entity in national accounts.
20. Both these treatments would avoid recording changes in acquisitions and disposals of inventories as exports/imports to the EU.
21. Summarizing, two options seem to be possible, according to who is viewed as the owner of the entity that is holding the inventories, to be classified in S.11:

Option 1) recognizing a quasi-corporation, implying that the owner of the entity remains government; or

Option 2) recognizing a notional unit, implying that the owner of the entity is the rest of the world (ROW).

Net worth of general government

22. Given it is argued that the EU owns the inventories, it is important to determine whether the changes in own funds of the entity owing to gains and losses on inventories at market value (which might be large from one period to the next) would impact either general government net worth, or the rest of the world net worth, or none of them.
23. It is important to determine whether the quasi-corporation option or the notional unit option would yield different, or very different, results from the point of view of the net worth of general government. It could be assumed as a preliminary conclusion that the result would be different as far as the net worth of the EU is concerned. This is because the latter would be impacted by gains and losses on inventories in the case of the notional unit option, but not in the case of the quasi-corporation option.
24. If the agency is an entity established by government, it is likely that some equity link will exist and will appear as an asset of general government when the agency is classified outside general government. However, changes in the price of inventories should not be reflected in the equity value of the entity (i.e. should not be reflected in the price of the asset of government) because by definition those gains and losses do not accrue to government but will eventually be returned to the EU or compensated by EU subsidies. Thus, in concept, the gains and losses should, at first sight, give rise to the appearance of a kind of payable/receivable with the EU, which would keep the own funds of the agency unchanged.
25. In ESA, *Own funds* is defined as net assets of units, excluding equity liabilities, while *Net worth* is defined as net assets of units, including equity liabilities. Thus, *Own funds* minus equity liabilities of units (i.e. equity issued) equals *Net worth*. See ESA10 7.02 and 7.06. The ESA net worth should thus not be confused with the business accounting notion of shareholders' equity or net worth. This business accounting notion of net worth is, in fact, closer to the ESA notion of own funds.
26. However, in concept, the time of the appearance of the payable/receivable also results from the time of recording of the subsidy, which accounting is specifically regulated in ESA.
27. This time of recording issue of subsidies would most likely lead to an impact on the own funds of the agency. However, conceptually, this should not impact the equity value of the agency. If the agency itself were to be sold, its valuation would be independent of the value of its inventories owing to the obligation of the EU to cover losses when incurred, or of the obligation of the agency to return gains to the EU.
28. Accordingly, gains and losses on inventories must be neutral from the perspective of general government net worth in all cases (notional unit or quasi-corporation), even if they are also neutral from the perspective of the EU net worth (quasi-corporation). Thus, holding gains and losses on market regulatory agencies inventories do impact only the non-financial corporations' (S.11) net worth, pending the recognition of the subsidy associated to the receivable/payable.
29. However, this will require that the valuation of the equity in the quasi-corporation will have to correspond to the financing provided to date, rather than being equal to its own funds: thus the unit net worth would be either positive or negative, although

only for short periods of time, owing to the gains and losses on inventories not yet realized or recognized, and thus not yet compensated or returned to the EU. Such deviations could nevertheless be seen as a reasonable approximation of the convention that the net worth of the quasi-corporation should be zero (ESA10 7.09).

Valuation of transactions in inventories

30. In national accounts, the transactions related to interventions in the market should be recorded in application of ESA10 4.33 and 4.35, in the context of notional or quasi-corporation units. These ESA paragraphs would still be applicable for the cases of notional or quasi-corporation units.
31. The transaction value on resale must include the EU subsidy. Thus, changes in inventories will tend to compensate over time. The reimbursements made by the EU correspond to the difference between purchase and resale prices, which is shown in national accounts as subsidies paid by the EU.

Accounting treatment in the financial accounts

32. The following discusses how to record in the financial accounts the links between the notional or quasi-corporation unit and the EU and/or government.

Under the **notional unit option**, the recording will be as follows: an acquisition of equity (F.5) by the EU is to be recorded, matched by an EU borrowing (F.4) from the entity financing the market regulatory agencies (often government itself). This would imply changing the present recording in the Rest of the World financial accounts.

Under the **quasi-corporation option**, no entries are recorded in the Rest of the World financial accounts, as the transactions in equity on the liability side of the quasi-corporation have a counterpart entry in the accounts of government.

Thus, in both cases the net change in inventories that is *de facto* financed by the entity inside government (by way of borrowing from third parties or of drawing down on its liquidities) is recorded in the financial accounts of general government, instead of in the non-financial accounts as would otherwise be the case (under changes in inventories – P.52): either as transaction in equity (F.5 – quasi-corporation option) or as loans to the EU (F.4 – notional unit option).

A theoretical advantage of the notional unit option, over the quasi-corporation option, is that it reflects the genuine economic ownership of the EU.

However, a main disadvantage of the notional unit option is that this requires entries in the ROW financial accounts that do not even exist when the regulatory agency unit is classified outside general government in the first place: thus the notional resident unit option seems to introduce an apparent asymmetric treatment between those market regulatory agencies that are classified inside general government and those market regulatory agencies that are classified outside general government. This would seem to go against a homogeneous treatment across Member States.

In addition, the impact of the movement in the market value of inventories not yet covered by subsidies is likely to be small and temporary, and on average zero over time. In this context, the merit of imputing government lending to the EU and, simultaneously, EU financing of the inventories may be doubtful.

33. Finally, it should be reminded that strictly following a recording that portrays the change in the economic ownership would have implied recording imports and

exports which is deemed not to be particularly useful for analytical purposes (balance of payment). It may be noted, however, that both options leave the same impact on the Government Deficit and Debt.

I.4.3.1 “Shell” treatment

34. When the notional unit or the quasi-corporation is seen as a "shell", for simplicity purposes, it would be conceived in national accounts as only holding inventories and undertaking transactions in those, with counterpart entries in the financial accounts: equity liability. The "shell" option would also mean that no reinvested earnings would be recorded.
35. Alternatively, these units can be conceived to be more complete entities, showing a more complete sequence of national accounts, such as generating a margin and incurring costs.

I.4.3.2 Time of recording of the subsidy

36. ESA105 4.39a indicates that the time of recording of "*subsidies which take the form of the difference between the purchase price and the selling price charged by a government*" is "*at the time the goods are bought by the agency*". But how should this be interpreted?
37. When a product is bought for 120 by the agency in period T, and resold for 100 in the following period T+1, a subsidy on product is recorded in T. In T, the output of farmers (S14/S11) is then 120, the GDP 100, changes in inventories +100. In T+1, the output of farmers is 0, GDP is 0, final consumption is 100, and changes in inventories are -100.
38. However, ESA105 4.39a specifically indicates: "*if the selling price is known at that time*", which needs to be interpreted. The resale price is *a priori* generally not known in advance. But an expected price is probably known: suppose it was 106 in the example above. Then 6 (=20-14) only is the non-expected element.
39. The reference in ESA10 above presumably intends to avoid that holding gains/losses enter the production account. Only the part that the scheme is expected to finance should contribute to output. But at the same time, in the case of agricultural market regulatory agencies, no holding gains and loss will ever be borne by farmers or by the agency: all the changes in price will be eventually assumed by the EU.
40. Finally, the selling price of the goods might have fallen to 102 by end of year T. This would be the value of inventories recorded on the balance sheet at the end of period T.
41. If ESA10 4.39a also covers cases when the selling price will be known only in the next period, then the amount to record as subsidy in T (and parallel acquisition of a receivable) by the agency is either:
 - Option (1) the actual amount observed in T+1 (20); or
 - Option (2) the expected amount observed in T (14); or
 - Option (3) an amount reflecting the market price observed as of end of the year (18).
42. In option (1), the recordings are straightforward but imply a revision in the data, when the information is gradually available (notably for quarterly data). In option (2) and (3), one issue is how to record in T+1 the difference of 6 (=20-14) or 2 (=20-18). One approach is to enter those flows in the revaluation accounts of the financial accounts (thus recording subsidies on an expected basis), which seems

difficult. Another approach is to record a subsidy on production in T+1 for the remainder (that could be either positive or negative) matched by an entry in change in inventories (although this might appear artificial). In doing so an entry in the revaluation account in the non-financial assets occurs (of $+4=6-(20-18) = (20-14)-(20-18) = 18-14$) in T+1 in option (2) compensating the holding loss arising in T (of $-4=14-18$). No revaluation occurs in option (3) neither in T+1 nor in T. It should be noted that in option (3), the net worth of the quasi-corporation are always zero (see section above). In option (1) or (2), the net worth deviates from zero, for either positive or negative amounts, but for limited time spans.

I.5 Units engaged in financial activities: general issues

1. This part considers whether certain types of public units undertaking financial activities (i.e. showing mainly and diversified financial instruments on both side of their balance sheet) should be classified to general government or as public financial corporations S.12 (ESA10 2.55).
2. Within the financial corporations sector S.12, units principally engaged in financial intermediation, as defined in ESA10 2.56 to 2.58, are to be classified in one of the following sub-sectors: S.121 (Central bank), S.122 (Deposit-taking corporations, except the central bank), S.123 (Money market funds), S.124 (Non-monetary market investment funds), S.125 (Other financial intermediaries, except insurance corporations and pension funds), S.128 (Insurance corporations) and S.129 (pension funds).
3. Units engaged in auxiliary financial activities, as defined in ESA10 2.639, are to be classified in the sub-sector S.126 (Financial auxiliaries). The captive financial institutions and money lenders, as defined in ESA10 2.98, for their part, are classified within the sub-sector S.127.
4. ESA10 (2.67) also retains the notion of Monetary Financial Institutions (MFIs), comprising the sub-sectors S.121, S.122 and S.123.³¹
5. Supervisory authorities of financial intermediaries and of financial markets are classified as financial auxiliaries (S.126) when they are separate institutional units. Especially concerning banking supervision and frequently also for insurance and pension supervision, the corresponding tasks are conducted within the national central bank (possibly the ECB under the Banking Union in Euro Area). Supervision of the financial markets (or other related activities) occasionally might be with the Ministry of Finance. If these tasks are not separate from the hosting institution (i.e. they are not conducted by an identifiable institutional unit) they should be included in the hosting unit and implicitly allocated to the hosting unit's institutional (sub) sector.
6. Protection funds for the financial sector, especially entities that manage a deposit protection scheme or an insurance or pension protection scheme, are classified as financial auxiliaries (S.126) when they are separate institutional units. Where these tasks are not separate from the hosting institution, who then ultimately assumes the full responsibility of honoring the scheme's obligations, they should be included in the hosting unit. Cases where it is thought that a possible deviation from the general treatment would exist should be discussed between the Member State and Eurostat.

The levies paid by the relevant financial institutions to the supervisory authorities or the protection funds are classified as taxes. Where these supervisory authorities or the protection funds are classified outside the government sector, the levies should be rerouted via the central government subsector. The amounts forwarded by government to the supervisory authorities or protection funds would be classified as an income transfer. In case the levies would be in accordance with the risks of the individual financial institutions, the classification of these levies as output of the supervisory authorities or the protection funds would be relevant. A possible

³¹ The definition of MFIs is under the responsibility of the European Central Bank because of their essential role in the transmission of monetary policy decisions. (See the updated list published by the ECB.)

deviation from the general treatment should be discussed between the country and Eurostat.

7. An important criterion for classification as a financial intermediary in sector S.12, apart from financial auxiliaries, is the crucial issue of risk. ESA10 2.57 states that units engaged in financial intermediation must "place itself at risk". Otherwise, the unit should be integrated within its parent company or, at least, one part of its activity should be re-allocated ("rerouted") to the unit taking such risk which is by definition attached to financial assets and liabilities. Therefore, it may happen that a public corporation which apparently seems to act as a financial intermediary is classified in government sector because a government unit is directly bearing all or almost all of the risks. For instance, it is evidenced that government will repay its liabilities or will compensate any loss resulting from shortfalls in asset performance. On the opposite, the fact that government may be the unique or predominant shareholder of a financial corporation does not mean that the latter does not "place itself a risk" in the context of its activity on financial instruments. It is a general feature that shareholders bear the final risk in a corporation but as the financial institution issues and bears these instruments in its own name, the creditors bear a risk on this unit and may not directly ask the shareholders to substitute to it. In addition, the effective degree of support that the shareholders might provide is uncertain.
8. In some cases, government may grant explicit guarantees on liabilities which transfers all or part of the ultimate risk on it. The existence of these guarantees, recognized as contingent liabilities, is normally not a criterion for reclassification of units, whatever the extent of the guaranteed liabilities in the balance sheet of units. If in this case the guarantor may be seen as the "final" or "in last resort" holder of the risk, its obligations are nevertheless conditional on a default by the guaranteed unit (which issued the instrument "in its own name"), which is of course uncertain at inception of the guarantee.³² However, in some cases, government may grant guarantees directly on all or almost all of the assets held by a non-government unit (and not on the liabilities of the unit), such that any loss on non-performing loan or other asset is automatically (in some cases only partially or with caps/floors) covered by a transfer from government. Under these conditions, the unit is ensured to be in a position to face its own debt obligations, at least partially.³³ Such units are not considered to be "placing themselves at risk" on these assets covered by the guarantee and re-allocation (rerouting) of the assets to government, which is de facto taking credit risk, must be implemented. (See IV.5 "financial defeasance").

³² See chapter VII.4 of this Manual.

³³ Most cases of default on their debt by financial institutions come from the shortfalls in asset performance.

I.6 Specific public entities

I.6.1 Background to the issue

1. This chapter deals with some specific units under the control of government with a specific area of activity, such that the usual criterion market/non-market distinction is not relevant as far as their sector classification is concerned. In addition, there is some overlapping as regards the provisions in ESA10 related to such units. Thus, this chapter covers the cases of special purpose entities (SPE), head offices, public sector holding companies, privatisation agencies, restructuring agencies and captive financial institutions.
2. Special Purpose Entities (also called Special Purpose Vehicles – SPVs) are legal entities established to undertake the economic and financial transactions associated with a single legal contract or linked set of legal contracts.³⁴ ESA10 2.17 specifies that SPEs are usually “created to fulfill narrow, specific or temporary objectives and to isolate a financial risk, a specific taxation or a regulatory risk.” The governing board of an SPE is usually a trust whose sole purpose is to ensure that the SPE implements the legal contract effectively. This board has no autonomy to direct the SPE to enter into other business activity. The legal contract is usually constructed in a way that makes it very unlikely that the SPE will become insolvent or make large profits. ESA10.18 lists usual characteristics of an SPE
3. Securitisation arrangements often use an SPE to legally separate to issuance of debt from the initial owner of the securitised assets/rights. It is the SPE which issues the securities, uses the proceeds obtained from their issuance for the purpose of taking legal ownership of the securitised assets/rights, and then services the debt thus issued. Sometimes, such SPEs are set up outside the territory of its controlling unit usually in active financial centres, to benefit from easier issuance and wider markets.
4. SPEs are also set up for reasons other than securitisation. For example an SPE might be created to hold bad assets of a bank in financial defeasance, or to raise debt for a PPP arrangement.
5. Government frequently controls some bodies which are at the “top” (through equity stakes) of a group of other units which constitute a group. The main issue are the criteria to consider them as separate institutional units from government, and, if they are, their sector classification.
6. ESA10 2.14 (a) defines a head office as “a unit that exercises managerial control over its subsidiaries and which is “allocated to the dominant non-financial corporation sectors of their subsidiaries, unless all or most of their subsidiaries are financial corporations, in which case they are treated as financial auxiliaries (S.126) in the financial corporation sector.” (See also ESA10 20.35). Thus, a head office is significantly involved in the management of the other units in the group by providing some services, including the coordination of the group.³⁵ It means that it exerts direction tasks which go beyond the simple regular participation in the Assembly of

³⁴ This is different from a “conduit” that may be set up in the context of the issuance of some financial instruments (such as short term bills, notes) but has no legal basis. In this case, there is no separation from the “parent unit”.

³⁵ As mentioned in ESA10 20.36, in practice the term “public holding companies” also covers what is described in ESA10 as “head offices”. It is however important to make a clear distinction between these two types of entities in national accounts for sector classification reasons.

- the entities of the group, such that the more important decision at a lower level are taken or approved by the directing bodies of the head office.
7. ESA10 2.14 (b) states also that, on the contrary, a holding company holds assets of subsidiary corporations (essentially shares with voting rights), exerting control on them but undertaking no management activities, i.e. does not have an active role as regards the daily activity of the group. They just monitor the income distribution of the subsidiaries, in a redistribution perspective and/or only rerouting its income to its parent entity. More precisely such entities “do not provide any other service to the businesses in which the equity held.” According to ESA10, from a general perspective, they must be considered as a captive financial institution (S.127).
 8. Government may create units in the context of a privatisation process, to hold shares in public corporations that the government intends to dispose of such units are not head offices in ESA10 terms, as they do not really intervene (or only in a marginal way) in the management of the corporations they hold, but are created with the aim to facilitate their disposal on market.
 9. Government may also set up, as mentioned in ESA10 20.44, “restructuring agencies” with the aim, for a given period of time, to “restructure” several corporations (public but possibly also private), notably when they show persistent losses; this generally implies a dramatic change in their business model and significant adjustment in human and physical capacities. In this context, such units may provide capital transfers, loans, acquire equity or grants one-off guarantees.
 10. Finally, ESA10, following SNA2008, has created a new category of financial institutions under the category of “captive financial institutions”, described in ESA10 2.98-99 and which may be linked to a government unit.³⁶ Such institutional units do not engage in financial intermediation or in financial auxiliary services. Their activity is restricted to a narrow range of transactions.³⁷

I.6.2 Treatment in national accounts

Special purpose entities

11. ESA10 (see 2. 27 and 20.47-48) specifies that such SPEs must be treated as an “integral part of the general government and not as separate units” (consolidated), if they are resident units. If the entity is resident in another territory from that of its parent, which may be the case for securitisation or other financial purpose where such entities are set up on rather active financial centres (issuance is easier and market deeper) they should be considered as separate institutional units and “any transactions carried out by them abroad shall be reflected in corresponding transactions with government”.
12. ESA10 20.48 provides some precisions on this point. The transactions carried out by the non-resident SPE are recorded as such in the territory but imputed “mirror” transactions will be added between the SPE and government. For instance, any borrowing by the SPE will give rise to a claim on government (after transfer of the proceeds from issuance) and thus an increase in government debt. In case of securitisation through such SPEs, the sale of assets (financial or non-financial)

³⁶ According to the list in ESA10 2.99, some cases of such units may also be covered by types of units mentioned above.

³⁷ ESA10 (2.24-25) mentions the case of “artificial subsidiaries” which are wholly owned by a parent corporation and provide some services to it or to other corporations in the same group. They are close to being ancillary units, except for the scope of the types of activity carried out. Normally, government is not concerned by them except in the case of a parent company which would be classified within the general government sector. Otherwise, the case would be covered by other kinds of specific public bodies considered in this chapter.

would not be recognised and the arrangement will result in a new borrowing by government.

13. ESA10 foresees in 2.18 the case of SPEs set up by government which might be classified outside the government sector (most likely S.12). However, there should be in the case strong evidence that a SPE created by government would actually act “independently” and not under a restrictive framework totally defined by government. Where a SPE is established to serve a government unit, the lack of independence of action could be indicated, among other factors, by:
- *de facto* management³⁸ of the SPE’s debt by government (for instance by the Debt Management Office or the Treasury); or
 - the absence of the right or capacity to actively manage its assets in response to market conditions (arbitrage) , such as government having the right to approve any significant decision in this matter; or
 - a contract or convention signed by government fully determining the SPE’s operations.
14. In some cases, an SPE will be formally set up with a financial institution status (which implies a registration by some supervision and regulatory obligations), to purchase and securitise government assets and acting as arranger. In these cases, if the SPE is not acting independently and has thus a very restricted autonomy of decision, it should be classified within the government sector if government is really originating the transaction, the financial institution only acting as arranger, placing at no time itself at risk, and does not take assets management decisions during the life of the securitisation. In practice, this would need a case-by-case analysis. If the SPE meets the condition to be considered as a separate unit and benefits from large power for actively managing the assets and liabilities risks exposure, such that this qualifies as financial intermediation), it should be classified as a financial corporation (S.12).

Head offices and public holding companies

15. ESA10 2.14 defines head offices as institutional units that exert managerial control over subsidiaries, providing services, whereas holding companies do not undertake management activities and are instead more of a shell. For a unit to be classified as a head office outside of general government, it is necessary that the unit, and not government, appoints the directors of the corporations under its control, and that the unit, not government, may make decisions on the management of the entities beyond the definition of their general policy. In other words, on a case-by-case approach³⁹, it is important to check the actual role of such units in the direction of the group, their statute and internal regulations, the human⁴⁰ and physical means,

³⁸ This could be presumed if the management of the SPE is fully carried out by members of the government entities or if all decisions are subject to an ex-ante approval by government. But an SPE could still lack independence from government even where its Board is only made of so-called “independent” non-government appointees if its status and/or the contract with government strongly restricts its decision power.

³⁹ In some EU countries, there may be a very great number of entities which are labeled “holdings”, with in many cases an “artificial” nature. It seems that an “algorithmic approach” (formula to be applied automatically) is the only practicable solution. This cannot be the case for units under the control of government as their number is limited and with regard to the consequences of the sector classification on the EU budgetary surveillance.

⁴⁰ In this regard, a very small number of staff may be indicate, notably in the context of a group with numerous subsidiaries, that the unit does not act as a head office but is rather as a holding company.

the source of its revenue and the nature of its expenditure.⁴¹ The presence of private shareholders (with an actual influence on some decisions, at least important for the entities of the group) is also a relevant indicator to be considered. On the contrary, when government set up a public holding, under its exclusive or quite preponderant control, which by evidence acts as a government agent (a simple “relay”), this should be classified inside government sector, for transparency and comparability reasons. Indications are given by the time life for which it has been created and/or the tasks, generally limited, it has been entitled with.

16. Public sector head offices, when assessed as such, are classified in the sector S.11 (Non-financial corporations) if they control a group of market producers or in S.12 (Financial corporations, as S.126 financial auxiliaries) if they control a group predominantly engaged in financial intermediation. In case of a "mixture", it is on the basis of the predominant share of value added that the classification must be undertaken. In any case, public holdings under the predominant control of government should be classified in government sector S.13 and not in S.12, as it would be the case for private holdings.
17. The sector classification of subsidiaries, when they are institutional units, should be assessed on their own and tested individually for the market/non-market criteria. Non-market institutional units controlled by government, through the public holding or the head office, are to be classified inside general government. This may imply recognising equity liabilities of general government.

Privatisation and restructuring agencies

18. Privatisation agencies should be classified in the general government sector, because they manage assets on behalf of government which is the ultimate owner of the assets. Similarly, when restructuring agencies are acting on behalf of government, under its narrow control and with a clear support by government for own funding, these entities should be classified within the government sector and not in the financial sector. Defeasance structures (which are often part of restructuring process) are treated in the Part IV of the Manual).
19. In the case of a public head office engaged both in business market activities (in the sense of the coverage of the costs by sales) and in the management of assets to privatise for some of its subsidiaries, it might not be possible to split the unit in two separate institutional units. ESA10 1.78 should be applied: "When a unit carries out a transaction on behalf of another unit (the principal) and is financed by that unit, the transaction is recorded exclusively in the accounts of the principal". Therefore, when one unit carries out transactions on behalf of another unit included in the general government sector, these transactions should be recorded in the accounts of the latter.

Captive financial institutions

20. Conceptually, in ESA10 2.20 to 2.23 it appears that an important criterion is the degree of "independence". Although both notions must be difficult in some cases to distinguish, "independence" should not be confused with the autonomy of decision which relates to the fact that even for day-to-day management an entity either has no decision powers, or very negligible decision-making powers. "Independence"

⁴¹ Thus, an entity which has mostly revenue under the form of dividends with very small, if any, management fees and/or sales of business services, and which repays all or most of the dividends to its government owner, would not be considered as a head office as described in ESA10.

refers rather to the fact that the daily management takes place in narrow conditions. According to ESA10 2.22 the independence refers to the "substantive control" over the assets and the liabilities and the risks and rewards associated to them. If the unit is mostly acting under instructions of its parent and/or under a very restrictive framework which does not let room of manoeuvre (for instance, investment instruments, beneficiaries of intervention) for developing on its own initiative its activity (like a commercial financial entity) - the unit, although showing formally an autonomy of decision, is deemed not to be acting with sufficient independence and, thus, has to be classified in the sector of its parent, thus possibly the government sector.

In ESA10 2.98 it is mentioned that such captive financial institutions are not engaged in financial intermediation (by reference to the risk on their assets) and that "most of their assets (financial) and their liabilities are not transacted on open market." In other words, "captive" means that they do not find their resources on banking (deposits) or financial markets (securities), but through a bilateral relation with a "superior" unit under possible various forms. In general, such units have not to ensure a sufficient return on their assets in order to cover, as much as possible, a market cost of borrowing as it is very likely that the provider of their resources (also referred to as "sponsor") is not requesting it.

21. Examples of captive financial entities are given, although it is not exhaustive and heterogeneous. ESA10 2.99 provides the following list:
- 1) "Units as legal entities such as trusts, estates, agencies accounts or brass plate Companies" (normally not applicable to government.)
 - 2) "Holding companies that hold controlling-levels of equity of a group of subsidiary corporations and whose principal activity is owning the group without providing any other service to the businesses in which the equity is held, that is, they do not administer or manage other units." (See above)
 - 3) "Special purpose entities that qualify as institutional units and raise funds in open market to be used by their parent company." (See above)
 - 4) "Units which provide financial services exclusively with own funds, or funds provided by a sponsor, to a range of clients and incur the financial risk of the debtor defaulting." As a matter of principle, for such government-controlled units where government is also the "sponsor" (i.e. providing all or most resources of the unit under any form, including full guarantees – generally at first demand and unconditionally - on some liabilities), the unit should be classified in general government sector both because of the control exerted by government over the assets and the absence of creditors who could hold rights overpassing the government stake in the unit.⁴²
 - 5) "Special purpose government funds, usually called sovereign wealth funds, if classified as financial corporations.

I.6.3 Rationale of the treatment

Special purpose entities

22. ESA10 2.18 lists some usual characteristics that are assumed to be "typical" of such entities. They must be considered as indications, totally partly or not

⁴² Such units are not submitted to minimum profitability requirements in order to face their debt service obligations.

observed.⁴³ ESA10 2.19 states that in case it is recognised as a separate unit, it has to be "allocated to sector and industry according to its principal activity." ESA 2.20 further clarifies this by stating that "captive financial institutions, artificial subsidiaries and special purpose units of general government with no independence of action are allocated to the sector of their controlling body. The exception occurs when they are non-resident, in which case they are recognised separately from their controlling body. But in the case of government, the activities of the subsidiary shall be reflected in the government accounts."

23. ESA10 2.90 refers to "Financial vehicles corporations" (FVC) engaged in securitisation transactions (even though they are better known as SPEs) that are to be classified in sub-sector S.125 if they are recognised as a separate unit.⁴⁴ For the financial corporations sector, this identification of the FVCs separately from the beneficiary entity unit can be analytically important. Where the beneficiary is a government unit this classification is not appropriate. ESA10 2.20 states that special bodies of general government with no independence of action (with a very restricted scope) are allocated to the sub-sector of their controlling government unit.
24. ESA10 does not provide details on the lack of independence which is the term used for these entities. As already mentioned there could be some tasks performed by the entity, provided that it has its own staff or give rise to specific fees to other entities. However, the lack of independence means clearly that there is no large room for flexibility in respect of the principal function of such entity which is facilitating borrowing of government and management of the debt that is incurred. The SPE should be recorded as separate unit only if it would be clear that the SPV does not act on behalf of government, which means that it can fully decide on the type and date of instruments to be issued and on any further decisions related to the management of the debt and/or the corresponding assets. In this regard, ESA10 2.57 states that "a financial intermediary does not act as an agent for these other institutional units but places itself at risk by acquiring financial assets and incurring liabilities on its own account".

Head offices, public holdings companies and other group entities

25. ESA10 defines the preconditions in order for an entity to be considered as a head office: it has to satisfy to the criteria for being an institutional unit, it has to control and direct subsidiaries, it has to provide services to the latter. In practice, this would not be the case if such bodies were set up for a restrictive purpose: for instance, to reorganize, restructure the corporations and manage their total or partial disposal, or for a limited period of time and not as a permanent structure.
26. According to ESA10 2.12: "The institutional unit is an economic entity characterised by decision-making autonomy in the exercise of its principal function. Among the other criteria, this one may be seen as fundamental. An important point is that whenever an entity is recognised as an institutional unit, its classification should be assessed individually. The main question in the classification of head offices and their subsidiaries is to judge whether this general rule prevails or whether there are, or there should be, any special rules concerning these entities. ESA102.15 specifies that "each member of the group is treated as a separate unit if it satisfies

⁴³ Notably: no employees, no non-financial assets, mainly managed by other units, always exclusively related to another unit (including subsidiary). ESA10 2.98c also specifies that SPEs will have either their assets or their liabilities not transacted on open markets.

⁴⁴ The ECB maintains a list of FVCs in line with the legal framework for FVCs set out in Regulation (EC) No 24/2009 of the European Central Bank of 19 December 2008 concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions (ECB/2008/30). This list is not relevant for national accounts classification purposes.

the definition of an institutional unit." Otherwise, it must be combined with the unit which controls it.⁴⁵

27. ESA10 2.14 provides clear guidance on the classification of head offices and their affiliates. A non-financial corporation or a financial corporation must always be classified within their respective sector, while the head office must be classified either as non-financial corporation or as financial auxiliaries, according to the composition of the group. A public holding company, for its part, should be in sector S.12 according to ESA10 but this does not seem to be applicable to government public holdings. From ESA10, it must be deduced that, a public unit holding shares of corporations as a group:
- a) Is classified within general government if:
 - It is a "shell" as it does not perform management and effective direction tasks over the subsidiaries but is rather a kind of "accounting tool" as the control on the subsidiaries is de facto exerted by government. Or, it provides some services to its controlling government unit, similarly to an ancillary corporation (for instance collecting data from the group).
 - The unit is, permanently or occasionally, used for typical government activities, like channeling or managing public subsidies, which implies redistributing national income and wealth. It is acting as an agent of government as its main resources redistributed within the group are provided by government.
 - In both cases, the entity cannot be considered a market entity.
 - b) Is recognised as a "head office"(see above) and the sectorisation of institutional units must be assessed by reference to the standard classification rules, which would in general be independent from the parent/subsidiaries relationships that the parent maintains. When a head office has some noticeable production of services activity, it is deemed to be a market producer and the classification should be determined by reference to the entire activity of the group.
28. According to ESA105 2.14 (1), subsidiaries are deemed to be institutional units, even if they partially surrender one part of their autonomy to a central body. Except for some entities in the group which could be considered as ancillary corporations, strictly confined to services to the central body, the classification of subsidiaries is quite straightforward and has to be assessed on an individual basis. If two legally incorporated entities cannot be meaningfully considered separately, they should be treated as a single institutional unit. But, once each of the entities is deemed to be an institutional unit, the sector classification rules must strictly apply.
29. If a subsidiary is recognised as an institutional unit, and the entity is determined to be non-market, it should be classified into the general government sector, even if it is only indirectly owned or controlled by government through the head office/public holding corporation. It should be noted that if a market institutional unit conducts some non-market activities/transactions on behalf of government, the rules related to "rearranged transactions", as mentioned in ESA10 1.72 and following, must be applied.

⁴⁵ An important argument for this "multiple" approach is that the size and composition of the group can change over time.

30. Another aspect relates to the government control: can a subsidiary that is non-market, and that is only *indirectly* controlled by government, be classified inside the general government sector? ESA10 2.37 says:

"In order to control more than half of the shareholders' voting power, an institutional unit needs not own any of the voting shares itself. A corporation C could be a subsidiary of another corporation B in which the third corporation A owns a majority of the voting shares. Corporation C is said to be the subsidiary of corporation B when: either corporation B controls more than half of the voting powers on corporation C or corporation B is a shareholder in C with the right to appoint or remove a majority of directors of C."

ESA10 2.38 refers also to other indicators of control, as already mentioned in this chapter.

As a result, the corporation A is also controlling the corporation C, "in cascade". This may apply to the case of a government unit, here, the controlling corporation B. It must also be stressed that the government control must be assessed at the level of the general government control and this may result from the combination of interest of several government units in the same unit.

31. A consequence of classifying a subsidiary of a public holding/head office as a unit in the general government sector is that a liability in equity (AF.5) would be recorded in the financial accounts of the general government sector. An alternative recording, that may be sometimes more appropriate, would be to record an imputed equity holding by government on the subsidiary. In this latter case, this AF.5 amount would be deducted in the consolidated financial accounts from general government AF.5 position, on the asset side.
32. Concerning the gross or net presentation of the equity liability of the government, it might be useful to distinguish cases according to the owners of the corporation. If the public holding/head office is the sole owner, both net and gross presentations might be appropriate. However, if the subsidiary is not solely indirectly owned by government, then a gross presentation is more appropriate, in order to show the equity liability of general government to other sectors.
33. It should also be noted that capital injections from government benefiting, notably via the holding entity, such non-market subsidiaries, would not be shown as government expenditure, even if the subsidiaries were loss-making, because the transactions would be consolidated within the general government sector.

Captive financial institutions

34. Captive financial institutions under government control act differently from private financial institutions. Their aim is not maximising profit for government (or optimising taxation) but to carry out some financial tasks exclusively in the context of public policies objectives, under control of government. In fact, they represent an alternative to performing these tasks directly by a government unit, avoiding any recording of assets and liabilities in government balance sheet. However, this is in substance largely artificial as the so-called financial unit is entitled to a restrictive range of activity and its fundamental nature is in fact very close to an SPE, even if it does not show most of the usual features (notably, having been recognised an autonomy of decision), as listed in ESA10 2.18. Therefore, for conceptual, consistency and comparability reasons, they have to be included in the government

sector.⁴⁶ This is the underlying rationale in ESA10, as stated in § 2.27, on all specific entities set up by government. In addition, it seems doubtful that such entities set up by government for reasons different from the case of those depending on other economic agents would benefit from a noticeable large independence in the conduct of their operations. Finally, from a risk perspective, it is also clear that government will have automatically and immediately to ensure totally any defaulting performance of such entity.

⁴⁶ This does not mean that they should be automatically included in another government unit. Although the borderline between autonomy of decision in daily activity and independence in the management of assets and liabilities is frequently difficult to draw, they should generally be considered as “other bodies” in the relevant government sub-sector.

I.7 Government debt management offices

I.7.1 Background to the issue

1. The functions of Government debt management agencies or offices, frequently observed at the level of central government, vary from country to country. These functions can cover a range of financial activities. The more frequent of them are issuing securities, possibly incurring other forms of borrowing, hedging risks, managing government's liquidity (notably through repurchase agreements). They are generally set up in order to benefit from special financial expertise and ensure closer relations with market areas. In some cases, they may grant lending to other public units (for instance for emergency liquidity support or for long term, notably to foreign governments). In some countries the national central bank might perform some of these tasks for Government where they are in other Member States directly carried out by the Ministry of Finance (Treasury) or by the authorities in another sub-sector.

I.7.2 Treatment in national accounts

2. When public debt management offices are separate institutional units, they should be classified in the general government sector as they act on behalf of general government. They appear to be simple agencies and their activity is very similar to an auxiliary activity.
3. They should not be classified as financial corporations as they do not perform financial intermediation. The proceeds of borrowing by debt management offices are transferred to government and they are generally not held on the debt management body's balance sheet but in an account of the government unit they are servicing. Similarly, the repayment of the borrowing is provided by the government unit from its resources or by roll-over of the debt through new issuances carried out by the debt management office.

I.8 Joint ventures

I.8.1 Background to the issue

1. The case of joint ventures where government units are involved is covered in ESA10 chapter 20. ESA10 20.49 mentions that "many public units enter into arrangements with private entities or other public units to undertake a variety of activities jointly, on market or non-market basis." Three types of arrangements are foreseen: jointly controlled units ("joint ventures"), jointly controlled operations and jointly controlled assets. This chapter does not refer to joint ventures which would be arranged by market public corporations with private sector.⁴⁷
2. In the case of joint ventures, a unit is set up (as corporation, partnership or any other legal form) which is clearly an institutional unit, i.e. meeting the criteria as defined in ESA10 2.12, i.e. entering into contracts in its own name and possibly raising finance for its own purpose. Joint ventures are not restricted to the case of only two partners as there may be more complex arrangements. In addition, a joint venture may be set to carry out activities in a non-resident territory and rules similar to the case of non-resident SPE might apply. A joint venture may also be set up in the context of PPP projects and, in this case, rules stated in VI.5 should apply as far as the classification of the partner is concerned.⁴⁸

I.8.2 Treatment in national accounts

3. If the joint venture is owned by an exact equal percentage of ownership by a government unit and a private unit, it is recommended to consider other indicators of control than ownership, as mentioned in ESA10 20.307. It may happen that government holds some rights higher than for the private partner(s), such as veto power or priority rewards, or bear more risks. In these cases, the rule mentioned in paragraph 5 should apply.
4. In case the joint venture is owned by a government unit and a private unit in equal percentages, and that there is no evidence of some superiority of control by either party, ESA10 20.320 states that if the joint-controlled unit does not satisfy the criteria to be classified as a market producer, it must be fully allocated to the general government sector. If it is recognised as a market producer, the unit would be included in the non-financial corporations sector S.11 but should be split, one half being considered as public-controlled public corporation and the other half allocated to the private sector.
5. If the joint venture is not owned by exactly equal percentages of ownership, by each of the public or private parties, the unit must be allocated to the party which holds the majority. If it is the government unit, the unit will be classified within the government sector if the joint venture has a predominant non-market activity and as a public corporation if the unit is recognised as a market producer. It is however recommended to check whether some other provisions related to rights and decision power are not de facto giving a different view as far as the effective control of the joint unit is concerned.

⁴⁷ Normally, according to the share in control, the JV could be classified in the private sector, in the public sector or in both. However, if the public corporation would no longer be a market producer, the JV should be classified within the government sector.

⁴⁸ It is assumed that there is no issue for possible (but rather hypothetical) joint ventures for financial intermediation (or financial auxiliary services) as, by definition, such entities should be classified within the financial institutions sector S.12

6. When a joint venture involves only units classified in the public sector (for instance a joint venture between a public corporation and a government unit), the sector allocation of the unit will depend on its market/non-market nature. Non-market units are recorded in the government sector and market units within the public corporations sub-sector in S.11.
7. For the other arrangements which are not run by a separate institutional unit, but involve only some assets, it must be determined which unit owns the asset on the basis of which unit is exposed to the majority of risks and rewards allocated to the assets. Both expenses and revenues, recorded on gross basis, are nevertheless re-allocated according to the arrangement. (20.49).

I.8.3 Rationale of the treatment

8. In case a separate unit is jointly set up to carry out an activity, the single criterion of the percentage of ownership may not be sufficient to decide on the sector classification of the unit. Other features of control need to be analysed. In many cases government has de facto more influence than the private partner (s) and taking more advantage of it. The exact purposes of the creation of the unit, notably the importance of public interest reasons, should be closely considered.
9. For other types of arrangements involving assets but without any separate unit jointly, any asset in national accounts is allocated to only one controlling unit and thus to its institutional sector.

I.9 European entities related to the Euro Area sovereign debt crisis

I.9.1 Background of the issue

1. The European sovereign debt crisis, which started in 2010, has led to setting up of new entities with the objective of providing intergovernmental financial support to Member States. In a first step, the EA Member States⁴⁹ agreed to grant bilateral loans to Greece in the context of a new European Financial Stability Mechanism involving also both the European Commission and the IMF. These financial supports are recorded without difficulty in Government finance statistics as loans incurred by borrowing countries directly from Member States (bilateral), from the Commission (EFSM) and from the IMF. However, it quickly appeared, because of contagion, spill-over and overshooting effects on EA debt markets, that there was a need to set up specialised institutional bodies.
2. In this regard, the European Financial Stability Facility (EFSF) was created by the euro area Member States following the decisions taken on 9 May 2010 by the ECOFIN Council with the aim to provide financial assistance to euro area Member States under the condition of a macro-economic adjustment programme. The EFSF, created in October 2010 as temporary mechanism (providing support during 2013 but continuing to function after this date until extinction of supports/borrowings) issues bonds or other debt instruments (bills and notes) on the capital markets. Furthermore, it has been decided that the EFSF could also intervene in the primary and secondary bond markets⁵⁰, act on the basis of a precautionary programme⁵¹, recourse to more original tools (see below) and provide resources to governments for financing recapitalisations of financial institutions in non-programme countries.
3. In October 2010, it was decided to create a permanent rescue mechanism, the European Stability Mechanism (ESM), based on a specific Treaty signed on 11 July 2011 and to be approved by MS. After the ratification procedure came to an end, the Treaty entered into force on 27 September 2012, the ESM was "inaugurated" on 8 October 2012 and started its operations in December 2012. It is currently the instrument to finance new support programmes and is enabled to provide support under various tools similarly to the EFSF.⁵²

⁴⁹ Several other EU MS took also part in this bilaterally-based support.

⁵⁰ The EFSF has also granted support by delivering its own bonds or notes, without raising funds on markets. In some cases, these "cash less" operations are only temporary while in other cases the EFSF debt instruments will be kept by holders until maturity and may be used as collateral in repo transactions.

⁵¹ Such precautionary lines are treated as contingent assets until actual drawing down by the beneficiary country.

⁵² For detailed information on these bodies, and notably all relevant documents, see <http://www.efs.europa.eu> and <http://www.esm.europa.eu>

1.9.2 Treatment in national accounts⁵³

EFSF

4. As explained in Eurostat's decision of 27 January 2011 on EFSF, the EFSF does not possess all the normal characteristics of an institutional unit under ESA10. It has no capacity for initiative and a limited autonomy of decision in the exercise of its primary function, providing loans to countries in difficulty and their financing. Decisions related to this primary function are in practice subject to the prior approval, usually unanimous, of the Euro group members taking part in a support operation. The EFSF cannot be regarded as an international financial institution, of which it has none of the usual characteristics. It cannot be consolidated with any of the European institutions established by the Treaties. Finally, the EFSF is an accounting and treasury tool to enable the same conditions for access to borrowing for members of the euro area, acting exclusively on behalf of them and under their total control.
5. As a consequence, from a theoretical point of view, EFSF operations must be partially consolidated in national accounts tables with the institutional units to which it belongs, in this case, the government of euro area Member States." Partially means that the consolidation is based on some assets held by the EFSF and not the totality of its balance sheet for technical reasons, as explained below. As a basic activity, the EFSF is borrowing on markets with the guarantee of Member States, according to a contribution key linked to their share in ECB's capital.⁵⁴ Initially, up to December 2011, for rating purpose, one part of the proceeds of borrowing was not transferred to the borrowing countries under the form of loans and invested into high rated debt instruments. This was known as the Loan Specific Cash Buffer (LSCB). The EFSF debt used for the "LSCB" is not recorded in national accounts as debt imputed to the MS guarantors. As an extension, only the asset side of EFSF corresponding to actual support to EA countries is rerouted to the guarantor Member States. The loans, which include the Cash Reserve⁵⁵ not disbursed but to be repaid by the borrowing countries, initially matched totally the borrowing conditions (basic rates and maturities) obtained by the EFSF. Whether in the form of loans or government bonds bought on primary or secondary markets, the lending to beneficiary Member States are considered as loans granted to the MS guarantors who, as a result incur a corresponding increase in their gross debt but hold an equal claim on the beneficiary country from the support. For the borrowing country, this is only a change in geographical allocation of its borrowing.⁵⁶
6. Furthermore, in the course of 2011, following decisions in Euro Summits the EFSF support framework was, on one side, amended, with the disappearance of the LSCB (grossing-up of guarantees by 160%), the significant reduction in Cash Reserve (no longer margin), the diversification and pooling of resources (short

⁵³ See decisions on Eurostat website: http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-27012011-AP/EN/2-27012011-AP-EN.PDF
http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Eurostats_preliminary_view_on_the_recording_of_the_futu.pdf

⁵⁴ For rating purposes, the guarantee of each MS was initially grossed up by 120% and the key is adjusted in order to take into account the share of countries which are not in a position to provide guarantees (notably when benefiting from bilateral loans or EFSF's support).

⁵⁵ "Cash reserve", corresponding to an up-front service fee and capitalisation of a margin added to the EFSF cost of borrowing.

⁵⁶ The possible purchase of bonds by the EFSF is also re-allocated (rerouted) for the amount paid on markets.

term instruments) on the other hand, completed by intervention tools other than loans.⁵⁷ It must also be pointed out that the EFSF set up a liquidity buffer which is not reallocated to the MS guarantors.⁵⁸ Under these conditions, a part of the debt actually raised by the EFSF is not imputed as debt of the MS guarantors.

ESM

7. As explained in Eurostat's decision of xx January 2012 on ESM, the ESM is treated as an institutional unit, more precisely a European Union international organisation, on the basis of the converging analysis of several factors, notably: a permanent basis, an establishment by Treaty, an international legal framework, a significant amount of capital, including 80 billion of paid in capital⁵⁹, an autonomy of decision due to a governance structure similar to that observed in some other international institutions in the financial area.
8. As a result, all its support operations have no impact on the debt of the EA MS which are not benefiting from them. No loan or other kind of intervention is reallocated to the members of the euro area. The only impact on the debt of these members is linked to the possible need to borrow the cash for any tranche of paid-in capital. As far as the impact on the deficit of the MS guarantors is concerned, it relates mainly to the existence of an interest margin. However, should the guarantors agree upon a debt cancellation to the benefit of a borrowing country, a capital transfer would be recorded as expenditure for these MS. The effective payment of the initial paid-in capital is considered as increase of equity, while the callable capital is considered a contingent liability. The impact on government accounts of an actual call would be treated as a capital transfer only if it were to cover losses of the ESM or shortfalls in payments by a debtor country to the ESM.

1.9.3 Rationale of the treatment

9. Looking at the EFSF, there is evidence, on one hand, that it could not be considered as an actual financial intermediary as it does not bear any risk under the guarantee arrangement. In addition, there is no significant risk to the shareholders, the capital having just a formal role, as mentioned above. Also, the EFSF could not be considered as an international organisation, although it was the result of an inter-governmental agreement. This was due to its status of private company and, moreover, the ex-ante approval by the Euro group for its main decisions.
10. The crucial point is that the EFSF has no autonomy of decision for carrying out its principal function. The decision to enter into a financial rescue operation is in the hands of the Euro group which represents the Euro area Member States. The unanimity is required for most of the related decisions. Similarly, the EFSF has a restricted power of initiative regarding the liabilities incurred on its name, conditional to decisions taken by the EA MS. It may borrow funds only with de facto approval of the guarantors. The room of manoeuvre in this respect is limited

⁵⁷ In addition to purchase of bonds on primary or secondary markets, precautionary lines, bank recapitalisation, the EFSF, through a vehicle, could provide credit enhancement to bonds issued by EA governments (certificates covering first losses) and could enlarge its sources of funding by a Co-Investment Fund opened to investors.

⁵⁸ As far as the impact on the deficit of the MS guarantors is concerned, it related to mainly to the existence of an interest margin. However, should the guarantors agree upon a debt cancellation to the benefit of a borrowing country, a capital transfer would be recorded as expenditure for these MS.

⁵⁹ For comparison, the ESM has a subscribed capital of 700 billion (of which 80 paid in five instalments over 2012-2014 if no acceleration is needed), for a lending capacity of 500 bn, while the EFSF has only a capital of 30 million, for a lending capacity of 440 bn.

- (choice of maturities, size and investment of the liquidity buffer, for instance). Thus, the EFSF does not show an independent action capacity comparable to what is normally observed for a financial intermediary. However, the EFSF could not be consolidated, neither in the Euro group which is not an institutional unit, nor its financial statements proportionally split into the EA Member States owning it because of practical difficulties (change in contribution key, retained borrowing proceeds and, since December 2011, pooling of resources). The rerouting of the EFSF's interventions to the Member States granting guarantees on the debt issued by the EFSF is the correct solution in order to reflect the nature of the entity.
11. It is important to note that in practice the EFSF has been registered as a limited corporation in Luxembourg and is classified as a financial intermediary, submitted to the normal reporting requirements. However, for statistical purpose, its operations are retreated as mentioned above. Eurostat, with the cooperation of the statistical authorities in Luxembourg, provides every month to the Member States all the relevant information in order to treat the EFSF both in their Balance of Payments and in their national accounts, according to the classification decision. In addition, Eurostat publishes twice a year, in the context of the EDP notified data, information on the Intergovernmental lending in EU, which include the rerouted lending of the EFSF.
 12. For its part, the ESM appears to meet the full attributes of an institutional unit, and more precisely, of an international organisation, as mentioned above. It is permanent (like normally such international units), created by an EU Treaty (high rank in legal norms), has an international organisation status, has a large amount of paid-in capital and a significant amount of callable capital which will secure its interventions. The size of capital clearly plays a significant role in the recognition of the difference between EFSF and ESM, as regards its recognition as an institutional unit. Even if the Euro group exerts a strong influence, which is a normal feature linked to its genuine specific function, the ESM shows very similar governance to that observed in other international institutions: Board of Governors, Board of Directors and General Manager entitled with noticeable powers. Finally, some decisions, which cannot be regarded as having a negligible impact, do not need unanimity as in the case of the EFSF. Thus this entity meets the usual EA95 criteria of an institutional unit. As a consequence, there is no reason to reallocate to other MS any support intervention provided by the ESM. Only the borrowing country will record an increase of its debt. However, if ESM would participate directly in the recapitalisation of banks of one country, no debt would be recorded for the country's government, provided that it has taken no commitment vis-à-vis the ESM as regards the assets/claims held by the latter on the banks.
 13. Under ESA10, the ESM will be classified, in the accounts of all EU countries, as a non-domestic euro area resident, within the sector rest of the world S.2, under the sub-sector S.21 (the European Union) and among the institutions of the EU (S.212). In the accounts of the European Institutions (seen as a separate "Member State"), the ESM is classified as "Other financial intermediary" (S123 in ESA 95 and S125 in ESA 2010).

I.10 Keywords and accounting references

Captive financial institutions	ESA10, 2.298-99
Control	ESA10, 2.37-37 and 20.309-310
Defined-benefit pension schemes	ESA10, 17.57
Defined-contribution pension schemes	ESA10, 17.54
Economically significant price	ESA10, 20.19-22
Employer pension schemes	ESA10, 17.49
Financial intermediation	ESA10, 2.57-2.62
General government sector and sub-sectors	ESA10, 2.111-117
Holding corporation, Head offices	ESA10, 2.14 and 20.35-37
Institutional unit	ESA10, 2.12-13
Market output	ESA10, 3.17-19
Market/non-market	ESA10, 3.32-37 and 20.19-34
Non-market output	ESA10, 3.23
Non-profit institution	ESA10, 2.129-130
Pension fund	ESA10, 2.105-110
Public/private producer	ESA10, 20.303
Quasi-corporation	ESA10, 2.13f
Rearranged transactions	ESA10, 1.75-178
Social assistance	ESA10, 4.105
Social insurance schemes	ESA10, 4.88-4.90
Social security fund	ESA10, 2.117
Social security schemes	ESA10, 4.88
Special purpose units of government	ESA10, 2.27-29

II

Time of recording



Part II Time of recording

II.1 Overview

1. ESA10 1.101 instructs that flows are recorded on an accrual basis; that is when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled. 2. Thus, output is recorded when produced, not when paid for by a purchaser. The sale of an asset is recorded when economic ownership of the asset changes, not when the corresponding payment is made. Interest is recorded in the accounting period when it accrues, regardless of whether or not it is actually paid in that period. Recording on an accrual basis applies to all flows, monetary as well as non-monetary and intra-unit as well as between units.
2. The time of recording of transactions has an impact on the Government net lending/net borrowing; but over a long period of time the differences between accrual and cash recording is eliminated since the accrual recording simply shifts the cash transactions into a different time period. An accruals recording has no impact on the Government debt because accounts payable/receivable (the category that accounts for the differences between accrual and cash) are excluded from the definition of Government Debt.
3. However, in some cases it is necessary to show flexibility as regards time of recording. There is one deliberate adaptation from the general principle concerning the recording of taxes and social contributions. As this revenue is often recorded on a cash basis in public accounts and basic source information, it needs to be converted to an accrual basis. Specific rules regarding recording of taxes and social contributions were devised, so that net lending/borrowing of general government (and of counterpart sectors) do not include amounts of taxes and social contributions unlikely to be collected. Two recording options are available and described in chapter 2, which aims to avoid recording artificially revenue for government.
4. In determining the correct time of recording on an accruals basis, there are a number of events to consider: economic, judicial and administrative. For example, economic activity can generate a liability to pay taxes but the amount of tax might only be determined some time after the economic activity; after which, a specific document is sent requiring payment for some future date. The time at which the tax liability is created differs for different types of tax. National accountants need to decide on which of these dates to record the tax and they must fully capture the fact that some levies would in practice never be collected.



II.2 Recording of taxes and social contributions

II.2.1 Background to the issue

1. Taxes and social contributions in the European Union represent at least 80% of government revenue. Their recording in national accounts is particularly crucial in the context of the excessive deficit procedure. Any method must be transparent and the impact on government deficit comparable. In addition, unpaid taxes must imperatively not be recorded as government revenue and, as a matter of principle, in the long run there must be full convergence between accrued and paid amounts.
2. ESA2010 states that taxes and social contributions accrued (or assessed as due) but unlikely to be collected, for various reasons (such as bankruptcy of companies, lack of efficiency of the tax collecting system, disappearance of individual tax payers, etc.), shall not be included in the collected amount, with no impact on general government net lending/borrowing.
3. ESA10 4.82 says that taxes and social contributions recorded in the accounts may be derived from two sources: amounts evidenced by assessments and declarations or cash receipts.
 - a) If assessments and declarations are used, the amounts shall be adjusted by a coefficient reflecting assessed and declared amounts never collected. As an alternative treatment, a capital transfer to the relevant sectors could be recorded equal to the same adjustment. The coefficients shall be specific to different types of taxes and net social contributions (see ESA10 4.95 for the latter).⁶⁰
 - b) If cash receipts are used, they shall be time-adjusted so that the cash is attributed when the underlying activities, transactions or other events, took place to generate the tax liability (or when the amount of tax was determined, in the case of some income taxes). This adjustment must be based on the average time difference between the activities, transactions or other events (or on the determination of the amount of tax) and the effective cash tax receipt.⁶¹ This is currently labeled “time adjusted cash”.

II.2.2 Treatment in national accounts

4. Time of recording is, focusing on substance and not form, when the economic activity took place which generated the tax liability or, in the case of some income taxes, when the amount of tax due is determined with certainty by the government, creating an obligation for the tax payer.
5. Amounts to be recorded are those which are deemed to be very likely collected in the future.
6. The first two options are relevant if the amounts referred to are those evidenced by assessments or declarations as amounts due:
 - a) Amounts to be recorded are assessed amounts adjusted by a coefficient reflecting the assessments never collected. The coefficients are estimated on the basis of past experience and current expectations in respect of assessed amounts never collected.

⁶⁰ In particular, it is crucial that the coefficients, or the amount of capital transfer, notably when more or less sophisticated models are used, must reflect without delay the impact of business cycles or some exceptional events which may have a strong effect on the effective collection of taxes and social contributions, upwards as well as downward.

⁶¹ There is no ambiguity in ESA2010 (see paragraphs 20.171-175) that any method may be chosen by the national statistical authorities, provided that it is the best way for recording the actual revenue under accruals principle. Eurostat is entitled to ask for a change in the method, if deemed as not appropriate.

- b) Amounts assessed as due are entirely recorded as taxes and social contributions but the gap between this theoretical amount and the actual cash receipts is treated as a capital transfer in favour of the defaulting taxpayers.
 - c) Cash amounts are recorded in national accounts: but they shall be time-adjusted so that they are attributed to the period when the activity took place to generate the liability.⁶²
7. ESA10 4.81 (and also 20.167-168) refers to the issue of tax credits which are amounts government has to refund to individuals or corporate tax payers, by opposition to any mechanism (such as allowance, exemptions, deductions) which impact the tax base, before the application of the tax rate. There are two categories for these:

- 1) They may be “non-payable” (non-refundable, “wastable”), i.e. limited to the amount of the tax liability during the same fiscal year or during several fiscal years when carry over is allowed. In any case, all amounts above the tax due in the period (or more) are “lost”. This refund is recorded negatively on the tax revenue, which therefore reduces government revenue (and the “tax burden ratio”).

The time of recording is normally similar to the one of the tax on which they are imputed, both for recording based on assessment method⁶³ or on time-adjusted-cash.

- 2) On the contrary, such credits may be fully repayable (refundable, “not wastable”), independently of the amount of tax liability which may due their beneficiaries. In this case, tax credits are recorded as subsidies (D39, other subsidies on production) or as “social assistance benefits in cash” (D623) depending of the nature of the beneficiary.⁶⁴ Also in this case, this treatment is neutral on government net lending/net borrowing but has an effect on the calculation of the “tax burden”.

As far as the time of recording is concerned, for subsidies, ESA10 4.39 specifies that “Subsidies are recorded when the transaction or the event (production, sale, import, etc.) which gives rise to the subsidy occurs.” However, in practice there may be some deviation from this principle when the right to the subsidy must be assessed, controlled, certified, etc., i.e. at the time a claim of a certain amount has been recognised by government. (For investment grants, it is “when the payment is due to be made” – see ESA10 4.161).

For social benefits, ESA10 4.106 specifies that “time of recording of social benefits other than social transfers in kind (D.62) : a) in cash, they are recorded when the claims on the benefits are established.”

As a result, for payable tax credit, it does not matter the exact time when the credit is used as a reduction of the tax liability and/or paid in totality or for the excess of the tax liability. This is only a payment modality and any time lag between the time of recording the expenditure and the time of the imputation/payment gives rise to an entry in other accounts F8.

II.2.3 Rationale of the treatment

8. The impact on the general government net borrowing/net lending of taxes and social contributions recorded in the system shall not include amounts unlikely to be collected. The underlying reasoning is that, when there is evidence that some of the

⁶² As examples : VAT paid by firms to the tax authorities in the first or the first two months of one year is allocated to the previous year; final adjustment for income taxes is preferably (if not determined after a too long time) recorded in the same year in which main payments have taken place (monthly withholding, advance installments, etc.)

⁶³ In this case, the tax credit must be imputed at the time of the assessment of the tax liability and not at the time of the effective liquidation of this liability by the tax payer.

⁶⁴ Although this is not explicitly mentioned in ESA10 (or in SNA2008), such tax credits could also be recorded as investment grants where they refer to capital expenditure.



taxes and social contributions that have been assessed will never be collected, the difference between assessments and expected collections represent a claim that has no real value and should not be recorded as government revenue.

9. The impact on the general government net borrowing/net lending of taxes and social contributions recorded in the System on an accrual basis should be equivalent over a reasonable period of time to the corresponding amounts actually received.
10. As far as tax credits are concerned, the fact that government may be obliged to repay an amount to a tax payer in the absence of any liability of the latter, results in an outright payment which must be recorded as expenditure for government. When the refund has only as a result to reduce the tax revenue (even to off-set it) at individual level, it must be imputed to the amount of tax revenue and recorded separately as expenditure.



II.3 Changes in the due for payment dates

II.3.1 Background to the issue

1. Sometimes Governments change the due for payment dates for taxes, subsidies, compensation of employees, social contributions and benefits, which are generally the last moment the liable units can pay without incurring additional charges or penalties.
2. The time of recording is defined in ESA10 for the different transactions. As a general rule, the system records flows on an accrual basis, that is, when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled (ESA10 1.101).
 - Wages and salaries and employers' and employees' actual social contributions are recorded in the period during which the work is done. However, ad hoc bonuses or other exceptional payments, 13th month, etc. are recorded when they are due to be paid (4.126).⁶⁵
 - Taxes on production and imports are recorded when the activities, transactions or other events occur which create the liability to pay taxes (4.26).
 - Subsidies are recorded when the transaction or the event (production, sale, import, etc.) which gives rise to the subsidy occurs (4.39).
 - Current taxes on income, wealth, etc. are recorded at the time when activities, transactions or other events occur which create the liabilities to pay. (4.82)
 - In some cases, the liability to pay income taxes can only be determined in a later accounting period than that in which the income accrues. Some flexibility is therefore needed in the time at which such taxes are recorded. Income taxes deducted at source, such as PAYE taxes and regular prepayments of income taxes, may be recorded in the periods in which they are paid and any final tax liability on income can be recorded in the period in which the liability is determined (4.82).
 - Social benefits in cash are recorded when the claims on the benefits are established (4.107).

II.3.2 Treatment in national accounts

II.3.2.1 For most distributive transactions

3. The time of recording refers to an "accrual basis": the amounts to be recorded in year (n) should then include amounts due in respect of transactions realised from 1 January (n) to 31 December (n), that is, amounts in respect of transactions realised during the 12 months of the year.
4. An example is the reduction of the time lag for VAT payment granted by the State to enterprises: this time-lag is for instance reduced from 2 months to 1 month. The due for payment date for VAT is therefore brought forward by one month. The State budget on a cash basis will then record 13 months of VAT receipts during the year when this time-lag reduction takes place.
5. However, VAT recorded as revenue in national accounts should not include the additional cash receipts of the thirteenth month and remains based on a twelve-month year. In this case, only financial accounts should be affected (flows in F.2 and F.8 - other accounts receivable).

⁶⁵ The time of recording of stock options is normally spread over the period between the grant date and the vesting date (from which point the option may be exercised).



6. Any change in the due for payment date, although it does affect the cash amounts in public accounts, should not have an impact on the calculation of the taxes recorded in national accounts on accrual basis.
7. As already mentioned, taxes and social contributions recorded as government revenue can be derived from two sources: cash receipts or amounts evidenced by assessments and declarations. If cash receipts are used, they should be time adjusted so that the cash is distributed when the activity took place to generate the tax liability (except for the cash of some taxes on income). This adjustment can be based on the average time difference between the activity and cash tax receipts. Therefore, in the example given above, the cash receipts would be adjusted in order to take into consideration the reduction of the time-lag for VAT, and the additional receipts of the thirteenth month would be neutralised.
8. For most distributive transactions, any change in due for payment dates thus have no impact on the government net lending/net borrowing which is measured on an accrual basis according to ESA2010 rules.

II.3.2.2 Exceptions

9. Exceptions to the general rule are allowed for some distributive transactions such as: ad hoc bonuses or other exceptional payments, 13th month, etc. paid by the employer to his employees; and certain income taxes, social contributions by self-employed and non-employed persons for which the liability to pay can only be determined in a later accounting period. Therefore, changes in the due for payment date (for instance forward payments) for these kinds of transactions could affect the government net lending/net borrowing.
10. For instance, corporations pay income taxes in several instalments in year (n+1) following the year (n) of reference for the income. It is assumed that they are required to pay in advance, at the end of year (n) the first instalment. When should this forward payment be recorded? In year (n) or in year (n+1)? More precisely, under which circumstances could the due for payment date be considered as changed?

II.3.2.3 Rule concerning the change in the due for payment date

11. Any change in the due for payment date, which affects the amounts cashed by government, resulting from a law or a simple administrative decision and expected to be permanent, i.e. not applicable only one-off, has an impact on the amounts recorded in non-financial accounts and thus on the general government net lending/net borrowing.
12. On the contrary, when a change in the due for payment date resulting from a law or a simple administrative decision, is expected to be temporary (by evidence announced as a one-off measure with a unique application) and would affect the cash amounts received by government, it should not be taken into account under an accrual recording. As a consequence, there should be no impact on the general government net lending/net borrowing.



II.4 Recording of interest

II.4.1 Background to the issue

1. Recording interest on an accrual basis is a general principle in national accounts, introduced in international statistical standards in the 1990's.

II.4.2 Treatment in national accounts

2. General ESA accounting rules:
 - All financial instruments bearing interest are to be recorded on an accrual basis.
 - Interest is accrued on the basis of a "debtor approach".
 - Accrued interest can be calculated by simple or compound interest method.
 - Accrued interest is exclusively reinvested under the instrument.⁶⁶
 - All instruments issued at a discount are treated in a similar way.
 - Arrears are kept under the instrument.
3. Application to specific instruments or transactions
 - Stripping has no effect on the amount of accrued interest.
 - Adjustments may be necessary in the case of instruments with floating rates and fungible issues (including savings premiums).
 - Lottery instruments are normally recorded on an accrual basis.
 - The accrual rule applies to index-linked bonds.
 - There are no specific rules in the case of short-term negotiable instruments.
 - Accrued interest may be recorded during grace periods.
 - Accrued interest on instruments denominated in foreign currencies gives rise to an adjustment in the revaluation account.
 - Income of mutual funds assigned to holders is recorded on an accrual basis.
 - Early redemption of debt instruments (including exchange) may give rise to nominal holding gains.

II.4.3 Rationale of the treatment

II.4.3.1 Full coverage

4. The accrual principle covers all financial instruments bearing interest. In ESA10 chapter 4, all kinds of debt instruments are mentioned: deposits, loans, debt securities and other accounts receivable and payable (when applicable). ESA10 4.50 states that "interest is accruing continuously over time on the amount of principal outstanding". No exception is specified for applying this rule.
5. Recording interest on an accrual basis is a general principle which must apply to all financial instruments bearing interest, independently of any specific arrangement possibly observed at national level.

II.4.3.2 "Debtor approach"

6. From a general point of view, interest can be accrued according to three possible treatments that could be respectively called:
 - "Debtor or original cost of borrowing principle", based on the rate or yield prevailing at the time of creation of the financial instrument, applied to the principal outstanding amount or the issue price;

⁶⁶ This is not applicable to the valuation of Maastricht debt at face value.



- “Acquisition principle”, based on the “historical” rate or yield prevailing at the time the creditor records for the first time the financial instrument in the balance sheet, applied to the purchasing price;
 - “Market approach” (also referred as “creditor approach” in ESA10), based on the rate prevailing at each point of time applied to the current market price of the instrument observed at the same time.
7. In ESA10 interest is accrued from the point of view of the debtor, as specified in ESA10 20.180.
 8. ESA10 focuses on the financial burden, the cost of borrowing, that was anticipated when the debtor raised funds through the issuance of financial instruments and secondary markets transactions, when existing, have no influence on the accrued interest to be recorded.
 9. From a theoretical point of view, under the three approaches, the total flows resulting from the contractual arrangements would be similar during the whole life of a financial instrument. But there would be a difference in the split between transactions and other flows. Changes in the price of a financial instrument are recorded as nominal holding gains/losses whereas ESA10 chapter 6 specified that accrued interest does not generate holding gains as it gives rise to a non-financial transaction and simultaneously a financial transaction under the form of “the acquisition of an asset which is added to the existing asset”.

II.4.3.3 Method for calculating accrued interest

10. The choice for recording accrued interest is between simple interest, applied only on the principal outstanding amount, and compound interest that takes into account the amount of interest previously accrued. However, as accrued interest is considered in ESA10 (4.50) as “an acquisition of a financial asset by the creditor and an equal acquisition of a liability by the debtor”, on which interest are theoretically charged, interest should be preferably calculated in a compound way.⁶⁷

II.4.3.4 Reinvestment of accrued interest under the instrument

11. ESA10 5.242 states that “interest accrued and arrears are recoded with the financial asset or liability on which they accrue, and not as other accounts receivable/payable”. However, it is also mentioned that it could be classified in other accounts receivable/payable “if the interest accrued is not recorded as being reinvested in the financial asset.” It is not specified under which conditions this could be the case.⁶⁸ Therefore accrued interest under the instrument should be recorded in all cases, possibly under a sub-item in the related instrument category. This is, in addition, the only possible solution for zero-coupon bonds, or short-term securities issued at a discount, because, contrarily to other kinds of debt securities, accrued interest linked to the discount is not identified separately from the value of principal when a transaction occurs.
12. ESA10 4.46b specifies that bonds issued at a discount may have two interest components, one for the discount accrued over the life of the bond and one for the coupon regularly paid. They must be treated in the same way as far as the reinvestment of accrued interest is concerned.
13. In the case of transactions on secondary markets, the amount of accrued interest is simultaneously exchanged with the principal. It cannot be separately negotiated. The transaction must be considered as a whole. The buyer pays to the seller the amount of accrued interest. All the value of the transaction is to be recorded in the

⁶⁷ Note that for instruments with regular (annual or semi-annual) coupon payments, the difference between both methods is relatively small, so that in practice the simple interest method is acceptable. This would not be the case for deep-discounted (including ZCB) instruments issued for long maturities.

⁶⁸ ESA10 5.243 indicates that interest under securities lending and gold loans must be recorded under other accounts receivable/payable for consistency reasons.



financial accounts, with no entry in property income. This transaction has no effect on the compilation of accrued interest from the point of view of the issuer. In the accounts of the new holder, interest is accrued since the date of entry in his portfolio. Later, if the new holder has kept this asset, the actual coupon payment would be recorded only in the financial account (the non-financial account has already recorded interest accruing continuously), and can be considered as a sale back to the issuer of the accrued interest acquired when the asset was purchased plus any interest accrued since that day.

14. A similar treatment should apply in the case of issuance of debt securities under the form of tranches⁶⁹, where a coupon is frequently “sold” to the investors at each issuance (the amount of interest accrued to date since the last coupon payment related to the security). ESA10 20.183 specifies that “these sold coupons are neither government revenue at time of sale nor treated as premium. They are instead a financial advance”. They should be recorded under the financial instrument they relate. In addition, they should not be netted with the interest expenditure, in accrual terms.

II.4.3.5 Non-negotiable instruments

15. For deposits, ESA10 7.65 only mentions that they are recorded in the balance sheet at nominal value, which is defined in ESA10 7.39 as follows: “nominal value reflects the sum of funds originally advanced, plus any subsequent advances, less any repayments, plus any accrued interest.” This definition covers both sight deposits and saving deposits, where the deposited amounts may vary during the course of the accrual period, as well as term deposits when theoretically the amount is locked during the accrual period.
16. For loans, ESA10 7.70 states that “the values to be recorded in the balance sheet of both creditors and debtors are the nominal value irrespective whether the loans are performing or non-performing.” This implies that interest must always be added to the remaining amount of the principal of the loan.
17. Recording accrued interest under deposits and loans should not be linked to the national practice nor the own views of the transactors. For deposits, interest is frequently added to principal only under certain arrangements (at the end of a given period). For loans, the contract between debtor and creditor mentions explicitly a value of principal (due capital) that excludes interest. In addition payments of interest and repayments of principal are not necessarily concomitant. However, as ESA10 explicitly states that accrued interest is assimilated to the acquisition of new amounts of the instrument, the reinvestment of accrued interest must analytically be considered as principal. In the case of deposits, the payment of accrued interest is thus, from a conceptual point of view, a partial liquidation whereas payment of interest on loans is integrated in the amortisation process.

II.4.3.6 Instruments issued at a discount

18. Bills and other short term instruments (generally with a maturity not exceeding one year) are issued with a discount or a premium, which means that interest is equal to the difference between the issue price and the redemption value, normally at face value. This interest has to be accrued over the lifetime of the instrument and, in case of transactions on secondary market there must be a clear distinction between the effect of a change in the market price of the instrument (recorded as holding gain/loss) and the accumulated amount of accrued interest which is exchanged by

⁶⁹ These bonds (also referred as to “fungible” or “linear” bonds) are a largely common practice for central government bonds. All tranches have the same nominal interest rate, coupon payment date and final maturity. Each tranche is issued at a specific price according to the prevailing market conditions. As far as accrued interest (expenditure) is concerned, each tranche should be identified separately. For its part, the identification of the counterpart sector may raise some practical difficulties, notably due to the, often intensive, trading of such securities.



parties. Conceptually, there is no difference in this regard between short-term instruments and zero-coupon bonds which are issued for longer term maturities (generally at least 5 years). This issue is covered in ESA10 in 4.45, 4.46 and 20.184 to 20.186.

However, there may exist also bonds paying a regular coupon which, for different reasons (notably in the case of fungible bonds mentioned above) are issued with discount or premium, even small as in the case of some technical issuance process under the form of re-offer price for adjusting the yield to market conditions (bid rates from the investors). For its part, the coupon (asked rate) is generally set at rounding figures (generally by 25 basis points). Thus, there is no reason to make a distinction between deep-discounted bonds and others bond issued at discount. The former term is mentioned in ESA10 4.46b but it is not proposed any difference in treatment for any size of discount, which is confirmed in ESA10 20.184. This is in line with recommendation of the MGDD, since first edition.⁷⁰

II.4.3.7 Arrears of interest recorded under the instrument

19. Arrears of interest arise when interest is not paid on its contractual payment date. They are recorded with the instrument in the same way as the reinvestment of accrued interest as discussed above. Both are recorded under the instrument until they are effectively paid or, in some cases, cancelled⁷¹ (which is therefore a kind of debt cancellation to be treated according to normal rules).

Specific instruments or transactions

II.4.3.8 Stripped bonds

20. There is in ESA10 5.96d a reference to stripping which is a way to transform a "normal" bond into a set of zero-coupon bonds, at the initiative of the holders. Traditionally, it results in the creation of separately tradable certificates representing future payments of interest and future repayment of principal or, in the case of "fungible certificates" all flows related to a given maturity. This operation is neutral for the issuer in terms of streams of effective payments. Stripping concerns mainly bonds issued by central governments.
21. As stripping is operated on a voluntary basis by investors, the conversion takes place only for a part of the total outstanding amount of a bond. In most cases, stripping is a permanent option that can be exercised at any time and is reversible, i.e. a bond may be "reconstituted" under its original form at any time by considering a complete set of strips. Where strips are fungible for a maturity date, this allows the creation of synthetic new bond from certificates issued from different original bonds. As mentioned above, the sum of the strips' values are actuarially equal to the total streams of flows, including principal redemption and regular payments of interest, of the original bond or even, from other bonds. Therefore, strips should not be recorded as new debt instruments different from the original instrument. Where the debt is recorded (in issuers' books and for the excessive deficit procedure) at face value, there is no change in recording the primary debt when a bond is stripped. When debt is recorded at market value, a stripping operation does not change the total market value of the debt.
22. As a result, stripping does not change the cost of borrowing and provides no additional funding to the issuer. This has no impact on accrued interest which must still be based on the rate prevailing at the time of the issuance of the original bonds.

⁷⁰ In practice, when the discount is very small (less than 0.5%) and when the remaining maturity is rather short (no more than 1 year) the accrued coupon could not be split over the life of the instrument but recorded in the issuance year.

⁷¹ As a matter of principle, interest accrued is never retroactively revised, apart from errors in the rate used for the calculation of the amount of the instrument.



II.4.3.9 Floating rates and assimilated issues (including savings premiums)

23. Floating rate debt instruments do not raise any special conceptual issues for the recording of interest on accrual basis. In the case of mixed bonds, where fixed and floating rates are combined, two different instruments must be considered.⁷²
24. In the case of securities, there is usually a link between the nature of the rate index and the frequency of interest payments. Quarterly indexed interest is normally paid every quarter with a delay of one quarter. Thus, the exact amount paid to the holders is known in advance. Interest is said to be as “pre-determined”.
25. However, interest may be “post-determined”. For instance, annual interest may be indexed on an average over the previous twelve months. The exact coupon is known just a very short time before the actual payment. Provisional estimates of accrued interest could differ from the actual amount and so must be corrected when the actual amount is known.
26. As regards loans and deposits, where no compilation on an individual basis is practicable, global information must be used, notably for deposits. Under these conditions, interest would be accrued on the basis of estimates of the most probable rate that would be effectively paid.
27. Saving premiums are not mentioned in ESA10. Such premiums are paid under conditions generally regarding the length of time the instrument is held as a reward for stability. It is additional property income and not a nominal holding gain. A saving premium must be treated as interest and, thus, must be recorded on an accrual basis. Under some schemes, the premium is acquired only at the end of the whole saving period and the exact total amount paid cannot be known with certainty before the end of a given period. However, in most cases, only a very small minority of holders do not get the additional remuneration, as the majority would have a rational behaviour for maximising its return on saving. Therefore, interest should be accrued on a “maximum basis”, i.e. including the premium. When the exact proposition of “rationale” savers would be known with certainty, a correction would be implemented, retroactively, on the whole accrual period but, if only small amounts are involved, only on the last compilation period. Under other schemes, the “reward” takes the form of a step-up annual interest, acquired if the holders have not reduced their saving the previous year (s). In this case, interest should be accrued with the maximum possible premium for a given year, possibly applicable only on the certain proportion of rational savers but, in any case, with a final adjustment when the exact information is available.

II.4.3.10 Lottery instruments

28. Securities with lottery payments, i.e. where interest is paid as prizes to randomly selected holders, are not mentioned in ESA10 as such instruments are currently rather rare among government debt instruments. Such lottery payments are treated as interest and not considered as a holding gain for the holder. Although individual holders do not know what they will receive, the issuer does know the total amount to be paid out in prizes and so the interest can be recorded using the usual rules applying to the debtor principle.

II.4.3.11 Index-linked instruments

29. Some units in general government may issue debt instruments, generally under the form of bonds, which include a clause specifying that all or part of the remuneration depends on a published economic index number. It may apply only to the coupon, similarly to variable interest financial instruments. It may concern only the value of

⁷² There may also be “mixed interest rate” debt securities (see ESA10 5.102) where the interest is made of two fixed/floating components, permanently or successively. Accrued interest rules are thus different for each component.



principal, the coupon being affected through the rate applied to principal. In other cases, principal and coupons follow the same index.

30. ESA10 4.46 c makes a distinction between general price index and narrow index. The first case is, for instance, a consumer price index or commodities index, whereas the second refers to a particular price of a commodity or a stock. Government issued inflation-linked bonds, sometimes in a noticeable proportion of their debt. The second category is not frequent but, as observed in the past, there might be an indexation on gold. ESA10 4.46.c states that, in the first case, the change in value of the instrument due to the index during an accrual period is treated as interest accruing in this period, in addition to the “normal” interest accrued over this period (which may also be index-linked). For the second case, it is considered that there is a holding gain motive and in this case the interest to be accrued would include an expectation of the holding gain linked to the reference level of the index at inception; any deviation from these expectations would be recorded as positive or revaluation effect. However, in chapter 20, this distinction is not mentioned. Therefore, for all index-linked instruments issued by government, it is recommended, notably for practical reasons (difficult to anticipate holding gains, for instance related to change in gold price), to consider all change in value due to the index as interest.⁷³
31. In case a debt instrument (denominated in domestic currency) would show an index-linkage to a rate of exchange in a foreign currency, all change in value of the instrument related to the variation of the rate of exchange would be recorded as holding gain or loss, and not as interest, by consistency with the treatment of instruments denominated in foreign currency.

⁷³ In practice, EU MS currently issue only instruments indexed on Euro Area or domestic consumer price indexes but there have been in the past issuances on other references, such as gold.



Example: Calculation of interest accrual on an index-linked bond: broad-based index

A bond is issued on Jan 1, Year 1 at a price 1000 for five years, with no coupons, indexed to a broad price index. The index value at the beginning of the period is 100.

The index and bond values, with the derived interest and revaluations are as follows:

	Broad Price Index	Interest	Revaluation	Bond
	End of Period			Dec. 31
Year 1	107.0	70	-12	1,058
Year 2	113.0	60	-17	1,101
Year 3	129.0	160	58	1,319
Year 4	148.0	190	10	1,519
Year 5	140.3	-77	-39	1,403
Years 1-5		403	0	

Notes:

- Total interest over the five years (i.e., 403) is determined by the movement of the index (i.e., 40.3 percent increase).
- Since this is a bond, revaluations also arise because of changes in market conditions, such as changes in market interest rates, credit ratings, and expectations about the future path of the index. However, they are zero over the life of the bond when it is repaid at its indexed value.
- Negative values of interest can arise in the periods when the index declines.
- The corresponding entry to the interest accrued is an increase in debt securities in the financial account.
- Fluctuations in market interest rates cause changes in the value of the bond, but the calculation of interest is unaffected.

II.4.3.12 Short-term negotiable instruments

32. ESA10 5.A1.14 strictly defines short-term maturity as a maximum of one year (term of the instrument or notice in case of repayment on demand at the request of the creditor). Most Central Governments issue Treasury Bills within this limit. As already mentioned, these instruments are issued at a discount (or premium) which is treated at interest accrued over the life of the instrument. Generally, the total amount issued by government under these short-term instruments may vary significantly from one year to another, because of volatility in market conditions. It is thus important to be in a position to correctly allocate accrued interest to the relevant fiscal year, or quarter in short-term government finance statistics.

II.4.3.13 Instruments with step-up interest and instruments with grace period

33. A special arrangement concerns instruments with “step-up interest”. Government may hold or issue securities or other debt instruments where the coupon or the contractually defined profile of interest payments (at regular dates) shows a “step-up” (or reversely “step-down”) profile based on series of fixed interest rates set up at inception over successive periods (e.g. $x\%$ over years 1-4, then $x+1\%$ over years 5-8, etc.). In addition, such securities may be issued with a discount which is considered as interest spread over the life time of the instrument (see ESA10 4.46 and above II.4.3.6). As mentioned in this chapter (II.4.3.2) accrued interest is based on a “debtor approach” with reference to the “cost of borrowing” as observed at the time the instrument is created. As a consequence, interest must be accrued using



the market rate (yield-to-maturity) or the contractual rate available at inception of the instrument. Interest not paid in the same period is accrued and should be considered as reinvested under the instrument; thus it bears the same rate of interest (see above II.4.3.3 and II.4.3.4) independently of the moment it is paid. (See below the box "Step-up and Grace period").

34. Some financial instruments may include an interest grace period, generally over the first years, during which no interest is paid by the debtor to its creditor(s). The instruments involved are typically government financial assets such as loans but cases where such a grace period applies to a government liability have also been observed, although rather infrequently. This case is mentioned in ESA10 4.102 but the recording of interest is not specified.
35. As a general rule, the debtor approach implies that interest, both for assets and liabilities, must be accrued over the full lifetime of the instrument, including the grace period, on the basis of the relevant market rate observed at inception (yield-to-maturity) or the contractual rate available at inception. (See below the box "Step-up and Grace period" where the grace period is assimilated as a simple particular case of a "step up" debt instrument where the first coupons paid are equal to zero.)
36. However, exceptionally, no interest should be accrued during the grace period if both of the following conditions are strictly and jointly met:
 - a) During the grace period, the issuer is entitled to redeem the principal amount of the instrument (possibly including pro rata payment of discounts). Any additional payment will be considered as a form of remuneration.
 - b) After the grace period, there is no compensation by the debtor for the absence of interest payments during the grace period, such as an increase in the regular interest payments for the amounts previously not paid, or a higher coupon rate by comparison to similar instruments without grace period issued at the same time.

Box 1

Analytical Example

This example covers at the same time the issues raised in paragraphs 36 and 38 of the present chapter. The case of loans is mentioned in a second part.

A debt security is issued by government which has the following pattern of coupons: zero during five years ("grace" period), 4 during 5 years, and 9.92 during 5 years. Let us suppose the two conditions of paragraph 36 are not met.

Let us suppose that the market interest rate at time of issuance of the debt security is 4% and remains constant all over the period, an issuance value equal to 100 equal to the redemption value (no discount or premium). According to the "debtor approach" (see II.4.3.2), the market rate at inception (which is different from the "coupon rate") must be used for accruing interest over the life time of the security.

The market value (or net present value) to be recorded in the government ESA balance sheet is, in this simplified example, equal to issue value incremented by the capitalisation of interest accrued (similarly to the reinvestment of an existing coupon) but not paid at each period, in the absence of any change in the market rate for similar bonds issued by this unit.

In this case, the accrual accounting of the interest flow in ESA cannot be equal period by period to the effective coupon payments, which represent interest paid but not interest accrued.

The table below shows in column AF.33 (liabilities) the "market value" of the debt security at the end of each accounting period to be recorded in the ESA balance sheet of government. The market value is equal to the net present value (NPV) at the end of each accounting period based



on the (in this example constant all over the period) market interest rate of 4% (also assuming zero credit risk).

Interest (D.41) is the amount that government becomes liable to pay to the holder of the debt security in an accounting period without reducing the amount of principal outstanding. This is a general principle which applies to any financial instrument.

Therefore, **interest (D.41) for debt securities (F.3)** has in each accounting period two components (4.46 b):

- the amount of money income payable by government from coupon payments in the respective accounting period;
- the amount of interest accruing in the respective accounting period attributable to the difference between the redemption price and the issue price, calculated in the same way as for zero-coupon bonds, i.e. on a debtor approach.

In this context, the interest accrued (D41 Payable) in each period is equal to the sum of the coupon paid plus the change in the market value of the debt security in the period.

Example of grace/step up interest for a security.

Principal: 100 (issue and redemption value)

Market interest rate at inception: 4% (constant all over the period)

Coupons: 0 in the year 1 to 5; 4 in the years 6 to 10; 9.92 in the years 11 to 15.

The coupon of 9.92 is fixed such as the Net Present Value is equal to 100, based on the market interest rate of 4% observed at inception. (Accrued interest is totally paid over the period to creditors)

D41 Payable is obtained as the sum of the coupon plus the difference between the market value of the instrument at the end of the current period and the previous period.

	Annuity	Market value	AF.33L	F.33L	D.41 Payable
Issuance		100,00	100,00		
1	0	104,00	104,00	4,00	4,00
2	0	108,16	108,16	4,16	4,16
3	0	112,48	112,48	4,33	4,33
4	0	116,98	116,98	4,50	4,50
5	0	121,66	121,66	4,68	4,68
6	4	122,53	122,53	0,87	4,87
7	4	123,43	123,43	0,90	4,90
8	4	124,37	124,37	0,94	4,94
9	4	125,34	125,34	0,97	4,97
10	4	126,35	126,35	1,01	5,01
11	9,92	121,49	121,49	-4,87	5,05
12	9,92	116,43	116,43	-5,06	4,86
13	9,92	111,17	111,17	-5,26	4,66
14	9,92	105,69	105,69	-5,47	4,45
15	109,92	0,00	0,00	-105,69	4,23
Total interest	69,90				69,90



Non-tradable instruments

The case of **loans** (and more generally any not tradable instruments for which no market exists on a permanent basis and no market/fair value has to be recorded in national accounts) needs specific consideration.

In the case of an amortising loan, it is recommended to follow the amortisation table which could exceptionally foresee several successive “regimes” as regards the calculation of the share in annuities between principal repayment and interest charge. Even if the debtor was not entitled to any early redemption, at any time, the value of his debt must strictly reflect the amortisation table agreed at inception.

In the case of a loan totally redeemed in fine, one has to consider whether it takes the form of a series of different loans over the whole period or as a single until the final maturity. The criterion is the possibility of redemption during each sub-period (even only at the end), delimited by a given nominal rate of interest, the debtor paying the accrued interest not paid over the period and possibly an additional indemnity.

If it is not the case (no cancellation before the final maturity), the loan must be considered as a single one and, by consistency with the case of a bond⁷⁴, a similar treatment (“only one rate”) should be implemented.

II.4.3.14 Accrued interest on instruments denominated in foreign currencies

37. For these financial assets and liabilities, the normal rules for accruing interest should be applied but specific attention must be given to the issue of the conversion into the national currency. In ESA10 10.27 “the nominal holding gains and losses (K7)- realised or not - on an asset are the increases or decreases in the asset’s value accruing to its economic owner as a result of increases or decreases in its price, including exchange rate movements.” ESA10 specified in 6.65:

“Nominal holding gains may therefore occur from both changes in the price of the asset and the exchange rate” ; and

“the value of assets and liabilities denominated in foreign currency is measured by their current market value in foreign currency converted into national currency at the current exchange rate.

“Transactions in assets and liabilities denominated in foreign currency are converted into the national currency using the exchange rates at the time the transactions occur.”

As a consequence, nominal holding gains and losses may appear due to differences in exchange rates used for transactions and for balance sheets.

38. Where interest is denominated in foreign currency, it must be converted into the national currency by the exchange rates prevailing at the time it accrues. Ideally, interest should be accrued daily, and so using a daily exchange rate. In practice, the calculation is made over a period on the basis of the average exchange rate observed during the period (but not using a “spot” exchange rate, observed at only one specific point of time). Where interest is accrued by means of a compound method, theoretically, this average should be weighted by the amounts of accrued interest at each point time during this period. However, a simple arithmetic average may be an acceptable proxy.

39. The actual payment of interest is a transaction in the underlying instrument and with a counterpart in “currency and deposits” and uses the exchange rate at the actual date payment are made. Although the amounts of accruing interest associated with cash payments (taking into account for example both coupons and discounts/

⁷⁴ In some cases, government could meet the alternatives as recourse to market and contracting a loan with a bank or a syndicate, at very similar total cost of borrowing.



premiums) are perfectly equal in foreign currency, the amounts of accrued and paid interest may diverge in national currency, due to exchange volatility. So an adjustment is in all likelihood needed in the revaluation account. It results from the difference between, on the one hand, the "spot" exchange rate observed at this time (used for the conversion of outstanding amounts) and, on the other hand, an average rate used for interest accrued during the last period or the "spot" rate observed at the end of the previous period for interest previously accrued but not paid during the last period. Conceptually, the exchange rate effect is different from the case of instruments with variable interest rate for which a correction in the amount of interest, accrued and reinvested, is made when the exact interest rate is known. In the case of instruments denominated in foreign currencies, the adjustment is not due to a wrong estimation but comes from the fact that transactions occur at different points in time. Later, when the effective payment of this interest occurs, there is a new adjustment in the revaluation account due, on the one hand, to the gap between the exchange rate at this time and the rate used at the end of the last period, and, on the other hand, to the difference between the rate used for accruing since the beginning of the period and the rate at the time of payment.

40. On some occasions - as in the case of annual period of compilation for interest paid every three or six months or for discounted instruments of shorter maturity - there is no "overlapping" between the accruing period and the period of payment. In principle only one adjustment is necessary, as mentioned at the end of the last paragraph. In this case, interest is fully accrued and paid during the same period of compilation. The new claim/liability resulting from the reinvestment of accrued interest is created and extinguished during the same period. In this time-scale, the concept of accrued interest may be seen as rather theoretical. Thus, for simplification, it could be acceptable to enter directly in the property income the amount of the effective payment converted into the national currency, avoiding any adjustment.
41. These entries are fully meaningful from an economic point of view. More generally, such adjustment is frequently observed for financial instruments denominated in foreign currency for which transactions with opposite signs (as creation/extinction of a liability) of equal amounts in original currency may not be offset after conversion in national currency.

II.4.3.15 Income of mutual funds

42. Units classified within the general government sector may hold shares issued by mutual funds. The income received by the mutual fund is recorded according to ESA10 rules, i.e. on an accrual basis for interest and at the "ex-dividend" time of the price of the share (in practice at the time of the payable date) for dividends. The income assigned to shareholders is considered reinvested. It is the income received by mutual funds, after deduction of management fees, considered in the system not as a distributive transaction but as financial services. As this income is automatically and continuously⁷⁵ attributed to the holders, it should be recorded when "earned", i.e. on an accrual basis, in the same conditions as for other debt instruments, regardless of whether this income is distributed regularly or capitalised and so automatically included in the value of the share.

II.4.3.16 Early redemption of debt instruments (including exchange)

43. Whatever the instrument, a debtor may have the right to break the initial contract and offset his debt before the maturity date agreed at inception. In some cases, he

⁷⁵ Even in case of funds invested in shares (apart from other invested according to regulations), the value of the shares includes the implicit expected dividends within the value of the portfolio.



must give notice of at least a specific period of time. The creditors are normally entitled to compensation.

44. For securities, an early redemption may take the form of repurchases on the market by the issuer. It may also be the result of an exchange of securities. The issuer calls for some specific bonds and provides in exchange a new security or a new tranche of a security previously issued. A difference, sometimes called a premium, is observed between the nominal value and the effective redemption value. Where the difference is positive, it is a holding gain for the holder and a holding loss for the issuer, recorded in the respective revaluation accounts. Under ESA10, financial instruments are valued in principle at current prices, notably for debt securities. Thus, the gain/loss is equal to the difference between the value of the outstanding amount at the end of the previous period and the price of the exchange. The treatment of these exchanges of bonds is very similar to transactions of bonds on secondary markets between holders of securities.
45. In the exchange, there is equivalence between the amount bought back by the issuer and the new amount issued - with possibly a cash payment for any marginal difference in value. For bonds with regular interest payments, there is, in addition, a payment by the issuer for the accrued coupon. Such exchange may happen in the context of special operations with the aim to reduce the nominal debt, which means that there could be a discount of the previous bonds higher than the observed market price, if any (the issuer may be in a stress situation reflected in market disruptions or very high volatility for its debt instruments).⁷⁶ In any case, i.e. whatever the procedure of the exchange, there is no effect on net borrowing/net lending at the time of the exchange.
46. An early redemption can also occur for loans. The debtor may be allowed to reimburse a loan before the final maturity and frequently the bank is legally entitled to ask for compensation. The latter cannot be considered in national accounts as a capital transfer, nor as the price of levying an option held by the borrower, nor as a service charge. The correct treatment depends on the way the compensation is calculated. Two cases should be distinguished:
 - a) If the compensation is equal to an amount of interest (for instance a 6 months interest charge at the contractual rate, as if, in fact, the early redemption were taking place three/six months later) on the remaining principal amount at time of the redemption, it is treated as supplementary interest. However, as derogation to the accrual principle, it could be recorded only at the time of payment and not spread all over the time the loan had been in force. There would be an impact on net borrowing/net lending.
 - b) If the compensation is calculated as a fixed percentage (for instance 3%) of the remaining principal, the compensation should be recorded as a holding gain (for the lender) and loss (for the borrower). This indemnity is de facto added to the principal.
47. For some time or saving deposits, a given rate of interest may be paid only under the condition of a minimum holding period. An early liquidation, if contractually allowed, is balanced by a reduction in the rate of interest paid to the holder. For recording interest on an accrual basis, the rate of interest taken into account is the maximum rate that the depositor could receive in the normal course of the contract, i.e. respecting the arrangements about maturity or notice. When it is not the case, the amount of interest accrued previously is corrected on the basis of the final rate. As this amount is in all likelihood globally very small compared to the total interest on deposits, for practical reasons, the correction for the total amount can be recorded in the latest time period only.

⁷⁶ This discount is generally set by negotiations between the issuer and representatives of the creditors, notably when securities are issued with Collective Action Clauses.



II.4.4 Accounting examples

II.4.4.1 Instrument issued at par and regular coupon/interest payments

On first of July in year 1, central government issues a bond of 1000; an annual rate of interest of 5% paid every year on that date; a maturity of 10 years; and a full redemption at that time. At end of year 1, the market price is 1045 (including 25 of accrued interest not yet paid). At end of year 2, the market price is 1075 (including 25 of accrued interest not yet paid).

YEAR 1				YEAR 2			
				Opening balance sheet			
		R		A		L	
						AF.32 1045 (1044.3)	
						(EDP: 1000)	
Non-financial account				Non-financial account			
U		R		U		R	
D.41	25 (24.3)			D.41	50		
		B.9	-25 (-24.3)			B.9	-50
Financial account				Financial account			
ΔA		ΔL		ΔA		ΔL	
F22	+1000	F.32	+1025 (1024.3)	F.22	-50	F.32	+25 -50 +25
		B.9	-25 (24.3)			B.9	-50
Revaluation account				Revaluation account			
ΔA		ΔL		ΔA		ΔL	
		F.32	+20			F.32	+30
Closing balance sheet				Closing balance sheet			
A		L		A		L	
		AF.32 1045 (1044.3)				AF.32 1075 (1074.3)	
						(EDP:1000)	



YEAR 1

YEAR 2

Opening balance sheet

A	L
	F.332 1045 (1044.3)
	(EDP: 1000)

Non-financial account

U	R
D.41 25 (24.3)	
	B.9 -25 (-24.3)

Non-financial account

U	R
D.41 50	
	B.9 -50

Financial account

ΔA	ΔL
F22 +1000	F.332 +1025 (1024.3)
	B.9 -25 (24.3)

Financial account

ΔA	ΔL
F.22 -50	F.332 +25 -50 +25
	B.9 -50

Revaluation account

ΔA	ΔL
	F.332 +20

Revaluation account

ΔA	ΔL
	F.332 +30

Closing balance sheet

A	L
	F.332 1045 (1044.3)

Closing balance sheet

A	L
	F.332 1075 (1074.3)
	(EDP:1000)



II.4.4.2 Instrument issued at a discount with regular coupon payments

On 01/10 in year 1, central government issues a new tranche of a bond (principal 1000, rate of interest 5%, maturity 10 years, payment date on 1st July, and redemption *in fine*). The issue price is 95% (roughly a yield of 6%). The discount of 50 is spread for 1 in the first year, 4 in the second year and 3 in the tenth year. For simplification, the bond is always quoted 100% at ends of period (Figures are rounded).

YEAR 1				YEAR 2			
				Opening balance sheet			
		R		A		L	
						AF.32	976
Non-financial account				Non-financial account			
U		R		U		R	
D.41	13.5 (12.5 +1)	B.9	-13.5	D.41	54	B.9	-54
Financial account				Financial account			
ΔA		ΔL		ΔA		ΔL	
F.22	+962.5	F.32	950+12.5+13.5	F.22	-50	F.32	+4 +36.5 -50 +13.5
		B.9	-13.5			B.9	-54
Closing balance sheet				Closing balance sheet			
A		L		A		L	
		AF.32	976			AF.32	980
		(EDP: 1000)				(EDP: 1000)	



YEAR 10

Opening balance sheet

A	L
AF.32	1022

Non-financial account

U	R
D.41	
28	
	B.9
	-28

Financial account

ΔA	ΔL
F.22	
-1050	F.32
	-1022
	B.9
	-28

Closing balance sheet

A	L
	AF.32
	0



II.4.4.3 Instrument issued at a discount without regular coupon payments

Central government issues on 01/07 a zero-coupon bond for 3 years for 75 (nominal value is 100). The implicit interest rate is 10%. (Figures are rounded) No change in the market interest rate.

YEAR 1				YEAR 2			
				Opening balance sheet			
		Non-financial account				Non-financial account	
U			R	U			R
D.41	3			D.41	8		
		B.9	-3			B.9	-8
		Financial account				Financial account	
ΔA			ΔL	ΔA			ΔL
F.22	+75	F.32	+75 +3			F.32	+8
		B.9	-3			B.9	-8
Closing balance sheet				Closing balance sheet			
		Non-financial account				Non-financial account	
A			L	A			L
		AF.32	78			AF.32	86
		Financial account				Financial account	
				(EDP: 100)			
YEAR 3				YEAR 4			
Opening balance sheet				Opening balance sheet			
		Non-financial account				Non-financial account	
U			R	U			R
D.41	9			D.41	5		
		B.9	-9			B.9	-5
		Financial account				Financial account	
ΔA			ΔL	ΔA			ΔL
		F.32	+9	F.22	-100	F.32	-95
		B.9	-9			B.9	-5



Closing balance sheet		Closing balance sheet	
A	L	A	L
	AF.32 95		AF.32 0
	(f: 100)		

With change in market rate

At the beginning of the following year, the rate of interest increases up to 15% for a maturity of 2 years and a half (and does not change any more). The price on the market falls to 70. (Figures are rounded).

YEAR 2		YEAR 3	
Opening balance sheet		Opening balance sheet	
A	L	A	L
	AF.32 78		AF.32 81
Non-financial account		Non-financial account	
U	R	U	R
D.41 8		D.41 9	
	B.9 -8		B.9 -9
Financial account		Financial account	
ΔA	ΔL	ΔA	ΔL
	F.32 +8		F.32 -9
	B.9 -8		B.9 -9
Revaluation account		Revaluation account	
ΔA	ΔL	ΔA	ΔL
	F.32 81 -86		F.32 93 -90
Closing balance sheet		Closing balance sheet	
A	L	A	L
	AF.32 81		AF.32 81 +12



YEAR 4

Opening balance sheet

A		L
	AF.32	93

Non-financial account

U		R
D.41	5	
	B.9	-5

Financial account

ΔA		ΔL
F.22	-100	F.32
	B.9	+5 -100
		-5

Revaluation account

ΔA		ΔL
	F.32	100 -98

Closing balance sheet

A		L
	AF.32	0



II.4.4.4 Strips

Central government has issued the following bond: fixed rate of 15%, principal of 1000, redemption at maturity, payment date on 1st July. At a remaining maturity of three years, it is decided to create a set of four strips.

On the basis of the original interest

As the interest rate is unchanged, the market price of the bond is equal to the nominal value. Three coupon certificates for each annual interest payment (valued respectively 99, 113, 130 on the basis of price equal to 65.8%, 75.7% and 87% for a nominal of 150) and one certificate for the final repayment of principal (valued at 658 as the price is 65.8% for a nominal of 1000) are created. The total market value of the four certificates is always equal to the nominal value. Accrued interest may be calculated on the basis of the previous form of the bond or, from the time of stripping, as the difference in the market price of the zero coupon securities (no other factors intervening), i.e. the sum of 49, 10, 9 and 7. At the end of the year, 1075 is the sum of the market values of four certificates: 707 + 106 + 122 + 140 or is the sum of 1000 (principal) and 75 (accrued interest on six months). This example covers clearly the case of Maastricht debt, recorded at nominal/face value and, thus, ignoring by definition any effect of stripping on the original debt. (Figures are rounded).

YEAR 1			
Opening balance sheet			
A		L	
		AF.32	1075
Non-financial account			
U		R	
D.41	150	B.9	-150
Financial account			
ΔA		ΔL	
F.22	-150	F.32	+150
		B.9	-150
Closing balance sheet			
A		L	
		AF.32	1075



During the second year, again, accrued interest is unchanged compared to the previous form of the bond. It is also equal to the differences in the prices of the certificates between the beginning of the year and the time of redemption for the first coupon certificate, and the end of the year for the other three (10, 106, 16, and 18). At the end of the year, 1075 is the sum of the market values of three certificates (813, 122, 140) and is still equal to the sum of 1000 (nominal) and 75 (accrued interest on six months).

YEAR 2

Opening balance sheet

A		L
	AF.32	1075

Non-financial account

U		R
D.41	150	
	B.9	-150

Financial account

ΔA		ΔL
F.22	-150	
	F.32	+150
	B.9	-150

Closing balance sheet

A		L
	AF.32	1075



With a change in interest rate

Stripping is implemented in new market conditions, for instance when the market rate has fallen to 10%. The current price of the bond is 1125. At this time, the values of the strips are 113, 124, 136 and 752 (on the basis of prices in percentage 75.2, 82.7 and 90.8). At the end of the year, the sum of market values of the four certificates is 1182 (790, 119 130, 143), which is also the market value of the nominal (1107), or "clean price", and accrued interest (always 75).

There would be no asymmetry in recording the asset and liability sides. But this example shows clearly that the differences in market prices cannot be used for accrued interest (the sum would be 57 for half the year, against 75 at the original rate). Thus, accrued interest must be estimated on the basis of the previous form of the bond and cannot be based on the information from the holders. The adjustment is entered in the revaluation account. The loss (the current price of the liability is higher than the "theoretical" one) is a gain in the accounts of the counterparts.

YEAR 1			
Opening balance sheet			
A			L
		AF.32	1075
Non-financial account			
U			R
D.41	150	B.9	-150
Financial account			
ΔA			ΔL
F.22	-150	F.32	+150 -150
		B.9	-150
Revaluation account			
ΔA			ΔL
		F.32	1182 - 1075
Closing balance sheet			
A			L
		AF.32	1182



There is no change from the previous year concerning estimation of accrued interest. 1143 is the sum of the market values of the three remaining certificates (869, 131, 143) and also the market value of principal (1068) incremented by accrued interest on six months (75). The adjustment in the revaluation account is now a gain for the issuer and is estimated only from current prices at beginning and end of the period.

YEAR 2			
Opening balance sheet			
A			L
		AF.32	1182
Non-financial account			
U			R
D.41	150	B.9	-150
Financial account			
ΔA			ΔL
F.22	-150	F.32	+150
		B.9	-150
Revaluation account			
ΔA			ΔL
		F.32	1143 - 1182
Closing balance sheet			
A			L
		AF.32	1143



II.5 Military expenditure

II.5.1 Background to the issue

1. Military expenditure is a particular category of government expenditure which frequently takes place under specific procurement contracts (including sometimes the use of leasing for high value equipment). Owing to difficulties in some countries in obtaining precise information, in 2006 Eurostat introduced some recording rules in order to avoid differences in national accounting practices concerning the time of recording of government expenditure related on acquisition of military equipment.
2. By its nature, military equipment frequently included sophisticated technology. This has three consequences. First, military equipment may be constructed from a large variety of components that are often produced by different suppliers. Second, the production process may be spread over several years. Third, contracts frequently also cover the provision of service maintenance in order to keep the equipment under operational conditions. These three factors resulted in different interpretations in countries on the time of recording in national accounts of government expenditure on military equipment; it was therefore important for Eurostat to provide clarifications.

II.5.2 Treatment in national accounts

II.5.2.1 Identification of military equipment

3. ESA10, similarly to SNA2008, makes a clear distinction between “weapon systems” and the other goods used by military forces in the completion of their missions. In ESA10 chapter 7, “weapon systems” (AN.114) are defined, among fixed assets, as “vehicles and other equipment such as warships, submarines, military aircrafts, tanks missile carriers and launchers, etc.” This list is not deemed to be complete but it gives a clear indication of the nature of such equipment that is designed for delivering, as many times as possible (and expected to last for more than one year), destructive instruments. Arms of mass destruction are a specific case: ballistic missiles with highly destructive capability, that are judged to provide on-going deterrence against aggressors, are classified as fixed assets.” The rationale is that they are expected not be used (and thus destroyed) and instead provide a service of deterrence.
4. As a consequence, the acquisition of these fixed assets is recorded as Gross fixed capital formation and is subject to consumption of fixed capital, similarly to any other fixed asset acquired by military forces. It is specified in ESA10 chapter 7 that “machinery and equipment other than weapon systems acquired for military purpose are included” in AN.113, but not separately identified as such. The military GFCF also includes expenditure for improvement of military fixed assets, such as “major repairs” that lengthen their lifetime and “retrofits” for modernisation. ESA2010 also created a new category of military inventories (AN.124) exclusively for stock of “ammunition, missiles, rockets, bombs and other single-use military items delivered by weapons or weapon systems.” When they are used, they are recorded as reduction change in inventories and intermediate consumption expenditure.

II.5.2.2 The time of recording of military equipment expenditure: general rule

5. Using general national accounts principles, the time of recording of government expenditure for equipment is the time of their delivery, which is deemed to mark a change in economic ownership. This is of course not specific to military equipment.



6. In other words, the delivery is assumed to take place when the military forces take possession of the equipment from an economic point of view, i.e. bearing the risks and rewards of the equipment. This applies whatever the operation to be effectively carried out with it, such as training or actual military missions. After delivery, military forces are normally in a position to use the military goods for any operation and without any restriction, whereas for some equipment, there is a period of testing, generally on military premises, during which the constructor is still largely responsible for the equipment. In this regard, a relevant criterion is generally the insurance arrangement as, generally, military equipment in effective use are self-insured by government. This time of delivery may be quite different from the time of the corresponding cash flows. It is unusual for expensive “heavy” equipment to be fully paid for at time of delivery.
7. When the delivery of the equipment is accompanied by the provision of services, simultaneously or later, the expenditure on services must be separately identified and recorded as intermediate consumption, at the time the service is delivered. The exception is of the costs of transfer of ownership, incurred by the new owner, as defined in ESA10 3.133. The coverage of these costs is rather restrictive and it does not include the tests and tuning needed by highly sophisticated military equipment.

II.5.2.3 The time of recording of the expenditure on military equipment in the context of long-term contracts

8. An examination of contracts signed by government authorities to acquire military equipment found that the following features are frequently present:
 - many items are delivered over a number of years,
 - services (such as maintenance) are provided for a number of years,
 - delivery of final components is needed to make the complex equipment fully operational for military missions. Examples are electronic equipment and arm systems for fighters, frequently delivered by firms other than the main supplier and which are assembled in military premises. This case must be clearly distinguished from the assembly by a constructor/manufacturer of components from, frequently, numerous sub-contractors, and which will give rise to a single delivery (and single invoice).
9. The time of recording of government expenditure impacting on government net lending/net borrowing, is as follows:
 - where long-term contracts include deliveries of identical (or “basically” identical as in the case of “standards” for aircrafts) items staged over a long period of time, government expenditure should be recorded at the time of actual delivery of each item;
 - where long-term contracts also cover the provision of services over a long period of time (such as maintenance and technical monitoring), government expenditure should be recorded at the time of the provision of the services. Standard analytical accounting techniques allow for apportioning the expenditure in relation to the goods and services delivered within contracts;
 - where spare parts, for maintenance and repairs, are delivered simultaneously with the equipment, they are recorded at the same time; if they are part of an identifiable maintenance contract, it is at the time they are separately delivered to military forces;
 - where long-term contracts involve complex systems from different suppliers, government expenditure should be recorded at the time of delivery of the individual (and operational in the sense that the individual piece of equipment meets all the necessary specifications to be fully functional when connected to other elements of the complex system) pieces of equipment that compose the



systems, and not at the time of completion of delivery of all pieces under the contract. An example is ship, where hull and motors are provided by a shipyard and more specific military equipment by other specialised suppliers, possibly in other locations.

II.5.2.4 Military equipment built over many years

10. A specific type of military contract concerns heavy equipment that takes many years to build/produce, such as large ships or submarines. In this regards, since such military equipment are fixed assets, there is no reason to apply specific rules other than those in ESA10 for fixed assets. In ESA10 the general rule is that unfinished goods are part of work in progress which is recorded in the inventories of its producer and are reduced when the production process is complete and economic ownership transfers to the clients (see 3.148).
11. There is an exception for ‘structures’ (covering buildings and immovable other assets) acquired under a contract of sale agreed in advance and that must be treated as gross fixed capital formation of the purchaser. The rationale is that the latter has taken the commitment to take over the structure, under some conditions related to the compliance with specifications. In this case, the transfer of ownership is assumed to take place progressively. In practice, the gross fixed capital formation would be recorded according to milestones payments and, in their absence, to other indicators, such as the cost incurred by the constructor during a given year. The rationale is that it is very likely that the structure will be acquired by the ordering unit, either because it is a very specific one, or because it has an imperative need of it.
12. The above-mentioned rule is not applied to “uncompleted other fixed assets”. ESA10 3.148 mentions ships as an example of this category. It therefore does not foresee any exception for military equipment recorded as assets. In this case, work-in-progress is recorded in the inventories of its producer until the transfer to the purchaser. Under these conditions, the military equipment would be recorded at the time of the transfer of ownership, on a delivery basis, like any other fixed assets not covered by the exception.⁷⁷

II.5.2.5 The treatment of leases relating to military equipment

13. Some manufacturers of military equipment (sometimes at the initiative of government) arrange contracts that make the equipment available under leasing arrangements. This has been observed in the case of fighters in several Member States. The question is then whether such leases should be considered in national accounts as financial leases or as operating leases.
14. Leases of military equipment should always be considered as financial leases, and therefore recorded as an acquisition of the equipment by the government (as lessee) with the incurrance of a matching government liability to the lessor, as stated in ESA10 20.19.
15. Thus, there is an impact on government deficit at the time when the equipment is put at the disposal of military authorities, under the conditions specified below, and not at the time of payments relating to the lease. As the corresponding liability is an imputed loan, government debt is also impacted at that time. Payments are

⁷⁷ In other words, the strong specificity of military equipment is not sufficient to state a specific treatment as regards work in progress. It is true that in many cases it seems very unlikely that government could renounce to it, as illustrated by examples where, in spite of substantial delays and large over-costs, governments confirmed their intention to acquire the equipment. Moreover, very often, the construction/manufacturing of the equipment takes place under a very close and permanent control of the military authorities so that government is thoroughly involved in the production process, much more than what could be observed for other fixed assets, but this is not, as such, a criterion in national accounts



considered as debt servicing, and partitioning into interest and repayments of the imputed loan.

16. Some lease contracts cover civilian equipment that may also be used for military support, possibly through quick addition of light technical tools. Examples are air tankers and cargoes. Generally, it is not possible to distinguish them from the similar assets used by civilian units. This borderline case could be treated as operating lease only where there is evidence that the majority of the use over time is for pure civilian purposes. For instance, if a given number of pieces in a fleet are permanently at the unique disposal of military forces (using them fully at will) and are at risk, for example when they are majority used as support in military missions (fighters' refueling, troops transportations to combat zones), their use should be recorded as in a financial lease. This rule must also apply to "shared" communication (including satellites) equipment.

II.5.2.5 Recording of military research and development

17. ESA2010, following SNA2008, involves a significant change as regards Research and Development (R&D). ESA10 3.127 stated that R&D is part of Gross fixed capital formation "...including the production of freely available R&D". However, it is specified in ESA10 annex 4.1 in chapter 7 that: "Research and development that will not provide a benefit to the owner is not classified as an asset and is instead recorded as intermediate consumption." (See also similarly in SNA2008 6.230). The question is therefore whether this should be applied to all research and development expenditure related to military purpose carried out by government. In the context of research of "innovative" equipment or weapon systems this may be observed, notably at an earlier stage of a programme which might be stopped afterwards. This would need a case-by-case analysis.

18. If the R&D is realised independently of the final product or is not foreseen to be reimbursed in the absence of "successful results" and, de facto, not exclusively related to specific military equipment to be delivered, the corresponding expenditure is recorded when the research and development work takes place or when a cash transfer is made by government to finance it. Concerning the recording under GFCF, several cases should be distinguished.

Where the R&D expenditure does not imply any manufacturing of a given number of pieces of equipment⁷⁸, at least at this step of research:

- either, there is evidence of "appropriation" of the benefits by government (which have a possible exclusive benefit of them) or is, by "altruism", made freely available for any other unit (which seems rather unlikely in highly sensitive R&D); the expenditure is considered as GFCF in AN.117 and, in practice, recorded at the time of the payment;
- or, the possible benefits from such research is fully and exclusively appropriated by the unit benefiting from the expenditure (with potential "spin-off" on other own products or through patents); as no benefit is captured by the paying government, the expenditure has to be recorded as a kind of investment grant (D.92) in government accounts, as it results in an asset AN.117 for the corporation, at the time the payment is to be made.

19. In other cases, all or a part (clearly identified) of the R&D is strictly related to a contract which foresees future manufacturing of a given number of identical items on the basis of an outright order, which however could be revised, of military equipment. In this case the corresponding expenditure has to be apportioned to the deliverable goods and recorded later. Normally, such R&D is "refundable" under the form of future delivery of equipment, generally in pieces over a long time. Payments

⁷⁸ This may imply the production of prototypes on the basis of which government could take the decision to enter in a new contract to deliver equipment derived from this research.



by government for such R&D are recorded as a financial advance (in other accounts receivable F.8).⁷⁹ At the time of delivery of each single pieces of the equipment, a proportionate part of the F8 is transferred to the value of the asset AN.114 acquired by government.⁸⁰ If in the initial contract it was agreed that one part of this research expenditure would not be transferred in the prices of the single pieces to be delivered in a second step, this part should be recorded as GFCF in AN.117.

II.5.3 Rationale of the treatment

II.5.3.1 The time of recording of military equipment expenditure: general rule

20. As a general rule, in national accounts, the time of recording of the acquisition of goods is the time of change of economic ownership. In the case of military equipment, there are several events that might correspond to a stage of change of ownership, notably in the context of long-term contracts: the time of contract signature (as it is very likely that government will eventually take delivery of the equipment or at least ensure the financing of the corresponding research and development costs), the time of delivery (to be specified), the time of cash payment, or the time of contract completion (for instance when the equipment is transferred to the responsibility of the military).
21. In some limited cases, this time is specified by ESA10 to be in advance of the complete delivery of the goods: construction projects in the framework of contract of sale agreed in advance, own account construction. For “Machinery and equipment” (AN.113), the time of recording is at the change of ownership, which is the economic concept of delivery (possibly different from the time of the “physical delivery”), even when their production is spread over several accounting periods. The fact that military equipment, as specifically defined, is a sui generis category of assets, classified as AN.114, with high specificity, a quasi-certainty of actual taking over by the ordering government unit, means that the equipment in progress should not be considered as transferred to government before the entire completion.
22. Except in the case covered in the previous paragraph, as a simple but fundamental consequence, pre-payments on deliveries (which may partly cover R&D related to the programme) of military equipment and other goods must be recorded as financial transactions (financial advances, F.81 asset of government), while subsequent deliveries are recorded as expenditures with a counterpart financial transaction liquidating that redeems the government asset.
23. For post-delivery payments for military equipment, government expenditure is recorded at delivery and is matched by a financial transaction (F.81 liability of government). When the cash settlement occurs later, this is recorded as financial transactions (i.e. one in cash and one that redeems the government liability).

II.5.3.2 Time of recording of government expenditure on military equipment in the context of long-term contracts

24. Contracts often foresee staged deliveries of similar items over many years. Examples are fighter planes delivered in batches over a given period or a series of warships to be delivered over several years.

⁷⁹ A specific case is where the payment is used for R&D purposes but does not contractually oblige a definitive purchase of military goods, and instead gives a right to future purchases at a reduced price, uncertain at the time of the expenditure, and then a transfer is recorded at the time of the payment. If an eventual acquisition of military goods occurs, this is recorded at full market value, as if acquired by a third party not subject to the reduction, and a capital transfer receipt is imputed for the difference.

⁸⁰ A very specific case should also be considered when a government decides to cancel a military equipment programme for which some R&D expenditure has already been undertaken. This expenditure was recorded as financial advance, “amortised” by effective deliveries. As the later will not take place (or only partially), it should be examined if the advance should be returned by the corporation to government. If this is the case, there will be a new financial transaction. If this is not the case, it should be recorded a capital transfer or an investment grant if the corporation could take some advantage of the past R&D expenditure for itself. This should be recorded at the time of the final decision of cancellation.



25. The application of the accruals rule for recording the acquisition of military goods implies that such staged deliveries should be recorded as Gross fixed capital formation by government when they occur. Standard analytical accounting techniques should allow identification of the value of partial deliveries. Confidentiality should not be a major issue, as the precise nature of the equipment is not revealed in national accounts data. Thus, the moment of impact on government net lending / net borrowing is not at the completion of the contract, or at the time of payment, but according to the pattern of deliveries. The rationale is that each piece (or a given set delivered together) must be considered separately as regards the risks and rewards attached to it.
26. Delivery of sophisticated military equipment is often associated with the provision of training and related services. In addition, as the maintenance of specific high technology equipment requires sophisticated skills, there is a growing tendency to closely associate supplying firms to these tasks. This raises an issue in cases where a single and global contract is agreed. The accruals principle implies that government expenditure on services should be accounted for at the time they are actually provided and recorded as intermediate consumption. Standard analytical accounting techniques also allow the apportionment over time of the expenditure in relation to the services delivered, with the relevant information likely to be found in the contract.
27. In the case of complex systems, some post-delivery tasks need to be performed for the equipment to be fully operational. Military equipment goods generally require specific preparation, including further components. The equipment may not be fully operational before the completion or assembly of other kinds of equipment (for instance electronic arms systems).
28. Some military programmes, accounting for significant amounts, are based on the combination of several kinds of components that may be completed in different periods so that the expenditure may be spread over several fiscal years before the system becomes fully operational in its entirety. The issue here is whether post-delivery tasks are under the full responsibility of the authorities/military forces or of the suppliers.
29. Where the post-delivery tasks are under the full responsibility of the supplier, the supplier of the contract has not yet fulfilled its contractual obligations, and the recording of the delivery of the equipment should only be at that the point when those obligations are met.
30. Where all these tasks (and notably their timetable) are under the full responsibility of the government authorities/military forces, the supplier of the components is assumed to have fulfilled its contractual obligations. As a result, the time of recording of the delivery of the goods should not be the time of completion of the whole contract, but instead determined according to delivery or, possibly, progressive transfer of ownership.

II.5.3.3 The treatment of leases relating to military goods

31. Military equipment can be leased instead of purchased outright. Whether the lease is labelled as operating or a financial lease in the contract is not important. The question is the appropriate classification of such leases in national accounts.
32. As a reminder, the classification of leases into financial or operating leases in national accounts rests mainly on the transfer of risk (ESA10 15.05) and is not determined by the legal terminology included in the contract.
33. One issue to consider is if it is possible to record an operating lease or a financial lease on a good that is not a fixed asset in ESA10. The answer is that national accounts can record both, whether the good is an economic asset or not. As an example, cars are not economic assets to households, by convention, in the national accounts system, but financial leases on cars are common and recorded as such.



34. Applied to the case of military equipment, the transfer of risk implying a change in economic ownership occurs when military forces take possession of the equipment and are responsible for taking decisions regarding its use. They will bear all the risks that may be associated with the military missions.
35. A specific characteristic of military missions is to put military equipment knowingly at risk, whereas other economic activities usually avoid putting goods at risk or insure against such risks. By its nature, military equipment is used in missions where some parties are likely to try to destroy it or weaken its capacity. Another issue points to the rapid possible obsolescence of such equipment so that replacements are required quicker than expected.
36. Under these conditions, by their nature, risks associated with military equipment lie with the military authorities, the bodies that have the sole competence to decide if and when to use it during conflicts, thereby knowingly exposing it to potential damage.
37. In this context, any leasing contract on military equipment (as defined above) should be recorded in national accounts as a financial lease, even when the contract is labelled as an operating lease. The time of recording of the acquisition of the military equipment will therefore be when the military forces take full responsibility for its use. The lessees' liabilities under financial leases are classified as loans (F4), and are hence a component of Maastricht debt when the lessee is government.

II.5.3.4 Research and development

38. A complication may arise when the contract foresees that expenditure is incurred for Research and Development purposes in the earlier years of the contract, well before actual deliveries. Here, it is important to examine the nature of such R&D expenditure.
39. As a general rule, if R&D is realised independently of any final product (but may include the realisation of prototypes) or is definitely spent (and not reimbursed in any form) and, de facto, not exclusively related to the specific military equipment to be delivered, the corresponding expenditure is to be recorded, as for any other type of R&D activity purchased by government, when the work takes place or when the transfer is made by government to finance it. As a general rule, it is recorded under ESA10 as Gross Fixed Capital Formation in the asset AN.117. However, it should be recorded as intermediate consumption and not as gross fixed capital formation if there is no expected clear benefit to be kept by government (including possibly making it generally available) or if possible results would be exclusively appropriated by the beneficiary of the expenditure.
40. In some cases the research and development is part of a contract whose includes an order for at least a first series of pieces of equipment, notwithstanding the length of research and development step before the launch of the industrial step. As R&D will be integrated to the price of single pieces, this should be recorded as a financial advance for future deliveries of assets AN.114. This treatment is implemented only if the contract foresees a global expenditure for the equipment to be delivered and not in the cases where the order of the equipment depends on the results of the R&D.



II.5.4 Accounting examples

Example 1

Government orders a military capital good for a value of 100. In year 1, it makes a payment of 45. In year 2, the good is delivered and immediately usable by military forces and government pays 30. In year 3, government pays the residual. (For simplicity, the costs of the supplier are not shown)

YEAR 1					
General government			Supplier		
Current account					
U		R	U		R
Financial account					
ΔA		ΔL	ΔA		ΔL
F.2	-45		F.2	+45	
F.81	+45				F.81 +45
		B.9	0		B.9
					0
Closing balance sheet					
A		L	A		L
AF.81	45				AF.81
					45

YEAR 2					
General government			Supplier		
Opening balance sheet					
A		L	A		L
AF.78	45				AF.81
					45
Current account					
U		R	U		R
P.2 (or P.52)	100				P.1
B.9	-100		B.9	+100	
					100



Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	-30			F.2	+30		
F.81	-45	F.81	+25	F.81	+25	F.81	-45
		B.9	-100			B.9	+100
Closing balance sheet							
A		L		A		L	
		AF.81	25	AF.81	25		

YEAR 3							
General government				Supplier			
Opening balance sheet							
A		L		A		L	
		AF.81	25	AF.81	25		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	-25			F.2	+25		
		F.81	-25	F.81	-25		
		B.9	0			B.9	0
Closing balance sheet is empty							

Example 2

Government enters into a leasing contract with a supplier for a military good. The contract foresees that the good has a value of 100 and that government will make 10 annual payments of 14, (corresponding to annual interest payments of about 6.6) from the period following the delivery in year 1. The good is usable as soon as delivered. (For simplification, the costs of the supplier are not shown). Note also that the interest recorded will actually decrease throughout the period.

YEAR 1							
General government				Supplier			
Current account							
U		R		U		R	
P.5	100					P.1	100
		B.9	-100			B.9	+100



Financial account					
ΔA		ΔL	ΔA		ΔL
	F.4	+100			
			F.4	+100	
	B.9	-100			B.9 +100

Closing balance sheet					
A		L	A		L
	AF.4	100	AF.4	100	

YEAR 2

General government

Market unit

Opening balance sheet					
A		L	A		L
	AF.4	100	AF.4	100	

Current and capital accounts					
U		R	U		R
D.41	+6.6				D.41 +6.6
B.9	-6.6		B.9	+6.6	

Financial account					
ΔA		ΔL	ΔA		ΔL
F.2	-14	F.4	-7.4	F.2	+14
				F.4	-7.4
		B.9	-6.6		B.9 +6.6

Closing balance sheet					
A		L	A		L
	AF.4	92.6	AF.4	92.6	

**Example 3**

A government orders a military capital good for a value of 100 in year 1 that takes four years to be delivered. Government pays 10 each of the first three years then settles the remaining amount at time of delivery in year 4. The good is assumed to be usable as soon as delivered. For the sake of simplicity the suppliers' costs are not shown.

YEAR 1						
General government			Supplier			
Capital account						
ΔA		ΔL	ΔA		ΔL	
			P.52	+25	P.1	+25
Financial account						
ΔA		ΔL	ΔA		ΔL	
F.2	-10		F.2	+10		
F.81	+10				F.81	+10
		B.9	0		B.9	0
Closing balance sheet						
A		L	A		L	
AF.81	10				AF.81	10

YEAR 2						
General government			Supplier			
Opening balance sheet						
A		L	A		L	
AF.81	10				AF.81	10
Capital account						
ΔA		ΔL	ΔA		ΔL	
			P.52	25		
Financial account						
ΔA		ΔL	ΔA		ΔL	
F.2	-10		F.2	+10		
F.81	+10				F.81	+10
		B.9	0		B.9	0



Closing balance sheet

A		L		A		L	
AF.81	20					AF.81	20

YEAR 3

General government

Supplier

Opening balance sheet

A		L		A		L	
AF.81	20					AF.81	20

Capital account

ΔA		ΔL		ΔA		ΔL	
				P.52	25		

Financial account

ΔA		ΔL		ΔA		ΔL	
F.2	-10			F.2	+10		
F.81	+10					F.81	+10
		B.9	0			B.9	0

Closing balance sheet

A		L		A		L	
AF.81	30					AF.81	30

YEAR 4

General government

Supplier

Opening balance sheet

A		L		A		L	
AF.81	30					AF.81	30



Current and capital accounts

U		R		U		R	
P.5	+100			P.52	-100		
B.9	-100			B.9	+100		

Financial account

ΔA		ΔL		ΔA		ΔL	
F.2	-70			F.2	+70		
F.81	-30					F.81	-30
		B.9	-100			B.9	+100



II.6 Grants from the EU Budget

II.6.1 Background to the issue

1. The European Institutions make significant transfers from the EU budget to the Member States for various common policies, mainly the Common Agricultural Policy and the Structural Funds. The nature of these flows can be quite diverse, while the final beneficiaries may be non-government units (as it is the case for most transfers under the Common Agricultural Policy) or government units (as it is the case for a large part of transfers under the Structural Funds).
2. In practice there are two significant cases of EU-grants, which need specific attention for recording in national accounts. First, there are the grants paid from the European Agricultural Guarantee Fund (EAGF). These represent mainly subsidies paid to non-government units as final beneficiaries. Secondly, there are the grants paid in the context of the Cohesion policy, from the Structural Funds (and the European Agricultural Fund for Rural Development (EAFRD), Financial Instrument for Fisheries Guidance (FIFG), European Social Fund (ESF), European Regional Development Fund (ERDF) and the Cohesion Fund. These are mainly current or capital transfers paid to both government and non-government units. The current budget of the European Institutions also includes other expenditures. Among them a growing part is dedicated to supporting research and development in the EU. Usually the beneficiaries of this expenditure are non-government units, but in some cases they can also be government units, such as public universities.
3. Besides the above mentioned cases, three important grant types are worth mentioning: the Schengen-facility, the Transitional facility and the Cash-flow facility, which provide temporary financial assistance to Member States which more recently join the EU. In the case of the Schengen and Transitional Facilities, the activities for which they could be spent by Member States are defined by the EU. These activities relate to different common EU policies and initiatives (e.g. Schengen area, customs union, but also common agricultural policy national administrative structures), therefore the rules set out in this chapter relate also to these two facilities. The Cash-flow facility however is provided by the EU unconditionally and without any specification of areas for which they would need to be spent. The European Institutions do not monitor the way in which the beneficiary Member States uses these funds. The EU also does not have the right to stop their monthly payments or claim any amounts to be repaid to the EU budget, therefore the Cash-flow Facility has rather the nature of current transfers in the context of international cooperation as defined in ESA10 4.121-4.124.
4. Transfers are a category of distributive transactions where, often, only two parties are involved, the payer and the receiver. But, in the case of transfers paid by the European Institutions, there might be in practice three or even more parties involved. In addition, in general, payments transit through government even when the final beneficiaries are non-government units (generally in the context of a co-financing procedure, with the European Institutions supporting an investment effort by government but not substituting it).
5. In practical terms, the European Institutions make payments to final beneficiaries on the basis of information that is transmitted by national governments. Most payments are routed through accounts held by governments (some exceptions are observed only in the case of payments related to agricultural policy even if, in this case, national governments are not involved in the economic decision that determines the payment by the EU. The fact that the transfers are paid from EU-funds to specific accounts managed by government units in the countries is of course a positive factor as regards the availability of the information needed by national accountants.



In some countries only one account could be used for all payments from the Member State to the European Institutions, and from the European Institutions to the Member State. In such cases the impact of inflows from the EU (for example advance payments at the beginning of a multi-year programme) on the net borrowing should be correctly assessed.

6. Notwithstanding issues stemming from the divergence between data sources (EU budget, Balance of payments) that would need specific investigation while compiling national accounts, there are two important issues to be considered: first, the time of recording and, second, the classification in national accounts of the specific transaction.
7. Regarding the classification in national accounts of the specific transaction, this can take one or a mixture of the following forms:
 - subsidy (coded as D.3);
 - other current transfer (coded as D.7);
 - capital transfer (coded as D.9).
8. For reasons of comparability, as this classification may have consequences on some aggregates or balancing items in national accounts (but not on net borrowing/net lending, which is crucial for EDP purposes), transactions of a similar nature should be classified in the same (above-mentioned) ESA10 categories. This chapter does not provide guidance on this classification of transactions.
9. The rules relating to the EU budget are rather complex, and considerably differ in the case of agricultural payments (mostly subsidies) and in the case of cohesion policy payments of structural funds (mostly current or capital transfers), including prepayments, interim and final payments, and these payments are frequently made, as mentioned above, not to the final beneficiary but to a national government agency, which then pays the final beneficiary.
10. The Cohesion policy payments are granted in the framework of 7-year long programming periods. Once the compulsory national programmes are adopted, Member States receive advance payments for the whole period. During the programming period the European Institutions make interim payments to reimburse actual expenditure certified by the Member States up to a maximum of 95% (including the advance payment at the beginning of the programming period). The balance of 5% is paid on the closure of the programme once all documents are submitted and approved by the Institutions.
11. There is an issue concerning the time of recording, which might have a direct impact on deficit data. Once the expenditure by the final beneficiary has occurred (and generally with a very short delay), the managing authority sends to the European Institutions all relevant documents in order to be reimbursed for the appropriate (and legitimate) amount. The European Institutions authorise and undertake payments to beneficiaries only after checking compliance with the agreed rules and conditions, on the basis of supporting documentation that has been forwarded. It generally takes a maximum of two months between receipt of the supporting documentation and the authorisation of payment.
12. Under these conditions, imbalances are observed at the end of each year (mostly due to administrative delays), and there have also been cases of a disallowance or a cancellation of an EU transfer, for example in the case of fraud. A disallowance appears when a national government has paid subsidies or other transfers on behalf of the EU, but after an auditing process the EU does not approve part or all of the expenses and refuses to reimburse at least some of them.
13. Some aspects of these payments of EU-grants might have major effects on government deficit. It may happen that governments pay agricultural subsidies in advance (for example during September, year t) while the reimbursement from the European Agricultural Guarantee Fund (EAGF) is made only later (for example



during January year t+1). Similarly, the Structural Funds can make prepayments to governments at the beginning of a program period.

14. This chapter provides guidance for an homogeneous recording of EU-grants in Member States and neutralising the timing effect of EU related flows. As government is acting as an agent by delegation from the European Institutions while transferring the grants to the final receivers, the method in use influences not only the sector account of the rest of the world but that of government as well.
15. Eurostat published a guidance note on the appropriate recording of changes in inventories of Market Regulatory Agencies on its website (see also I.4 in this Manual). Therefore this topic is not analysed in this chapter.
16. Finally, this chapter does not deal with the contributions of Member States to the EU budget.

II.6.2 Treatment in national accounts

General rule

17. As a general rule, EU transfers shall have no impact on government deficit/surplus at the moment in which they are made. In other words, possible time lags observed between the revenue and expenditure flows, or in the financing of these transactions, should not result in national accounts in improving - or worsening - the net lending/net borrowing of the general government.
18. The treatment in national accounts depends on the final beneficiary (the unit undertaking the activity which qualifies for an EU grant) of these EU-grants. Grants received by a government unit as a final beneficiary are treated differently from those for which the final beneficiary is a non-government unit.

II.6.2.1 The beneficiary of the EU grants is not a government unit

General rule

19. In case the final beneficiary is not government, the transfer is recorded in the final beneficiary's accounts as appropriate according to ESA10 rules, and the related transactions are exclusively recorded in the financial accounts of general government, without any impact on government deficit/surplus.
20. In national accounts, these transfers must be recorded as distributive transactions directly between the European Institutions (uses) and the non-government beneficiaries (resources). For subsidies (D.3), the amounts are recorded in the accounting period when the transaction or the event (production, sale, import, etc.) which gives rise to the subsidy occurs. This is a general ESA10 (4.39) rule that should be met as far as possible. However, in some very specific and exceptional cases, it may be difficult to collect information on the precise period when the relating economic activity took place. By convention, the time of the cash payment (either from the European Institutions or from government as an advance – see below) could be considered as a proxy measurement of the period for recording on an accruals basis. Statistical authorities must however make all possible efforts to cover with appropriate information, or adequate estimation methods, most of the transactions where the time lag between the economic activity and the payment could lead to an incorrect picture of the government balance.
21. For other current transfers (D.7), the amounts are recorded in the accounting period in which the obligation to pay arises (ESA10 4.123 "the time the regulations in force stipulate the transfers are to be made in the case of obligatory transfers, or the time the transfers are made in case of voluntary transfers.").
22. For capital transfers (investment grants, D.92), the amounts are recorded in the period when "the payment is due to be made" (ESA10 4.162).
23. *Example:* the European Institutions make a payment, at the time when due, in February of year t+1 to a non-government unit relating to the fourth quarter of year



t. If it is a subsidy, it should be recorded in the accounts of year t as a resource of the non-government unit and as a use of the “Rest of the World”. If it is a capital transfer, whatever the period in which the capital expenditure took place, it should be recorded as revenue of the non-government unit in the year t+1, when the payment from the European Institutions is due.

Specific case of government advance

24. Frequently, government makes advanced payments to a non-government unit that is entitled to receive transfers from the European Institutions (mostly as far as farmers are concerned). This is made for the purpose of reducing the financing burden of the beneficiaries, and to compensate them at a time close to the one in which they carried out the relevant economic activity.
25. Any advanced payment in this respect, whatever its underlying transaction in national accounts (D.3, D.7 or D.9), must be recorded as a financial transaction (creation of a financial asset of government and a matching liability of the Rest of the World in the category AF.8) at the time it is made by government, or if a commitment accounting system is used, at the time the payment is ordered by the competent authority.
26. With this treatment, there is no impact on government deficit or surplus because the transfers from the EU institutions are not considered as national government expenditure but as EU expenditure. The only expenditure incurred by the government consists of the financing costs of the financial advance.
27. *Example:* the government makes a payment on behalf of the EU to a non-government unit in September of year n. This is recorded in the same accounting period as revenue of the non-government unit received from the Rest of the World (it is not to be considered as government expenditure), according to the nature of the transaction (D3, D.7, D.9). This payment by government gives rise to a financial claim on the European Institutions (AF.8). Following the verification procedure, the European Institutions repay government in January t+1. This repayment liquidates the government claim at the time it takes place. Thus a government payment to a non-government unit on behalf of the EU is recorded as a financial transaction without any impact on government net lending/net borrowing.

I.6.2.2 The beneficiary of the EU grants is a government unit

28. A government unit is the final beneficiary of the EU transfer if the transfer covers an expenditure carried out by that government unit, for any purpose: social assistance, training, education, or increase in fixed assets held by government. Of course the government unit that takes the economic decision (project manager) must be distinguished from the government unit that receives and reallocates the funds from the EU (cash manager). This is relevant for national accounts if they are in different sub-sectors.

General rule

29. In general, the time of recording of government revenue from the EU is the same time as the national government expenditure. This is done for practical reasons to ensure that there is no impact on government deficit/surplus arising from these transactions.
30. *Example:* government makes expenditure in October of year n for an amount of 100 under a given project. Government then sends the appropriate documents to the European Institution in November of year t. Government records in October a transfer from the Rest of the World as government revenue, coded according to the nature of the transaction (which does not influence the time of recording). Government records as a counterpart a claim on the EU in its financial account (F.8). The European Institution then reimburses 100 in February t+1. The claim is liquidated at this time.



31. If the European Institution decides at a later date not to reimburse the government on an individual claim and if the time lag is short (within the year, as normally the case), the past accounts may be revised to remove the government revenue and other accounts receivable or a part of it.

Specific case

32. In some cases it might happen that the time of expenditure differs considerably from the time of submission of claims to the European Institutions, since at the time of expenditure the intention of submitting the claim was not known. In this case, the time of submission of claims might substitute for the time of expenditure for the purpose of defining the time of recording, depending on the availability of information on the expenditure, the amount involved and the size of the time lag between the time of expenditure and the time of the submission of claims. Nevertheless, the time of submission of claims can be used as the time of recording only in justified cases.
33. In accordance with paragraph 32, the time of recording is the time of submission of claims, when no reliable information on the date of expenditure is available; or, when amounts involved are very small; or, when amounts involved are big and the time lag between the moment of expenditure and the submission of claims is very small (flexibility option). In order to facilitate the decision about the time of recording for this specific case, a decision tree is placed at the end of this chapter.
34. After sending the claims, in the expectation of the settlement by the European Institution, a counterpart financial transaction of government revenue is recorded in the form of other accounts receivable (a claim on the European Institutions), codified as AF.8. This is liquidated at the time of reimbursement by the European Institutions.

II.6.2.3 Initial advance payment by the European Institutions

35. All payments received by governments from the European Institutions at inception of a multi-year programme period are treated as financial advances (AF.8 government liability). Thus, there is no impact on government deficit/surplus.
36. This liability is unchanged until total payments by the European Institutions have reached a ceiling calculated as 95% of the total amount agreed by the European Institutions in all the multi-year periods less the amount of the initial advances. Then, until a ceiling percentage is reached (usually 95%, since in principle the European Institutions keep 5% of the total agreed), the reimbursement of final beneficiaries' expenditure is recorded as revenue for the same amount, with a counterpart financial transaction in the form of a reduction in the advance received by government.
37. The remaining part of the expenditure of the project (5%) has to be pre-financed by the final beneficiary (and treated as other accounts receivable, F.8) and the EU will repay these expenditures only later (at which time the other accounts receivable will be neutralised).
38. If at the end of the multi-year period, the total government expenditure does not reach the ceiling percentage of the total agreed amount for the period, the part of the advance not "consumed" by government is reimbursed to the European Institutions, with no impact on government revenue, and with an impact only in the financial accounts.

II.6.2.4 Measures taken to deal with deficiencies in Member States

Disallowance

39. It might happen that the European Institution decides that part of the amount paid to final beneficiaries by government on behalf of the EU was not justified or that a penalty has to be paid by the Member State (e.g. for agricultural overproduction). In this case the European Institutions will place a sanction either by withholding the



reimbursement in the period following the payments to final beneficiaries or deducting the amount from a future payment. There are three main issues: the time of recording, in which sectors the entries should be made, and what to record.

40. The time of recording is when the Commission takes the decision of partial reimbursement of the amounts paid by the paying agencies of Member States to final beneficiaries.
41. The counterpart sector depends on whether the final beneficiary is allowed to keep the payment or not, or, in the case of sanction for overproduction, whether the government is allowed to pay on behalf of the penalised sector or not (for instance in the case in which it would not be considered as a distortion of competition in the EU Internal Market).
42. If the beneficiaries should have been definitively able to acquire the advanced payment by government (government would be allowed to complete the aid from the EU), then at the time of the European Institution decision on the final reimbursement (or non-reimbursement), the original amount must be recorded as a capital transfer (D.9) from government to the final beneficiary, and, at the same time, as transfer from the final beneficiary to the ROW (Rest of the World) sector (European Institutions).
43. If the advanced payment by government cannot be kept by the beneficiaries (government would not be allowed to pay more than what is defined by the EU rules), two cases must be distinguished.
44. If the final beneficiary is able to pay back the advanced amount to the government, a repayment must be imputed from the final beneficiary to the ROW sector for the repaid amount, and the repayment amount enters the financial accounts of the government, at the time of the European Institution decision.
45. If there is no full repayment from the final beneficiary, and the European Institution penalises the government, the government must record a current transfer from general government to the ROW sector (European Institutions), at the time of the European Institution's decision.

Interruption of payment deadline, suspension of payments, financial corrections

46. It might happen that the Commission interrupts the payment deadline for a maximum period of 6 months (officially called interruption of the payment deadline), in order carry out additional verifications on the certified statement of expenditure (a claim sent to the EU). In the recording of national accounts this should have no effect on the recording: the Member State would record revenue and claim (F.8) against the EU, however it might take more time to receive the money (F.2) and extinguish the F.8.
47. The Commission may also suspend all or part of interim payments at the level of priorities or programmes in case there is a serious deficiency in the management or control systems, there is serious irregularity which has not been corrected or there is a breach of its obligations by the Member State (suspension of payments). In case the Member State has taken the necessary measures (normally within 2 months), the suspension is lifted. Where the required measures are not taken by the Member State, the Commission may adopt the decision to cancel all or part of the community contributions to the operational programme (financial corrections).
48. The suspension of payments, similarly to the interruption of payment deadline has no immediate consequence on the recording in national accounts. However, if the suspension of payment leads to financial correction (meaning the cancellation of funding from the EU), this has to be reflected in national accounts, similarly to the case of disallowances in paragraph 39. It must be noted that financial corrections can come to existence even without the suspension of payments.
49. The time of recording of financial corrections linked to past expenditures is the earlier of (1) the acceptance by the Member State of a financial correction proposed by the EU, or, (2) the final Commission decision. If the financial correction also



includes the cancelation of funding to future projects, then the time of recording is the time of the actual future expenditure.

50. The counterpart of the government expenditure is the Institutions and bodies of the European Union (S.212).

II.6.3 Rationale of the treatment

II.6.3.1 Non-government unit, as beneficiary

51. Government is not the final beneficiary because either the subsidy is linked to the economic activity of units outside the government sector, or the transfer obviously supports directly the income of a non-government unit, or the transfer covers a capital transaction that is devoted to finance all or a part of the acquisition of non-financial assets by a non-government unit. This includes the case of payments to regulatory units that have been classified as market producers, outside the general government sector (see Part I of this Manual). This is mainly the case for the Common Agricultural Policy but it could also concern some payments from other Structural Funds (notably in the case of the Social Fund and the Cohesion Fund).
52. The treatment follows the ESA10 rules as regards time of recording, based on an “accrual” approach. Subsidies are recorded when the transaction or the event (production, sale, import, etc.) which gives rise to the subsidy takes place (ESA10 4.39). The event might be for example agricultural production or export of goods. For other current transfers (in cash), the time of recording is the time the regulations in force (or contractual agreements) stipulate the transfers are to be made (ESA10 4.123). Investment grants in cash are recorded when payment is due to be made to the unit recording the GFCF expenditure in its own accounts (ESA10 4.162).
53. In practice, amounts to non-government final beneficiaries usually transit via government accounts. However, these flows must be recorded only in the financial accounts of government. This is because the ESA105 4.122b) establishes that current transfers made by the European Union to resident market producers are shown as subsidies paid by the rest of the world. A similar principle is established in ESA10 4.152 for investment grants.
54. As far as the time of recording of the transactions is concerned, there might be some confusion between the moment where the obligation is recognised and the time at which the European Institutions will pay. In practical terms, nevertheless, once the European Institutions have taken the decision to pay, there is usually only a very short delay before the funds are effectively transferred. In addition, it seems that for some countries the information is available in direct form only on a cash basis in reporting systems.
55. In the case of an advance by government on behalf of the EU to a non-government beneficiary, from an economic point of view the treatment described in paragraph 24 is justified because the financial position of the final beneficiary is affected at the time when government is paying and it is this, which is relevant for its economic behaviour. Government is here acting “on behalf” of the European Institutions. Of course, in national accounts one must record a financial claim of government on the European Institutions.
56. In practice, the amount paid to the beneficiaries by government will be different from the final repayment only in exceptional cases, mainly due to errors and fraud activities. However, it might happen more frequently that the European Institutions ask for additional documentation such that the reimbursement is delayed.

II.6.3.2 Government unit, as final beneficiary

57. Government unit as final beneficiary can occur in various EU schemes. It is notably the case for Regional Development and Social Funds where a government unit is



managing a project under an agreement with the European Institutions but with certain autonomy as regards the completion of the project. The nature of national government expenditure may be of various types: P.2, P.5, P.7, D.1 and, possibly, other distributive transactions (D.3, D.7, and D.9). It seems that government may, in very specific cases, also acquire shares.

58. Once the expenditure by government has occurred (and generally with a short delay), government sends to the European Institutions all relevant documents in order to be reimbursed for the appropriate (and legitimate) amount. However, in exceptional cases the intention of government of submitting the claims is not known at the time of expenditure.

Specific case when the intention of submitting the claim is not known at the time of expenditure

59. Only in this latter case, in order to better reflect economic reality, it might be more appropriate for practical reasons to record the revenue for government at the time government sends the documents to the European Institutions. The conditions under which this may take place are illustrated in the flow chart in Annex I.
60. The treatment envisaged here is based on the experience clearly showing that the European Institutions pay almost always what is effectively declared. Effectively, it is extremely rare (and usually for very small amounts in comparison of the total of the flows) that the EU does not reimburse government.
61. In the context of the EU agreements, government expenditure by definition must fulfill precise requirements and governments would not try to claim undue revenue. In addition, the European Institutions have imposed domestic controls such that misusing of the funds, non-completion of the program, frauds, etc. are rather exceptional. Nevertheless if the European Institutions do not reimburse government – given that the time lag is normally short – a suitable backward revision of government revenue from the European Institutions would be appropriate.
62. The treatment proposed is also in compliance with ESA10 4.162 where it is said that investment grants in cash are recorded when the payment is due to be made. The "due to be made" reflects the expectation of government of reimbursement. If, at the time of expenditure, there was no expectation of the reimbursement, the time of recording shall not be the time of expenditure, but when the expectation arose, that is when the claim was submitted. This corresponds to the principles laid down in the chapter.

Specific case when the precise amount of the expected reimbursement is not known at the time of expenditure

63. If the expectation arose at the time of expenditure on the project but the precise amount (the percentage of the amount of expenditure) of the expected reimbursement was not known, a prudent estimate must be made for the expected initial payment by the European Institutions

II.6.3.3 Initial payment by the European Institutions

64. The initial payment by the European Institutions may only be treated as a financial advance in national accounts, with no impact on government deficit or surplus.
65. This treatment is justified by the fact that the EU rules stipulate that it is only when government expenditure has been made that government may ask for the reimbursement by the European Institutions, under determinate and set conditions. Therefore, the advance cannot be recorded as revenue until the occurrence of the corresponding expenditure.



II.6.4 Accounting examples

1. The final beneficiary is not a government unit (case of government advance)

A non-government producer is entitled to receive 1000 from the European Institution as investment aid in year t. It receives this amount from the national government in year t but the European Institution makes a late reimbursement payment of 1000 in year t+1.

Year t

General government				Rest of the World			
Non-financial account							
ΔA/U		ΔL/R		ΔA/U		ΔL/R	
						D.9	-1000
				B.9	-1000		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	-1000					F.8(GG)	+1000
F.8(ROW)	+1000					B.9f	-1000
		B.9f	0				
Closing balance sheet							
A		L		A		L	
AF.8	1000					AF.8	1000

Non-government producer

Capital account

ΔA		ΔL	
		D.9	+1000
B.9	+1000		

Financial account

ΔA		ΔL	
F.2	+1000		
		B.9f	+1000



Year t+1

General government				Rest of the World			
Opening balance sheet							
A		L		A		L	
AF.8	1000					AF.8	1000
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	+1000			F.2	-1000		
F.87	-1000					F.8	-1000
		B.9f	0			B.9f	0
Closing balance sheet							
A		L		A		L	

2. The final beneficiary is a government unit

A government unit has spent 2000 (here in the form of gross fixed capital formation) in year t in the framework of a project co-financed to the extent of 50%. Appropriate documents are sent to the European Institution but the latter reimburses 1000 only in the course of the following year t+1.

Year t

General government				Rest of the World			
Capital account							
ΔA		ΔL		ΔA		ΔL	
P.51	2000	D.9	+1000			D.9	-1000
B.9	-1000			B.9	-1000		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	-2000						
F.8	+1000					F.8	+1000
		B.9f	-1000			B.9f	-1000
Closing balance sheet							
A		L		A		L	
AF.8	1000					AF.8	1000



Year t +1

General government				Rest of the World			
Opening balance sheet							
A		L		A		L	
AF.8	1000					AF.8	1000
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	+1000			F.2	-1000		
F.8	-1000					F.8	-1000
		B.9f	0			B.9f	0
Closing balance sheet							
A		L		A		L	

3. Disallowance

3.1. Agricultural allowances when the government is allowed to complement the original payment (paragraph 30)

Government sends a claim of 1000 to the European Institutions for reimbursement of subsidies paid in November of year t, but the European Institutions only pay 800 in January of year t+1, as 200 is withheld as penalty relating to inappropriate claims of earlier periods (t-1 or earlier). The original subsidy is kept by the final beneficiary.

Year t

General government				Rest of the World			
Non-financial account							
ΔA/U		ΔL/R		ΔA/U		ΔL/R	
						D.3	-1000
B.9nf	0			B.9nf	-1000		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	-1000					F.8(GG)	1000
F.8(ROW)	+1000					B.9f	-1000
		B.9f	0				



Closing balance sheet

A		L	
AF.8	1000		

A		L	
		AF.8	1000

Non-government producer

Non-financial account

$\Delta A/U$		$\Delta L/R$	
		D.3	+1000
B.9nf	+1000		

Non-government producer

Financial account

ΔA		ΔL	
F.2	+1000		
		B.9f	+1000

Year t+1

General government

Rest of the World

Opening balance sheet

A		L	
AF.8	1000		

A		L	
		AF.8	1000

Non-financial account

$\Delta A/U$		$\Delta L/R$	
		D.9 (final ben)	-200
B.9nf	-200		

$\Delta A/U$		$\Delta L/R$	
		D.9 (final ben)	200
B.9nf	200		

Financial account

ΔA		ΔL	
F.2	+800		
F.8	-1000		
		B.9f	-200

ΔA		ΔL	
F.2	-800		
		F.8	-1000
		B.9f	200

Non-government producer

Non-financial account

$\Delta A/U$		$\Delta L/R$	
		D.9 (govt)	200
		D.9 (ROW)	-200
B.9nf	0		

Non-government producer

Financial account

ΔA		ΔL	
		B.9f	0



3.2 Agricultural allowances when the government is not allowed to complement the original payment and the final beneficiary is not able to pay back the full amount (paragraph 33)

Government sends a claim of 1000 to the European Institutions for reimbursement of subsidies paid in November of year t, but the European Institutions only pay 800 in January of year t+1, as 200 is withheld as a penalty relating to inappropriate claims of earlier periods. The original penalty cannot be kept by the final beneficiary, but the final beneficiary is not able to pay it back.

Year t

General government				Rest of the World			
Non-financial account							
$\Delta A/U$		$\Delta L/R$		$\Delta A/U$		$\Delta L/R$	
B.9nf	0			B.9nf	-1000	D.3	-1000
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	-1000					F.8	+1000
F.8	+1000					B.9f	-1000
		B.9f	0				
Closing balance sheet							
A		L		A		L	
AF.8	1000					AF.8	1000



Non-government producer

Non-financial account

$\Delta A/U$		$\Delta L/R$	
B.9nf	+1000	D.3	+1000

Financial account

ΔA		ΔL	
F.2	+1000	B.9nf	+1000

Year t+1

General government

Rest of the World

Opening balance sheet

A		L		A		L	
AF.8	1000				AF.8	1000	

Non-financial account

$\Delta A/U$		$\Delta L/R$		$\Delta A/U$		$\Delta L/R$	
D.8(ROW)	200			B.9nf	200	D.8(GG)	200
B.9nf	-200						

Financial account

ΔA		ΔL		ΔA		ΔL	
F.2	+800			F.2	-800	F.8	-1000
F.8	-1000	B.9f	-200			B.9f	200



II.6.5 Keywords and accounting references

EU subsidies	ESA10, 4.31
Subsidies (time of recording)	ESA10, 4.39
Current international corporations	ESA10, 4.123
Other capital transfers (time of recording)	ESA10, 4.166
Other accounts AF.8	ESA10, 5.230-244



II.7 Court decisions with retroactive effect

II.7.1 Background to the issue

1. When there is controversy about claims/liabilities, there might be a need for a Court decision - or any other accepted way of settling the dispute (Arbitration) - to impose a settlement of the dispute and state an incontrovertible right of the claimants against government to a given amount. Such judgment must be definitive and thus directly applicable by the parties, which would have exhausted all the ways of appeal (recourse).
2. Sometimes, amounts could have been due by the government for several years and not paid because of a disagreement. Legal actions may take a long time, considering notably the different levels of recourse that can be activated by the parties.
3. The issue is, thus, at what time these claims and liabilities should be recorded as, from a theoretical point of view, this could take place:
 - at the time they were accruing or supposed to be due, or
 - at the time the Court decision settles the dispute and fixes the amounts irrevocably.

II.7.2 Treatment in national accounts

4. ESA10 20.189 states that, when a Court of Justice rules, as a definitive judgement, that a compensation must be paid, or a transaction reversed, the time of recording of the expenditure or revenue is when the right of one party (and the obligations of the counterpart) is irrevocably established, if the amount to be paid (or retroceded) is precisely fixed. This may be at the time of the decision taken by the Court when it is immediately enforceable. The obligation to pay for government may be set up after a time lag. In some cases the Court has explicitly mentioned in its decision the fractioning of the payments due by or to government.⁸¹
5. If the Court has only set a principle of compensation without fixing a precise amount, letting it to another decision (for instance another Court) or when the eligibility for compensation must give rise to further checks/validation, notably under the form as a specific application by the plaintiffs (as it may be the case in the context of "class actions"), then the time of recording the expenditure or revenue is only the time when the amount of the claims/obligations is definitively determined with certainty.
6. To be implemented, the decision of the Court must be considered as "final", i.e. when it is no longer possible for parties to lodge an appeal. This includes the different domestic judicial levels, the instances of the EU Court of Justice and in some cases private "Arbitrage Courts". It may also apply if the parties in the dispute renounce, openly or de facto, to any appeal (which normally must be expressed under strict deadlines). It may be the case that a Court ruled, as definitive decision, a right to compensation, but has left to lower courts to solve the dispute. Such new recourse might be automatic, de jure, but it may also result from a voluntary action. In this case, the time of recording would be at the time of the decision (s) of these courts, acting as second resort.
7. In any case, the amount should be recorded in F.8 accounts/payable receivable until the time of actual payment in cash. Amounts should not be distributed over the

⁸¹ The Court may have fixed an amount which is deemed to be close to the final amount, but not necessarily identical, for technical reasons (but excluding cases covered in § 5). The potential gap should be analysed and if it is very small, the full amount could be recorded immediately, with further slight revisions in the future.



past periods when they accrued, except for that part of the claims that were not the subject of controversy.

8. A simple postponement of payments by the government without government disputing the obligation to pay should not prevent recording the payments at the time they are due (see section on “Changes in the due for payment dates”) with entries in F.8 accounts / payable receivable for the amounts accrued but not yet paid.
9. The amount of any compensation is generally recorded as a capital transfer D.99 (it relates to amounts that would have accrued over a number of years) but a part could also be considered as fines and penalties (D.759).

II.7.3 Rationale of the treatment

10. A distributive transaction – and more generally, claims and liabilities – may be recorded in the accounts when established with sufficient certainty, when known and accepted by both parties (even in cases where imposed by law, such as for taxes and social contributions).
11. In some cases – when a new situation is created (new rights and obligations, for instance) - the subject of controversy and dispute can be resolved only by a Court decision which creates the obligation to pay, and either specifies the exact amounts to be paid or indicates the conditions in which the latter would be fixed. The date of the obligation to pay is therefore the time when the transactions are to be recorded.
12. This is true also for any penalty or interest charge awarded by the Court.



II.8 Keywords and accounting references

Accrued interest	ESA10, 4.50
Arrears	ESA10, 5.242
Discounted bonds	ESA10, 4.46, 5.96
General accrual principle	ESA10, 1.101
Index-linked securities	ESA10, 4.46 and 5.100
Instruments denominated in foreign currencies	ESA10, 6.64
Interest and financial transaction	ESA10, 5.41-44
Mutual fund shares	ESA10, 5.160-166
Nominal holding gains	ESA10, 6.27-36
Social contributions	ESA10, 4.96
Taxes on income and wealth	ESA10, 4.80-82
Taxes on production (other)	ESA10, 4.26, 4.27
Time of recording interest	ESA10, 4.50
Time of recording of social benefits:	ESA10, 4.106

III

**General Government and corporations
controlled by government**



Part III General Government and corporations controlled by government

III.1 Overview

1. The classification of a transaction between government and a public corporation can be complicated because of the different roles played by government in the economy. The transaction can arise for several different reasons due to the different objectives of government activity. These activities include Government's role:
 - as the owner of financial assets:
 - seeking a return on investment, similarly to a long-term investor;
 - managing its treasury.
 - acting for public policy purposes, supporting economic and social policy:
 - paying subsidies and investment grants;
 - using public units to help deliver public interest policies – such as for public transport;
 - restructuring public units.
 - implementing its budget:
 - levying taxes and social contributions;
 - ensuring the optimal financing;
 - facing pensions obligations.
2. In borderline cases, when determining the classification of a transaction, it is necessary to consider which role the government is playing in the transaction and apply a recording that recognises the economic substance of the transaction if this differs from its legal form. In some cases more than one role can apply and it is necessary to consider which role is more significant for the purpose of recording most accurately the economic reality of the transaction.
3. Some activities are undertaken by government and never by market units: government does not act only as a manager of assets seeking a financial return. It may also manage the assets in a way to support economic activity and meet social objectives. Also, the government is the only agent in a position to make massive transfers to other agents of the economy.
4. This means that flows to and from public corporations are not always recorded in a symmetrical way. For example, an unrequited payment recorded as an "investment grant", a non-financial transaction ("something for nothing", as stated in ESA10, chapter 1) might contribute to a significant improvement of the enterprise's wealth in the mid-term. If the public enterprise would then make an exceptional payment out of its own funds, this payment might be recorded as a withdrawal of equity (partial liquidation of assets).
5. National accountants consider carefully the economic context of units and transactions for classifying them. However, it is important sometimes to look through the legal form of an institutional unit or of an economic flow to report the economic reality. This applies to both the classification of units and the classification of flows.

Examples are given below.

 - a) A unit might undertake some activities that are typical of government units but the unit might not be included in government in public accounts. Such activities might be for example: making unrequited payments to other units; charging levies on particular industries; securitising poor quality loans; giving guarantees



- on lending; building public infrastructure, and so on. The very first question is whether the unit should be classified to general government (even if it is called a corporation or not normally considered to be part of government).
- b) If the classification as a market unit is correct, the next question is whether it is necessary to impute equal and opposite payments through government (also known as rerouting) to show that some of the unit's transactions are carried out on behalf of government. This could apply for example to any unrequited payments (such as subsidies) to other units: these would be recorded as payments by government with an adjustment to other transactions between the unit and government to balance the accounts.
 - c) Rerouting can be appropriate in cases of indirect privatisation when the proceeds are kept by a public corporation to fund the unrequited payments to other units (Chapter V.2 discusses this), or to fund loss-making activities within the unit under the instructions of government as part of its economic and social policy (corporations with some non-market activity). In these cases the payments rerouted through government are shown to be funded by payments from the public unit to government in respect of the indirect privatisation.
 - d) When classifying a transaction in national accounts, one is not necessarily tied by the denomination the transaction may have either in public accounts or in the book keeping of enterprises. For instance, in some specific cases, what is called a tax in the tax legislation or a dividend in corporation accounts might be more appropriately recorded in national accounts as a financial transaction.
 - e) On the other hand some flows having the legal denomination of equity injections may be classified, in national accounts, as capital transfers either because no economic return (such as dividends) is actually expected from the equity injection or because it is linked to the acquisition of a fixed asset (which would make it an investment grant). In this respect an important distinction has to be made between flows channeling income from public corporations to government and other kinds of payment. The first ones undoubtedly have to be classified as non-financial transactions. The second category includes in particular large payments made out of the proceeds of sales of assets by public corporations. They have to be classified as financial transactions. See the decision tree at III.2.2.
 - f) In general, the principles concerning transactions between general government and public corporations also apply to transactions between Government and private corporations and between Government and other governments. Some private companies might be "too big to fail", or perform some crucial role in the economy such as owning and operating vital infrastructure and utilities, so that Government is forced to continue the existence of such companies when dealing with them. In such circumstance, payments to these companies that are presented as financial (injections of capital or equity) might in economic terms be grants.



III.2 Capital injections into public corporations

III.2.1 Background to the issue

1. Analysts in the media commonly refer to “capital injections” made by the government into a public corporation, when some significant financial support is provided to the corporation in an attempt to capitalise or recapitalise the corporation.
2. The generic expression “capital injection” is used in the ESA10 and in the SNA2008 and, like in the media, it may cover many types of payment from government to a public corporation which in national accounts are classified in different categories, as capital transfers or as financial transactions. For example, the terminology covers transactions that might be described in public accounts as investment grants, capital grants, commutation grants, loans, equity injections, acquisition of share capital. Other forms of support, like debt assumption, cancellation and rescheduling, may also be considered as capital injections (see chapter VII.2).
3. The payment from the government commonly referred to as a “capital injection” should be recorded in the national accounts as either:
 - a financial transaction: this would be in the general case an addition to equity – or, in other cases, to loans or securities other than shares - recorded in the financial account, with no impact on the government deficit, or,
 - a non-financial transaction: assuming that this is an unrequited payment, it would be a capital transfer, government expenditure with a negative impact on net lending/ net borrowing.
4. In some rare cases, it could be a combination of the two (see the section “Treatment in national accounts”).
5. Capital injections are most often made in cash, but can also be made in kind. This chapter deals with injections in cash. Injections in kind are the subject of another chapter (“Capital injections in kind” – chapter III.4). Injections in kind are very specific and do not fulfill some of the characteristics of injections in cash – those recorded as financial transactions - notably a certain degree of freedom of use by the corporation of the funds injected (see also the “Rationale of the treatment”).
6. This chapter covers only the case of a transaction, i.e. an economic flow that results from the interaction between two institutional units by mutual agreement (or an action within an institutional unit that it is useful to treat as a transaction - see ESA10 1.66). Therefore, it excludes the case of corporate restructuring, involving a restructuring of assets and liabilities or reclassification of units.
7. This chapter deals with capital injections by government into public corporations (owned, even partially, and controlled by general government), including the central bank. The case of capital injections into public quasi-corporations is covered in chapter III.3. It may also apply to capital injections in corporations not controlled by government but where the latter had or gets a rather significant influence after the capital injection (bigger than any other private shareholder).
8. Government carries out also capital injections in financial institutions, public or private, notably in the context of the financial crisis, in some cases for significant amounts. The basic principles for the classification of such operations are the same. However, they need specific consideration as the banking sector (together with the



Insurance sector) is subject to specific regulations (such as minimum capital adequacy), which is not the case for non-financial corporations.⁸²

III.2.2 Treatment in national accounts

III.2.2.1 General principle

9. The principle in the general case, also referred to as "the capital injection test", is the following:

- When the government, acting in the same capacity as a private shareholder, provides funds while receiving contractually something (usually financial instruments, such as shares or debt instruments) of equal value in exchange and expecting to earn a sufficient rate of return on its investment, mostly in the form of dividends and interest, and a higher value of the financial instrument which represents the government's property rights on the corporation, the capital injection is to be recorded as a financial transaction in shares and other equity (see also box 2 in the section 3. Rationale of the treatment: "a sufficient rate of return"). In national accounting terms, the financial transaction has no impact on the government net borrowing/net lending.
- Often government does not manage funds to acquire profitable assets (like private shareholders do) but to pursue social or collective policy objectives for which private capital might not be available. Acting this way is a management of assets for public policy purposes. Thus, the capital injection is to be recorded as a capital transfer if the funds are provided in one of the following cases:
 - The funds are provided without receiving anything of equal value in exchange;
 - The funds are provided without expecting a sufficient rate of return on investment;
 - The funds are provided to a corporation that has shown a recent series of losses.

10. A capital injection that is recorded as a capital transfer (a non-financial transaction) has an impact on the government net borrowing/net lending (B.9; increasing the deficit or reducing the surplus). A possible change of government's net worth will depend on whether the capital injection gives rise to a revaluation of the corporation's assets (the difference between the assets' valuation on a "going concern basis" and a "non-going concern basis"). The value of the government's equity assets will increase accordingly. Considering the specificity of government, a sufficient rate of return expected on funds invested (see also box 2 in the Rationale of the treatment) would have to be at least equal to long-term (10 years)⁸³ government bonds rates⁸⁴, or, in some specific cases (notably when government invests together with other investors, by the risk adjusted minimum rates of return

⁸² See: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/FT%20-%20Eurostat%20Decision%20-%209%20July%202009%203%20final.pdf
http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Note_on_statistical_implications_of_summits-updated-12_A.pdf
http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Impact_bank_recapital_on_gov_fin_v20130514.pdf

⁸³ In most Member States, the average maturity of long-term debt is close to 10 years.

⁸⁴ It may be estimated as an average over several months when there is high volatility on markets and/or exceptional disruptions.



(usually referred to as ROE) normally requested by private investors on similar equity investments in the same sector of activity.⁸⁵

11. Generally, the following provisions can only be implemented on a case-by-case analysis, based on the information available. As an operational guidance, the following key questions must be examined, in order to make this analysis:

- Is government acting alone (possibly together with one or more public corporations, for a minor part) or jointly with private shareholders (as defined in ESA10 chapter 2) participating in the injection?
- Has the public corporation (and possibly, in some cases, the private corporation⁸⁶) accumulated net losses over several years, or during the last exercise (referred to as “one-off losses”, by opposition to “exceptional losses”), as recorded according to national accounts (e.g. net saving), according to generally accepted accounting principle, or based on other evidence, such as the negative trend of the corporation's own funds?⁸⁷
- Is it likely that government will receive a sufficient rate of return on its investment?

III.2.2.2 There are no private shareholders investing

III.2.2.2.1 The corporation has accumulated net losses or made exceptional one-off losses

12. When the corporation has accumulated net losses or, made “one off” losses, as a general rule, the capital injection is treated as a non-financial transaction for its full amount.

13. Special case (partition of the transaction): when a capital injection exceeds the net amount of losses and

- a) government can provide evidence that these funds in excess will receive a sufficient rate of return (for example, they are specifically used to make further investment in already profitable operational areas of the corporation's activity, as shown by past results, or in the context of a forthcoming privatisation of the business), or
- b) there is an obvious fundamental restructuring of the corporation, in order to prevent the occurrence of new losses and to return to sustainable profitability after the complete implementation of the new business plan, and evidence that government should benefit from a sufficient return on its new investment. There should be a large consensus that the restructuring will be efficient. This would not be the case if the return on the new investment is still uncertain (the restructuring plan is largely considered as insufficient as regards the main sources of losses and/or the restoring of profitability depends substantially on factors not under the control of the corporation), such that it would take time to offset the accumulated losses.

14. In this special case, the capital injection is treated as a non-financial transaction up to the limit of the losses and as a financial transaction beyond this amount.

15. For this special case, an operational guidance might be the rating - or change in rating - of the debt (notably long-term debt), the significance of management re-organisation, the shift to new activities, the competitiveness on the market etc.

⁸⁵ In any case, the calculation of the rate of return must be after deduction from the corporation's revenues of transfer payments from government (see box 2).

⁸⁶ However, if the private investors inject equity capital strictly under the same conditions as government, this will presume that the test on return of investment is successful. (See below §22)

⁸⁷ Exceptional losses are large losses recorded in only one accounting period in the business accounts of a corporation, arising from an exceptional event not “under the responsibility” of the corporation, i.e. independent of its own business model and/or its past investment policy. These exceptional events hit a large number of corporations, whatever their own financial and economic situation, generally simultaneously in several countries (spill-over effects).



III.2.2.2.2 The corporation has not accumulated net losses

16. Normally, this means that, on a regular basis, the corporation makes profits, either distributed or reinvested.
17. Where government is acting similarly to a private shareholder, meaning that, when it provides funds, it receives in exchange financial assets and expects a sufficient rate of return on its investment (in the form of dividends and higher value of the financial instrument representing the government's property rights in the corporation),
18. The capital injection is recorded as a financial transaction in shares and other equity for its full amount.
19. Where the capital injection is undertaken for specific purposes relating to public policy or in the context of a fundamental change in the conditions in which the activities are carried out and which are imposed by government, the consequence on future profitability of the new government investment must be carefully checked. In such cases:
 - If an expected sufficient rate of return were still very likely, the capital injection would be treated as a financial transaction for its full amount.
 - If a sufficient rate of return were unlikely, the capital injection would be treated as a non-financial transaction for its full amount.
20. Some public corporations may be subject to statutory provisions so that their revenue can equal but not exceed their total costs (this could be the case of market NPIs, classified in the non-financial corporations sector, for instance). By definition, these cannot provide a market return, and government, when investing in such units, is not acting in the same way as a private shareholder. These should be assimilated to cases of capital injections made for public policy purposes.

III.2.2.3 **There are private shareholders investing**

III.2.2.3.1 Private shareholders participating in the capital injection in unquoted shares

21. Private shareholders may already hold equity in the corporation. This case covers also the initial introduction of private shareholders in the event of the current injection, for instance under a process of restructuring.
22. Where the private investors:
 - a) take a significant share in equity during the injection, in proportion to their existing shareholding (where appropriate), at the same time as the capital injection by government,
 - b) exercise the usual influence of minority shareholders according to rights provided by current Corporate Law,
 - c) bear risks and rewards similar to government, as regards their rights on the net assets, in the event of liquidation (ESA105 5.148) for instance,
The capital injection is treated as a financial transaction for its full amount.
23. Where the private investors do not fulfill one of the conditions mentioned above, the capital injection should be treated according to rules specified for the cases where there are no private shareholders.

III.2.2.3.2 Private shareholders participating in the capital injection in quoted shares

24. Where, in exchange for its payment to the corporation, the government acquires quoted shares, which it could immediately sell for the price paid, then the transaction is a financial transaction in shares and other equity (F.511).⁸⁸

⁸⁸ In other words, government should not acquire the shares above their market price (possibly estimated as an average of a period no longer than 3 months). For unquoted shares, the reference should be a fair value, estimated according to usual business valuation methods.



III.2.2.3.3 Special case: It is a new corporation, or new activity/assets are considered

25. The treatment will depend on the specific examination based on the various indicators as usually used in investment analysis. The presence of private investors would also be a key indicator. In any case, it should be certain that government does not intend to use the new unit only for public policy purposes.
26. As a result:
- Either, the conditions support the conclusion that, after a "normal" temporary period of losses (as also often observed for similar private investments), the corporation would be structurally profitable, so to earn an overall adequate rate of return, the capital injection by government is treated as a financial transaction for its full amount.
 - Or, on the basis of various factors (an uncertain economic environment, the nature of the activity and of the sector, the non-compensation of some costs imposed by government, the consensus opinion of independent experts in different areas like accounting, economics and financial analysis, etc.) there are doubts on the long-term profitability of the project, the capital injection is treated as a non-financial transaction for its full amount.
27. If the return on a capital injection turns out to be very different from the return originally expected (e.g. profits or other gains are made instead of planned losses; or conversely losses are made instead of expected profits), the accounting of the capital injection is not revised due to new information or subsequent events, unless the initial plan was misleading and misrepresenting the economic reality (See box 2). No revenue or expenditure is recorded to account for these differences in expectations: instead these differences between realisations and expectations are reflected in the revaluation accounts.
28. In particular, returns of money to government by an entity that benefited from a capital injection in previous years that was recorded as a capital transfer expenditure of government, is not necessarily recorded as government revenue. Instead, the proceeds collected by government are subject to the super-dividend test to determine if these are government revenue or withdrawal of equity.

Box 1

Recording transactions: straightforward cases and difficult areas

In practice, compilers are confronted either with straightforward cases that lead to clear statistical treatments, or with borderline cases that require further inquiries and applying various tests.

Straightforward cases

a. Investment grant: D.92

A capital injection that "would consist of a capital transfer in cash or in kind made by government (...) to another resident (...) institutional unit to finance all or part of the costs of its acquiring of fixed assets" is to be recorded as an investment grant (D.92). ESA10 4.152

b. Past losses: D.99

A capital injection made to cover accumulated losses is recorded as other capital transfer (D.99) (ESA10 4.165b)

c. Acquisition of quoted shares: F.5

A capital injection that results in government acquiring quoted shares of equal value is recorded as a transaction in shares and other equity (F.5).

d. Loans and bonds: F.3 and F.4

- Loans: a provision of funds in the form of a loan evidenced by a legal document specifying the borrower's obligations (redemption date of principal and interest to be paid) is recorded as a transaction in F.4.



- Bonds: a provision of funds by the government purchasing bonds issued by the corporation (again to be evidenced by legal document) is recorded as a transaction in F.3.

e. Debt cancellation/assumption

Debt cancellation or debt assumption gives rise to a capital transfer, or a unit being privatised within the limit of the amount of privatisation proceeds (ESA10 20.227).

f. Privatisation: F.5

A capital injection that is made as part of a privatisation process within a short-term perspective (less than one year), such that government expects to get its money back, are recorded in F.5 within the limit of the amount of the privatisation proceeds (consistently with the rationale of ESA10 20.227 in the case of debt cancellation/assumption, see also item e) above).

Borderline cases

In the following difficult areas, two guidelines are very useful:

- A pattern of repetitive payments would be an indication and presumption of unrequited transfers, and therefore lead to record a capital transfer;
- The qualification by the European Commission of government payments as “State aids” should be taken into consideration for the statistical treatment as an analytical indicator. The flows deemed to be State aids have to be recorded as capital transfers.

a. Expected future losses/repetitive losses: D.9

A capital injection made to cover expected future losses, perhaps so that the corporation can reduce its borrowing costs, should be recorded as a capital transfer (D.9), even if shares (or equivalent) are issued. In this context, it is likely that the corporation will not be profitable for a long time, because of the specific conditions of its activities. If shares are issued, it can be assumed that they have no value.

b. An expected profitable investment: F.5

A capital injection given to a public corporation with the objective of increasing the government’s future dividends should be recorded in F.5. This would be when the corporation is free to use the funds to maximise profits and the government expects a market return on its investment, i.e. a return similar to that, which could be obtained, from the acquisition of shares quoted on the market.

c. Partnership with private sector partner: F.5

If, acting jointly with a private partner, the government makes a capital injection into a unit such that the property rights, including rights to property income, are modified in proportion to the value of the injection, it indicates that the investment is expected to be profitable and should be recorded in F.5.

Where such proportionality does not exist (ownership rights do not change in the same proportion), it could be an indication that the government is serving public policy purposes and is making an unrequited transfer. If this is the case, the injection must be recorded as a capital transfer.

d. Body manages financial assets on behalf of government: F.5

A capital injection to a public holding company or a financial corporation, managing assets in a profitable way on behalf of government, in order to acquire more financial assets, could be recorded as a transaction in F.5. The condition here would be that the assets are managed to maximise the return for government, and that higher dividends are expected.

e. Loans granted in certain contexts

In certain contexts (financial defeasance, business rescuing, export insurance...), the characteristics of “loans” provided by government – and the contractual obligations - should be examined closely to check the relevance of the classification in F.4. In the special case where the public corporation receiving the loan would be in financial distress and not in a position to repay the loan, the provision of funds should be recorded as a capital transfer (D.99). If the public corporation (and possibly, in some cases, the private corporation) would be in a position to repay most of the loan, but not all, this could be a case to partition the loan into F.4 and D.99 (see ESA10, 1.72 and 76-77).



III.2.3 Rationale of the treatment

III.2.3.1 Three common ways of providing funds to a public corporation

29. Government may increase a public corporation's holdings of financial assets (generally cash) at a given point in time, usually in three ways: a) providing a grant, b) providing equity capital, c) providing loan capital. It matters in national accounts to clearly distinguish them as they result in different treatments, according to the classification of transactions and assets provided by ESA10:

- a) Providing a grant (i.e. a gift): in national accounts terms, this is a capital transfer. It has the effect of changing the net borrowing/net lending (B.9), and of changing the net worth due to transactions (B.10.1) (and therefore the own funds of the corporation). An important feature of such capital transfers is that they are transactions which are usually undertaken only by governments. The beneficiaries of these transfers are usually enterprises that do not operate in competitive markets. Acting this way, the government expects no return on its investment in the form of dividends (most of the time the enterprise receiving such transfers does not pay dividends) or in the form of other proceeds notably realised in the context of a privatisation. Government is acting for public policy purposes, and only expects some general economic or social results from the use of the funds.
- b) Providing equity capital: this is a financial transaction in shares and other equity. There is no change in the net borrowing/net lending (B.9) and no change in the net worth (but there is a change in own funds due to the increase in equity capital). Usually, corporations raising equity capital are competing on markets and need to strengthen their financial position, by increasing their own funds, in order to plan investments etc. In providing equity capital to the corporation, the government acts similarly to a private shareholder, with the strong expectation of a sufficient return on investment. In this regard, the actual payments of dividends to the shareholder and/or the positive trend in the value of the shares are decisive criteria for treating the injection as an increase in equity. In addition, as shown in the decision tree (see section 2: "Treatment in national accounts"), the participation of private shareholders in the business is also a strong indicator for the recording as equity capital, especially if the shares are quoted on the stock exchange. However, the private investors' share of equity in the corporation should not be diluted by the government's new shares acquisition (which would reduce their participation to a level where they could not exercise influence). They must also bear similar risks and rewards to those borne by government notably as regards their rights on the net assets of the corporation in case of liquidation (case of issuance of shares with specific features).
- c) Providing loan capital (or possibly acquiring corporation's bonds): this is generally a financial transaction. In this case, there is no change to the net borrowing/net lending (B.9), no change to the net worth (B.10.1) (and no change to the own funds) of either government or the corporation. As a lender, government is expecting that the public corporation, as a borrower, will be in a position to repay the loans, according to a schedule agreed at inception.

**Box 2****A sufficient rate of return**

In order to test whether government acts similarly to a private investor/shareholder, so that the capital injection can be treated as an increase in equity (F.5), the expected return on investment (usually also referred to as "Return on Equity", ROE) is a crucial indicator. Such a return, in the form of dividends or holding gains, provides evidence that the legal financial instrument (e.g. the shares) given to its owners in exchange for the funds injected is a source of future economic benefits (meeting thus the basic definition of an asset in ESA10) and has a market value.

Such an expected "adequate rate of return" or "market rate of return" may be referred to, in government finance statistics, as a "sufficient rate of return" (see III.2.2.1).

Government has a very specific function in the economy. It is in charge of collective concerns and of dealing with externalities so to ensure, in the long run, the prosperity and well-being of the community (public health and education, public order and safety, public infrastructure, environment ...) and therefore acts primarily as a non-market producer. Funds invested in this context are provided for public policy purposes, without any expectation of a direct financial return: in national accounts these invested funds are to be recorded as capital transfers (D.9).

However, government also interacts directly in the economy like other investors and shareholders, i.e. through public corporations, with the aim to make them as efficient and profitable as possible, in such a way that they can also be a source of revenue or other gains.

Capital invested by government always has an opportunity cost. Therefore, when government is investing with expectations of a return on investment, it would be appropriate to expect a similar return as for comparable investments by private actors, under ideal circumstances. This calls for using market rates of return as benchmarks. However, there could be reasons for government to target different required expected returns on investment. Capital markets may not function perfectly, and therefore market rates of return may not reflect the correct opportunity cost. Moreover, governments often invest in areas – or at an industrial stage - where no private actors operate, therefore making difficult benchmarking on private sector returns.

To define the appropriate minimum return required on an investment, there are several standard methods known in the theory of finance. These methods often use an opportunity cost approach, which takes into account the rates applicable to alternative investments or to the cost of financing (i.e. other opportunities). These methods investigate both the asset side (investment) and the liabilities side (financing) of the company in order to estimate the expected rate of return on the investment. One commonly used method is the Capital Asset Pricing Model (CAPM), which might be appropriate in some cases. This approaches the return from the asset side and implies estimating a risk adjusted rate of return. This involves calculating a required minimum expected rate of return on an investment as a function of the risk, where the return can be calculated by an equation with the risk-free interest rate, the average market return, and an indicator expressing the risk pertaining to the asset class in question being present.

In practice, the observable return in the past – when there is no indication of a change in future – may be used for determining an expectation of sufficient rate of return, notably in the absence of business plan analysis.

Taking into account the specificities of governments as an investor, the "sufficient rate of return" is used as a proxy for the expected market return as a fundamental benchmark for establishing the appropriate expectations of returns on government investments.

Therefore, considering the specificity of government, a "sufficient rate of return" expected on funds invested would have to be equal at least to:



- when government is the only investors in the corporations, as a general rule, long-term (10 years)⁸⁹ government bonds rates, which means that government is not expected to receive a return inferior to its cost of borrowing;

- when government is investing together with private investors (whatever their share),, risk adjusted rates of return normally required, in average and over a sufficient period of time, by private investors on similar equity investments in the same sector of activity; in practice the Return On Equity currently observed in average in the sector (branch) of the corporation(of comparable size) could be used as a proxy, if available.⁹⁰

The rates being compared should be on the same basis, real or nominal.

Transfer payments by government or supranational authorities made to producers to cover losses, in the form of subsidies, other current transfers or capital transfer (rather than by outright purchases of products), should be excluded from the measure of the return on investment (i.e. these have to be taken into account, as negative discounted cash flows). These payments, together with all other payments to cover an overall deficit, should not be included in the measure of the capital invested. Some payments however, such as payments granted to any producer in this type of activity (where it is observed that there are both public and private recipients), including all payments linked to the volume or value of output, may be retained in the calculation of the rate of return.

Case where a business plan has been used: the initial classification of the injection transaction should not be revised due to later economic events changing the original outlook. However, evidence that the original business plan was incorrect or misinterpreted, observable from subsequently published annual accounts, updated business plans or audit office reports, should lead to a re-assessment of the original statistical classification and a subsequent data revision.

III.2.3.2 Characteristics of financial and non-financial transactions involved

III.2.3.2.1 Recording a financial transaction in equity

30. A capital injection should be recorded as a financial transaction only when the government receives in exchange a financial asset of equal value to the payment. This is a fundamental characteristic of financial transaction". A holding gain on shares and other equity, possibly recorded after the capital injection, is not a "financial asset received in exchange" (but an "other flow").
31. In the majority of cases, the financial instrument involved is shares and other equity (AF.5). A transaction in equity in this context is the action of "placing funds at the disposal of a corporation" (ESA10 4.53), increasing the equity capital. This is to be recorded in national accounts as a financial transaction, in shares and other equity (F.5). In accordance with ESA10 4.53 and 5.142, this transaction increases the property rights of shareholders of the corporation. The investment is made predominantly under market conditions and not only for public policy purposes.
32. In particular, it should be emphasised that, in providing equity capital to the corporation, the government acts as a shareholder under market conditions, normally with the expectation to receive dividends in return. The actual payment of dividends to the shareholder is an important criterion for treating the injection as equity.

⁸⁹ In cases (notably in the context of government support to banks) where a resale of equity is foreseen in a small number of years, a 4-6 government bond benchmark reference could be used.

⁹⁰ As an example, for commercial banks, ROE should at least reach 10%. It should be lower in industrial sector.



33. Additionally, a capital injection that is made as part of a privatisation process within a short-term perspective (less than one year), such that government expects to get its money back, is to be recorded in F.5, within the limit of the amount of privatisation proceeds (consistently with ESA10 20.201). This case, as well as others described in this chapter, should be considered as exceptions to the rule that implies that recording a flow in the national accounts increasing the “shares and other equity” (F.5) of a quoted corporation should normally be related to actual issuance of new shares.
34. Two cases must be distinguished:
- Case of quoted shares: A capital injection that results in government acquiring quoted shares of equal value is a straightforward case. It has generally to be recorded as an acquisition of equity (F.5). The fact that the shares are quoted means that the shares may be traded on the market by private investors (as defined in ESA10 chapter 2) and therefore that the corporation is respecting some minimum market requirements in the long run.
 - Case of unquoted equity: Where the capital injection is given to an unlisted public corporation, the capital injection should be recorded in F.5 only if government has the objective of increasing its wealth, under the form of dividends or a higher value of the financial instrument received in counterpart (or at least equal to the amount injected, under an on-going process of privatisation, to be achieved in a short-term perspective).
35. Normally, a condition is that the public corporation has not accumulated net losses as recorded according to generally accepted accounting standards in its balance sheet (t or with evidence, for instance, being given by a negative trend in own funds). However, even in such cases, any part of the capital injection (in excess of the accumulated losses) used for investment in profitable areas of activities on which government will earn an adequate return on its investment may be recorded as financial transaction (typically in F.5).
36. A capital injection may also be recorded as a financial transaction in two specific cases:
- new corporations or quasi-corporations ("start-ups"): If government sets up a new market unit that is not the result of a restructuring of existing corporations, the treatment depends on a close examination of the project, using various indicators similar to investment analysis and taking account of other aspects relating to the transaction. As a result, the transaction may be treated as a financial transaction or as a non-financial one, according to the analysis, for its full amount. This applies also where an existing corporation is starting a completely new activity or is acquiring new kinds of assets for large amounts.
 - bodies managing financial assets on behalf of government: a capital injection into a public holding company or a financial corporation managing assets in a profitable way on behalf of government, in order to acquire more financial assets, could be recorded as a transaction in F.5. The condition here would be that the assets are managed to maximise the return for government, and that higher dividends or higher equity value are expected.

III.2.3.2.2 Special cases: Transactions in other financial instruments

37. Not every provision of funds recorded as a financial transaction takes the form of acquisition of equity (F.5): other possibilities are the making of a loan (F.4) or the purchase of bonds. (F.3).
38. Loans: a provision of funds in the form of a loan with evidence in a legal document specifying the borrower's obligations (redemption date of principal and interest to be paid) should generally be recorded as a transaction in F.4.



39. One exception is where government grants a loan to a loss-making public corporation, where it is very likely that the corporation would not be in a position to repay most of the loan because of recurrent losses (and, thus, not because of exceptional losses occurring in the year the loan is granted) and because there is no expectation of restoring profitability before the maturity date(s). In this case, the funds transferred to the corporation by government should be recorded as a non-financial transaction for their full amount, unless a reliable estimate of the losses would be available, allowing a partition of the loan. If it would be expected that the debtor would reimburse by itself⁹¹ most of the loan, this would be a case for partitioning the loan, the part corresponding to the expected losses being recorded as a capital transfer at the time the loan is made. The stock of loans to be entered in the balance sheet should be increased by the value of the recorded loan transaction. Any subsequent recognition by government of loans or parts of the loans which would not be re-paid should be treated in accordance with the guidance in Chapter VII.2.
40. Thus, in certain specific contexts (financial defeasance, business rescue, export insurance...), the characteristics of “loans” provided by government (the contractual obligations) should be examined closely to check whether it is correct to classify them in F.4.
41. Debt instruments: a provision of funds when the government purchases bonds or notes or hybrid instruments⁹² issued by the corporation (evidence also to be given by some legal document) should be recorded as a transaction in F.3.
42. However, where the corporation has accumulated significant losses and the bonds are purchased almost exclusively by government, the acquisition by government should be considered as a non-financial transaction.
43. In addition, the case of a bond issuance by a corporation with a record of debt service default, such that the purchase of bonds by private investors could be achieved only with a full guarantee from government (with investors' opinion as evidence) should be closely examined. Recording as a transaction in F.3 requires that, at the time of the transaction, the corporation is in all likelihood in a position to meet its obligations relating to the debt service (interest and principal) according to the contractual schedule of payments.

III.2.3.2.3 Recording a non-financial transaction

44. Excluding the cases of subsidies (D.3, see ESA10 4.30 and following) and of other current transfers (D.75, see in particular ESA10 4.138b), the non-financial transaction relevant for capital injections is a capital transfer.
45. The case of capital injections in kind (such as transfers of fixed assets) is dealt with in the following part of this chapter III.4, and only capital transfers in cash are considered here.
46. A capital injection should be treated as a non-financial transaction where the provision of funds is an unrequited transaction. The government does not receive in exchange a financial asset of an equal value, and any possible effect on the government's equity is indirect, sometimes not immediate, uncertain and of a different size. This sort of payment is recorded as a capital transfer (D.9). Two

⁹¹ This means mainly from sales, including subsidies on products (with the exception of subsidies described in ESA10 4.35c), other subsidies, property income.

⁹² This refers notably to some “preferred shares”, convertible bonds (including contingent convertible, usually referred to as “Cocos”), subordinated loans or bonds. In any case, in national accounts, a debt instrument is recognised as such (classified as AF.3 or AF.4) only if it bears an unconditional remuneration for the holder, i.e. due independently of any distributable profit (treated as interest to be recorded on accrual basis). Otherwise, this is considered as an equity instrument subject to the rules developed in this chapter. There may be special clauses related to the accumulation of returns, such as carrying over non-paid interest. An instrument could be recorded as debt only if such carry over does not exceed the following exercise. Any longer period, or even total uncertainty, would result in treating the instrument as equity.



transactions in this category are defined in the ESA10 (see below a: D.92 and b: D.99).

47. An important feature of capital transfers is that, in general, they are typically government transactions, made for public policy purposes. Acting this way, the government expects nothing in return in terms of dividends (most of the time the enterprise receiving such transfers does not pay dividends), nothing else than an improvement of the corporation's wealth and the meeting of some social needs (public infrastructures, employment, etc.).

a) Investment grants (D.92)

A capital injection that "would consist of a capital transfer in cash or in kind made by government (...) to another resident (...) institutional unit to finance all or part of the costs of its acquiring of fixed assets" is to be recorded as an investment grant (D.92).

b) Other capital transfers (D.99) for accumulated losses

A capital injection made to cover accumulated losses (either on a repetitive pattern during several recent fiscal years, or irregularly but with profits not compensating losses), as recorded according to generally accepted accounting principles and, for instance, with evidence given by the trend of the corporation's own funds, is normally treated as a non-financial transaction for its full amount (as a capital transfer D.99), even if some pieces of paper (called "shares" or equivalent) are issued.

48. Similarly, capital injections made to compensate owners of capital goods destroyed by acts of war, other political events or natural disasters are also to be recorded as capital transfers (D.99).

Box 3

ESA Concepts

- **Own funds and equity capital**

ESA10 7.07 defines the own funds in the following way: "Own funds are the sum of net worth (B.90) plus the value of equity and investment fund shares ((AF.5) as liabilities in the balance sheet."

"Corporations raise equity capital to strengthen their financial position on the market, by increasing their own funds. Expressed through the issuance of shares, the equity capital is therefore part of the own funds."

The immediate result of providing equity capital and increasing the own funds is that the corporation is in a better position to finance investment or refund existing debt, borrow additional debt if necessary (creditors are reassured by the financial solvency of the corporation), and finally to make and distribute profits. Shares and other equity (AF.5) in the balance sheet of a corporate enterprise are to be recorded - like most assets and liabilities in the national accounts - at market value (ESA10 7.34, 7.25 and 7.71).

- **Dividends (D.421)**

"Dividends (D.421) are a form of property income received by owners of shares (AF.5) to which they become entitled as a result of placing funds at the disposal of corporations. Raising equity capital through the issue of shares is an alternative way of raising funds by borrowing. In



contrast to loan capital, however, equity capital does not give rise to a liability that is fixed in monetary terms and it does not entitle the holders of shares of a corporation to a fixed or predetermined income.” (ESA10 4.53)

- **Shares and other equity (F.5)**

“The category shares and other equity (F.5) consists of all transactions in shares and other equity (AF.5) that are financial assets which represent property rights on corporations or quasi-corporations. These financial assets generally entitle the holders to a share in the profits of the corporations or quasi-corporations and to a share in their net assets in the event of liquidation.” (ESA10 5.142) The transactions in shares and other equity – for instance, a capital injection providing equity capital to a corporation have thus a strong legal basis, these financial assets representing the property rights on the corporation.

A transaction in equity has usually three characteristics:

- Funds are placed at the disposal of a corporation, which has a large degree of freedom in the way it can use them.
- Shareholders are entitled to receive a return on their investment.
- New shares are issued (for an amount equal or related to the funds placed) in the case of corporations having the legal status of incorporated enterprises.

As a result, in national accounts, shares and other equity must be valued at a market value that reflects the expectations of return, in both the national accounts balance sheet of the holder and the issuer, whereas in the own balance sheet of the issuer they are usually accounted for at historic value (or book value). Where shares are listed on a market, their value is the observed price. Where equity does not consist of shares, or consists of shares that are not tradable on a market - as it is frequently the case for a public corporation - a proxy market value must be implemented in national accounts (see ESA10 7.73 and following).

- **Capital transfers (D.9)**

The notion of capital transfer is defined in chapter 4 in ESA10. A capital transfer imparts a voluntary transfer of wealth between two units ("something for nothing"). Capital transfers have three main characteristics (see SNA2008 8.10):

- They are transactions, made by mutual agreement between two units (unlike other changes of assets).
- There is no counterpart being received in exchange.
- They involve a commensurate change in ownership of assets (or cancellation of liabilities by a creditor) between the two parties, or acquisition or disposal of assets).

The first two characteristics are common to all transfers (current and capital transfers). In addition, all transfers may be made in cash, or in kind.

Another characteristic of capital transfers is that they tend to be large and infrequent. Two types of capital transfer are then distinguished (ESA10 4.146):

Capital transfers in cash: these consist of transfers in cash involving changes in ownership of assets. The recipient is often obliged to use the cash to acquire assets as a condition of the transfer (e.g. investment grant) (ESA10 4.146).

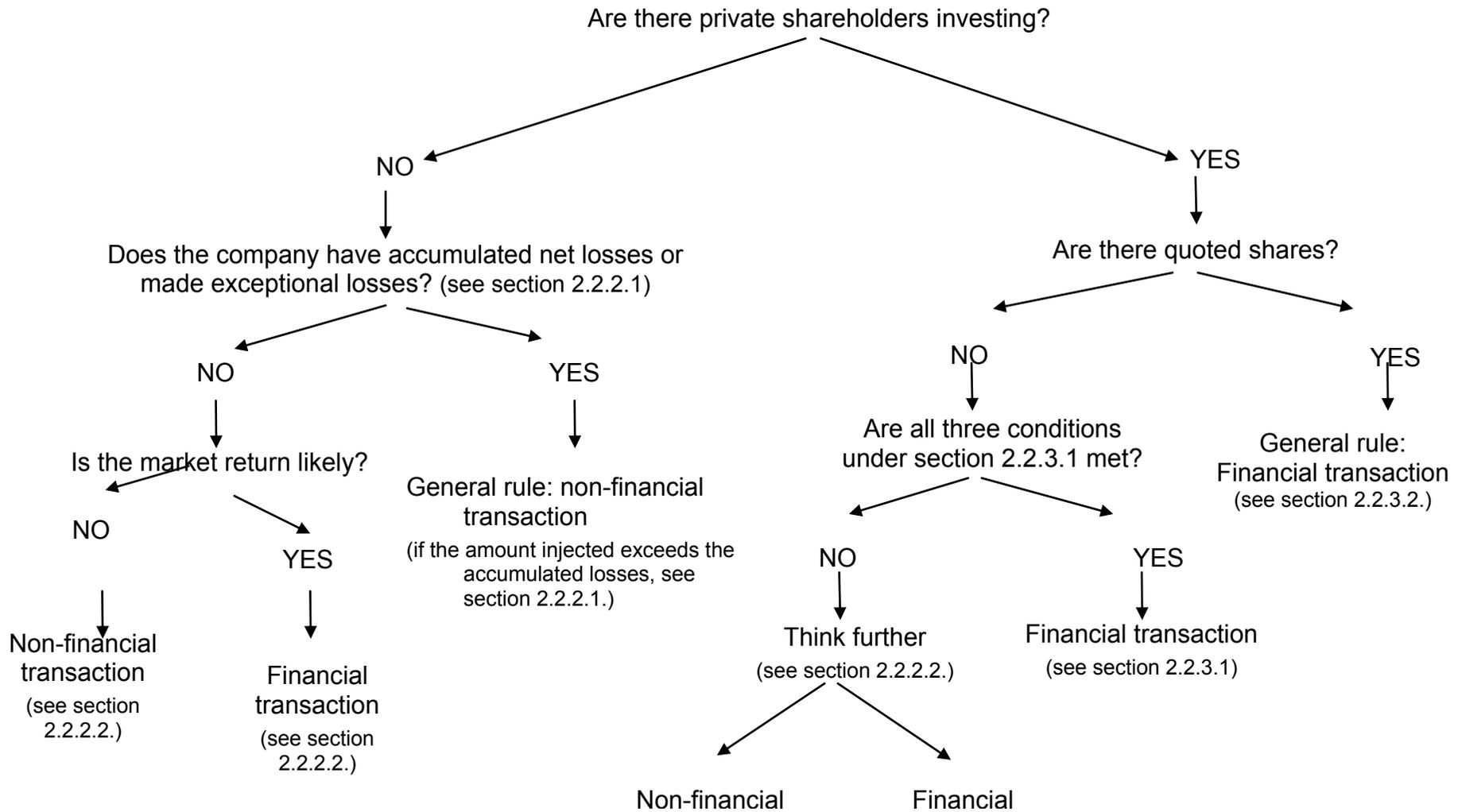
Capital transfers in kind: cases of transfers of ownership of assets other than cash or of cancellation or assumption of debt without counterpart.



Capital transfers are generally government transactions: public policy purposes may lead government to make transfers without counterpart to corporations. A presumed effect of a capital transfer on the value of the equity (through the reaction of the market, for example) is not a sufficient reason for regarding the transaction as a financial one: again, the effect is not certain, as well as its size.

Therefore, unlike financial transactions, capital transfers are the counterpart flow of those “one-way” changes in assets or liabilities, which means that the recipient is made wealthier, when the other party is made poorer. This is expressed by an increase in net worth in the balance sheet of the first party, and a decrease in net worth in that of the other party.

Decision tree for capital injections (other than investment grants)



III.3 Capital injections into public quasi-corporations

III.3.1 Background to the issue

1. One of the cornerstones of the national accounts is the concept of institutional units, and the grouping of those into institutional sectors. Since the aim of the system is to describe how economic agents interact in order to underpin economic analyses, the main qualifier for being recognised as institutional units lays in their capacity of exercising autonomous economic decision making in their principal function, rather than other considerations such as their legal status.
2. The concept of public quasi-corporations is intended to separate public entities from their government owners because they are engaged in market activities in such a way that they fulfill the criteria of being a market producer. In addition, even though they are unincorporated enterprises, they are sufficiently independent and they behave differently from their owners and similarly to corporations. In particular, they can be the owner of assets, take economic decisions, and enter into contracts and incur liabilities (ESA10 2.12). Public quasi-corporations must keep a complete set of accounts or it would be possible and meaningful, from both an economic and legal viewpoint, to compile a complete set of accounts if they were required; otherwise, it would not be feasible from an accounting point of view to distinguish them from their owners (ESA10 2.13f). In order to be said to keep a complete set of accounts, a unit must keep accounting records covering all its economic and financial transactions carried out during the accounting period, as well as a balance sheet of assets and liabilities.
3. Since public quasi-corporations are recognised in the system as institutional units and as market producers (i.e. charging economically significant prices), they should in principle be treated as any other corporation. However, for the recording applicable to quasi-corporations, there are some exceptions explicitly mentioned in ESA10 from the treatment of other public corporations. The aim of this chapter is to give a short but comprehensive guidance on when government injections or other transfers to their quasi-corporations should be recorded as financial or non-financial transactions.

III.3.2 Treatment in national accounts

4. The recording of government transfers to their own public quasi-corporations in national accounts should in general follow the same rules as for other public corporations (see chapter III.2), unless there are, in ESA10, explicit prescriptions for the contrary. The capital injection test, as defined in sub-section III.2.2, should be applied based on whether the quasi-corporations are making losses or profits.
5. The following operational guidance applies:
 - a) When a public quasi-corporation is making profits and expecting to make sufficient profits in future, government transfers of a capital nature, such as for the purpose of acquiring assets or reducing liabilities, should be recorded as financial transactions, other equity F.519 (ESA10 5.154f), otherwise a capital transfer should generally be recorded.
 - b) When a public quasi-corporation is running a persistent operating deficit, as a matter of deliberate government or European economic and social policy such that it would charge an insufficient price to final users, regular government



- c) transfers should be recorded as non-financial transactions, subsidies D.319¹ (ESA10 4.35c and 4.61).
 - d) When a public quasi-corporation receives transfers from government to cover accumulated losses or exceptional losses beyond the control of the entity, these should be recorded as non-financial transactions, other capital transfers D.99 (ESA10 4.165b). However, any part of a capital injection in excess of accumulated losses, may be recorded as a financial transaction (F.519) when appropriately documented. Payments intended to cover future losses are also treated as other capital transfers D.99.
 - e) When the government owner cancels financial claims against, or assumes liabilities from, a public quasi-corporation, this should lead to the recording of financial transactions, equity F.519 (– ESA10 4.165f) unless the operation is intended to cover accumulated losses or an exceptionally large loss, not covered by the case mentioned in III by recording another capital transfers D.99. In case of expected future losses, these are also treated as other capital transfers D.99. (ESA10 4.165b)
 - f) When government transfers to public quasi-corporations take the form of investment grants, these are to be recorded as financial transactions, other equity F.519 (ESA10 5.154), unless these payments are intended to cover accumulated losses or in the context of an exceptional large loss, in which case they are recorded as other capital transfer D.99 – ESA10 4.165 b. This treatment also applies in case of future foreseen losses. Similarly, payments intended to cover persistent losses are recorded as D.319 – ESA10 4.61. Furthermore, in case of persistent losses, the capital transfer equals the positive net fixed capital formation of the public quasi-corporation since consumption of fixed capital is included in the calculation of the subsidy to the public quasi-corporation.
6. Under these conditions, government inflows, in cash or in kind, into non-profitable public quasi-corporations should be recorded as non-financial transactions (4.165b “prevails over 4.165 f in such cases). For their part, government inflows in excess of losses, accumulated or expected, may be recorded as financial transactions.

III.3.3 Rationale of the treatment

- 7. The concept of public quasi-corporations is introduced into the system because their behaviour is different from their government owners and similar to corporations; they are therefore recognised in the system as institutional units and market producers. Thus, one in national accounts aims at reflecting the economic nature of the transactions between quasi-corporations and their government owners. Due to their similar behaviour, it is appropriate to bring the treatment of public quasi-corporations as close as possible to the treatment of other public corporations.
- 8. In order for a public quasi-corporation to be recognised in national accounts, government must allow the management of the entity considerable discretion with respect to the management of the production process and the use of own funds as defined in ESA10 7.07; for the decision making autonomy criteria to be fulfilled – ESA10 2.12. Public quasi-corporations must be able to maintain their own working balances and business credit and be able to finance some or all of their capital formation out of their own savings, depreciation reserves or borrowing. The ability to distinguish flows of income and capital between quasi-corporations and government implies that their operating and financing activities can be fully distinguished in finance statistics from government revenue in practice, despite the fact that they are

¹ However, as stated in part I of this manual, these subsidies on products are not taken into account in the market/non-market test.



9. not separate legal entities. The net operating surplus of a public quasi-corporation is not a component of government revenue, and the accounts for government record only the flows of income and capital between the quasi-corporation and government. If the entities cannot be separated in these respects from their government owners, the entities cannot be treated as quasi-corporations.
10. The zero net worth convention for quasi-corporations (equity is valued at the own funds of the entity, i.e. its net assets in ESA10) stated in ESA10 7.09 has sometimes been emphasised as a conceptual rationale for determining the recording of transactions between governments and their quasi-corporations (as transactions in equity). However, the fact that quasi-corporations' net worth is zero in practice does not by itself justify treating transactions as financial rather than non-financial. This is because capital injections are generally net worth neutral for beneficiaries, as the valuation of their equity liability generally increases by the amount received. For example, the equity of unquoted public corporations may routinely be valued as the net assets, but this would not preclude applying the capital injection test. In these cases, recording capital injections as non-financial transactions only entails an entry in the revaluation account. The recording of transactions between governments and their quasi-corporations should reflect the economic nature of the transaction, irrespective of the valuation method used for equity.
11. When government payments to public corporations and public quasi-corporations are intended to cover losses, accumulated or foreseeable, these should be treated as capital transfers in accordance to ESA10 4.165b as further elaborated in chapter III.2 of this Manual. When regular government transfers are conducted in favour of public quasi-corporations running persistent operating deficits, subsidies should be recorded D.319 in accordance to ESA10 4.61, 4.35c.
12. When governments conduct debt cancellations or debt assumptions benefiting their quasi-corporations, the transactions are by convention recorded as financial transactions, by exception to the general recording applicable to corporations (capital transfer), according to ESA10 4.165f, unless this is to cover losses, in which case ESA10 4.165b prevails. ESA10 4.165b is applicable to debt cancellations/assumptions as well as to cash transfers because means to recapitalise entities, in cash or in the form of other financial assets/liabilities, should generally not change the accounting recording of the transaction in question.
13. In the case of transfers in the form of investment grants, these are recorded as capital transfers (D.92) when granted to public enterprises recognised as independent legal entities- ESA10 4.157. This paragraph (together with ESA10 4.61) has been interpreted to prevent recording investment grants (D.92 – ESA10 4.152) to quasi-corporations, as by definition quasi-corporations are institutional units but are not independent legal entities and the government department, in which the quasi-corporation was identified for national accounts purpose, has a direct and automatic stake in the unit for the funds injected in the unit, except in some specific cases, similar to a “normal” owner of a corporation. Under these conditions, government payments into quasi-corporations cannot be recorded as investment grants (D.92), as per ESA10 4.157 and 4.61 the following rules apply: government payments into loss-making quasi-corporations should be recorded as either subsidies (D.319) or other capital transfers (D.99) – ESA10 4.165b, 4.61; and government payments into profit-making quasi-corporations should be recorded as acquisitions of equity (F.5).

III.3.4 Accounting examples

Example 1

A government carries out an injection in cash of 100, in period 2, to a loss making quasi-corporation (that had losses of 50 in period 1 and 2).

Period 1

General government				Quasi-corporation			
Opening balance sheet							
A		L		A		L	
AF.2	200			AN.1	1000	AF.4	100
AF.5	1000	B.90	1200	AF.2	100	AF.5	1000
						B.90	0
Production and capital account							
U+ΔA		R+ΔL		U+ΔA		R+ΔL	
		D.9	0	D.1	100	P1	200
				P.2	150	D.9	0
B.9	0			B.9	-50		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	0			F.2	-50		
F.5	0					B.9	-50
		B.9	0				
Revaluation accounts (K.7)							
ΔA		ΔL		ΔA		ΔL	
F.5	-50					F.5	-50
		B.10.3	-50			B.10.3	+50
Closing balance sheet							
A		L		A		L	
AF.2	200			AN.1	1000	AF.4	100
AF.5	950	B.90	1150	AF.2	50	AF.5	950
						B.90	0

**Period 2**

General government				Quasi-corporation			
Opening balance sheet							
A		L		A		L	
AF.2	200			AN.1	1000	AF.4	100
AF.5	950	B.90	1150	AF.2	50	AF.5	950
						B.90	0
Production and capital account							
U+ΔA		R+ΔL		U+ΔA		R+ΔL	
		D.9	-100	D.1	100	P1	200
				P.2	150	D.9	100
B.9	-100			B.9	+50		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	-100			F.2	+50		
F.5	0					B.9	+50
		B.9	-100				
Revaluation accounts (K.7)							
ΔA		ΔL		ΔA		ΔL	
F.5	+50					F.5	+50
		B.10.3	+50			B.10.3	-50
Closing balance sheet							
A		L		A		L	
AF.2	100			AN.1	1000	AF.4	100
AF.5	1000	B.90	1100	AF.2	100	AF.5	1000
						B.90	0

Example 2

A government carries out an injection in cash of 100, in period 2, to a profit making quasi-corporation (that had profits of 20 in period 1 and 2).

Period 1

General government				Quasi-corporation			
Opening balance sheet							
A		L		A		L	
AF.2	200			AN.1	1000	AF.4	100
AF.5	1000	B.90	1200	AF.2	100	AF.5	1000
						B.90	0
Production and capital account							
U+ΔA		R+ΔL		U+ΔA		R+ΔL	
		D.9	0	D.1	100	P1	200
B.9	0			P.2	80	D.9	0
				B.9	20		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	0			F.2	20		
F.5	0	B.9	0			B.9	+20
Revaluation accounts (K.7)							
ΔA		ΔL		ΔA		ΔL	
F.5	20					F.5	20
		B.10.3	20			B.10.3	-20
Closing balance sheet							
A		L		A		L	
AF.2	200			AN.1	1000	AF.4	100
AF.5	1020	B.90	1220	AF.2	120	AF.5	1020
						B.90	0

**Period 2**

General government				Quasi-corporation			
Opening balance sheet							
A		L		A		L	
AF.2	200			AN.1	1000	AF.4	100
AF.5	1020	B.90	1220	AF.2	120	AF.5	1020
						B.90	0
Production and capital account							
U+ΔA		R+ΔL		U+ΔA		R+ΔL	
		D.9	0	D.1	100	P1	200
				P.2	80	D.9	0
B.9	0			B.9	20		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	-100			F.2	120		
F.5	100					F.5	100
		B.9	0			B.9	+20
Revaluation accounts (K.7)							
ΔA		ΔL		ΔA		ΔL	
F.5	+20					F.5	+20
		B.10.3	+20			B.10.3	-20
Closing balance sheet							
A		L		A		L	
AF.2	100			AN.1	1000	AF.4	100
AF.5	1140	B.90	1240	AF.2	240	AF.5	1140
						B.90	0

III.4 Capital injections in kind

III.4.1 Background to the issue

1. Sometimes governments transfer fixed assets (such as buildings), and/or non-produced non-financial assets (such as land), to a public or private corporation that already exists or has been created for that purpose of holding such assets. The capital injection does not take the usual form of a flow of financial assets (in most cases cash, AF.2), but instead a flow of non-financial assets. This is done to allow the enterprise to use these assets in the production process, usually because the enterprise is assumed to be in a better position than the government to operate this economic activity.
2. In some cases, the government expects to receive some direct benefits from the transfer of the asset, in the form of property income streams (dividends, for instance) or an increase in the economic value of the corporation. In other cases, the government is satisfied that there are sufficient economic and social benefits for the nation as a whole to justify the government's loss of an asset. Such transfer may also take the form, in some countries, of "public utility concessions" in which a public infrastructure, under a time-limited contract (but with a rather long maturity) is managed by a "concessionaire" which may be in some cases a public corporation but is more frequently of a private nature. (See VI.4). As a result, the rules to be followed may also apply to transactions with private corporations.

III.4.2 Treatment in national accounts

Two solutions are relevant:

III.4.2.1 **No expectations of return**

3. A straightforward transfer of a non-financial asset, with no other rights or obligations being established, nor new units being created, is a "gift" made by government to the corporation, and thus is to be recorded as a non-financial transaction.
4. In this context, the transfer of the non-financial assets is an investment grant in kind (D.92) made by the government, counterbalanced by a decrease in its capital formation, P.51g (and/or NP, if any land is involved). (ESA10 20.203)
5. The result of recording two flows of an equal amount in non-financial account is that there is no impact on net borrowing/net lending.
6. There is an increase in the corporation's net worth due to the capital transfer (investment grant), and symmetrically a decrease in the government's net worth. Depending on the method used in national accounts to value the government's equity in the corporation, it might be necessary to assume that the value of the equity of general government in the public enterprise reflects the increase in net worth of the latter. If so, the transformation in the enterprise's account of the positive net worth (B.10.1) into equity capital (F.5) may be described via a holding gain (K.7) in the revaluation account.

III.4.2.2 **Expectation of higher return**

7. Governments may transfer non-financial assets to a public corporation in the expectation of receiving a higher economic return from the management by the corporation than by directly exploiting the asset itself, because of expected better efficiency. In addition, the transfer may be part of a package of events that changes some aspect of the relationship between government and the corporation (for instance, through new obligations, rights and claims) or creates new units.

8. This situation can be regarded as the exchange of a non-financial asset for a financial one (government's equity in the public corporation). No transactions need to be recorded like in the case described above. Instead, the asset provided should enter the balance sheet of the corporation (and leave the government balance sheet) via the other change in volume assets account (K.61). (See ESA10 20.203 and 20.6.19)
9. In this case, as in the previous one, there is no impact on the net borrowing/net lending. There is no impact on net worth either, since two flows of an equal amount are recorded which balance in the other changes in assets account.

III.4.3 Rationale of the treatment

III.4.3.1 For treatment as investment grant

10. **ESA10 1.70:** "The system records all transactions in monetary terms. The values to be recorded for non-monetary transactions must therefore be measured indirectly or otherwise estimated."
11. **ESA10 4.145:** "Capital transfers require the acquisition or disposal of an asset, or assets, by at least one of the parties to the transaction. Whether made in cash or in kind, they result in a commensurate change in the financial, or non-financial, assets shown in the balance sheets of one or both parties to the transaction."
12. **ESA10 4.146:** "A capital transfer in kind consists of the transfer of ownership of an asset (other than inventories and cash), or the cancellation of a liability by a creditor, without any counterpart being received in return."
13. **ESA10 4.153:** "Investment grants in kind consist of transfers of transport equipment, machinery and other equipment by governments to other resident or non-resident units and also the direct provision of buildings or other structures for resident or non-resident units."
14. The paragraphs above show that recording the gift of a fixed asset as a capital transfer in kind is valid within ESA10 (another way to view it, from a conceptual point of view and equivalent in terms of accounting impact, would consist in considering the capital transfer as an imputed flow of funds, then used by the corporation to buy the asset from government).

III.4.3.2 For treatment in other flow accounts

15. Restructuring assets and liabilities via a significant transfer of assets are different from transactions in the usual meaning of this word, and, in any case, different from a simple grant of an asset.
16. **ES10 6.20:** "When a corporation is legally split up into two or more institutional units, the appearance of financial assets and liabilities is recorded as changes in sector classification and structure."
17. **ESA10 6.19:** "Changes in structure of institutional units cover appearance and disappearance of certain financial assets and liabilities arising from corporate restructuring."
18. K.611 seems also to apply to non-financial assets. "Changes in structure" is assumed to include significant changes in the balance sheet of unit when they coincide with other changes such as the functions of the unit.

III.4.3.3 Comment on recording the event as an injection of other equity in F.5.

19. To record an injection of other equity through the financial account is not appropriate. The use of F.519 (other equity = equity not evidenced by shares) in national accounts is restricted to a limited number of well-defined cases. Such treatment would artificially improve the net lending / net borrowing of government (through the counterpart transaction in P.51g or NP).

20. Moreover, even if it would not be incorrect from a pure accounting point of view, this would have no economic content. In fact, when a unit has a net borrowing, this means that there was a gap of resources which had to be financed possibly by a reduction in its assets. In the present situation, the appearance of other equity has a kind of automaticity that is more appropriately recorded in the other changes in the volume of assets accounts.

III.4.4 Accounting examples

In the following example, it is assumed that government gives a building worth 100 to a public corporation. In the first case it is a pure gift; there are no associated events nor does the government expect increased property income arising from the transfer of the asset. In the second case the transfer of the asset is part of a reorganisation of the delivery of some services involving the corporation.

a. Recording a capital transfer and capital formation

In the following example, the capital transfer is assumed to result, in the first instance, in an increase of the public enterprise net worth. Subsequently, it would be possible to assume that this increase in net worth is "absorbed" by an equivalent increase in the equity of government in the public enterprise, via the revaluation account: this second step is not described here. Moreover, in the closing balance sheet, only the change in net worth is shown.

General government				Public enterprise			
Opening balance sheet							
A		L		A		L	
AN.11	100						
Capital account							
ΔA		ΔL		ΔA		ΔL	
P.51	-100	D.92	-100	P.51	+100	D.92	+100
B.9	0	B.10.1	-100	B.9	0	B.10.1	+100
Closing balance sheet							
A		L		A		L	
AN.11	0	$\Delta B.90$	-100	AN.11	100	$\Delta B.90$	+100



b. Recording a change in classification and structure

General government				Public enterprise			
Opening balance sheet							
A		L		A		L	
AN.11	100						
Other changes in the volume of assets account							
ΔA		ΔL		ΔA		ΔL	
AF.5 (K.12.1)	+100			AN.11(K.12.1)+100		AF.5 (K.12.1)	+100
AN.11 (K.12.1)	-100						
		B.10.2	0			B.10.2	0
Closing balance sheet							
A		L		A		L	
AF.5	100			AN.11	100	AF.5	100
AN.11	0						
		$\Delta B.90$	0			$\Delta B.90$	0

III.5 Dividends, super dividends, interim dividends

III.5.1 Background to the issue

1. Payments made by public corporations to governments as shareholders are usually called "dividends" with reference to commercial law and business accounting². In most cases, these payments are also recorded as property income (dividends, D.42) in the ESA framework. The question addressed in this chapter is if there are payments made by public corporations to governments which, though they might qualify as dividends with reference to business accounting, require a different treatment in the ESA framework, for macro-economic statistics purposes, i.e. whether they need to be recorded differently from property income. The following rules normally do not apply to dividend payments by private corporations where government is a minority shareholder, unless there is evidence that government had a decisive influence on the allocation of profits and their distribution.³
2. Two elements may notably challenge the nature of the transaction and therefore the ESA classification of the payment: the size of the payment, in relation with the accrued profit of the corporation, and the timing of the payment, and sometimes a combination of the two.
3. Dividends are paid and recorded in a corporation's accounts when decided by the owners of the corporation (normally proposed by the Board and subject to approval by the majority of the general assembly of shareholders), usually based on the observed profit of an accounting year. This decision is commonly made in the year after the accounting year of the realised profit, when the accounts for this year are approved. However, it is not uncommon, notably for large corporations preparing semi-annual or quarterly accounts (or publishing regular profit warnings), that interim dividends are paid during the accounting year, before the final yearly earnings are known. In commercial company accounting, this is a frequent practice. Some public corporations (including central banks) in the EU have a similar practice. ESA10 explicitly addresses the case of interim dividends.
4. Another issue is the size of the payment. According to the definition of income in national accounts (see above 2.1.1 "Overview of principles"), a large payment may not result from the profit of the year realised by the corporation, but from a withdrawal of previously accumulated reserves, included in its own funds. Payments made to the government, whether made to the government after the annual profit of the corporation is known, or before (interim payments), must be closely analysed for the relevant recording of transactions in national accounts.

III.5.2 Treatment in national accounts

III.5.2.1 Dividends and super-dividends: definitions

5. Dividends: ESA10 4.53: "Dividends (D.421) are a form of property income to which owners of shares (AF.5) become entitled as a result of for instance placing funds at the disposal of corporations."
6. In the ESA10 framework, the following principles are established:

² Under ESA10 the notion of dividends covers more than what is strictly called dividends in business accounting (see ESA10 4.54)

³ Note that in some cases, government may have such control in the absence of a majority of shares (multiple voting rights, special arrangements). Here, the important issue is whether government has a predominant role over the other investors on any decision related to profits. There are cases where government holds no ordinary shares in an entity but is entitled to decide to take most of the dividends.

- The resource available for distribution by a unit (a corporation) as dividends (...) is the distributable income of the unit, which is equal to the entrepreneurial income (B4)⁴ plus all current transfers receivable less all current transfers payable and less the adjustment for the change in pension entitlements.” (4.55).
 - Following this logic, the resources from which dividends have to be paid should neither include the proceeds of sales of assets nor holding gains (...) which are not part of the distributable income.
 - A large payment out of reserves, reducing the own funds of a corporation, is not a distribution of income. Such a payment is in substance a capital withdrawal, to be recorded as a transaction in shares and other equity.
 - In practice, the operating profit or surplus (including the net interest charge in order to be consistent with the “B.4” concept in ESA10 as defined in 8.26-8.27) of the corporation could be used as a proxy for the distributable income.⁵
7. Corporations may smooth the amounts of dividends they pay from year to year. In one year they may put part of the profit into a dedicated reserve for distribution and use it in the following year, for the purpose of dividend smoothing. Whilst it is conceptually acceptable within the national accounts framework to record such smoothed payments as dividends, since they effectively come from distributable income but provided that it was clearly approved by the General Assembly of the corporation the previous year and recorded in an identified reserve set up exclusively for this purpose, the case of large payments exceeding any special reserve set up for short term adjustment and by evidence made from reserves accumulated from more than one year earlier is considered in substance to be a withdrawal of capital, to be recorded in national accounts as a financial transaction in shares and other equity.
8. Super-dividends are different in nature from dividends, as they are paid out of accumulated reserves, accounted for in the own funds of the corporation. Any withdrawal from own funds is to be recorded as a withdrawal of equity (F.5), at least for the amount in excess of the distributable income of the accounting year.
9. The "super-dividend test", as described in ESA10 20.206-207, must be applied to all sizable payments that significantly differ from the usual amounts of dividends and frequently out of proportion to the average distributable income over recent past. Only the part of the payment equivalent to the distributable income can be recorded as property income. Any amount in excess is to be recorded as a transaction in equity (F.5). This recommendation applies to all corporations, including the central bank.

III.5.2.2 Time of recording

10. The present guidance in the ESA10 is the following:
- For dividends (D.421), paragraph 4.57: "The time of recording of dividends is the point in time at which the share price starts to be quoted on an ex-dividend basis and not at a price that includes the dividend. “ In practice it is very close to the time they are effectively paid to the shareholders. For unquoted shares it is the time dividend are to be paid.⁶ Thus, it is clearly not the time at which the final

⁴ ESA10 20.206 specifies that “in the absence of a measure of the entrepreneurial income, the operating profit in business accounts is used as a proxy.” Generally, both measures are very close.

⁵ Income statements may strongly differ when established on a national or proper to a corporation basis. In all cases it must refer to the net result of current activity (“continuing” under IFRS), before distribution and income tax, excluding any exceptional transactions generating holding gains or losses.

⁶ Contrarily to the case of debt securities where the yield is contractually due from the issuer, dividends are not accrued as such, as they depend on profits and distributive policy that are uncertain or not definitive until the accounts of the year are established, audited and approved.

decision for distribution is taken/approved⁷ And is in line with principle of ex-dividend valuation on markets.

- For withdrawal from the income of quasi-corporations (D.422), paragraph 4.62: "Time of recording: withdrawals from the income of quasi-corporations are recorded when they are made by the owners." They are therefore to be recorded on a cash basis.

III.5.2.3 The case of interim dividends

11. As mentioned above, an "interim dividend" refers to the case where the corporation makes a payment to the shareholder during the accounting year, before the final annual result of the corporation is known. They are described in ESA10 20.207.
12. General principle: as a consequence of the definition of dividends – as income - and of super-dividends – as capital withdrawals - interim payments made to the government by public corporations, including the central bank, cannot be deemed to be always treated in national accounts as property income at the time the payment is due and need to be examined on a case by case basis.
13. An interim dividend payment is recorded as property income (D.42) in national accounts if two conditions are fulfilled. First, the amount of dividend paid is based on short-period accounts available to the public, covering at least two quarters (thus, there must be evidence that the entrepreneurial income (or operating surplus in business accounting as a proxy) would be able to fund the dividends). Second, the interim dividend should be consistent with the level of distribution of dividends observed in previous years, taking into account the trend in profitability of the company.
14. If both conditions are not met, the interim payment is to be recorded as a financial advance (for government, another account payable, F.8). The whole dividend would then be recorded as property income (D.42) in national accounts – being subject to the "super-dividend test" - only when the final dividend is transferred to the shareholders, which takes place only after the annual results of the corporation are known with certainty (in the following year)

III.5.2.4 Rules to record and partition the transaction

15. In order to decide how to partition an interim dividend between the dividend and financial components, the amount distributed is compared to the distributable income (in practice the operating surplus) for the period from the start of the accounting year to when it was declared. If this income is higher than the amount distributed, the entire amount is recorded as a dividend. Any excess of the distribution over the distributable income which has been already observed in the published accounts⁸ is recorded as another account payable of government, awaiting the final annual result. This flow at the final assessment will be converted either as dividend, or as withdrawal of equity in case of super-dividend.
16. The general approach for partitioning a final dividend or super-dividend between dividend and financial components is to compare the distributable income (in practice the operating surplus) for the relevant period less any amounts recorded as dividends relating to interim dividends paid since the last annual dividend was paid.
17. If the distributable income is higher than the amount distributed, the entire amount is recorded as a dividend. Any excess of the distribution over the associated distributable income is recorded as withdrawal of equity. As a final dividend usually

⁷ There is generally a delay between the payment of a dividend and the date at which its distribution was decided. For quoted shares, the market price normally includes the value of the dividend until it is paid. For unquoted shares the only available information would be the time of the payment to government.

⁸ The interim dividend cannot be based on expectations of future operating surplus resulting from an activity which has not yet been actually carried out.



18. relates to income earned in the corporation's accounting year prior to when the payment is made, this is the relevant period for the entrepreneurial income.

III.5.3 Rationale of the treatment

19. The rationale of the recording of distributions as dividends is that they must derive from the distributable income of the corporation, accruing in the period to which the dividend relates. In such a case, there is a close link between the dividend payment and the accrued (current) income of the corporation.
20. The rationale for recording super-dividends as financial transactions is to consider that super-dividends are different in nature from dividends: whilst dividends correspond to a distribution of income, super-dividends correspond to a distribution of the corporation's wealth, reducing the own funds of the corporation. In the case of large payments out of accumulated reserves, there is no link with the accrued income of the corporation during the relevant accounting year. Only the distributable income can be distributed as property income (D.42) in national accounts.
21. The rationale behind the possibility to record an interim dividend as property income is that, under certain conditions, based on a few criteria (the income already observed, the usual distribution ratio and the trend in growth of profits the corporation), the interim payment may be considered as a transfer of accrued income. In this case, the recording of a property income, before the annual results are known, does not contradict the basic statistical and accounting rules.
22. When the criteria and conditions to record a dividend at the time of interim payment are not met, this payment is recorded as a financial advance, with reference to 5.240 in the ESA10: other accounts receivable/payable, excluding trade credits and advances, (F.89) are "financial claims arising from timing differences between distributive transactions (...) and the corresponding payments." Dividends are an example provided in 5.241. The rationale to record a financial advance is that, before knowing with certainty the annual result and the distributable income, there is a risk that the payment may turn out to be higher than the distributable income, thus including an element of super-dividend.

III.6 Impact on government accounts of transfer of pension obligations

III.6.1 Background to the issue

1. This chapter deals only with the recording of receipts by government (frequently referred to as “lump sum”) from a public corporation, and possibly a private corporation, in the context of a transfer of pension obligations to government in one-off operations.

III.6.1.1 Employers' pension schemes⁹

2. In several Member States, institutional units, including public corporations and government, may set up specific pension schemes for their own staff. ESA10 4.89b describes these schemes as a second type of social insurance schemes: “The second type consists of other employment related schemes. These schemes derive from an employer-employee relationship in the provision of pension and possibly other entitlements that are part of the conditions of employment and where responsibility for the provision of benefits does not devolve to general government under social security provisions.” Under ESA10, such responsibility is designed as “pension manager” (“sponsor” under ESA10), by opposition to the role of a “pension administrator”, acting only of behalf of the former. Such schemes may be organised separately from the parent unit (referred to as “autonomous” or “non-autonomous” pension schemes in ESA10 2.106) in which cases, they are classified in the S.129 pension funds sub-sector or even in the sub-sector “insurance corporations” S.128). They may be organised directly by the unit, under the form of a segregated reserve, or, through accounting conventions, an equivalent is recognised. In this case, they are not considered as institutional units in national accounts and recorded in national accounts within the unit instead.
3. Such employer pension schemes are not treated in national accounts as social security schemes, i.e., the flows of contributions (by the employer and/or the employees) and pension benefits are not part of government revenue or expenditure. Therefore, the flows and stocks are allocated to the pension funds' sub-sector, to the life insurers' sub-sector or to the sector in which the employer organising/managing the scheme is classified (sector S.11 for non-financial corporations or sector S.12 for financial corporations. The corporations that run the scheme may be public or private corporations.
4. Where the scheme is classified in sub-sectors S.129 or S.128, it is by definition funded. If the scheme is classified in the sector of the employer, it may be funded or unfunded.
5. An employer scheme is funded if the employer builds up a segregated reserve in its own balance sheet – whether because of legal obligations, specific regulations, contractual clauses, accounting standards or only on voluntary basis – that reflects the pension obligations (on an actuarial basis) against the beneficiaries. This reserve, with associated earmarked assets, ensures an important protection of the pension rights of the beneficiaries, notably in the cases of merger or bankruptcy of the employer (it is considered as the ownership of the beneficiaries).
6. An unfunded employer pension scheme occurs where the scheme does not hold assets to specifically meet the pension obligations. Such schemes are also often labelled as “pay as you go” (PAYG) schemes. Under them, the pension benefits due in a year are financed from the accrued contributions of the same year, with

⁹ For more detail, see Chapter I.3 in this Manual and ESA10 chapter17.

possible additional payments. In business accounting, at least for some corporations (notably those quoted in a stock market) a commitment must be recognised, including those in the form of a provision (as the occurrence of the payment is deemed to be certain). In other cases, it may be only additional information provided in the annual report of the corporation. ESA10 recognises in the core accounts the pension liabilities for employer pension schemes for sector S.11 and S.12.

7. Pension obligation towards beneficiaries is recorded as "pension entitlements (AF.63)" in ESA10. If the employer scheme is underfunded, a liability of the employer towards the pension administrator is recorded in "Claims of pension funds on pension managers (AF.64)" but only if the scheme is not recorded within the employer's sector, covering the gap between the present values of the obligations to the beneficiaries, recorded in AF.63, and the earmarked assets. As a reminder, in the case of a defined-benefit funded scheme (pensions set up by a set formula, notably with a link to their salary), this liability is valued as the present value of the outstanding pension net obligations of the employer. In the case of a defined-contribution scheme, the outstanding pension obligations are equal to the market value of the investments, as the manager normally in this case does not normally take any risk on the pension obligations and, thus, recording a liability AF.63 for the employer-manager would not be relevant.

III.6.1.2 Transfer of employers' pension obligations to government

8. For various reasons, government may take over these pension obligations. Examples include plans for (total or partial) privatisations or new stock market quotation. Government, as the owner of the public corporations (or in the context of a support to a private firm), may wish to improve their financial situation by "cleaning" liabilities from their balance sheet. For instance, in the case of a planned privatisation, investors may be reluctant to purchase the equity of a corporation encumbered with pension obligations, notably in case of under-funding (where the assets of the scheme have a lower value than its obligations and the employer has a commitment to bridge the gap). In the case of a private corporation, the reason may also be to improve the situation of the corporation but possibly also to enlarge the coverage of social security.

III.6.1.3 The key issue in national accounts

9. At the time of the transfer of the pension obligations to government, the corporation has to pay (possibly by installments over a given period of time) a lump sum (in cash or under the form of other financial assets, such as securities¹⁰) in order to compensate government for becoming responsible for the service of pensions (both for retirees and future beneficiaries still in activity) as, in most cases, the employees of the corporation will be subject to the "normal" Social Security scheme obligations, based on a "PAYG" system.. This means that by the transfer as such any funded scheme would be at the same time transformed into an unfunded scheme. Analytically, one may consider that government takes over pension obligations which will be considered as an unfunded scheme (no AF.63 liability in ESA10) whatever the nature of the scheme in which these obligations were recognised. Some operations may occur before the transfer but will concern exclusively the accounts of the corporation, the households, possibly a pension scheme or an insurance corporation, but not government (see below). Cases where the change would take only the form of a change in the management of funded scheme without change in the nature of the scheme (i.e. its disappearance, replaced by an

¹⁰ As it is frequent that funded pension schemes invest in government securities, the transfer to government of such assets would reduce the EDP Maastricht debt, through consolidation.



unfunded scheme for the same level of pension entitlements) might also be observed.

10. When the value of the assets is equal to the value of the pension obligations, this is to be considered as a financial transaction with no impact on government net lending / net borrowing. The transfer of the assets is counter-balanced by a liability. According to 20.273-275, this must be viewed as a financial advance, the prepayment of social contributions. These new participants, who will pay normal contributions to government in the future as long as they are active, have acquired rights to pensions without any contribution to this scheme before the transfer. This is also the case of the existing beneficiaries of pensions at the time of the transfer. It is to be noted that in case some non-financial assets (as buildings) would be transferred within a compensation package, there will be an impact on government B9 through an increase in Gross Fixed Capital Formation.

III.6.2 Treatment in national accounts

III.6.2.1 Case 1: the pension obligations are not recognised in government accounts

11. A first case is the transfer of the employer pension obligations to an unfunded scheme under the responsibility of government, i.e. a Social Security scheme. The calculation of the obligations (in present value terms) must be based on the various pension parameters observed at the exact time of the transfer and not on the basis of some future decisions by government changing some parameters used in the calculation, such as the discount rate.¹¹ Even if, in a very short term after the transfer, government would change some parameters (such as the level of pension or the required time of contributing), for instance by aligning them on those of the government scheme, this would be considered as independent from the original conditions under which the transfer took place. De facto, the employer's pension funded scheme would be "liquidated" just before the transfer and recorded only in the accounts of the corporations and households (which would only concern the accounts of the scheme and households through K.62 other flow in volume for the extinction of the AF.63 liability) and in this case the assets would be deemed as transferred from the households to government. This does not change the impact on government accounts but only the counterpart sector.
12. As a matter of principle, under this case, it is assumed that, as a general case, the "lump sum" paid to government matches or will match¹² the pension obligations taken on by government. No liability AF.63 is to be recorded in government's balance sheet but only a liability AF.89, equal to the value of the assets transferred as a counterpart. At the time of the transfer, this has no impact on government net lending/ net borrowing (unless some non-financial assets would be transferred.) The impact on government net lending/net borrowing would only appear after the extinction of this liability AF.8.
13. It might happen, although rather exceptionally, that there might be evidence, based on some public information following consensus between experts and/or parliamentary debate, either that the net present pension obligations are actually under-estimated¹³, or that government has not received enough assets in exchange for taking over pensions obligations, as valued according to the generally accepted

¹¹ By definition, such a calculation over a very long period of time, as for pension entitlements which cover a significant number of decades, gives only a picture at a given point of time. It is quite certain that the future reality would be different for many reasons but such a net present calculation is the only rational method to measure time equivalence of long term commitments.

¹² In case of installments, as previously mentioned, government will record in its assets a receivable together with the transferred financial assets.

¹³ This under-estimation should however go beyond the generally accepted margin of error (or approximate) for such actuarial calculations.

calculation methods. In such cases, the above-mentioned AF.89 liability should be revalued and any difference between this new amount of liabilities and the value of all assets, transferred as compensation, so that a capital transfer, with an immediate impact on government net lending / net borrowing, should be recorded at that time. It would be considered in this case that government has deliberately accepted, clearly in order to support the corporation, to enter in an unbalanced transaction.

III.6.2.2 Case 2: the pension obligations are recognised in government accounts

14. This case involves the transfer of pension obligations to government which places them in a scheme, at least during a first period, where the beneficiaries' entitlements are recognised in the core national accounts by an AF.63 liability in the accounts of government. However, it is likely that government would not take over the tasks of pension administrator and, thus, the scheme would be classified in S.129 or S.128.

If the scheme was still classified in the pension sub-sector in national accounts, government being substituting itself to the corporation as "manager" but not as "administrator", there would be, at the time of this change, a claim of the fund on the corporation in case of an insufficient funding of the scheme (recorded as AF.64 in ESA10). The corresponding amount should be viewed as a debt assumption and, therefore, a capital transfer from government to the corporation should be recorded, notwithstanding any measures taken by government after the transfer in order to improve the net situation of the fund.

All in all, the basic assumption is that the market value of the assets (cash, shares, debt securities and possibly also non-financial assets) transferred to government matches the value of the pension obligations (recorded as AF.63 in national accounts) transferred at that time. This equivalence has thus no impact on government net lending/net borrowing (with the exception, already mentioned, of non-financial assets). However, if there is a difference between the market value of the financial assets and the value of the liability (not applicable to defined-contributions schemes as mentioned above), a capital transfer should be recorded for the difference at the time of the transfer, with an impact on net lending / net borrowing, in order to show the decrease in government net worth due to the unbalanced transaction.

III.6.2.3 The recording of transactions after the transfer

15. After the transfer, the management of the scheme by government (i.e. receiving social contributions and paying pension benefits, both recorded on an accrual basis) should be neutral on government net lending / net borrowing, until the complete extinction of the liability AF8. The latter represents a payment in advance, which is to be "amortised" in the form of a D.759 imputed revenue off-setting the actual payment of benefits to the pensioners of the former employer scheme. This progressive extinction might follow the planned schedule for benefits payments or, for practical reasons, take the form of a linear imputation on a given period (such as 20-25 years). It is important to point out that it would not be necessary to check whether the payment of pensions to former employees of the corporation would correspond exactly to what had been foreseen at the time of the transfer. In other words, in reality, it is very likely that government could actually pay either more or less what was foreseen at the time of the transfer¹⁴, which would have an implicit impact on its net lending / net borrowing. This would notably occur because of the revision of some parameters.

¹⁴ There are several reasons for that, excluding changes in basis parameters, such as deviation from the hypotheses used in the estimation of the future pension benefits (mortality tables, inflation, etc.)

16. However, for time-equivalence purposes, as the liabilities are calculated in present terms (any expenditure in the future has a lower current value), it is necessary to reverse this situation at the time of the effective payment of the benefits. For this reason, interest expenditure should also be imputed in the non-financial account of government. In this regard, the rate of discount used for the estimation of the pension obligations at the time of their transfer to government could be used or, as a second best, a government benchmark long term interest rate. The lump sum may be invested specifically earmarked assets (escrow account) of which revenue be used to increase the value of the liability (from net present value to current value). Generally, government is not acting like that, benefiting from the lump sum for reducing its borrowing needs in the year of the transfer. However, in this case, there will be an “opportunity gain” for government due to the reduction in borrowing and conceptually this would be equivalent to the investment in assets.¹⁵

III.6.3 Rationale of the treatment

17. The main references in ESA10 are the following:

20.273: “On occasion, units may pay a lump sum to government in exchange for taking over some of their pension obligations. Such large one-off transactions occur between a government and another unit, usually a public corporation, often linked to the change of status of the corporation, or to its privatisation. The government usually assumes the obligations in question in exchange for a cash payment covering the expected deficit resulting from the transfer.”

20.274: “In concept, being an equal exchange of cash for the incurrence of an obligation that is a liability, the transaction should not affect measures of net worth and financial net worth, and should not alter the government net lending/net borrowing. However, the pension obligation may not appear as a liability on the balance sheet of either of the units transferring and assuming the obligations. For example, when transferred to the government, the pension obligations may be merged with a social security scheme for which no liability is recognised.”¹⁶

20.275: “In this context, such a lump sum payment should be viewed as a prepayment of social contributions. In consideration of the various arrangements observed in practice and in order to avoid any distortion in the calculation of some aggregates such as labour costs and compulsory levies, the lump sum is recorded as a financial advance (F.8), a prepayment of miscellaneous current transfers (D.75) which will be recorded in the future in proportion to the related payments of pensions. As a result, the lump sum payment has no impact on the net lending/net borrowing of the general government in the year of transfer of obligations.”

18. In case the obligations taken on by government are not recognised in its balance sheet, generally, no capital transfer should be recorded. It is assumed that such transfers would normally take place under a procedure which ensures a “fair” compensation to government. There is notably a democratic control by Parliament and it should be rather exceptional that a significantly insufficient compensation, largely evidenced by independent experts, could be effectively conducted and government enter in “unfavourable deals”. In addition, in most cases, the agreement of the European Commission would be required as the reduction in the pension obligations insufficiently without a corresponding equal decrease in cooperation’s assets as compensation to government, could be considered as a source of distortion, according to competitive rules, such unbalanced transaction resulting in an immediate improvement in the financial position of the corporation (which, as

¹⁵ However, as the liability covers long term pensions, in practice, there would be a gap due to change in refinancing costs.

¹⁶ The case of transfer to a government employer’s scheme is not foreseen in ESA10, as it seems highly unlikely because it will imply a change in the status of the employees of the corporation.

mentioned above, is generally the reason for carrying out the operation). This would be considered as a clear support from government to the corporation, which, for reasons of transparency and substance, must be recorded in national accounts.

19. However, such cases of unbalanced compensation may effectively happen, under some specific circumstances and for various reasons (for instance, for corporations which might not fall under competition rules because of the nature of their activity or if there is an on-going privatisation plan). Thus, there is a need to complement ESA10 in this Manual as, in the above-mentioned case, the net worth of the government would be (negatively) affected, as well as the net worth of the corporation involved in the transaction (in a positive sense).

As a general principle in national accounts, when government carries out unequal transaction, by evidence not for “purely commercial reasons” which would imply equivalence between the two legs of the transaction, a capital transfer has to be recorded. ESA10 5.21 states that in the case of a transfer as counterpart (totally or partially) of a financial transaction “the transaction value is identified with the current market value of the financial assets and/or liabilities involved”. In other words, the financial transaction is recorded for an amount higher than what was observed and includes the transfer component which is added to the effective amounts of assets exchanged between parties.

20. In the case of transfer of pension obligations, the recording of the difference between the lump sum and the pension obligations is clearly described in SNA 17.188: “If government assumes the responsibility for pension provision for the employees of a non-government unit through an explicit transaction, a pension liability should be recorded in the balance sheet of government. If the government does not receive matching assets in return, the difference between the increase in the government’s liability and the assets received is shown as a capital transfer to the non-government employer.”
21. Contrarily to SNA2008, ESA10 does not recognise pension liabilities in the balance sheet of the government, notably for social security schemes or for its own employer pension schemes. This is why only an AF.8 liability can be recorded (instead of AF.63) in government accounts. However, in both cases, the transfer of the pension obligations results in future commitments for government and it is clear that government has not undertaken the transaction with the aim to receive a full compensation for the obligations taken over. It has deliberately accepted to enter in a transaction in which there is by evidence an unrequited element. From an economic point of view, the substance is quite similar.

Under these conditions, the national accountants, which must provide a description “optimal for economic analysis and the evaluation of economic policy” (ESA10 1.25d) must view the codification of the liability as conventional and consider it as a rather secondary technical point. This would be particularly reinforced in cases where the unbalanced transaction could be considerable; government could even decide to take over the pension liabilities from the corporation completely for free or for a token value. This could account for a significant percentage of GDP. As a consequence, whatever the agreed conventions in national accounts about the recording of the pension obligations, there is no difference between SNA2008 and ESA10, which is legally enforceable in EU, as regards the economic substance of the transaction. In both cases, there must be an entry of the obligations in government’s balance sheet for their exact value. Thus, if the transaction is not balanced, for any reason, i.e. the pension obligations exceeding the assets received in exchange, the transaction must be “rebalanced” and, under ESA10, the only way is to adjust the liability in government accounts, whatever its codification. This will create a gap between the assets received by government in the transaction and the “final” amount of liabilities recorded in the balance sheet. According to a basic

principle in national accounts, this must be recorded as a capital transfer, with an impact on government deficit/surplus.

This would be independent from any measure (of which the impact and the timing are uncertain and not predictable at the time of the transaction) that government could take in the future in order to cover the gap. There are other cases of recording a capital transfer only by reference to the impact on the financial position of government as observed at the time of a transaction and not on the basis of information on possible, but fully uncertain or quite contingent, future actions by government or future events.

III.6.3 Accounting simplified examples¹⁷

III.6.4.1 Case 1: pension liability not recognised in government accounts

A public corporation transfers to the government its obligations related to pensions for its staff that the corporation has organised on its own (recorded as AF.63 in national accounts). Government accepts to pay future pensions, under the “universal” Social Security Schemes. It has been agreed (and not questioned) that the pension obligations have a net present value of 1000. In a future given year (t+20), pensions payable to the former employees of the corporation are 50 (assuming that they are identifiable), whereas they were expected to be 40 at the time of the transfer, according to the schedule available at this time and after reconversion in current value. (By simplification the rate of interest on government holdings is equal to the discount rate and the corporation and the households are shown in a consolidated way.)

a) the transaction is balanced

Government receives in return a cash payment of 1000, equal to the pension obligations taken on and immediately invested in securities. The impact on B9 appears only when the liability AF89 is exhausted, which is assumed not to be the case here after 20 years, even if the effective payments do not fit the amount foreseen.

Year t

General government				Corporations/Households			
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	+1000	F.89	+1000	F.2	-1000		
		B.9	0	F.89	+1000	B.9	0
Closing balance sheet							
A		L		A		L	
AF.3	1000	AF.89	1000				

¹⁷ The examples are focusing on the impact on B9 and or debt and do not aim to show all recordings in total economy.



Year t+20

General government				Households			
Current/Capital account							
U/ΔA		R/ ΔL		U/ΔA		R/ ΔL	
D.6211	50	D.75	50	D.75	50	D.6211	50
D.41	5	D.41	5				
B.9	0			B.9	0		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	-50	F.89	-50	F.2	50		
		B.9	0	F.89	-50	B.9	0
Closing balance sheet							
A		L		A		L	
AF.3	X(>1000)	AF.89	X(> 1000)				

b) the transaction is not balanced

Government receives in return a cash payment of 500, less than the pension obligations taken on (1000) and immediately invested in securities. A capital transfer is recorded for the gap whereas AF.89 is not equal to the assets received in the transaction. This has an impact on B9 of the year the transfer takes place but not on the following years as long as the liability AF.89 is not exhausted. The difference with the previous case is that this appears before the 20th year (the closing balance in year t+20 is not shown as there is no longer link with the initial transaction).

Year t

General government				Corporations/Households			
Current/Capital account							
U/ΔA		R/ ΔL		U/ ΔA		R/ ΔL	
D.99	500					D.99	500
B.9	-500			B9	+500		

Financial account

ΔA		ΔL		ΔA		ΔL	
F.2	+500	F.89	+ 1000	F.2	-500		
		B.9	-500	F.89	+ 1000	B.9	+500

Closing balance sheet

A		L		A		L	
AF.3	500	AF.89	1000	AF.89	1000		

Year t+20**General government****Households****Current/Capital account**

U/ ΔA		R/ ΔL		U/ ΔA		R/ ΔL	
D.6211	50					D.6211	50
B.9	-50			B.9	+50		

Financial account

ΔA		ΔL		ΔA		ΔL	
F.2	-50	B.9	-50	F.2	50	B.9	+50

III.6.4.2 Case 2: pension liability recognised in government accounts after the transfer of the obligations**a) the transaction is balanced**

In year t, a public corporation transfers to government AF.63 pension obligations related to its current or former employees. Government will pay future pensions from a scheme for which a pension liability AF.63 is still recognised in national accounts (and here recorded within government). Government receives in exchange a cash amount of 1000 immediately invested in F3 (or more likely directly F3 or F5 assets – by simplification there is no change in price in the example). In a future given year (t+20) pensions payable are 50 and they are paid from the assets which have been transferred. There is no impact on B9 as there is no need of borrowing to cover the payment of pension (the adjustment in non-financial account is recorded as D75).



Year t

General government				Public corporation/Households			
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	+1000	F.63	+1000	F.2	-1000	AF.63	-1000
		B.9	0			B.9	0
Closing balance sheet							
A		L		A		L	
AF.3	1000	AF.63	1000	AF.2	X - 1000		
				AF.63	1000		

Year t+20

General government				Households			
Current/Capital account							
U/ΔA		R/ ΔL		U/ΔA		R/ ΔL	
D.6211	50	D.75	50	D.75	50	D.6211	50
B.9	-0			B.9	0		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	+50 -50 = 0	AF.63	-50	F.2	+ 50		
F.3	- 50			F.63	- 50		
		B.9	-0			B.9	-0
Closing balance sheet							
A		L		A		L	
AF.3	X - 50	AF.63	X - 50	AF.2	Y + 50		
				AF.63	X - 50		

b) the transaction is not balanced

Under the same operation, for 1000 of pension liability, government receives in exchange a cash amount of 500 immediately invested in F3 (or more likely in F3 or F5 assets – by simplification no change in price in the example). This gap is reflected as a capital transfer as government has de facto assumed an implicit liability AF.64 of the corporation (which does not appear in the example as corporate and households are



consolidated). The difference with the previous case is that in year t+20 pensions payable are 50 but government no longer holds assets to finance the pensions and thus it must incur new borrowing which would substitute to AF.63. (This has an impact on Maastricht debt as it is instrument included in it, contrarily to AF.63).

Year t

General government				Public corporation/Households			
Current/Capital account							
U/ Δ A		R/ Δ L		U/ Δ A		R/ Δ L	
D.99	500					D.99	500
B.9	-500			B.9	+500		
Financial account							
Δ A		Δ L		Δ A		Δ L	
F.3	+500	F.63	+1000	F.2	-500	AF.63	-1000
		B.9	-500			B.9	+500
Closing balance sheet							
A		L		A		L	
AF.3	500	AF.63	1000	AF.2	X - 500		
				AF.63	1000		

Year t+20

General government				Households			
Current/Capital account							
U/ Δ A		R/ Δ L		U/ Δ A		R/ Δ L	
D.6211	50	D.75	50	D.75	50	D.6211	50
B.9	0			B.9	0		
Financial account							
Δ A		Δ L		Δ A		Δ L	
F.2	+ 50 - 50 = 0	AF.63	- 50	F.2	+ 50		
		AF.3	+ 50	F.63	- 50		
		B.9	0			B.9	0

**Closing balance sheet**

A		L	A		L
	AF.63	X - 50	AF.2	Y + 50	
	AF.3	50	AF.63	X - 50	

III.7 Selected ESA10 transactions

III.7.1 Payments by public corporations to government

D.5 (Current taxes on income and wealth), D.91 (Capital taxes)

In general it should be clear what is a tax, and public corporations pay taxes as the others do. However, in some specific cases, for classification questions, the government's role levying taxes might conflict with its role as the owner of the public unit, such that it is more appropriate to treat a payment of tax as a withdrawal of equity. This is more likely to apply to taxes on transactions initiated by government.

Relevant examples are:

- the case of a large payment related to privatization
- the case of large payments related to an exceptional sale or revaluation of foreign assets reserves

D.75 (Miscellaneous current transfers)

Could be transactions related to abnormal pension charges (in symmetry with ESA10 4.138b).

D.421 (Dividends)

Dividends arise from government's ownership of the unit. They apply to payments from the unit to government that are funded from the unit's income. Dividends do not apply to payments funded by asset sales, capital gains, or reserves accumulated over several years (with the exception of those which are foreseen for smoothing of dividends), even if they are called dividends in the accounts of the unit. These should be treated as withdrawals of equity in F.5.

See section above on the notions and income and dividends.

D.6 (Social contributions and benefits), D.8 (Adjustment for the change in pension entitlements), D.92 (Investment grants)

Not applicable.

D.99 (Other capital transfers)

Capital grants are unrequited payments and so it is difficult to envisage circumstances in which D.99 would be appropriate for the classification of a payment from a market unit to government. Why should a business give its money away in return for nothing? ESA10 lists only two possibilities:

4.165 h Major payments in compensation for extensive damage or injuries not covered by insurance policies

4.165 i Extraordinary payments into social insurance funds made by employers (including government) or by government (as part of its social function), in so far as these payments are designed to increase the actuarial reserves of those funds. This option requires the existence of an actual fund of assets to finance the social benefits, with assets and liabilities recorded in AF.6. It would not apply to unfunded social insurance schemes run by government.

Public corporations might give fixed capital assets to government as part of a restructuring operation. The transfer of assets might also happen at the end of a leasing-type contract when an asset reverts to government ownership after a period during which the public corporation was allowed to exploit the asset under certain conditions. In these cases the use of K.6 (changes in classification and structure) is the most appropriate treatment for the difference between the price paid and the market value of the assets.

F.2 (Currency and deposits), F.3 (Debt securities), F.6 (Insurance, pension and standardised guarantees schemes),

Under F.66 “provisions for calls under standardised guarantees” the amounts of expected losses than government is expecting in the context of the guarantees given under such schemes. The counterpart is a capital transfer. See VII.4.

F.4 (Loans)

This includes actual repayment of lending and imputed repayments associated with debt cancellation. In most cases debt cancellation should be recorded as a transaction in F.4; the counterpart is usually a capital transfer from government - D.99 - (except when privatisation is imminent: the counterpart is a transaction in equity - F.5).

In some cases a debt write-off is recorded in K.61 (changes in classification and structure) or K.5 (other changes in volume) only if the write-off is associated with appearance and disappearance of units.

F.519 (Other equity)

- **Withdrawal of equity**

This includes significant one-off payments made to Government. The payment is funded by the liquidation of assets such as drawing on accumulated reserves; sales of financial or non-financial assets; or realised capital gains. It excludes those payments that can be classified as dividends either for theoretical or practical reasons (see D.4 above).

Payments to government that arise from significant sales of assets at the request of government, or as part of a government policy, should be recorded as withdrawals of equity rather than as dividends or other non-financial transaction.

The classification is appropriate even when the public accounts of the unit describe the transaction as something else such as dividend or, in some circumstances, a tax.

This treatment applies to indirect privatisation (see II.2.1). The treatment of privatisation receipts in national accounts consists basically of considering the sale of the government’s equity as an exchange of a financial asset (shares and other equity) for another type of financial asset (in general liquid assets). Following this logic, the privatisation receipt as such does not improve the government deficit, but modifies its financing. The government’s new liquid assets should go towards reducing the government debt, either directly by repurchasing government debt securities, or indirectly by reducing the need for new debt issuance.

In order to ensure consistency and transparency, this treatment of direct privatisation is extended to indirect privatisation, that is to say the cases where government equity is sold through an intermediary – usually a public holding company – and the proceeds of the sale paid back to the government (whatever the legal form of this repayment to the government: dividend, tax, transfer, etc.).

To be consistent with the sale of financial assets the treatment also applies to the indirect sale of significant non-financial assets (with no impact on net borrowing / net lending).

- **Withdrawals of equity in kind**

The case of payments in kind to government is difficult because of the conflicting desire to be consistent with both the treatment of the indirect sale of non-financial assets (treated as F.5) and the desire for symmetry with payments in kind by government to the public corporation (see D.9 below).

When the transfer of assets between public corporations and government is associated with other restructuring and changes in functions and responsibilities, it is appropriate to record the transfers in kind as a change in classification and structure (K.61), in the other changes in volume of assets account.

- Withdrawals of equity from central bank
- The classification F.5 also applies to some transactions between government and central banks. This is because central bank assets are treated in national accounts as public property, so for example a fall in the central bank's gold and foreign exchange reserves would reduce the value of government's equity in the central bank.

K.61 (Changes in classification and structure)

This is appropriate when units are created, closed down, or merged; or when there is a significant change in the functions and responsibilities of units that it is not possible to record adequately in the transaction accounts. This category also applies when assets revert to government ownership after a period during which the public corporation has been allowed to exploit them (see chapter 6.4 on public infrastructure financed and operated by corporations).

III.7.2 Payments by government to public units

In several of these cases it is important to consider whether government is making payments to increase its investment in financial assets, as any rational investor might do, or whether it is seeking to support particular types of economic activity. The phrase "capital injection" is often used to describe large payments from Government to public corporations. It is not a national accounts concept. In national accounts it could be either a capital transfer or transaction in equity.

D.2 (Taxes on production and imports)

Not applicable.

D.3 (Subsidies)

These are regular payments by government to reduce prices charged by the unit and cover losses. It is inappropriate to consider such payments as injections of equity (F.5) because they fund current expenditure and they are often paid conditional on the unit behaving in a particular way, such as charging low prices, which can reduce the value of the equity.

D.7 (Other current transfers)

Abnormal pension charges would be in D.75 (4.139b).

D.5 (Current taxes on income and wealth), D.6 (Social contributions and benefits), D.8 (Adjustment for the change in pension entitlements)

Not applicable.

D.92 (Investment grants)

This applies to all unrequited payments to public units conditional on the funds being used for fixed capital formation rather than current expenditure.

Capital expenditure financed by government payments can result in an increase of the value of the government's equity in the public corporation. However, this is not a sufficient reason for classifying the payment as an injection of equity (F.5) because there is no certainty that the value of the government's equity will increase by the same amount. The capital formation may be used by the corporation to implement the government's economic and social policies (for example building railway lines or hospitals) rather than to increase profitability. In other words it is important to consider the government's objectives when making "capital injections" into a public corporation.

"Capital injections in kind" are when government transfers the ownership of fixed capital assets from itself to a public corporation (see II.3.2). Straightforward cases of a gift by government to the corporation should be recorded as investment grants, with

corresponding negative amounts recorded in fixed capital formation. This leaves government net borrowing unchanged.

In more complicated cases, where the injection in kind is associated with other restructuring of assets and liabilities and, perhaps the creation of new units, it is better to record the outcome in the other changes in the volume of assets account (K.5) or changes in classification and structure account (K.61) according to the provisions related to these flows. This also leaves government net borrowing unchanged.

D.99 (Other capital transfers)

ESA10 4.165 identifies that D.99 is appropriate in the following cases:

- compensations for damage
- payments to cover losses made over several years or exceptional losses counterpart to the cancellation of debts except when part of a privatisation (record in F.5)

D.99 is also relevant for the acquisition of financial assets by government in cases where the transactions are not undertaken at market prices, but are undertaken primarily to support the unit. For example government might buy bad debts or give soft loans. In these cases it is necessary to estimate the difference between the market value of the financial assets acquired and the price paid by government. This difference is to be recorded as a capital transfer from government to the unit. In effect the payment by government is treated partly as an acquisition of financial assets and partly as a gift. This treatment is often appropriate for financial defeasance structures set up to rescue banks.

F.4 (Loans)

When classifying payments to public units as loans it is important to examine the likelihood of repayment and the commercial arrangements for repayment and payment of interest. In some cases where repayment is uncertain, it might be more appropriate to record the loans as capital transfers, or where the interest payments are not fixed, to record them as the acquisition of other equity.

F.5 (Equity)

Acquisition of equity in public corporations.

This category excludes any payment conditional on the acquisition of fixed capital and payments in kind: these should be recorded as investment grants. An important characteristic of an injection of equity is that the public unit should have freedom to use the funds in the way it thinks best to increase the value of the business. There are three cases:

a) Government is the only shareholder in the public unit

Category F.51 (equity) might be appropriate for the classification of some payments by government to the unit, but only if strict conditions apply. The payments must be made for financial reasons with the same objectives that a rational private investor would have when investing in a business.

In other words, government must expect to earn a market rate of return, for example in the form of higher dividends from its investment; or it must intend to sell the business and receive a higher price because of the injection of equity. Payments to the unit for other purposes (for example, to cover losses) must be classified as capital transfers.

b) Government and some other units are partners in ownership

Some payments by government might entitle it to a larger share of the unit and its future profits. If the unit were run in a commercial way such that the government would earn a return on its investment, classification as F.5 would be appropriate.

If the increase in the government's shareholding would not provide financial benefits, perhaps because the unit's objectives are to support government's social policies rather than profit making, classification as a capital transfer would be more appropriate.



c) Government owns tradable shares in the public unit

If the government acquires tradable shares for its payment, which it could immediately sell for the price paid, then classification as the acquisition of shares is correct.



III.8 Keywords and accounting references

Capital transfers	ESA10, 4.145 and following
Capital transfers in kind	ESA10 ,4.146
Changes in classification and structure	ESA10, 6.17-20
Corporate restructuring	ESA10, 6.19-20
Debt cancellation, assumption of liabilities	ESA10, 5.36-39
Dividends	ESA10, 4.53
Entrepreneurial income	ESA10, 8.26-28
Equity	ESA10, 5.141 and following
Equity capital	ESA10, 5.148
Financial transactions	ESA10, 5.17, 5.19-22, 5.32-35
Institutional unit	ESA10, 2.12
Investment grants	ESA10, 4.152-163
Net worth	ESA10, 7.01
Non-monetary transactions	ESA10, 1.70
Other accounts receivable / payable	ESA10, 5.230-244
Other capital transfers	ESA10, 4.164-167
Own funds	ESA10, 7.07
Persistent losses	ESA10, 4.35c, 4.61
Property income	ESA10, 4.41
Quasi-corporation	ESA10, 2.13
Subsidies	ESA10, 4.30

IV

**Relations between government and the
financial sector**

Part IV Relations between government and the financial sector

IV.1 Overview

1. This part of the manual concerns the recording of relations between the government and the national central bank (NCB), and between government and other financial institutions in the context of public support for them.
2. Some NCBs have been observed making significant payments to government. These reduce the government deficit if they are recorded as non-financial transactions. It is not always easy to determine whether such transactions are financial or non-financial because the government is in a sense the owner of the national central bank and so can influence it to undertake transactions with the objective of reducing the government deficit. A key issue is in determining whether government receipts from the NCB that are labelled as dividends or taxes should be recorded in national accounts as withdrawals of equity because that reflects better the economic reality (but does not improve the government deficit).
3. Government support for financial institutions in times of severe financial crisis is not covered by this manual but is subject to separate recording conventions developed by Eurostat. Cases of financial support outside of such times, sometimes referred to as “financial defeasance” are dealt with in Chapter IV.5.

IV.2 Payments between the Central Bank and government

IV.2.1 Background to the issue

1. The management of asset portfolios and interventions in foreign exchange markets for monetary policy purposes may generate capital gains for central banks which are liable to be distributed to general government, generally in the form of dividends. The amounts involved may sometimes be very large. Capital gains are not income in national accounts and therefore payments to government financed out of capital gains cannot be recorded as property income. This chapter describes how the recording of capital gains made by the central bank as property income in the government accounts should be avoided. It also states that the rules on capital injections when government makes a payment to the central bank. Such payments by government may be made to cover losses made by the central bank. Capital losses may occur due to foreign exchange holding losses. Operating losses may exceptionally occur due to the fact that interest and other operating income do not cover operational costs made by the central bank.¹¹⁰

IV.2.2 Treatment in national accounts

2. In national accounts, capital gains have to be excluded from the distributable profits of the central bank, which therefore essentially results, on one hand, from the net interest revenue (on foreign exchange, on monetary operations with the banking system, and on other assets and liabilities) and, on the other hand, from the operating costs incurred by the central banks. There may be also, in a various proportions, revenue from the sales of some services (including to government). For this purpose, a practical method may be applied using general available information on the central bank's profits and losses and payments between the central bank and government. It consists of comparing the two following amounts:
 - a) The amount of operating profits/losses: this amount is equal to the total profit/loss of the NCB before distribution minus the capital gains/losses included in the total profit/loss. Thus, it is equal to net interest income and other operating income minus operational costs, such as staff costs.
 - b) The amount paid to general government as part of distributed profits.
3. For the central banks that apply the Euro-system accounting rules (including many EU Members not part of the euro area), the item "net result of financial operations, write downs and risk provisions" (items 2.1, 2.2 and 2.3 of the profit and loss account in Annex IX of ECB/2006/16) should be deducted from the total profit/loss for the year, to arrive at the operating profit/loss. The net result of financial operations includes realised holding gains/losses arising from financial operations as well as unrealised holding losses (so-called "write-downs") and transfers to/from provisions for foreign exchange rate and interest rate risks. To compute the operating profit/loss in a harmonised manner among Member States, unrealised gains on financial assets that are part of the total profit of non-Euro-system central

¹¹⁰ The Euro-group agreed in February 2012 that certain Eurozone Member States would transfer to the Greek government the profits made on Greek government bonds held by their National Central Banks on an annual frequency by June. The transfers between these Member States (expenditure) and Greece (revenue) are recorded as current transfers D.75 while the transfers from the NCBs to their respective government should fully follow the rules stated in this chapter, notably as concerns the distinction between dividends and withdrawal of equity.

banks should be deducted from the total profit together with any realised holding gains and (un)realised losses included in the total profit.

4. The following rules apply:
 - 1) If the payment to government (B) is equal to the operating profit (A), the whole payment to government (B) is recorded as property income (D.4) in the government accounts.
 - 2) If the payment to government (B) is lower than the operating profit (A), the whole payment to government (B) is also recorded as property income in the government accounts. This is true for all cases where the payment to government (B) is lower than the operating profit (A), whether due to capital losses or due to an addition to the central bank's reserves.
 - 3) Where there is no payment to government, no property income is recorded in the government accounts.
 - 4) If the payment to government (B) is higher than the operating profit (A), an amount equal to (A) is recorded as property income. The difference between (B) and (A) is recorded as an equity withdrawal by government.
 - 5) If the operating profit (A) is zero or if there is an operating loss, no amount can be recorded as property income and the whole payment (B) is recorded as a withdrawal of equity (F.5.) by government.
5. These rules apply to payments that the government receives in its capacity as a shareholder of the central bank. Regular corporate taxes on profits (that are also levied on the profits of other corporations) paid by the central bank to government are recorded as a current tax on income and wealth.
6. If government is not the only recipient of the central bank's profits and they are distributed among several owners, the rules in this section have to be used to determine which part of total distributable profit should be recorded as property income paid by the central bank to all owners and which part as a withdrawal of equity by all owners. When government receives a part of the distributable profits, then the same proportion of total property income can be recorded in the government accounts as property income and the same proportion of the total withdrawal of equity should be recorded in the government accounts as a withdrawal of equity by government.

IV.2.3 Rationale of the treatment

7. Holding gains and losses result from changes in the price of assets. They are not the result of production or the distribution of income from production and are recorded in the other changes in assets account as a change in the value of the assets and liabilities (ESA10 1.80 and 1.8). Because holding gains are not distributive transactions, they cannot be recorded as property income (ESA10 4.01). Capital gains by central banks, as referred to in private bookkeeping, are not conceptually different from holding gains, as understood in national accounts: the only difference consists in the way they are calculated. The bookkeeping of the Euro-system central banks for instance includes realised holding gains and both realised and unrealised holding losses as capital gains/losses in total profit. Some non-Euro-system central banks may also include unrealised holding gains in their total profit.¹¹¹ Irrespective of how capital gains are computed, they are not part of income.
8. When a payment to government from the central bank (B) is lower than the operating profit (A) due to capital losses, the total payment (B) is recorded as

¹¹¹ However, the basic accounting principle of conservatism normally leads accountants to anticipate or disclose losses, but it does not allow a similar action for gains. For example, potential losses from lawsuits will be reported on the financial statements or in the notes, but potential gains will not be reported.

property income (see rule 2 in the previous section). In such a case it is not allowed to record an amount (A) as property income and the difference between (B) and (A) as an acquisition of equity in the central bank by government. Thus capital gains and losses are somehow not treated symmetrically. This is explained in more detail in Table 1.

Consider the following two cases in Table 1:

- case X presents the case where the central bank experiences a capital loss;
- case Y describes the case where the central bank has a capital gain.

9. In both cases the total profit is distributed to government.

Table 1: Annual accounts of the central bank and government

Recording in central bank's bookkeeping	Case X	Case Y
Operating profit (a)	100	100
Capital gain/loss (d)	-20	20
Total profit (e) = (a) + (d)	80	120
Payment to government (b)	80	120
Recording payment in government accounts	Case X	Case Y
D4R Property income	80	100
B.9 Net lending/ net borrowing	80	100
F.2 Currency and deposits	80	120
F.5 equity injection	0	
F.5 equity withdrawal		-20
Revaluation of F.5	0	20

The upper part of the table shows the recording in the central bank's bookkeeping system.

The lower part of table 1 shows the recording of case X and Y according to the rules set out in section 2.

10. Rule 2 in the section 2 determines that the whole payment in case X should be recorded as property income. Rule 4 determines that part of the payment in case Y should be recorded as property income and that part of the payment should be recorded as a withdrawal of equity. A symmetric recording of capital gains and losses would have led to the recording of 100 as property income and 20 as an equity injection by government in case X. Such a treatment would have been appropriate within a reinvested earnings framework, but this approach is only accepted in the international accounting standards (ESA10, IMF Balance of Payments Manual) in the case of foreign direct investment.

IV.2.3.1 Legal and economic ownership

11. The rules in section 2 only apply to payments made to government in its capacity as shareholder of the central bank. Even if, from a legal point of view, there is no

ownership relation between government and the central bank, equity is to be recorded in national accounts to reflect the fact that the central bank holds and manages reserve assets on behalf of the nation, and hence of government. Moreover, if the government receives part of the profits on a regular basis or has a right over the net assets in case of liquidation, this also indicates that government is the economic owner of the central bank. In such cases where government has economic ownership despite not being the legal owner, government ownership in the central bank is recorded as “other equity” in national accounts.

IV.2.3.2 Valuation of government equity

12. The equity stake of government in the central bank is valued on the basis of net assets. This includes equity capital (issued), revaluation reserves (notably gold and foreign exchange), legal and dedicated reserves, and retained earnings.

IV.2.3.3 Other payments

13. The rules above do not apply to payments made by the central bank for services provided by government or to the payment of taxes. Regular corporate taxes to which other corporations are also subjected, paid by the central bank to government are recorded as a tax on income (D.51) with the exception of taxes paid on exceptional transactions (see chapter IV.3). The fact that capital gains may be taxed as well is not an issue. According to ESA10, taxes on income are not only levied on income, but also on profits and capital gains (see ESA10 4.78).

IV.2.4 Accounting examples

Table 2 shows some stylised examples of the annual profit and loss account of the central bank and payments to government. The proper recording in the government accounts can be determined by comparing the payment to government (B) with the operating profit/loss (A). The holding gains/losses in F5 held by general government are computed by deducting the amount of property income paid from the total profit.

Table 2: Payments from central bank to government and their recording in national accounts

	1	2	3	4	5	6	7	8
Total profit (+) / loss (-)	100	150	150	100	100	150	50	50
Operating profit (+) / loss (-)	100	100	100	150	150	100	-50	-50
Capital gain (+) / loss (-)	0	50	50	-50	-50	50	100	100
Payment from NCB to Government	100	100	50	100	150	150	50	100
Change in reserves due to retained earnings*	0	50	100	0	-50	0	0	-50
Recording in Government accounts								

D4R property income received	100	100	50	100	150	100		
Impact on B.9 net lending (+)	100	100	50	100	150	100		
F5A acquisition of equity								
F5A withdrawal of equity						-50	-50	-100
F5A Holding gain (+) loss (-)		50	100	0	-50	50	50	50

* - Change in reserves due to other reasons is neglected in these examples (legal and dedicated reserves)

Table 3: Profit and loss account of a central bank

The table below represents the published profit and loss accounts of a central bank that applies the Eurosystem accounting rules.

1.1. Interest income
1.2. Interest expense
1. Net interest income
2.1. Realised gains/losses arising from financial operations
2.2. Write-downs on financial assets and provisions
2.3. Transfer to/from provisions for foreign exchange rate and interest rate risks
2. Net result of financial operations, write-downs and risk provisions
3.1. Fees and commissions income
3.2. Fees and commissions expense
3. Net income/expense from fees and commissions
4. Income from equity shares and participating interests
5. Net result of pooling of monetary income
6. Other income
Total net income
7. Staff costs
8. Administrative expenses
9. Depreciation of tangible and intangible fixed assets
10. Banknote production services
11. Other expenses
12. Income tax and other government charges on income
(Loss)/profit for the year

The operating profit/loss can usually be computed by deducting item 2 of the profit and loss account “net result of financial operations, write downs and risk provisions” from the total profit/loss for the year, to arrive at the operating profit/loss and by deducting all other provisions and reserves not recorded inside item 2, since it cannot be completely excluded that, apart from item 2, other items of the profit and loss account of a central bank also contains provisions and reserves (for instance item 5). These will then also have to be deducted from the total profit/loss to obtain the operating profit/loss.

IV.2.5 Annex: Bookkeeping in Central Banks

IV.2.5.1 Introduction

14. Following the creation of the euro area, the European System of Central Banks (ESCB) has harmonised its accounting practices on all central banking related activities for Euro-system financial reporting purposes. The harmonisation rules are described in ECB guideline of 11 November 2010 on the legal framework and financial reporting in the European System of Central Banks (ECB/2010/20) and the amending ECB Guideline of 10 December 2012 (ECB/2012/29). While the ECB Guidelines are legally binding to euro area NCBs (the Euro-system), a number of EU NCBs of non-participating Member States have also aligned their practices to them as preparatory step to a possible adoption of the euro. The Guidelines are not mandatory for some items (“Other assets”) for which the rules are only recommended. When a particular item is not covered by the Guideline, central banks apply International Financial Standards or national laws.
15. The implementation of the above mentioned ECB Guidelines has harmonised the accounting treatment of gains and losses within the Euro-system. However, the distribution of NCB profits is not determined by above-mentioned Guideline, but is governed by national law or based on an agreement with the Ministry of Finance and is still very heterogeneous from one country to another.

IV.2.5.2 Recording capital gains/losses

16. Realised gains or losses occur when financial assets are sold; while unrealised gains or losses are generated when financial assets are kept on the books and revalued. This annex presents firstly, the treatment of both realised and unrealised gains and losses in the Euro-system bookkeeping, and secondly the existing practices regarding the profit distribution of the EU NCBs. The Euro-system accounting concepts used hereafter do not necessarily correspond to the wordings used in National Accounts (e.g. income).

IV.2.5.2.1 Income recognition and balance sheet valuation Euro-system rules

17. The rules for income recognition and balance sheet valuation are based on a prudent accounting approach whereby unrealised capital gains are not recognised as income (and therefore are not distributed). The following main rules apply:
 - Realised gains and losses are taken to the profit and loss account;
 - Unrealised gains are not recognised as income in the profit and loss account but they are recorded on balance sheet in a revaluation account;
 - Unrealised losses are taken at year-end to the profit and loss account if they exceed previous revaluation gains booked in the revaluation account; the unrealised losses taken to the profit and loss account cannot be netted-out by new unrealised gains in subsequent years;
 - There is no netting of unrealised losses in any security, in any currency or in gold holdings against unrealised gains in other securities or currencies or gold.
18. These rules apply to gold, assets and liabilities in foreign currency, non-Held-to-Maturity marketable securities, marketable equity instruments that are not participating interests and are not held as permanent investments, and off balance sheet instruments. Held-to-maturity securities and non-marketable securities are presented at amortised cost subject to impairment. Illiquid equity shares, participating interests, and other equity shares held as permanent investment are also valued at cost subject to impairment while loans are presented at nominal value (or cost).

IV.2.5.2.2 Other systems

19. For those NCBs that have not yet implemented the ESCB Guideline, a balance sheet revaluation item that includes unrealised gains may also be available. However, in some cases all valuation gains and losses are accounted in the profit and loss account.

IV.2.5.3 **Recording distribution of profits**

20. Governments are usually the main shareholders of National Central Banks and therefore are the main beneficiaries of the distributed profits. The modalities in which the profits of the NCBs are attributed and distributed to the respective governments are, though, rather heterogeneous across the different EU Member States as this is subject to national practices.
21. For most NCBs, the allocation of profit is in most cases codified in national law but in a few cases the profit distribution is based on an agreement between the Central Bank and the Ministry of Finance. In one case, where the government is not a legal shareholder, the main part of the NCB's profit is transferred to the government. In this case the government's economic ownership of the NCB is recognised in the national accounts with the government recorded to hold "other equity" in the NCB.
22. The level of profit distributed to shareholders varies across the ESCB. In some cases the profit is equally shared between the NCB and the shareholders, while in other cases the shareholders (mainly the government) receive the bulk of the net profit. While some NCBs distribute pre-determined percentages of the net profit, other NCBs restrict the profit distribution depending on the level of reserves and provisions.
23. To protect themselves against foreign exchange and interest rate risk, a number of NCBs may transfer part of the profits to general provisions and reserves. The profit distribution to government is asymmetrical in the sense that the profits at least partially lead to payments to governments while losses do not necessarily lead (only in exceptional cases) to a payment from government to the NCB. In order to cover possible losses when they arise, general risk provisions and reserves might be created as financial buffers. A new paragraph was inserted in ECB Guideline ECB/2012/29, whereby: "Taking into due consideration the nature of the activities of the NCBs, an NCB may establish a provision for foreign exchange rate, interest rate, credit and gold price risks on its balance sheet. The NCB shall decide on the size and use of the provision on the basis of a reasoned estimate of the NCB's risk exposure". However, this article cannot supersede national laws and the creation of general provisions and reserves is still subject to national legislation. A common definition of these two terms is as follows (and is the case for the ESCB accounting guideline):
- "**Provisions** are defined as amounts set aside before arriving at the profit or loss figure in order to provide for any known or expected liability or risk, the cost of which cannot be accurately determined".
 - "**Reserves** are considered as amounts set aside out of distributable profits, which are not intended to meet any specific liability, contingency or expected diminution in value of assets known to exist at the balance sheet date".

IV.2.5.4 **Special transitional rules for countries entering the euro area:**

24. NCBs revalue all financial assets and liabilities at the date they become members of the Euro-system. Unrealised gains which arose before entry into the euro area are separated from those unrealised valuation gains arising after the entry into the euro area. The ECB Accounting Guideline recommends the NCBs not to distribute unrealised gains during the transitional period leading to the entry into the Euro-system. In this case, unrealised gains which arose before entry into the euro area

can be distributed once they have actually been realised through transactions that occur after the entry in the euro area.

IV.3 The sale of gold and foreign exchange by the central bank

IV.3.1 Background to the issue

1. The proceeds of a sale of gold or other reserve assets by the central bank may be transferred to government. This chapter explains why such a transfer does not reduce government deficit (or increases surplus) because it is considered a withdrawal of equity. This treatment is shortly mentioned in ESA10 20.217.
2. It is worthwhile, first, to give a definition of reserve assets. Such a definition may be found in the IMF's Balance of Payment Manual: "Reserve assets are those external assets that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for intervention in exchange markets to affect the currency exchange rate, and for other related purposes (such as maintaining confidence in the currency and the economy, and serving as a basis for foreign borrowing). Reserve assets must be foreign currency assets and assets that actually exist. Potential assets are excluded. Underlying the concept of reserve assets are the notions of "control," and "availability for use," by the monetary authorities."¹¹² "Reserve assets comprise monetary gold, SDR holdings, reserve position in the IMF, currency and deposits, securities (including debt and equity securities), financial derivatives, and other claims (loans and other financial instruments)."¹¹³ In the following sections, only gold and foreign exchange assets are considered.

IV.3.2 Treatment in national accounts

3. A central bank may sell a significant part of its reserve assets and pay part or all of the proceeds to government. In such a case, the payment of proceeds to government is completely recorded in the financial accounts of government and the central bank. It is recorded as a withdrawal of shares or other equity (F.5) from the central bank by government, with a counterpart entry as an increase in a financial asset (most likely deposits, F.2) held by government, or, possibly, a decrease in a financial claim of government (loans, F.4 for instance) on the central bank.
4. This treatment in the national accounts has to be made irrespective of how the payment is labelled in the central bank's bookkeeping or in public accounts, such as a dividend or taxes for instance. In the case of large payments related to an exceptional sale of gold or foreign exchange reserves, the payment of taxes has to be recorded as a withdrawal of equity (see chapter IV.2).
5. In national accounts the correct recording of the sale of gold in the NCB's accounts depends on whether the gold sold is monetary gold or not. Monetary gold is a financial asset and is gold to which the monetary authorities (or others who are subject to the effective control of the monetary authorities) have title and is held as reserve assets. Non-monetary gold is a valuable and hence a non-financial asset. The sale of monetary gold will have no impact on the net lending/net borrowing of the central bank. The sale of non-monetary gold (i.e. monetary gold that has been demonetised) will impact net lending/net borrowing of the central bank. In both cases the payment of proceeds by the central bank to government has no impact on the net lending/net borrowing of government.

¹¹² BPM6 (2009), chapter 6, page 111.

¹¹³ See BPM6, box 6.5, page 112.

IV.3.3 Rationale of the treatment

IV.3.3.1 The specific nature of reserve assets

6. Reserve assets have specific features compared to other financial instruments. Although the central bank has a full autonomy for managing them, this institution does not act in self-interest like a corporation, i.e. by maximising their shareholder's profits or wealth. The role of the central bank concerning the management of foreign assets is fixed by specific legislation. They are managed for macro-economic purposes and for the public interest, in the framework of monetary policy. Thus, these assets are not really owned by the units that manage them. They are owned by the nation, represented in national accounts by general government.

IV.3.3.2 The recording of foreign exchange in central banks' balance sheets

7. The above-mentioned specific nature of foreign exchange held by central bank has to be reflected in national accounts under the form of equity recorded on the asset side of general government and on the liability side of the central bank. Considerations and uniformity of statistical treatment across member states are given a more prominent role than the legal status of the central bank. Even if, from a legal point of view, there is no ownership relation between government and the central bank, equity is to be recorded in national accounts to reflect the fact that the central bank holds and manages reserve assets on behalf of the nation, and hence of government, or that government is the economic owner of the central bank, because it has right over the net assets in case of liquidation or receives part of the profits on a regular basis (ESA10 5.148).
8. The question is how to value the equity of government in the central bank in respect of the reserve asset holding. To answer this question, it is worth considering the money creation process due to foreign transactions: at the time reserve assets are acquired by the central bank, there is most likely, in its balance sheet, a counterpart entry on the liabilities side to record the issuance of (base) money. When the market price of reserve assets acquired in this way increases, there is a holding gain. In national accounts balance sheets, the holding gain leads to increase in the value of the instrument on the asset side of the central bank's balance sheet. This increase on the asset side has a counterpart on the liability side: an increase in government equity.
9. Thus, at a given point in time, the value of government equity in the central bank's balance sheet in respect of reserve assets will be captured by the difference between the prices at which these assets were acquired by the central bank and their present market prices. More precisely, it is equal to the accumulation of holding gains/losses minus any withdrawals of equity made by government. At this stage, it is useful to make a distinction between monetary gold and foreign exchange assets.
10. Gold was generally acquired by central banks a long time ago and gold prices have greatly increased since that time. As a consequence, government equity in respect of the holding of monetary gold is generally important insofar as central banks have kept reserve assets under this form.
11. It is more difficult to be so conclusive about the equity related to foreign exchange assets: the final influence of movements in exchange rates depends on too many factors, such as impact on both imports and exports, currency of settlements, etc. It might happen that the value of equity declines and even becomes negative due to holding losses.
12. Nevertheless, the existence of payments to government, related to foreign exchange assets, implies a positive difference between the present market value of foreign currencies and their acquisition price; if there were a loss, there would be no

room for payments from central bank to government. So, in the cases under consideration there has been a holding gain, and as a consequence the value of government equity in the central bank in respect of foreign exchange assets has increased.

13. All payments made by the central bank to government related to the activity of holding and managing reserve assets, occur because government has equity in the central bank in respect of these reserve assets. They are thus treated as a withdrawal of shares and other equity (F.5).

IV.3.3.3 Monetary vs. non-monetary gold

14. The sale of monetary gold is recorded differently in the NCB's accounts than non-monetary gold. Monetary gold is a financial asset held by monetary authorities (the central bank or in some countries the central government) as part of the foreign reserves (see ESA10 95 5.57). If gold is sold by the NCB to other (i.e. foreign) monetary authorities, it is recorded in the financial accounts of the domestic central bank as a decrease in financial assets with as a counterpart entry a decrease in the liabilities of the central bank vis-à-vis foreign monetary authorities (or an increase in the financial claims of the central bank on foreign monetary authorities). If gold is sold to non-monetary authorities, it is treated as a disposal of a valuable. Such a sale is preceded by a demonetisation of monetary gold in the central bank's accounts. Demonetisation, meaning the reclassification from monetary to non-monetary gold, is recorded in the other changes in the volume of assets accounts of the central bank (K62), see ESA10 6.22-6.24).¹¹⁴ Although the sale of non-monetary gold is recorded differently in the central bank's account than the sale of monetary gold, the transfer of the proceeds is in both cases recorded as an equity withdrawal because in both cases gold is managed by the central bank on behalf of the nation and hence of government. Furthermore, the sale of gold does not impact the operating profits of the central bank. The transfer of the sale proceeds to government can therefore not be recorded as property income in the government accounts irrespective of whether gold has been sold to monetary authorities or other institutional sectors. This treatment of the sale of non-monetary gold is consistent with the recording of indirect sales of non-financial assets (see sub-section 5.2.2.4).
15. A gold sales agreement over 5 years between a number of European central banks has been renewed in 2009 proposing a concerted program of sales over a period of 5 years and a threshold of annual sales that is not to exceed 500 tons in total. See <http://www.ecb.int/press/pr/date/2009/html/pr090807.en.html>.

IV.3.4 Accounting examples

Example 1

- Assume that the central bank holds monetary gold that increases by 100 million Euros in value in year 1.
- In year 2 the central bank sells 90 million Euros worth of gold to foreign monetary authorities.
- In year 3 the proceeds are transferred to government.

¹¹⁴ There may also be the reverse operation "monetisation" (for instance sized gold by custom transferred to central bank).

YEAR 1						
General government			NCB			
Opening balance sheet						
A		L	A		L	
AF.2	a		AF.1	y	AF.2	b
AF.5	z				AF.5	z
Other changes in assets account						
ΔA		ΔL	ΔA		ΔL	
F.5	100		F.1	100	F.5	100
Closing balance sheet						
A		L	A		L	
AF.2	a		AF.1	y + 100	AF.2	b
AF.5	z + 100				AF.5	z + 100

YEAR 2						
General government			NCB			
Opening balance sheet						
A		L	A		L	
AF.2	a		AF.1	y + 100	AF.2	b
AF.5	z + 100				AF.5	z + 100
Financial account						
ΔA		ΔL	ΔA		ΔL	
			F.1	-90	F.2/S.2	-90
Closing balance sheet						
A		L	A		L	
AF.2	a		AF.1	y + 10	AF.2	b - 90
AF.5	z + 100				AF.5	z + 100

YEAR 3						
General government			NCB			
Opening balance sheet						
A		L	A		L	
AF.2	a		AF.1	y + 10	AF.2	b - 90
AF.5	z + 100				AF.5	z + 100
Financial account						
ΔA		ΔL	ΔA		ΔL	
F.2	90				F.2/S.13	+ 90
F.5	-90				F.5	- 90
Closing balance sheet						
A		L	A		L	
AF.2	a + 90		AF.1	y + 10	AF.2	b
AF.5	z + 10				AF.5	z + 10

Example 2

- Assume that the central bank holds monetary gold that increases by 100 million Euros in value in year 1.
- In year 2 the central bank sells 90 million Euros worth of gold to financial corporations. The gold is demonetised before the actual sale takes place.
- In year 3 the proceeds are transferred to government.

YEAR 1						
General government			NCB			
Opening balance sheet						
A		L	A		L	
AF.2	a		AF.1	y	AF.2	b
AF.5	z		AN.13	0	AF.5	z
Other changes in assets account						
ΔA		ΔL	ΔA		ΔL	
F.5	100		F.1	100	F.5	100

Closing balance sheet

A		L		A		L	
AF.2	a			AF.1	y + 100	AF.2	b
AF.5	z + 100			AN.13	0	AF.5	z + 100

YEAR 2
General government
NCB
Opening balance sheet

A		L		A		L	
AF.2	a			AF.1	y + 100	AF.2	b
AF.5	z + 100			AN.13	0	AF.5	z + 100

Other changes in assets account

ΔA		ΔL		ΔA		ΔL	
				AN.13	+90		
				AF.1	-90		

Non-financial account

U		R		U		R	
				AN.13	-90		

Financial account

ΔA		ΔL		ΔA		ΔL	
						F.2/non S.13	-90

Closing balance sheet

A		L		A		L	
AF.2	a			AF.1	y+10	AF.2	b -90
AF.5	z + 100			AN.13	0	AF.5	z +100

YEAR 3						
General government			NCB			
Opening balance sheet						
A		L	A		L	
AF.2	a		AF.1	y+10	AF.2	b -90
AF.5	z + 100		AN.13	0	AF.5	z +100
Financial account						
ΔA		ΔL	ΔA		ΔL	
F.2	90				F.2/S.13	+ 90
F.5	-90				F.5	- 90
Closing balance sheet						
A		L	A		L	
AF.2	a +90		AF.1	y+10	AF.2	b
AF.5	z+10		AN.13	0	AF.5	z+10

IV.4 Non-returned banknotes and coins after a cash changeover

IV.4.1 Background to the issue

1. During a cash changeover, banknotes and coins in circulation denominated in national currency are returned to the respective issuers, which are the national central banks for banknotes and, in most cases, the national governments for coins. However, part of the national currency previously in circulation will never be returned because it has been destroyed or lost, or because holders have decided to keep it for collection or other reasons.
2. When an NCB no longer exchanges or expects to exchange old national banknotes, it writes off a liability. This write-off is then recorded as a profit in the profit- and loss statement of the NCB. The profits from the non-return of banknotes in national currency may ultimately accrue to government, either as a separate payment or as part of the regular payment of dividends and/or income taxes by the National Central Banks (NCB). The issue is whether such a payment affects government net borrowing / net lending.
3. The ESA10 recording rules only apply to the recording of stocks and flows in national accounts and do not prescribe rules for the actual bookkeeping done by the NCBs. ECB Guideline 2006/16 provides the legal framework for accounting and financial reporting in the European System of Central Banks.
4. In general, coins are a liability of government and the question arises whether their non-return impacts Government Deficit and Debt. (See below in 11 the treatment agreed by convention in ESA10.)
5. The recording principles in this chapter do not only apply to the case of a cash changeover to the euro, but also to other cases when existing series of coins or banknotes are substituted by new series of coins and banknotes, for instance due to a change in design of banknotes.

IV.4.2 Treatment in national accounts

IV.4.2.1 Non-returned banknotes

6. Gains from non-returned banknotes have no impact on government deficit. Banknotes in circulation appear in the balance sheet of the NCB under the category "currency and deposits" (AF.2). In a cash changeover, old national banknotes that have ceased to be legal tender and have not been returned to the NCB will be classified as "other accounts payable" (AF.8) in the balance sheet of the NCB. When banknotes that are not legal tender are exchanged against new banknotes, a reduction of "other accounts payable" is recorded with a counterpart entry in "currency and deposits".
7. The non-returned national banknotes are written-off from the NCB balance sheet in national accounts, when the NCB no longer exchanges them against new notes. In those countries where old national banknotes can be redeemed indefinitely against new ones, the old banknotes are written-off from the NCB's balance sheet when it is certain that they will no longer be returned even though the legal obligation to redeem the old banknotes still exists. In practice it seems generally prudent that statisticians derecognise NCB liabilities for the purposes of compiling the financial accounts, when the NCB's own accountants have done so. These write-offs are recorded as an "other change in volume" in the "other accounts payable" of the NCB.

8. The value of equity the government holds will increase by the same amount as that of the write-off, assuming that government is the only shareholder entitled to the gains from non-returned banknotes. This increase is recorded in the “other changes in assets account” of both the NCB and the government. When gains on non-returned banknotes are distributed to government, the amounts distributed have to be recorded as financial transactions (a withdrawal of equity (F.5) by government), not as government revenue (dividends, taxes on profits or capital transfers). In certain countries the government is not the legal shareholder of the NCB, but is nevertheless entitled by legislation to receive the proceeds from non-returned banknotes. In such cases national accounts recognise the economic ownership of government and record government holding “other equity” (F.519) in the NCB.
9. In cases where the NCB makes payments to government in anticipation of the write-off of the non-returned banknotes, the payments are treated in national accounts as advance payments. The payments are recorded as “other accounts payable” (F.8) in the government accounts and as “other accounts receivable” (F.8) in the accounts of the NCB, with counterpart entries in “currency and deposits” (F.2). When the actual write-off takes place, the amounts previously recorded in F.7 are reversed against the withdrawal of equity by government.

IV.4.2.2 Non-returned coins

10. Non-returned coins have an impact on government debt as defined for the Excessive Deficit Procedure, but leave government deficit unchanged. The treatment in national accounts is similar to the treatment of non-returned banknotes.
11. In public accounts, coins in circulation are not a liability of the central bank, but of central government, and therefore the central bank pays the central government the face value of the issued coins. However, coins are part of the monetary aggregates and, by convention, a liability equal to the amount issued is entered under the category “currency in circulation” on the central bank balance sheet, with a notional claim on central government in AF.8 and a liability AF.8 in government accounts. (See ESA10, chapter 5, box B.5.2)

In a cash changeover, old national coins that have ceased to be legal tender and have not yet been returned to government, but can still be officially exchanged against legal tender, are reclassified as "other accounts payable" (F.8) by an "other change in volume" (K.5) in the "other changes in assets accounts". This reduces the stock of debt when old currency ceases to be legal tender, since "other accounts payable" are not parts of government debt. If old currency is returned against new coins, government debt increases, as the amount of coins in circulation rises.

12. The write-off of the non-returned national coins in government's balance sheet takes place when the government no longer exchanges the old national coins against the new legal tender or when it is certain that they will no longer be returned. This should be recorded in national accounts through an "other change in volume" (K.5) of "other accounts payable" (AF.8) leaving the deficit unchanged.

IV.4.3 Rationale of the treatment

13. The ESA10 category "currency" (F.21) consists of coins and banknotes that are commonly used to make payments (see ESA10 5.76-78). Once old national banknotes and coins cease to be legal tender, they can no longer be used to make payments and therefore have to be excluded from the ESA10 asset category “currency” (F.21). This is not an interaction between institutional units by mutual agreement and as a consequence is not recorded as a financial transaction (see ESA10 1.66). Rather, an asset reclassification other than (de)monetisation of gold (K62) is to be recorded (ESA10 6.24) in the “other changes in assets accounts” of both debtor and creditor. As long as old coins and banknotes can be exchanged

against new ones, they still represent a financial claim on the issuers and they still have to be considered financial assets (unlike valuables) and are reclassified to the ESA10 category “other accounts receivable/payable”. They de facto function as a store of value to the holders, while the issuer has a liability, as it must redeem these instruments on presentation.

14. When old national banknotes and coins can no longer be exchanged against new currency and, thus, discontinue to constitute a claim against the issuer, another change in volume of financial assets and liabilities (K5) has to be recorded in the “other changes in assets account” of both debtor and creditor, because it is not the result of an interaction by mutual agreement and neither a financial transaction nor a capital transfer. In practice, accountants also write-off old currency when it is (almost) certain that the old banknotes and coins will no longer be exchanged, even though the legal obligation to exchange them still exists. Accountants know from experience that not all old banknotes and coins will be exchanged either due to exceptional losses (see ESA10 6.14a) or because old coins and notes are kept as collectibles. In this case, statisticians follow the same approach as the accountants and also record a write-off in the national accounts, so as to reflect economic rather than legal reality. If old banknotes and coins that have already been written off are, against expectation, handed in for exchange against new banknotes and coins, the write-off has to be reversed through the “other changes in assets account” of both debtor and creditor.
15. The value of the equity government holds in the NCB will increase due to the write-off of banknotes, since the amount of outstanding liabilities of the NCB is reduced. Changes in valuation of equity are also to be recorded in the “other changes in assets accounts” (in the “revaluation account”).
16. Payments made to government by the NCB following the gains made due to non-returned banknotes cannot be recorded as dividend income (given that equity is valued at the NCB’s net assets). These gains were not the result of production or the redistribution of production but the result of write-offs and therefore cannot be part of the operating profit of the NCB. This is the reason for which the payment made to government has to be recorded as a withdrawal of equity by government, leaving the government deficit unchanged.
17. Reclassifications or write-offs of old coins also leave the government deficit unchanged. Government debt, as defined for the purpose of the Excessive Deficit Procedure, consists of “currency and deposits” (F.2), “debt securities” (F.3 and “loans” (F.4). A reclassification of old coins from “currency and deposits” to “other accounts payable” once they cease to be legal tender, reduces the stock of debt, since “other accounts payable” are not part of government debt. If old currency is returned against new coins, government debt increases, as the amount of coins in circulation rises.

IV.4.1 Accounting examples

Example 1

- The euro is introduced on day 1 of year 1.
- After half a year old national banknotes are no longer accepted as legal tender. 100 million Euros worth of old banknotes have not yet been exchanged against Euros by the end of year 1.
- After one and half years the old banknotes can no longer be exchanged against Euros. 15 million Euros worth of old banknotes have not been exchanged against Euros by the end of year 2 and have been written-off accordingly.
- The amount of 15 million Euros is paid to the government by the NCB in the course of the second half of year 2.

- For the sake of simplicity, it is assumed that old banknotes are exchanged against new banknotes and not against coins or deposits.

YEAR 1					
General government			NCB		
Opening balance sheet					
A		L	A		L
AF.22	a			AF.21	x
AF.5	y			AF.22	a
				AF.5	y
				AF.8	z
Other changes in assets account					
A		L	A		L
				AF.21	-100
				AF.8	100
Closing balance sheet					
A		L	A		L
AF.22	a			AF.21	x - 100
AF.5	y			AF.22	a
				AF.5	y
				AF.8	z + 100

YEAR 2					
General government			NCB		
Opening balance sheet					
A		L	A		L
AF.22	a			AF.21	x - 100
AF.5	y			AF.22	a
				AF.5	y
				AF.8	z + 100

Financial accounts

A		L		A		L	
F.22	15				F.21	85	
F.5	-15				F.22	15	
					F.5	-15	
					F.8	-85	

Other changes in assets account

A		L		A		L	
AF.5	15				AF.5	15	
					AF.8	-15	

Closing balance sheet

A		L		A		L	
AF.22	a+15				AF.21	x-15	
AF.5	y				AF.22	a+15	
					AF.5	y	
					AF.8	z	

Example 2

- The euro is introduced on day 1 of year 1.
- After half a year old national banknotes are no longer accepted as legal tender. 100 million Euros worth of old banknotes have not yet been exchanged against Euros by the end of year 1.
- After one and half years the old banknotes can no longer be exchanged against Euros. In year 2, 15 million Euros worth of old banknotes are written off from the NCB's balance sheet. The amount of 15 million Euros is paid to the government by the NCB in advance in the course of year 1.
- For the sake of simplicity, it is assumed that old banknotes are exchanged against new banknotes and not against coins or deposits.

YEAR 1							
General government				NCB			
Opening balance sheet							
A		L		A		L	
AF.22	a	F.8	b	F.7	c	AF.21	x
AF.5	y					AF.22	a
						AF.5	y
						AF.8	z
Financial accounts							
A		L		A		L	
F.22	15	F.8	15	F.8	15	F.22	15
Other changes in assets account							
A		L		A		L	
						AF.21	- 100
						AF.8	100
Closing balance sheet							
A		L		A		L	
AF.22	a+15	F.8	b+15	F.8	c +15	AF.21	x - 100
AF.5	y					AF.22	a+15
						AF.5	y
						AF.8	z + 100

YEAR 2							
General government				NCB			
Opening balance sheet							
A		L		A		L	
AF.22	a+15	F.8	b+15	F.8	c +15	AF.21	x -100
AF.5	y					AF.22	a +15
						AF.5	y
						AF.8	z + 100

Financial accounts

A		L		A		L	
F.5	-15	F.8	-15	F.8	-15	F.21	85
						F.5	-15
						F.8	-85

Other changes in assets account

A		L		A		L	
AF.5	15					AF.5	15
						AF.8	-15

Closing balance sheet

A		L		A		L	
AF.22	a+15	F.8	b	F.8	c	AF.21	x-15
AF.5	y					AF.22	a+15
						AF.5	y
						AF.8	z

Example 3

- The euro is introduced on day 1 of year 1. Coins are a government liability.
- After half a year old national coins are no longer accepted as legal tender. 100 million Euros worth of old coins have not yet been exchanged against Euros by the end of year 1.
- After one and half years the old coins can no longer be exchanged against Euros. 15 million Euros worth of old coins have not been exchanged against Euros by that date. Of the 85 million old coins that were exchanged at banks, 40 million were exchanged against new euro coins. 45 million Euros worth of old coins were deposited on bank accounts.

YEAR 1
Government sector
Opening balance sheet

A		L	
AF.22	a	AF.21	x
		AF.8	y

Other changes in assets account

A	L
	AF.21 -100
	AF.8 +100

Closing balance sheet

A	L
AF.22 a	AF.21 x - 100
	AF.8 y + 100

Note that government debt is diminished by 100 million Euros at the end of year 1 due to the reclassification of old national coins.

YEAR 2
Government sector
Opening balance sheet

A	L
AF.22 a	AF.21 x - 100
	AF.8 y + 100

Financial accounts

A	L
F.22 - 45	F.21 + 40
	F.8 - 85

Other changes in assets accounts

A	L
	AF.8 - 15

Closing balance sheet

A		L
AF.22	a - 45	AF.21 x - 60
		AF.8 y

The final impact on government debt by the end of year 2 due to the cash changeover is smaller than the impact after year 1 due to the fact that a large amount of old coins have been exchanged against new legal tender.

IV.5 Financial defeasance

IV.5.1 Background to the issue

1. This issue is covered in ESA10 20.46 (classification of defeasance units), 20.243-20.246 (impact on government accounts of its some interventions, including more extensively any “bail out” of financial institutions).¹¹⁵
2. According to the experience in Europe in the 90’s and since 2008 onwards, financial defeasance has been identified as the management of problematic (bad) assets held by a financial institution, with significant negative impact on its profitability and also frequently on its solvency. In this context, the involvement of government is in most cases a key feature of financial defeasance.

For public policy reasons the government puts itself in a position to bear the major risks attached to the assets and/or to ensure the long term management of such assets. In case of public units, the government takes ownership of the entity (nationalisation) and intervenes, directly (capital injections for covering losses, loans, etc...) or more indirectly, through granting of guarantees, and sometimes through a public entity, owned directly or indirectly (through some public financial corporations) by government.

In this Manual and in national accounts, it will be defined as a rescue process of financial institutions, having three major characteristics:

- A financial institution has become financially distressed due to its involvement with considerable problematic (“bad” or “non performing”) assets;
 - Most of the time (but not always), the rescue process involves the creation of an entity dedicated to the management of those problematic assets, the defeasance structure, also referred to as a “bad bank”, while “normal” commercial activity, assumed to be profitable, remains in the financial institution;
 - Government is involved, directly or indirectly, in the rescue process through various ways, such as capital injections for covering subsequent losses due to the problematic assets (write-down, realised losses), financing at specific conditions, granting guarantees or nationalisation, in such a way that it may be viewed as assuming control or placing itself at risk (in fact taking over most of the final risk attached to assets of bad quality, while it might also be entitled to possible rewards).
3. It is important to note that in some situations the solvency and/or liquidity of banks, private or public, might be at stake and the government and/or the Central Bank might need to intervene, usually by providing collateral / liquidity in the context of specific schemes. This sort of rescue operation will not be referred to as “defeasance”, the financial institution not being relieved from the negative impact of its problematic assets. Nevertheless, these cases may show common features and may lead to similar recording recommendations (through for instance recognising the government as “the principal party to the transaction”(see below IV.5.2.6).
 4. A crucial point is the existence of problematic assets, which must be precisely defined. As a general definition, problematic assets are those non-performing assets (financial and, to a lesser extent, non-financial) that have negative consequences on the profitability of the financial intermediary that holds them and

¹¹⁵ This is different from “debt defeasance” which “occurs when a debtor matches debt instruments with financial assets having the same or greater debt service inflows” (ESA10 20.240). Generally, the liabilities are removed from the balance sheet and transferred to a special entity which, in national accounts, has to be consolidated with the original debtor.

are of sufficient size that they could endanger the solvency of the unit. They are assets that a “normal” financial intermediary would normally need to be relieved of. Such assets could be transferred through market transactions, however in this case the unit would incur immediate and frequently significant losses, which could not be covered through its own absorption mechanism. Problematic assets cover impaired and illiquid assets, as described below.

5. Impaired assets are valued in the business balance sheet in excess of their long term market or fair value and are therefore expected to incur losses in the future. The value of such impaired assets may have been already downgraded (or written down), in unusually high proportions compared to normal practice (observed on average for similar competitors on the market, which means that their nature diverges from market standards, and problematic assets are not defined by a minimum share of recorded or expected impairments). But further potential losses are usually still expected and the financial institution will not be in a position to meet such losses through its own loss-absorption mechanism. In the specific case of market assets, the unit could not dispose of them in a short term without incurring losses, such that the unit is de facto obliged to keep them and is subject to an involuntary exposure to market risk.
6. In some cases problematic assets take also the form of illiquid assets. In the context of this Manual, they are defined as those marketable assets which cannot be priced and disposed in the short term because of the absence of market functioning under normal conditions. There is thus high uncertainty on their future market value and the holder of the assets is not in a position to modify its risk exposure by another way than transferring it to a defeasance structure. For this reason, to ensure consistent treatment across countries, the definition of problematic assets used in this Chapter includes these types of assets.
7. In this context, the direct intervention of the general government may take various forms:
 - government provides to the financial institutions in difficulty a guarantee which will be called when these institutions record in their accounts losses on the problematic assets;
 - government buys directly the problematic assets from the financial institutions;
 - government creates on purpose public bodies with the aim to hold the assets of bad quality.
8. In practice, there may be more complicated arrangements where government intervenes in a more indirect way through units which are largely under its control or influence, for instance through some public financial corporations. The role of government will have to be ascertained in such situations, taking into consideration the guarantees which are usually granted by some government units to one of the entities involved in the rescue process. Generally such guarantees are explicit but in some cases the unit benefits from an implicit government guarantee due to its public legal status.

IV.5.2 Treatment in national accounts

IV.5.2.1 Sector classification – general rules

9. Any financial institution may be observed to hold some problematic assets, in many cases with no threat to the continued operation of the institution. It is important to distinguish those cases which are financial intermediaries as defined by ESA10 2.55-2.58, from those having the feature of financial defeasance structures, whatever their legal status.

A financial defeasance structure is an institutional unit, which has substantial problematic assets, whose principal activity is the resolution of these assets generally over an extended period. Such an institutional unit is not a financial intermediary as defined in ESA10.

Some or all of the features on the following indicative list would provide evidence of the defeasance structure nature of a unit, since they would call into doubt that the institution could be classified as a financial intermediary:

- being closed to new deposits-taking, or partly open under restrictive conditions. This includes the ceasing of deposit-taking from the general public or specified and relatively large sub-groups thereof. In particular, deposit-taking from the government, specific public corporations, would not be considered sufficient to conclude that the institution is engaging in financial intermediation;
- being closed to new lending, or partly open under restrictive conditions. The extending of loans which relate to the management of existing assets would not be sufficient to conclude that the institution is engaging in financial intermediation;
- strong externally imposed restrictions from competing on banking and financial markets;
- in most cases, a foreseen limited lifetime linked to the progressive liquidation of the assets by recovery or sales on the market.

10. For those institutions which do not satisfy the requirements to be classified as financial intermediaries (do not place themselves at risk - see ESA10 2.57), several cases can be distinguished:

- 1) A public body may be created by government with the clear task to hold problematic assets, frequently until their complete liquidation, and to directly assume losses that cannot be borne by “normal” commercial entities.
- 2) In other cases the assets are allocated to an entity, public-owned or closely controlled by government (the original shareholders having no or limited power) which is created in the context of the restructuring of an existing financial institution holding problematic assets. This may take various forms, according to the allocation of the problematic assets:
 - a) An existing financial institution is split between a new entity owned and controlled by government with the task to manage the problematic assets, and a remaining entity(ies) that is assumed to continue its financial intermediation activity in competition on the banking/financial market, possibly under a new name.
 - b) The financial institution transfers, under various procedures, its “commercial profitable activity” (such as deposit-taking, quality assets, low risk lending). As a consequence, the unit is left with the management of most or all problematic assets, which therefore become its main activity, and this is achieved with a strong support of the government and under its control (government being generally the main shareholder, directly or indirectly through other public bodies).

11. When there is evidence that the government is assuming the majority of the risks associated with the activities of the government-controlled defeasance structure, as described above, this structure is to be classified inside the general government sector, whatever its legal status. For instance, government is committed to cover the majority of the expected losses from the assets, through providing guarantees on the financing of the entity holding the problematic assets and the guarantee fee is not in line with the risks involved, and/or the main source of financing is the public

sector. The entity should be classified inside the general government sector from its creation (case 1 mentioned above) or reclassified (in case 2).

IV.5.2.2 Sector classification - implementation issues

12. In all cases, the sector classification of the publicly-controlled defeasance structure that will hold problematic assets as a major share of its assets has to be decided by analysing the degree of government sponsorship in the rescue process. Major share means that the book value of the assets on which exceptional losses (see above) have been recorded and further losses are still expected is a predominant part (and in some cases 100%) of the "earning assets" held by the entity.
13. There may be borderline cases where entities, meeting most of the fundamental features of a defeasance structure mentioned above, are still on the list of the Monetary Financial Institutions (which provides for the production of the ECB list of MFIs subject to the Euro-system's minimum reserves as well as a list of counterparties eligible for Euro-system operations). These cases will be analysed by Eurostat in close cooperation with the ECB, the national statistical institutes and the central banks, without prejudice to ESA10 2.67 and 2.68.
14. When the rescuing entity is a special purpose vehicle, not bearing most of the risks and not acting as a private investor would do, it should be considered as acting on behalf of government. Therefore, it will be regarded as a government-sponsored defeasance structure and should then be classified inside the general government sector, except in the cases specified in footnote 7.

IV.5.2.3 Impact on deficit and debt

15. As regards the impact on deficit, whatever the case envisaged (case of an entity created by government, case a above or case b above, or case of SPV), when the reclassification implies a transfer of assets for an amount higher than the market value that can be independently estimated, the difference should be considered as a capital transfer, with the assets added to the government balance sheet at market value. Any future holding gains/losses on these assets will be recorded in the revaluation accounts.

In the case of a defeasance structure which results from the restructuring of an existing financial intermediary which continues to operate with changed activities (case b above), the operation should be split into two steps:

- first, in order to take account of the support provided to the financial intermediary in the context of the operation, the difference between the transaction value of the transferred assets and their market value is recorded as a capital transfer to the debtors of the defeasance structure;
- then, the classification of the defeasance structure within the government sector is to be recorded as "Other changes in volume of assets account" (changes in sector classification and structure - K.62).

16. As regards the impact on government debt, in the case of restructuring under cases a and b above, or case of SPV, the classification of these entities to government will mean that both their assets and liabilities are included in the government balance sheet, and therefore gross government debt will include the relevant debt instruments of the entities.

IV.5.2.4 Treatments to be followed when government is only involved by its guarantee

17. Financial institutions or specific units controlled by those institutions, classified outside the general government sector, may receive government guarantees on all or part of the problematic assets that have been clearly identified in their portfolio.

Where such a guarantee exists, then

- If government takes on all or most of the risks and rewards directly attached to the problematic assets, government is considered the economic owner of the assets and the government accounts should record the acquisition of a financial asset with the counterpart transaction being a loan from the financial institution to the government. If the government acquires the assets above their market price or fair value, a capital transfer by government should be recorded for the part exceeding the market price or fair value. (See accounting example in annex).
- If, instead, the government guarantee covers only losses on the problematic assets, the treatment in national accounts should follow the general rules on guarantees as provided in chapter VII.4 of this Manual. In particular, the recording rules on guarantee calls, repeated guarantee calls and the specific cases in which it is known with certainty that government will be required to pay due to a guarantee call in the future¹¹⁶, shall apply for guarantees on problematic assets.

IV.5.2.5 Treatments to be followed when government buys the problematic assets

18. Government may also buy (or take over) the problematic assets. It does this directly or through specific units created on purpose which are considered to be part of the government sector. In the following section, both will be referred to as purchases by government. The main point is that government buys (or takes over) the problematic assets from the financial institution at a price that might differ / be higher than the market value (or fair value) estimated or observed at that moment.

a. Recordings at the start of the defeasance process

19. As a general principle, the purchase of the assets is a financial transaction but under the conditions above a capital transfer should be recorded when government buys the assets from a financial institution. The amount of the capital transfer in favour of the financial institution should be equal to the difference between the amount paid for buying them and their market value. It is useful to make a distinction between different kinds of assets.

In any case, the impact on the deficit is equal to the amount of the capital transfer at the time the assets are transferred to the government defeasance structure or to another government unit. If the transfer of the assets takes place in the context of a change in classification of a defeasance unit resulting from the restructuring of an existing financial institution, as described above, the impact on the debt is equal to the liabilities taken over by government.

20. Most assets, being traded on markets on a regular basis have an observable market value. This applies to securities, quoted shares and, to a lesser extent (depending on some specific conditions), to real estate. If (as it may be assumed) the sale price of these assets to the defeasance structure deviates from this market value, the amount of the capital transfer is equal to the difference between the sale price of the assets and the market value.

- For real estate assets, the financial institutions may be in distress because of the falling prices on the real estate market. Price indexes for real estate may be applied to their purchaser price, in order to calculate their market value.

¹¹⁶ This would depend of the comparison, at the time the guarantee is granted, between the book value of these problematic assets and their market value (in case of observed prices), their "fair value" (based on usual valuation technics) or (for loans) the expected recovery amounts, based on conservative hypotheses.

- For securities and shares, except in the case of persistent absence of market functioning, market prices can be derived from stock exchange information for quoted instruments. The price for unquoted shares should be derived from the trend of quoted shares in a similar sector.
- For problematic loans, the fair value (currently expected redemption value) will be less than the principal amount due by the debtors. They are transferred by the financial institutions usually at the principal outstanding amount (original contractual redemption value). By definition, as loans are not negotiable instruments on existing markets, there is no market value and thus their fair value must result from estimates, based on “realistic hypothesis” which should be carried out by an independent body in case of significant transfer to government. In the absence of any negotiation with the debtors, there is no change in the original obligations of the latter. As a consequence, the loans must be entered in the balance sheet at their nominal values. As the transaction is by evidence not made for purely commercial considerations (i.e. with an expectation on profit after it, see ESA10 5.21 stating that a capital transfer should be imputed for the difference between the transaction price and the market price). Nevertheless, if there is reliable information that some loans are irrecoverable (for instance because of the disappearance of the debtor), fully or for nearly their total amount, the real value of these loans should be accounted for at zero and a capital transfer is recorded for their full amount at the time of the transaction with the defeasance structure. In most cases, they should be written off by the defeasance structure after the transaction.

b. Recordings during the defeasance process

21. In this case it is also necessary to make a distinction between the transferred assets.

- In the case of non-financial assets, for instance buildings or, more generally, for real estate, the market value may change during the time they are held by a unit considered as a defeasance structure. The change has to be recorded in the revaluation account, with no impact on government net lending/net borrowing. If they are sold to units classified outside the general government sector, their sale is recorded as a disposal of non-financial assets, with a positive impact on lending/net borrowing of government (and possibly also a revaluation effect if the price is higher than the value recorded in the balance sheet).
- The same treatment applies to securities and shares, except that their sale has no impact on government net lending/net borrowing as it is purely a financial transaction.
- For loans, if they are not finally repaid at redemption at the principal value that has been recorded by the purchasing government unit, they may be subject to two possible procedures: a cancellation implying a capital transfer if the debtor still exist, or, in very exceptional cases a write-off to be recorded in the other changes in volume of assets account if the debtor does not exist anymore and the debt cannot be reimbursed by a pledging unit.

IV.5.2.6 The case where government provides direct financing

22. A unit, not reclassified inside the government sector and holding problematic assets or taking part in a support operation related to problematic assets, may enjoy

government financial support through direct financing in order to carry out specific transactions, at the initiative of government that a normal private investor would not undertake and that go beyond its usual activity. The government should be considered the principal party to the respective transaction (ESA10 1.78) and "the transaction should be rerouted in the accounts of the government" (ESA10 1.73 and 1.78). If the re-routed transactions involve the injection of capital by the financial intermediary into a financial or non-financial corporation on behalf of the government, the recording of this capital injection should be as outlined in the Chapter III.2 of this Manual or the Eurostat Decision of July 2009 on "The statistical recording of public interventions to support financial institutions and financial markets during financial crisis".

IV.5.3 Rationale of the treatment

IV.5.3.1 Classification issues

23. The defeasance structures seem to be involved in financial activity: they have borrowed resource (transferred or newly issued) in order to finance the impaired assets. However, they should not be considered as being real financial intermediaries, because they do not really place themselves at risk by acquiring financial assets and incurring liabilities on their own account, which is a typical feature of a financial intermediary according to ESA10 2.57. On the contrary, they act on behalf of government. This is the rationale for classifying them in the general government sector. Under these conditions, the exceptional cases mentioned above in §15 should be closely considered by the competent Authorities.

IV.5.3.2 The general principle for recording capital transfers

24. The recording of a capital transfer from government, with an impact on government net borrowing/net lending, can take place at four points in time:

- at the time of setting up the defeasance process, when government buys (or takes over) the involved assets for the amount paid in excess to the market or fair value, as observed at the time of the transfer;
- during the management of the defeasance, when government, normally through guarantee calls (on assets or on some liabilities), assumes losses from the financial institutions or other units classified outside general government;
- during the management of the defeasance, when government makes capital injections in the unit, either for covering losses or/and for providing the needed financing resources;
- during the management of the defeasance, when government cancels loans it may have granted to the unit.

25. In these situations, a capital transfer is recorded because there is a redistribution of wealth among the different units involved. This is in line with the definition of other capital transfers (D.99), given in ESA10 4.164.

26. The capital transfer is recorded at the time the transfer of wealth occurs. This can be, in the case where assets are taken over by government, at the time when the operation is agreed between the parties. For other cases, it is at the time government transfers the amounts corresponding to the assumption or cancellation of debt or capital injections.

IV.5.3.3 Valuation issues for assets other than loans

27. The general rule for valuing these kinds of assets in national accounting is to record them at their market price (fair value), which is consistent with the basic principle set up in international accounting standards (IFRS, IPSAS). For their part, financial

institutions, such as banks, may follow some specific rules, according to the supervisory regulations.

28. In the internal bookkeeping of the financial institutions, some impaired assets may be valued at the price paid for their acquisition. In other words, the book value of these assets, also possibly called the “accounting value” does not correspond to the market or fair value. Although banks should, in a prudent approach, anticipate possible losses on some assets by recording provisions, they have often the tendency to minimise such impact or wait as much as possible, in absence of explicit orders by the Supervisory Authorities.
29. The fact that such assets are placed in the defeasance means that the expected realisation value is far below the accounting value. If they are transferred at the accounting value, a capital transfer needs to be recorded in national accounts to reflect this difference between the accounting value and the market (fair) value. In the case where such value is not available but where an estimation of the expected losses may be carried out by an independent body on the basis of usual pricing methods, this estimate could be used as a proxy for the difference between accounting and market value.
30. Subsequent changes in the market (fair) price of these assets, when held by units classified inside general government, will give rise to the recording of holding gains/losses which have no impact on net lending/net borrowing.

IV.5.3.4 The case of loans

31. The valuation of loans is dealt with in ESA10 7.70. The general rule is to record, in the balance sheets of both creditors and debtors, “the amounts of principal that the debtors are contractually obliged to repay the creditors, even in cases where the loan was traded at a discount or premium”. This is the principal outstanding amount (original contractual redemption value). It is also the amount on which the interest is accrued. The notion of fair value (or market value) is thus not recognised for loans in the balance sheets in the system of national accounts, contrary to business and banking accounting systems.
32. In 5.122 and 6.58, ESA10 gives further guidance when loans are traded (as exceptional transaction) at a price which is different from the redemption value. The seller and the purchaser have to record the transaction at the effective price in their financial accounts but they must use the revaluation account for the difference between the transaction value and the redemption value (to be recorded in the balance sheet) before (the seller) and after (the purchaser) the transaction. This is based on the fact that, just at the point of sale, the assets are considered for a brief moment as market assets.
33. In the financial defeasance case, when loans are sold/transferred by the financial institutions to the specific government unit, the transaction value may be equal to their redemption value. Nevertheless, it is common sense to assume that the loans put in the defeasance would not be redeemed at the previously expected value. As the transaction is by evidence undertaken by government for other than purely commercial considerations (see ESA10 5.21) – here to support a financial institution in distress –, the transaction values would have to be identified with the “current market (fair) values” of the loans, which cannot be observed in practice. However, in many cases estimates on expected losses might become available and be used as a proxy for the difference between the amount paid and the fair/market value (see also IV.5.3.3). In addition, loan portfolios are likely to have been subject to provisions (impairments) in the accounting bookkeeping of financial institutions (which are frequently imposed by supervisory authorities). This may provide supplementary information on the potential size of the capital transfer to be recorded. It is recalled that in ESA10, “provisions for bad debt [...] do not appear anywhere in the system” (§4.165, f).

34. Moreover, if, among the transferred assets, there is reliable information leading to think that some loans will in fact never be repaid, the capital transfer to the financial institution disposing of them must be accounted for the full value of these loans. Afterwards, they should be removed (written-off) from the acquiring defeasance unit's balance sheet under the conditions mentioned above. This is recorded in the other changes in volume of assets account of the financial institutions.

IV.5.3.5 Global assessment of the treatments

35. When undertaken by government, defeasance leads to an impoverishment of general government. There are three ways in which this occurs, according to the above rules:

- when a capital transfer is recorded at the time a government unit buys the involved assets or directly covers the losses linked to such assets: this has a direct impact on its net lending/borrowing at the time the transfer is recorded;
- when government acts through its guarantee: this has an impact on its net lending/borrowing at the time the guarantee is called, according to the rules set in the current Manual (VII.4);
- when the assets bought by a government unit are loans which have been transferred without the recording of a capital transfer. This has an impact on government net lending/borrowing if the loans are cancelled to the benefit of the debtor and, on some exceptional occasions, when there is evidence that the debtor no longer exists and that no other unit is responsible for its debt, through another change in the volume of assets.

36. The classification inside the general government sector of units in charge of the defeasance process may also have an impact on government debt by the amount of their liabilities. It will then also have an impact on net lending/borrowing of the general government sector through the financing cost (interest) of the debt.

IV.5.4 Accounting examples

This example deals with the case where a unit classified inside general government buys some bad assets from a financial institution at their bookkeeping value. The government equity in the financial institution is not shown.

Setting up the defeasance

Assets transferred from financial institutions to the public unit in charge of the defeasance are the following ones:

- Securities / shares, with a bookkeeping value of 40, and a market value of 25 (value in the opening balance sheet);
- Buildings, with a bookkeeping value of 10, and a market value of 5 (in the opening balance sheet);
- Loans, with a redemption value of 50 (in the opening balance sheet): during the year and at the time the defeasance is set up, some loans are considered as being irrecoverable, for an amount of 10.

As the bookkeeping value of the assets is 100 (10+40+50) and as the market/fair value is falling to 70 (5+25+40), a capital transfer of 30 is recorded. The government unit is assumed to have borrowed all its funds.

General government unit				Financial institution			
Opening balance sheet							
A		L		A		L	
AF.2	x	AF.4	x	AN	5		
				AF.4	50		
				AF.5/AF.3	25		
Capital account							
ΔA		ΔL		ΔA		ΔL	
P.5	5	D.99	-30	P.5	-5	D.99	+30
B.9	-35			B.9	+35		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	-100			F.2	+100		
F.4	+40			F.4	-40		
F.5/F.3	+25	B.9	-35	F.5/F.3	-25	B.9	+35
Other changes in volume of assets account							
ΔA		ΔL		ΔA		ΔL	
				AF.4	-10	B.10.2	-10
Closing balance sheet							
A		L		A		L	
AN	5	AF.4	x	AF.2	100		
AF.2	x -100						
AF.4	40						
AF.5/AF.3	25	B.90	-30			B.90	+20

Management of the defeasance

Starting from the establishment of the defeasance until liquidation of the unit in charge of management of the assets, the following events occur:

- securities are finally sold for 30,
- buildings are finally sold for 8,
- of the total amount of 40 of loans: 30 are finally repaid, 6 are written-off, and 4 are cancelled by mutual agreement.

The repayment by the unit of the loan it has acquired, as well as interest payments are not shown.

General Government Unit			
Opening balance sheet			
A		L	
AN	5		
AF.2	x - 100		
AF.4	40		
AF.5/AF.3	25		
Capital account			
ΔA		ΔL	
P.5	-8	D.99	-4
B.9	+4		
Financial account			
ΔA		ΔL	
AF.2	+68		
AF.4	-34		
AF.5/AF.3	-30		
		B.9	+4
Other changes in volume of assets			
ΔA		ΔL	
K.10 on AF.4	-6		
		B.10.2	-6
Revaluation account			
ΔA		ΔL	
K.11 on AN	+3		
K.11 on AF.5/3	+5	B.10.3	+8
Closing balance sheet			
A		L	
AN	0		
AF.2	x -32		
Other AF	0	B.90	-2

In this example, government takes risk and rewards on problematic assets held by a financial institution (“economic ownership” case).

1) Problematic assets have a book value of 50, equal to their market/fair value.

GG				FI			
Opening balance sheet				Opening balance sheet			
A			L	A			L
				AF.3 /4	50		
Non-financial account				Non-financial account			
U			R	U			R
				B.9	0		
Financial account				Financial account			
ΔA			ΔL	ΔA			ΔL
F.3/4	+50	F.4	+50	F.3/4	-50		
		B.9F	0	F.4	+50	B.9F	0
Closing balance sheet				Closing balance sheet			
A			L	A			L
AF.3/4	50	AF.4	50	AF.4	50		

- 2b) Holding losses on the assets of 10 are recorded in government balance sheet. Government has to transfer in cash 10 to the financial institution (e.g. financed by borrowing on the market by issuing debt securities)

GG				FI			
Opening balance sheet				Opening balance sheet			
A		L		A		L	
AF.3	40	AF.4	50	AF.4	50		
Non-financial account				Non-financial account			
U		R		U		R	
B.9	0			B.9	0		
Financial account				Financial account			
ΔA		ΔL		ΔA		ΔI	
F.2	(+10 -10)	F.4	- 10	F.2	+10		
		F.3	+10	F.4	-10		
		B.9F	0			B.9F	0
Revaluation account				Revaluation account			
ΔA		ΔL		ΔA		ΔI	
F.3/4	-10						
Closing balance sheet				Closing balance sheet			
A		L		A		L	
AF.3	30	AF.4	40	AF.2	10		
		AF.3	10	AF.4	40		

2c) At the end of the lifetime of the assets there is a final holding gain of 5 on the assets (government receives 35, not 30). Government borrows 5 on the market (e.g. by issuing debt securities) in order to repay the loan of 40.

GG				FI			
Opening balance sheet				Opening balance sheet			
A		L		A		L	
AF.3	30	AF.4	40	AF.2	10		
		AF.3	10	AF.4	40		
Non-financial account				Non-financial account			
U		R		U		R	
B.9	0			B.9	0		
Financial account				Financial account			
ΔA		ΔL		ΔA		ΔL	
F.2	(+35+5-40)	F.4	- 40	F.2	+40		
F.3	-35	F.3	+ 5	F.4	-40		
		B.9F	0			B.9F	0
Revaluation account				Revaluation account			
ΔA		ΔL		ΔA		ΔL	
F.3	+5						
Closing balance sheet				Closing balance sheet			
A		L		A		L	
		AF.3	15	AF.2	50		

IV.6 Capital increases in multilateral development banks

IV.6.1 Background to the issue

1. Multilateral Development Banks are institutions that provide financial support and professional advice for economic and social development activities in developing countries. The term Multilateral Development Banks (MDBs) typically refers to the World Bank Group (notably the IBRD – International Bank for Reconstruction and Development and IDA International Development Agency) and four Regional Development Banks:
 - The African Development Bank (AfDB),
 - The Asian Development Bank (AsDB),
 - The European Bank for Reconstruction and Development (EBRD),
 - The Inter-American Development Bank Group (IDB).
2. MDBs are characterized by a broad membership, from both borrowing developing countries and from developed donor countries, which is not limited to member countries from the region of a regional development bank. Each bank has its own independent legal and operational status, although, with a similar mandate and a considerable number of joint owners, the MDBs maintain a high level of cooperation between themselves.
3. Most of the MDBs have two types of funds, often called lending windows or lending facilities. One type of lending window is used to make loans at market-based interest rates. Such non-concessional loans are, depending on the MDB, extended to governments and private sector firms in middle income, and some creditworthy low-income countries. The other type of lending window is used to make loans at (well) below-market interest rates (concessional loans) granted to the governments of low-income countries.
4. To offer non-concessional loans, the MDBs borrow money from international capital markets and then re-lend the money to developing countries. MDBs are able to borrow from international capital markets because they are backed by the guarantees of their member governments. This is provided through the ownership shares that member countries subscribe in each bank. Only a small portion (typically less than 5-10%) of the value of these capital shares is actually paid to the MDB (“paid-in capital”). The bulk of these shares is a form of guarantee that the donor stands ready to provide to the bank if needed. This is called “callable capital,” because the money is not actually transferred from the donor to the MDB unless the bank needs to draw on its members’ callable subscriptions because their resources are exhausted and they still need funds to repay bondholders.
5. Periodically, when donors agree that the future demand for loans from an MDB is likely to expand, they increase their capital subscriptions to an MDB’s non-concessional lending window in order to allow the MDB to increase its level of lending.
6. As the MDB extends concessional loans and grants to low-income countries, the window’s resources for such activities become systematically depleted. The donor countries meet together periodically to replenish those resources. Thus, these increases in resources are called “replenishments”, and most occur on a planned schedule ranging from three to five years. If these facilities are not replenished in good time, they will run out of resources and have to substantially reduce their levels of activity.
7. Some MDBs offer solely or mainly concessional loans (these are: IDA, Fund for Special Operations (FSO) at IDB, AfDF and AsDF) and therefore they are largely

funded by contributions from the governments of its richer member countries or from the income of other MDBs (for instance IDA receives additional funds from IBRD's and IFC's income), and from borrowers' repayments of earlier credits.

8. MDB concessional loans are characterized by a very low interest rate and long maturities with grace periods. IDA credits typically have maturities of 35 or 40 years with a 10-year grace period on repayment of principal. There is no interest charge, but credits do carry a small service charge of 0.75 % on disbursed balances. These are not only below market interest rates, but do not even cover funding and administrative costs.

IV.6.2 Treatment in national accounts

9. The treatment in national accounts of government injections in MDBs depends on the type of loans provided by multilateral development banks. Injections into MDB facilities whose main or sole purpose is to provide concessional loans at marginal or zero interest rate should be recorded as capital transfers, while investments into MDB facilities providing non-concessional loans should be recorded as acquisition of other equity, as set out in ESA10 5.154 d): "government investments in the capital of international and supranational organisations, with the sole exception of the IMF, even if these are legally constituted as companies with share capital (e.g. the European Investment Bank)" are to be recorded as AF.519, other equity.

Treatment of capital increase in MDBs

Type of capital injection / Type of MDB facility	Paid-in capital	Callable capital	Conversion of reserves into paid-in capital	Hybrid capital increase	Temporary increase	Encashment period
MDB facilities providing non-concessional loans	Shares and other equity F.5/F.513	Nothing recorded, until called	No implications	Examine on a case-by-case basis	Loans (F.4), if cancelled D.9	F.5 at inception
MDB facilities providing mainly concessional loans	D.9	Nothing recorded until called	N/A	Examine on a case-by-case basis	Loans (F.4), if cancelled D.9	D.9 when due to be paid

IV.6.3 Rationale of the treatment

10. MDBs may have two types of lending facilities or lending windows. Concessional loans are interest free loans or loans with an interest rate much below the market rate. Usually those loans are long term and have long grace periods. Despite a small service charge, MDBs facilities providing concessional loans are generally not able to cover their funding and/or administrative costs and thus their funding resources become depleted over time. In order to maintain their activities at least at the same level, MDBs facilities providing concessional loans have to receive

replenishments from their donors. It is clear from the very beginning that MDB facilities providing concessional loans are not going to be profitable, and in substance these replenishments are rather similar to capital injections aimed to cover losses. Therefore, following the capital injections rules, government injections into MDB facilities providing concessional loans should be treated as capital transfers.

11. Non-concessional loans are made at market interest rates which implies that a return is expected or at least the borrowing costs and/or administrative costs of the MDB's facility are covered. Once MDB facilities providing non-concessional loans accumulate reserves, these can later be converted into capital and used for further operations. Therefore in practice, it is not very common that a MDB draws down its callable capital. As a matter of fact, capital increases by donor governments are usually needed for the purpose of new or expanding activities. Thus, government injections into MDB facilities providing non-concessional loans should be treated according the ESA 10 paragraph 5.154 (c), as other equity AF.519.
12. In the case of MDBs, capital increases by governments usually take the following forms: paid-in capital, callable capital, conversion of reserves into paid-in capital, hybrid capital increase, temporary increase and encashment period.

IV.6.3.1 Paid-in capital

13. In most MDB facilities, providing non-concessional loans, new paid-in capital represents only a fraction of their total capital. In this case the paid-in part will be considered as a financial transaction (purchase of equity) not impacting the government deficit.
14. In the case of paid-in capital to MDB facilities providing mainly or solely concessional grants and loans, the injection is recorded as a capital transfer.

IV.6.3.2 Callable capital

15. A large part of an MDB capital increase is usually structured as callable capital, i.e. not paid-in. The statistical treatment is as follows: the callable part is to be considered as a contingent transaction, which is not to be recorded in the national accounts system. This applies to both types of facilities of MDBs. Of course, once capital is called it must be analysed as paid-in capital.

IV.6.3.3 Conversion of reserves into paid-in capital

16. (A part of) the capital increase may be implemented through a conversion of accumulated reserves into permanent paid-in capital without any cash being transferred from shareholders. The statistical treatment is as follows: in ESA10 it is not the number of shares which needs to be examined, but their value. If some of the reserves were to be converted into shares, the value of the shareholding would still be the same. There would be therefore no direct implications for the accounts and no impact on government deficit and debt.
17. Facilities of MDBs providing mainly concessional loans and grants normally have no accumulated reserves, as they deplete all of their funds. Therefore this case does not apply to them.

IV.6.3.4 Hybrid capital increase

18. (A part of) the capital increase could be implemented through issuing a form of hybrid capital instrument (in combination with callable capital) with both debt and equity features. The statistical treatment cannot be judged in general; the precise conditions will have to be assessed on a case-by-case basis.

IV.6.3.5 Temporary increase

19. Contrary to a permanent increase, a capital increase may be indicated as only for a temporary period and (a part of) it is re-paid to members after an agreed period of time (e.g. when a crisis is over and the lending activities have returned to normal levels). The statistical treatment is as follows: a temporary increase with a scheduled repayment would be seen as a loan, even if at zero interest rate. Scheduled repayment will progressively decrease the outstanding amount of the loan.
20. The initial treatment as a loan applies to both cases of MDB facilities. If there is a subsequent loan cancellation, this would have to be recorded as capital transfer.

IV.6.3.6 Encashment period

21. It may be decided to stretch the actual cash payment by members of the paid-in part of the capital increase over a longer period of time, in several instalments (this could be up to 10 years). Here the two types of MDB facilities have to be distinguished.
22. In the case of a MDB facility providing mainly non-concessional loans, the statistical treatment is as follows, assuming that the capital increase is decided at inception (i.e. one decision concerning one capital increase, although with deferred payments, and not concerning many decisions for separate capital increases over the years). An acquisition of equity is recorded at inception for the full amount of the paid-in capital. For the financial counterpart of amounts not paid initially in cash, the recording is determined by the length of the period of time in which instalments are to be paid. If they are paid quickly, within one year, the part not yet paid is recorded under other accounts payable (AF78, with no impact on the Maastricht debt. Beyond that, the counterpart is recorded as a loan (AF4) from the bank to government, with an impact on Maastricht debt.
23. For the MDB facilities providing mainly or solely concessional loans and grants, these payments are recorded as capital transfers. The time of recording would have to be in compliance with ESA10 par. 4.166, which is when the payment is due to be made.

IV.7 Keywords and accounting references

Rerouting and principal party to a transaction	ESA10, 1.73-75, 1.78
Financial intermediation / intermediary	ESA10, 2.87-88, 2.61
Other capital transfer	ESA10, 4.164-67
Valuation of transactions	ESA10, 5.19-22
Valuation of assets	ESA10, 7.33-41, 7.61

V

Sale of assets

Part V Sale of assets

V.1 Overview

- Governments sell financial and non-financial assets to raise cash or to optimise the size of assets. Governments might also transfer flows of receipts, or incur a future obligation to make payments, in return for cash today. In most cases, a sale of an asset is recorded as a sale, for the value of the transaction, in national accounts. However some cases are more complicated, particularly when:
 - sales take place through public corporations;
 - the economic risks and rewards are not fully transferred (no “true sale”);
 - the government’s proceeds for the sale are not in cash or differ from the market/fair value of the assets sold;
 - the asset that appears to be sold is not recorded in the Government’s balance sheet in national accounts.
- In the guidance that follows, the key principles applied are the recording of economic substance over legal form, the concept of economic ownership, the basic distinction between financial and non-financial flows and the coverage of the notion of income in national accounts.

V.2 Sales of financial and non-financial assets

V.2.1 Background to the issue

1. Privatisation normally means general government giving up control over a public enterprise by the disposal of shares and other equity in the enterprise. The scope of this chapter is larger than just that operation: it also addresses more general case of general government selling shares and other equity in enterprises, without necessarily having control on them or, if having it, without actually giving up this control. These sales may be made directly or indirectly. Sales of non-financial assets are also dealt with.
2. Four cases may be distinguished:
 - a) The government sells shares or other equity in an enterprise. This sale is said to be “direct”.
 - b) Assume Government owns enterprise A, which sells shares or other equity in an enterprise B and gives the proceeds of the sale back to government. This sale is said to be an “indirect” sale by government of financial assets.
 - c) The government sells non-financial assets. This is said to be a “direct” sale of non-financial assets.
 - d) Government owns enterprise A, which sells non-financial assets and gives the proceeds of the sale to government. This sale is said to be an “indirect” sale by government of non-financial assets.
3. The funds provided by the enterprise to government through an indirect sale may take various forms other than cash. For example they could consist of such as the redemption of amounts owed by the enterprise to the government. In the following, only provision of liquid assets is considered, but this assumption does not change the proposed treatments.

V.2.2 Treatment in national accounts

V.2.2.1 Direct sale of financial assets

4. The direct sale of financial assets has to be completely recorded in the financial accounts of general government and of the involved enterprise: it is a withdrawal of shares or other equity (F.5) from the enterprise which was, partially or totally, owned by government, with a counterpart entry as an increasing of a financial asset (most of the time, liquid assets, F.2).
5. This has no impact on the net lending/net borrowing of general government.

V.2.2.2 Indirect sale of financial assets

6. The indirect sale of financial assets also has to be recorded in the financial accounts of general government and of the above-mentioned enterprise A: it is a withdrawal of shares or other equity from enterprise A, with a counterpart entry as an increasing of a financial asset. This is true whether or not enterprise A gives to its owner, the government, all or parts of the proceeds of the sale. The indirect sale of financial assets has no impact on the net lending/net borrowing of general government.

V.2.2.3 Direct sale of non-financial assets

7. The direct sale of non-financial assets has to be recorded in the capital account of general government: it is a disposal of non-financial assets, with a positive impact of net lending/net borrowing of general government. Non-financial assets include fixed assets, inventories, valuables, land or other non-produced non-financial assets.

V.2.2.4 Indirect sale of non-financial assets

8. The general government accounts would record the indirect sale of non-financial assets as a financial transaction: it is a withdrawal of shares or other equity from the enterprise A which was, partially or totally, owned by government, with a counterpart entry as an increase in a financial asset in respect of the funds received.

V.2.2.5 Time of recording, amounts to be recorded

9. In the general government accounts:
- in cases of direct sales, transactions have to be recorded when the change of economic ownership takes place;
 - in cases of indirect sales, when the proceeds of the sales are paid back to general government.
10. The amounts to be recorded are the full amounts of the proceeds of the sale (less any amount kept by the owning company in the case of an indirect sale), as they are paid by purchasers: they correspond to the transaction value, as defined in ESA10 5.19, for the sale of the assets.
11. In particular, in the case of indirect sales, it may happen that the total or some parts of the proceeds are recorded as dividends, taxes or any other kind of flow in the internal bookkeeping of the parties to the transaction. They have nevertheless to be recorded as financial transactions in national accounts.
12. In the case of a partial refund to government of the proceeds of an indirect sale, the full payment to government is treated as financial transaction. In practice, such sales may require government to employ the services of financial intermediaries or other non-financial services. This is especially true in case of privatisation. The cost of these services has to be recorded as intermediate consumption. If they are actually paid out of the proceeds of the sales (through a reduction in the amount passed to government), an imputation should normally be made so that the total proceeds of the sale are recorded before netting off the service charge. Of course, if payments are made to general government - e.g. as dividends or taxes - in addition to the proceeds of the sales of assets, they have to be recorded, if relevant, in the specific non-financial transactions.
13. The case where a part of the proceeds of the sale is kept by enterprise A is dealt with in the following chapter V.3.
14. The cases of indirect sales addressed here deal with sales of assets of a substantial amount that are paid back to general government. Frequently these sales are part of a privatisation plan decided by the government. However, it may happen that, as part of their normal operations, enterprises sell a few assets and thus realise some capital gains. These capital gains might then be distributed to general government through dividends or specific taxation, in such a way that the proceeds of the sale of assets would be part of government revenue. The possible difficulties for obtaining information should not prevent from recording these flows as financial in all cases of rather significant proceeds of sales.

V.2.3 Rationale of the treatment

15. The rationale of the rules dealing with direct sales is straightforward. For the sales of financial assets, they stem from the definition of financial transactions (ESA10 5.01 and 5.02) and of the financial account (ESA10 8.50). Basically, in this direct exchange of one financial asset for another in the balance sheet of the government, there is no change in wealth, nor any flow of income. For the sales of non-financial assets, they stem from the definition of the disposal of the concerned assets and of the capital account (ESA10 8.46).

16. The rationale for the treatment of indirect sales is first based on the fact that the payment of the proceeds of the sales is not a transfer of income, but a transfer of wealth/assets. However, it cannot be considered as a capital transfer: the definition of other capital transfer (ESA10 4.165) does not make room for such a treatment. Moreover, in these cases, payments are provided only because of the rights of ownership that government has on the involved enterprises.
17. This is the rationale for the exclusion from capital transfers of the payment of privatisation proceeds, as indicated in ESA10 4.165, g: “However, the counterpart transactions of transfers to general government of the proceeds of privatisation made indirectly (through a holding company for example) are recorded as financial transactions in equity and investment funds shares (F.5) and have no impact on the level of net lending/net borrowing of the general government”.
18. Paying back the proceeds of the sale to the government diminishes the assets of enterprise A. This corresponds to a partial liquidation of the corporation as it reduces its net worth which should be reflected (decrease) in the value of equity owned by government in the corporation. This treatment of indirect privatisation must be applied to the case of sale by the corporation of any financial or non-financial asset.
19. The notion of dividend in national accounts is clear: this is a property income. Dividends must result from income streams and not from sale of assets or from revaluation of assets. Distributing income should not diminish the net wealth/net assets of the enterprise. What may be distributed to the owners is the entrepreneurial income (ESA10 8.26-28).

V.2.4 Accounting examples

In all the following examples, the counterpart flow of sales is a transaction in currency and deposits (AF.2). The enterprise of which general government sells shares or other equity or from which it receives the proceeds of such a sale is called public enterprise.

V.2.4.1 Direct sales of financial assets

General government				Public enterprise			
Opening balance sheet							
A		L		A		L	
AF.5	z					AF.5	z
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.5	-x						
F.2	+x	B.9	0				
Closing balance sheet							
A		L		A		L	
AF.5	z-x					AF.5	z
AF.2	+x	$\Delta B.90$	0			$\Delta B.90$	0

V.2.4.2 Indirect sale of financial assets

General government				Public enterprise A			
Opening balance sheet							
A		L		A		L	
AF.5	z			AF.5	y	AF.5	z
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.5	-x			F.5	-x	F.5	-x
F.2	+x	B.9	0			B.9	0
Closing balance sheet							
A		L		A		L	
AF.5	z-x			AF.5	y-x	AF.5	z-x
AF.2	+x	$\Delta B.90$	0			$\Delta B.90$	0

V.2.4.3 Direct sale of non-financial assets

General government

Opening balance sheet

A		L	
AN	z		

Capital account

ΔA		ΔL	
Disposal of AN	-x		
B.9	+x		

Financial account

ΔA		ΔL	
F.2	+x		
		B.9	+x

Closing balance sheet

A		L	
AN	z - x		
$\Delta A F.2$	+x	$\Delta B.90$	0

V.2.4.4 Indirect sale of non-financial assets

General government				Public enterprise A			
Opening balance sheet							
A		L		A		L	
AF.5	z			AN	y	AF.5	z
Capital account							
ΔA		ΔL		ΔA		ΔL	
				AN	-x		
				B.9	+x		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.5	-x			F.2	+x -x	F.5	-x
F.2	+x	B.9	0			B.9	+x
Closing balance sheet							
A		L		A		L	
AF.5	z -x			AN	y -x	AF.5	z -x
$\Delta AF.2$	+x	$\Delta B.90$	0			$\Delta B.90$	0

V.3 Privatisation proceeds from public corporations

V.3.1 Background to the issue

1. In some EU Member States, holding companies (referred below as to head Offices according to ESA10¹¹⁷) have been set-up by government in order to direct and manage a group of market enterprises, with profitable and competitive objectives. In this context they may restructure of the group. Thus, they may organise privatisations and transfer the proceeds of the sale of shares to other public corporations (owned by the holding company or not), through grants, loans or capital injections, or to government.
2. It may also happen that, in other countries where the units exist for a long time, some could be given this same function. This may also concern some public entities like regional development agencies managing funds (including shares and other equity) belonging to government or possibly to European institutions (structural or cohesion funds).
3. The main issue is: what is the relevant sector classification of this sort of unit managing privatisation and possibly making grants to other enterprises? Should this activity been considered as taking place on behalf of the government?

V.3.2 Treatment in national accounts

4. There are three possibilities:
 - 1) The public head office is a market unit and moves funds around within the group as part of a business strategy for the group, in the same way that a private corporation would behave.

No transaction is recorded in government accounts.

- 2) The public head office is a market unit and moves funds around within the group to support loss-making activities which are clearly identified as resulting from government's economic and social policy, the relevant entities acting on behalf of government and under evidenced instructions.

Transactions are rerouted through government.

- 3) The public head office is a market unit but provides grants and subsidies on behalf of government to units outside the group.

All payments are rerouted through government.

V.3.3 Rationale of the treatment

5. ESA10 2.14: "A head office is a unit that exercises managerial control on its subsidiaries". Holding corporations may usually be considered market producers, either non-financial or financial, according to the main activity of the group.
6. A problem arises when the head office implement a development strategy for its subsidiaries (in the framework of a long-term plan for the group), but also carries out restructuring and changing the ownership status of some corporations in the group,

¹¹⁷ See chapter I.6.

as well as channeling the funds from one to the other, redistributing income and wealth.

7. This public sector reorganisation project, involving management of assets and redistribution of income and wealth, is a direct implementation of a central government macro-economic strategy. In many EU Member States, this is (or was) often implemented by the Treasury itself. In the case examined here, the Treasury uses an existing intermediary entity, which is supposed to manage public assets and to redistribute funds in a short or medium-term context.
8. This specific type of activity should be regarded as a management of assets for public policy purposes, taking place on behalf of the government.
9. There can be a contradiction between the economic nature of relationships and of transactions between units, and the legal presentation of these units and of their relationships. Some provisions in the ESA910 (notably in chapter 1) allow for a statistical treatment that might diverge from the legal arrangements:
 - **1.72: Rearranged transactions**
“(...) however, some transactions are rearranged in order to bring out the underlying economic relationships more clearly. Transactions can be rearranged in three ways: rerouting, partitioning and recognising the principal party to a transaction.”
 - **1.75: Rerouting**
“(...) another type of rerouting is that of transactions recorded as taking place between two or more institutional units, even though according to the parties involved no transaction takes place at all.”
 - **1.78: Recognising the principal party to a transaction**
“When a unit carries out a transaction on behalf of another unit (the principal) and is funded by that unit, the transaction is recorded exclusively in the accounts of the principal (...).”
10. These statements derive from the general principle, according to which: “the basic principles of national accounts require that all transactions occurring in different legal settings, but having the same economic effects, are to be recorded in the same way”.
11. The rerouting of flows (proceeds of the sales of the assets and payments to public corporations) is only relevant when only a minor part of its activity consists of acting for public policy purposes (privatising, supporting public corporations...) on behalf of the government. Otherwise, this would mean that the unit cannot be (or no longer) considered as market producer and should be (re) classified within the government sector. Recording the payment as government grants or whatever sort of transactions is relevant in this context.
12. In the case of the transaction with the public subsidiary being a financial one (a loan for instance), it could be recorded first between the government and the public holding, and then between the public holding and the subsidiary. In the case of an investment grant, a direct recording between the government and the public enterprise would be preferable.
13. When the public holding company provides grants or any other type of transfers to enterprises (whether private or public) outside of its group, there is an even stronger presumption that it is acting this way on behalf of the government.

V.3.4 Accounting examples

Government owns a holding company that is classified in the non-financial corporation sector. This holding disposes – for an amount of 100 – of shares it has in a subsidiary A, as part of a privatisation programme decided by government. The holding company

keeps the proceeds of this disposal; from these proceeds, it pays 20 to another subsidiary B. This payment is analysed as being of a government nature – another subsidy on production, for instance – because there is no financial asset received in exchange and no expectation of return in form of property income. At the beginning of the period, equity of government in the holding company amounts to x, equity of the holding company in its subsidiary B amounts to z.

General government		Holding company		Subsidiary B	
Opening balance sheets					
A	L	A	L	A	L
AF.5 x		AF.5 z	AF.5 x		AF.5 z
Non-financial accounts					
U	R	U	R	U	R
B.9 -20	D.39 -20			D.39 -20	
				B.9 +20	
Financial accounts					
ΔA	ΔL	ΔA	ΔL	ΔA	ΔL
F.2 +20		F.2 +100	F.5 -20	F.2 +20	
F.2 -20		F.2 -20			
F.5 -20	B.9 -20	F.5 -100	B.9 0		B.9 +20
Closing balance sheets					
A	L	A	L	A	L
AF.5x -20		AF.5z -100	AF.5 x -20	AF.2 +20	AF.5 z
	$\Delta B.90 -20$	AF.2 +80	$\Delta B.90 0$		$\Delta B.90 +20$

V.4 Restitution and use of vouchers for privatisation

V.4.1 Background to the issue

1. In transition economies, the concept of privatisation can be extended to also include any transfer (disposal) to the public or former (private) owners of government assets previously nationalised or confiscated.
2. Three cases have been identified:

V.4.1.1 Restitution in kind

3. Restitution in kind refers to the return to the original owner of non-financial assets (in general land and buildings, but also production plants in some cases) formerly nationalised or confiscated by the State, and generally owned at the time of restitution by the government but in some cases by public corporations. The non-financial assets may, therefore, be fixed assets, inventories, valuables, land or other non-produced assets.

V.4.1.2 Restitution through financial compensation

4. In cases where the property to be returned to former owners does not exist or cannot be returned, financial compensation can be made in the form of money or other financial instruments such as bonds or shares.

V.4.1.3 Privatisation through the issue of vouchers

5. For carrying out the privatisation of publicly owned assets in some transition economies, governments have distributed vouchers to the population, either free of charge or sold at nominal prices. Holders of vouchers can acquire shares and other equity (directly or indirectly) or non-financial assets.

V.4.2 Treatment in national accounts

V.4.2.1 Restitution in kind

6. Restitution in kind represents a transfer of non-financial assets from the government to the sectors benefiting from the restitution. Two cases can be distinguished:

- a) **The non-financial asset to be returned is roughly the same as the one nationalised or confiscated in the past. This may be the case for land and other non-produced assets.**

This type of restitution could be considered as a reverse of an uncompensated seizure to be recorded in the other changes in volume of assets account. However, under ESA10, this return should rather be recorded as a transaction, a negative capital formation in the government account, counterbalanced by a "payment of a capital transfer in kind (with reversed sign in the accounts of the receiving sector). This has an impact on the stock of assets recorded in the balance sheets, and therefore increases the net worth of the sectors benefiting from the restitution and simultaneously decreases the net worth of general government.

- b) **The non-financial asset to be returned is different (in terms of appearance and value) from the one nationalised or confiscated in the past. This may be the case for dwellings and other tangible fixed assets.**

In this case, the return should be recorded as a transaction, a negative capital formation in the government account, counterbalanced by a "payment of a capital transfer in kind (with reversed sign in the accounts of the receiving sector). As both flows are balanced in the capital account, there is no impact on

the net borrowing/net lending of general government. However, the capital transfer leads to an increase of the net worth of the sectors benefiting from the restitution and simultaneously to a decrease of the government's one.

In both cases, the time of recording is at the time of the change in the economic ownership of the assets.

V.4.2.2 Restitution through financial compensation

7. Restitution through financial compensation represents a transfer of financial assets from the government sector to the sectors benefiting from the compensation. It should therefore be recorded in the government accounts as a decrease in financial assets, counterbalanced by a capital transfer in kind or in cash (payable), and in the accounts of the receiving sectors as an increase in financial assets, offset by a capital transfer in kind or in cash (receivable). The capital transfer has a negative impact on the net lending/net borrowing of general government, as well as on the net worth. The time of recording of the transaction is when government recognises a liability for a certain and irrevocable amount.

V.4.2.3 Privatisation through the issue of vouchers

8. The vouchers are used (mostly by households) to acquire financial or non-financial assets and can be seen as a commitment by the government to redeem them against those financial or non-financial assets. In general, vouchers are only conditional upon the acquisition of financial and non-financial assets and therefore considered, as contingent assets not recorded in the system.
9. In the system, contingent assets are considered as financial assets under certain conditions (ESA10 5.05):
- if tradable: a market develops where they can be traded or offset on a market;
 - if information exists on vouchers: on transactions carried out, and on market prices;
 - if the market has a sufficient volume of transactions so that the total value of the market can be derived.
 - if considered as financial assets, vouchers may be considered as special kind of financial derivatives (F.71).
10. A distinction can be made between the following two cases depending on whether vouchers are considered as financial assets or not:

V.4.2.3.1 Vouchers are considered as financial assets when issued

11. In this case, the vouchers are recorded in the national accounts system at the time of their issuance.

a) Acquisition of financial assets

The transfer of vouchers should be recorded as a financial transaction (in financial derivatives F. 71), counterbalanced by a capital transfer in kind from general government. This has a negative impact on the net borrowing/net lending of general government, as well as on the net worth.

To the extent that vouchers can be traded or offset on the market, a market will develop and their value will be determined on that market. Transactions in the vouchers are to be recorded as financial transactions between the respective sectors. Variations in the value of the vouchers during the same period should be recorded as holding gains and losses in the other changes in assets accounts (revaluation account) of the various sectors involved.

The exchange of vouchers for shares in public corporations is to be entirely recorded in the financial account of general government. This has no impact on net lending/net borrowing of general government.

b) Acquisition of non-financial assets

Vouchers are exchanged for commodities sold by non-financial corporations. The non-financial corporations acquire a claim against general government, and use it for bidding for shares owned and offered for sale by the general government.

The exchange of vouchers for commodities should be recorded as final consumption expenditure (P.3), counterbalanced by a decrease in financial derivatives (F.71) on the assets side of households. The government should record a decrease in financial derivatives on the liability side and a decrease of equity (F.5) in the public corporations on the asset side. As a result, there is no impact on the net borrowing/net lending and on the net worth of the general government.

V.4.2.3.2 Vouchers are only contingent assets

12. If vouchers are considered to be contingent assets they are not recorded in the system at issuance. They can only be used to acquire financial or non-financial assets.

13. In this case, no recording of the vouchers is done at the time of their issuance but only when the exchange for financial or non-financial assets takes place.

a) Acquisition of financial assets

The exchange of vouchers for shares in public corporations should be recorded as a financial transaction in “equity and investment funds shares” (F.5), counterbalanced by a capital transfer in kind (D.9) from general government. This leads to an increase in shares and other equity of households on the asset side and to a decrease of shares and other equity of government on the asset side. The exchange has a negative impact on the net lending/net borrowing of general government, as well as on the net worth.

b) Acquisition of non-financial assets

The exchange of vouchers for non-financial assets should be recorded as a negative capital formation (P.51), counterbalanced by a capital transfer in kind (D.9) from general government. This has no impact on net lending/net borrowing of general government. However, the exchange leads to a decrease of the net worth of general government.

V.4.2.4 Impact of vouchers on government debt

14. In the ESA10 framework, the recording of vouchers in the balance sheet of the government (as soon as considered financial liabilities) will increase the stock of government liabilities.

15. In the excessive deficit procedure framework, to the extent that we assume that the appropriate assets/liabilities for recording them are financial derivatives (F.71), vouchers would not influence the calculation of government debt (see part VIII).

V.4.3 Rationale of the treatment**V.4.3.1 Restitution in kind:**

16. The two following cases can be analysed differently:

- 1) The returned asset is the same as the one seized by government: this is a unilateral restitution of wealth giving back a non-financial asset, that the government took possession of in the past without compensation. The uncompensated part of such unilateral seizures is not a capital transfer (ESA10 6.10), but to be recorded in the other change in volume of assets account (K4). However, the restitution is not treated in a symmetrical way and recorded as the

disposal of an asset, matched by capital transfer expenditure in government accounts.

- 2) The returned asset has changed: the restitution is analysed as a voluntary transfer of wealth, made by mutual agreement (unlike other changes in volume of assets). The counterpart transaction is considered as a capital transfer (Other capital transfers, D.99: ESA105 4.164). This is concluded from the definition of capital transfers (ESA10 4.146: A capital transfer in kind consists of the transfer of ownership of an asset (other than inventories and cash), or the cancellation of a liability by a creditor, without any counterpart being received in return). One may also consider that the transfer will require some government financing. (See also ESA10 6.11).

V.4.3.2 Restitution though financial compensation:

17. The compensation is normally made many years after the confiscation (often 40 to 50 years). In distinction to restitution in kind (when the asset has not changed) restitution through financial compensation needs to be financed by the government. Like in all cases of transfer of wealth made by mutual agreement, the counterpart transaction is a capital transfer (Other capital transfers, D.99: ESA10 4.164).

V.4.3.3 Exchange of vouchers:

18. When considered financial assets, the exchange of vouchers for equity (AF.5) stem from the definition of financial transactions (ESA10 5.02) and of the financial account (ESA10 8.50): in direct exchange of one financial asset for another in the balance sheet of the government, there is no change in wealth, nor flow of income. For the exchange of vouchers for non-financial assets, the rules stem from the definition of the disposal of the concerned assets and of the capital account (ESA10 8.46).

V.4.4 Accounting examples

V.4.4.1 Restitution in kind

- i. **The non-financial asset to be returned is roughly the same as the one nationalised or confiscated in the past.**

In the following examples, the government is assumed to return non-financial assets (land) worth 100 to the households sector.

General government				Households			
Opening balance sheet							
A		L		A		L	
AN.211	100						
Other changes in volume of assets account							
ΔA		ΔL		ΔA		ΔL	
K.4 (AN.211)	-100			K.4 (AN.211)	+100		
		B.10.2	-100			B.10.2	+100
Closing balance sheet							
A		L		A		L	
AN.211	0			AN.211	100		
		$\Delta B.90$	-100			$\Delta B.90$	+100

ii. **The non-financial asset to be returned is different (in terms of appearance and value) from the one nationalised or confiscated in the past.**

In the following example, the government sector is assumed to return dwellings worth 100 to the households sector.

General government				Households			
Opening balance sheet							
A		L		A		L	
AN.111	100						
Capital account							
ΔA		ΔL		ΔA		ΔL	
P.51	-100	D.9	-100	P.51	+100	D.9	+100
B.9	0	B.10.1	-100	B.9	0	B.10.1	+100
Closing balance sheet							
A		L		A		L	
AN.111	0			AN.111	100		
		$\Delta B.90$	-100			$\Delta B.90$	+100

V.4.4.2 Restitution through financial compensation

In the following example, the government is assumed to compensate former owners of e.g. land or dwellings (households) with shares worth 100.

General government				Households			
Opening balance sheet							
A		L		A		L	
AF.5	100						
Capital account							
ΔA		ΔL		ΔA		ΔL	
		D.9	-100			D.9	+100
B.9	-100	B.10.1	-100	B.9	+100	B.10.1	+100
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.5	-100			F.5	+100		
		B.9	-100			B.9	+100
Closing balance sheet							
A		L		A		L	
AF.5	0			AF.5	100		
		$\Delta B.90$	-100			$\Delta B.90$	+100

V.4.4.3 Privatisation through the issue of vouchers

In the following examples, a privatisation agency (belonging to the general government sector) is assumed to issue vouchers to be distributed to the household sector, free of charge. Households can, during a stipulated period of time, be used to acquire shares and other equity owned by the government in public corporations and/or non-financial assets (e.g. fixed assets, AN.11).

i. Vouchers are considered as financial assets when issued

General government				Households			
Opening balance sheet							
A		L		A		L	
		AF.71	0	AF.71	0		
Capital account							
ΔA		ΔL		ΔA		ΔL	
		D.9	-100			D.9	+100
B.9	-100	B.10.1	-100	B.9	+100	B.10.1	+100
Financial account							
ΔA		ΔL		ΔA		ΔL	
		F.71	+100	F.71	+100		
		B.9	-100			B.9	+100
Closing balance sheet							
A		L		A		L	
		AF.71	100	AF.71	100		
		Δ B.90	-100			Δ B.90	+100

Acquisition of financial assets

General government				Households			
Opening balance sheet							
A		L		A		L	
AF.5	100	AF.714	100	AF.714	100		

Financial account							
ΔA		ΔL		ΔA		ΔL	
F.5	-100	F.714	-100	F.71	-100		
				F.5	+100		
		B.9	0			B.9	0

Closing balance sheet							
A		L		A		L	
		AF.71	0	AF.5	100		
		Δ B.90	0			Δ B.90	0

- ii. Vouchers are only contingent assets and therefore are not recorded in the system at issuance. They can only be used to acquire financial or non-financial assets.

Acquisition of financial assets

General government				Households			
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Opening balance sheet							
A		L		A		L	
AF.5	100						

Capital account							
ΔA		ΔL		ΔA		ΔL	
		D.9	-100			D.9	+100
B.9	-100	B.10.1	-100	B.9	+100	B.10.1	+100

Financial account							
ΔA		ΔL		ΔA		ΔL	
F.5	-100			F.5	+100		
		B.9	-100			B.9	+100

Closing balance sheet

A		L		A		L	
AF.5	0			AF.5	100		
		Δ B.90	-100			Δ B.90	+100

Acquisition of produced non-financial assets**General government****Households****Opening balance sheet**

A		L		A		L	
AN.11	100						

Capital account

Δ A		Δ L		Δ A		Δ L	
P.51	-100	D.9	-100	P.51	+100	D.9	+100
B.9	0	B.10.1	-100	B.9	0	B.10.1	+100

Closing balance sheet

A		L		A		L	
AN.11	0			AN.11	100		
		Δ B.90	-100			Δ B.90	+100

V.5 Securitisation operations undertaken by general government

V.5.1 Background to the issue

1. Governments may be involved in securitisation arrangements, an operation commonly undertaken by bank.
2. The government finance statistics issue is whether a securitisation operation by government entails a government borrowing, thus entering government debt, or a government sale of an asset.

V.5.1.1 Securitisation arrangements and definition

3. Securitisation is a financial technique that is described in ESA10 5.104 as follows: “Securitisation is the issuance of debt securities for which coupon or principal payments are backed by specified assets or by future income streams. A variety of assets or future income streams may be securitised including, among others, residential and commercial mortgage loans; consumer loans; corporate loans, government loans; insurance contracts; credit derivatives; and future revenue. “. ¹¹⁸
4. ESA10 5.105 also specifies that: “Securitisation of assets or of future income streams has been an important financial innovation that has led to the creation and extensive use of new financial corporations to facilitate the creation, marketing, and issuance of debt securities. Securitisation has been driven by different considerations. For corporations these include: cheaper funding than available through banking facilities; the reduction in regulatory capital requirements; the transfer of various types of risk like credit risk or insurance risk; and the diversification of funding sources.”
5. The originator conveys the legal ownership rights over assets and/or over specific future flows, to a securitisation entity, which in return pays an amount to the originator. The securitisation entity finances this payment by issuing securities using the assets and/or rights to future flows transferred by the originator as collateral. Such a securitisation entity is often, though not always, a special purpose vehicle (SPV) specially established for the purpose of the securitisation and legally separated from the originator. (See below the classification of the unit engaged in securitisation). Issuance of securities is generally organised by a third party, for example a private bank, however this third party usually takes on no risk or reward within the operation.
6. Investors buy securities issued by the securitisation entity only on the basis of the flows that are generated by the assets/rights, and not on the basis of the credit position of the originator. The investors usually have a direct and legal claim on the receipts generated by the assets or other rights in the event that the securitisation entity does not pay the interest and capital due. ¹¹⁹

¹¹⁸ This definition of securitisation – linked to most cases involving government units which has been effectively observed in EU may be considered as a “narrow” (or financial-market oriented) definition of securitisation. On one hand, there may be issuance of securities on which are attached direct rights on segregated assets by the holders of the securities (“on-balance sheet securitisation”). Such operations would not need specific guidance as the main point is the incurrence of new liability, not the specific rights and obligations attached to the debt instruments. On the other hand, government may “monetise” (transform into liquidity, which is the same result as in the case of securitisation operations considered here) any asset (financial or non-financial) by a transaction on organised markets or over the counter. This is matter of time (anything is finally monetised) and of the degree of discount compared to the fundamental value which government would accept to endure (see the “extreme” case of “fire sales”). In the latter case, the same basic principles related to the recognition of a “true sale” should fully apply.

¹¹⁹ As securitisation operation typically differs from a collateralised borrowing operation (such as for covered bonds which are normally not issued by government units): in the latter case the investor has both a claim on assets or other rights and a claim on the initial owner. Most securitisations operations do not provide for recourse for investors against the originator.

V.5.1.2 Issues for national accounts

7. The key question is how to record in national accounts the proceeds received by government from a securitisation and whether there should be an impact on general government debt and/or deficit (B.9).
8. It is necessary to determine whether the securitisation entails a sale of an existing ESA10 asset to the securitisation entity, or entails borrowing using future cash receipts as collateral. A secondary issue deals with the impact on the government deficit, which may be affected when non-financial assets are the object of the securitisation operation.
9. A disposal of assets by a general government originator is recorded in national accounts at the time the securitisation operation takes place if:
 - the items subject to the securitisation operation are assets recognised as such in national accounts and as transferable, and
 - the operation is designed in such a way that all the risks¹²⁰ and rewards attached to these assets are fully transferred to the securitisation entity, and
 - the securitisation entity that acquires the assets from the originator is an institutional unit that is not part of the general government sector.
10. The aim of this chapter is to provide rules on what can be recorded as a sale in national accounts in the context of a securitisation arrangement involving the government. The chapter not only discusses the securitisation by government of its assets, but also considers the case where a non-government unit securitises a flow of future payments from government to it, such as grants.

V.5.2 Treatment in national accounts¹²¹

11. There are two possible recording options in national accounts for securitisation proceeds collected by a government originator:
 - sale of an asset, i.e. the disposal of economic ownership of assets by government, in exchange for cash or other assets; or
 - government borrowing (incurring a liability).
12. The consecutive criteria used to decide the appropriate recording are shown in the decision tree below.

V.5.2.1 Recognition of assets in national accounts

13. A necessary, but not sufficient, condition for a securitisation operation to be recorded as the sale of assets by government is that the assets are recognised in national accounts as assets, and therefore recorded as such in the national accounts balance sheet of government at the time the securitisation takes place. In this context it is useful to distinguish between financial assets and non-financial assets, when discussing the notion of risks and rewards. The following paragraphs deal with cases where the securitised items are not recognised as assets or are not considered transferable in national accounts. In all these cases, the securitisation is recorded as government borrowing.

V.5.2.2 Securitisation of flows attached to unrecognised asset

14. Government may securitise future revenues that are unrequited transfers, such as future tax revenue. However, since the entitlement to receive such transfers is not

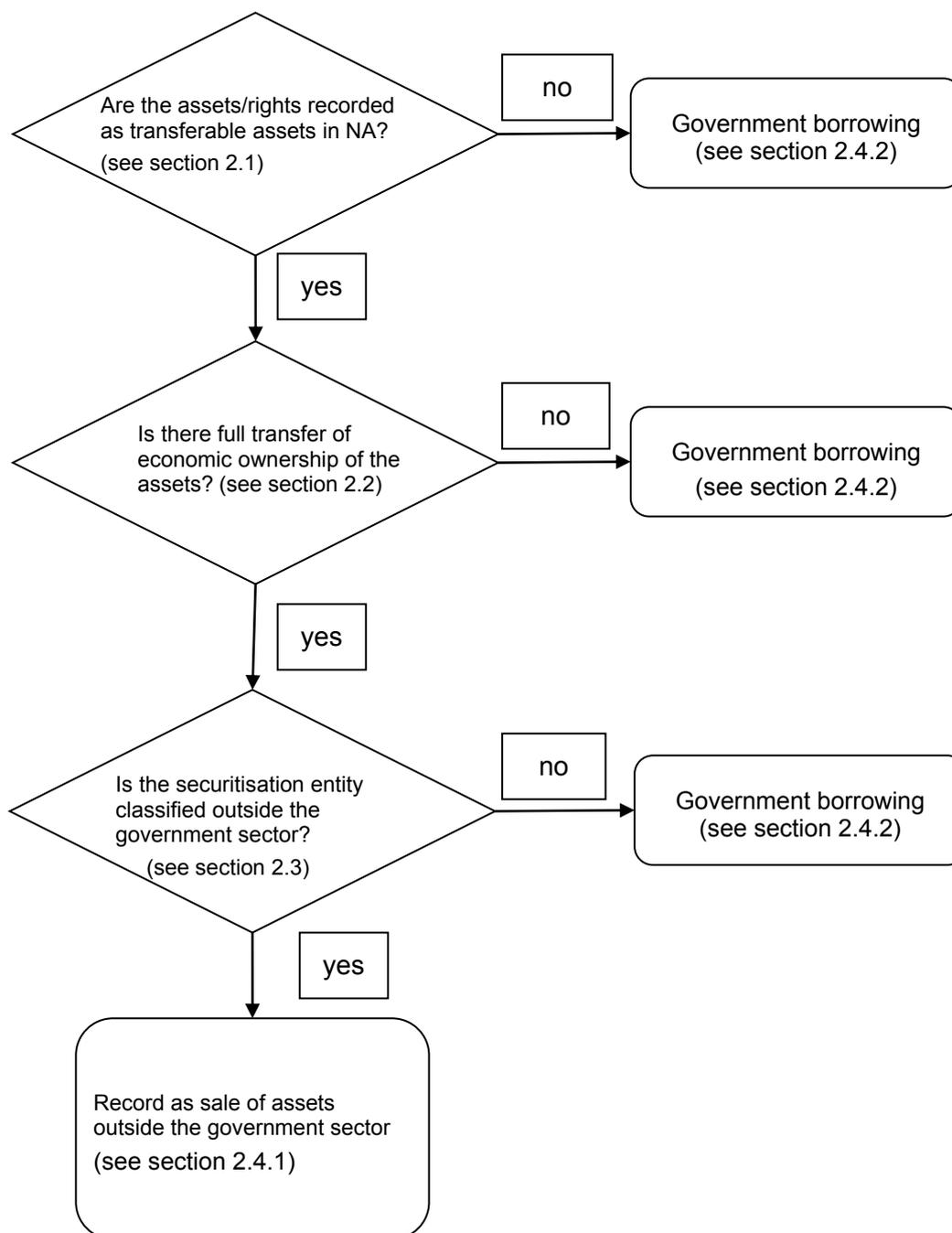
¹²⁰ However, under market standards for such transactions, a part of operational risks is usually kept by the originator, here government, together with the arranger. Such risks are frequently referred as losses resulting from execution, delivery, process management, internal and external frauds, business and continuity and system failure, damage to physical assets, inadequate or inefficient documentation, legal risks. They do not result from the risks associated to holding the assets (market/credit risks). However, in securitisations undertaken by government, it should be checked whether the operational risk borne by government is strictly restricted to the usual market practice.

¹²¹ SEE ESA10 20-262-271.

recognised as an asset in national accounts, it is not possible to record the sale of an asset in such cases. The revenue has not yet accrued, presumably because the event that leads to the tax liability has not yet taken place, and consequently no asset exists in the national accounts balance sheet. Thus, the securitisation by government of future tax revenue before the taxpayer's liability accrues is always recorded as government borrowing in national accounts.

15. The same recording (government borrowing) applies to the securitisation of transfers that government units may expect to receive from EU institutions or other international bodies, or from lottery receipts, licence fees or fines. More generally all unrequited distributive transactions should be treated as government borrowing, as long as no entry has been reported in the national accounts balance sheet.
16. Loans assets that were not recognised as such in national accounts at inception, due to the low likelihood of recovery – and thus which have been considered as non-financial capital transfers in government accounts, are recorded as borrowing when securitised.

Decision tree: Sale of an asset or government borrowing?



V.5.2.3 Securitisation of fiscal flows

17. The ownership of certain assets recorded in the government's balance sheet in national accounts may be deemed economically non-transferable. In these cases, their securitisation is necessarily treated as government borrowing.
18. An example is financial claims in respect of taxes already accrued and recorded as financial assets in the national accounts balance sheet, sometimes referred to as "fiscal claims". These fiscal claims (receivables) differ from the rights over future tax revenue (discussed in the previous section above). The revenue has been recorded in national accounts, together with a financial asset in the national accounts balance sheet (fiscal claims).

19. The national accounts balance sheet entry for fiscal claims should not be confused with the government's book-keeping accounts, as the former excludes the amounts deemed to be uncollectible (see below 3.1.2). The securitisation of amounts deemed uncollectible is also recorded as government borrowing in national accounts.
20. Even if government outsources their collection, taxes (and compulsory social contributions) are still considered government revenue.

V.5.2.4 Securitisation of flows from non-transferred assets

21. Government may securitise the 'income stream' flows generated by assets that are recorded in the national accounts balance sheet. These flows include rentals, rents, interest, dividends and other property incomes (P.1 and D.4). For instance, non-residential buildings generate rentals paid by the buildings' occupiers.
22. When government securitises several rental periods only amongst all the future rentals that they expect to receive, it does not dispose of the full risks and rewards of the assets, and therefore of the economic ownership on the buildings themselves. In such cases, the securitisation arrangement should be recorded as government borrowing in national accounts.
23. Similarly, the securitisation of (partial) future streams of property income generated by financial assets is also recorded as government borrowing when the economic ownership of the financial assets is not fully transferred. Criteria to determine the transfer of ownership are discussed in section 2.2 of this chapter.

V.5.2.5 Transfer of ownership: risks and rewards

24. Assuming that the securitised items are recognised as transferable assets in national accounts, a sale of these can only be recorded in national accounts if there is transfer of economic ownership from government to the securitisation entity. There is transfer of economic ownership of assets when the risks and rewards that are attached to these are completely transferred. If the risks and rewards are not completely transferred from government to the securitisation entity, the securitisation is recorded as government borrowing.

V.5.2.6 Notion of risks and rewards

Financial assets

25. The rewards associated with financial assets are the remuneration (unconditional as interest or contingent as dividends) and the holding gains which can result from their fluctuating market value, whereas the risks are usually mainly designed as:
 - Market risk: decrease in the value of a portfolio, either an investment portfolio or a trading portfolio, due to change in value of the market risk factors: equity risk (change in prices), interest rate risk (change with an impact on the value of fixed rate securities and on refinancing), currency risk (floating exchange rates and realignment), commodity risk (change in commodity prices); it includes also the risk that a corporation will not provide a "normal" and sufficient rate of return on equity;
 - Credit risk: incapacity of a borrower to face its contractual liability obligations on time with delay or definitively, or risk that a corporation to go bankrupt;
 - Counterpart risk: incapacity of a party in a transaction to fully execute it;
 - Operational risk (see above footnote).
26. In some cases, the government, in return for a fee, acts as an agent collecting the property income from financial assets sold, which it then passes to the purchaser. This might be because it would be costly to transfer such operations to the new owner or because of agreements with borrowers when the assets were first created. The originator's retention of the collection function is frequently observed in the private financial sector. In such circumstances, the sale can still be recorded as a disposal of financial assets, provided that the collection arrangement does not affect the transfer of

risks and rewards to the securitisation entity and is covering the actual management costs of the transferred assets. The sole fact that government is collecting the property income alone would not affect the economic ownership being with the purchaser (see below §74 - 75).

Loans

27. Loans are also frequently sold together - as a “loan book” or “loans pooling” - rather than sold individually. In this context, a partial sale of a loan book often takes place, which can be arranged in different ways, such as by randomly selecting (at time of securitisation) borrowers whose repayments are sold to the purchaser, or by selling a fixed proportion of the portfolio repayments received every day from the loan book. The partial sale of loan book through the sale of claims specifically selected can be recorded as a sale of loans in national accounts. The sale by government of a fixed proportion of the total repayments, without any straightforward allocation to some identified assets, cannot be recorded as a sale of loans in national accounts, and is to be recorded as government borrowing.

Non-financial assets

28. Frequently, the securitisation entity does not take possession of non-financial assets with the intention of holding them until the end of their economic life; instead, it intends to resell them. Therefore, in addition to the risks of default on the income (rentals and rents) that may be associated with these assets, there is a risk of holding losses, and conversely there are possible rewards if holding gains arise (as for financial assets) which may lead to lower or higher than expected revenue from the eventual sale of the assets.

29. The transfer of risks and rewards, such as the variability of maintenance and insurance costs, must also be considered when judging risk transfer in cases of securitisations involving non-financial assets.

V.5.2.7 Judging risks and rewards transfer

30. The risks and rewards associated with the asset are judged as not fully transferred, leading to a recording as government borrowing, if any of the following applies:

- Restrictions are imposed by government on the securitisation entity’s right to subsequently sell the assets;
- Securitised flows concern only a fraction of flows associated to a given asset;
- There exists a “Deferred purchase price (DPP)” clause or equivalent, which demonstrates some residual ownership by government;
- Government provides guarantees or other forms of risk alleviation to securitisation entities, including by way of a “substitution clause” or other arrangements;
- Other on-going involvement of government in the asset which prevents a full transfer of risks and rewards.

Equity tranche and DPP

31. In some securitisations, different tranches of securities issued are backed by different parts of the flows from the securitised assets. This means that there is a differentiation in the risks and rewards that are borne by investors. By this process, it is possible to include some mechanisms by which the originator, government, keeps a residual risk/reward (sometimes called an “equity tranche” or “last tranche”), to protect investors against an excessive under-performance of the securitised assets. This makes the securities more attractive to investors. This mechanism prevents a full transfer of risks to the securitisation entity and leads to the recording of the securitisation arrangement as government borrowing.

32. In a securitisation contract, a “Deferred purchase price (DPP)” is another device of credit enhancement whereby the securitisation entity is obliged to pay (performance related) to the originator additional proceeds from a sale at a later date. When such

clauses exist, the assets are disposed of at a value (a sale price) set below their market/fair value. A DPP should not be confused with delayed settlements of a fixed price, which must appear as originator's receivables and as the securitisation entity's liabilities at inception, in accordance with the accrual principle.

33. Securitisation of arrangements including equity tranches, DPPs or similar clauses giving rights to further payments for the seller of the assets, are recorded as government borrowing, because such clauses provide evidence that not all the risks and rewards of the operation have been transferred to the securitisation entity.

Guaranteed payments after the sale

34. Government guarantees may be granted in the context of a securitisation. In a securitisation contract, government may commit itself to repay the debt incurred by the securitisation entity in the event of the latter being unable to do so from its own resources, because of insufficient performing assets.¹²² Government securitisation arrangements that include ex ante guarantees are recorded as government borrowing. This rule does not apply to guarantees that have a general purpose and that are offered to other units for similar events, such as covering against the consequences of limited external events such as natural disaster, terrorism and war.
35. Substitution clauses are a specific kind of guarantee. These typically involve an option to substitute the original assets transferred to the securitisation entity with new ones, for example if the transferred 'asset' is later found not to exist or impossible to collect. The existence of a substitution clause is important when judging the transfer of risks and rewards between the government and the securitisation vehicle.
36. Except for marginal cases limited in scope and deriving purely from technical reasons or material errors and where the substituted assets have the same value as the new ones, the existence of a substitution clause leads to a recording as government borrowing.
37. Government may compensate later the securitisation entity, although this was not a requirement of the contract. Such compensation may take the form of cash, debt assumption, or a direct or indirect guarantee granted as response to unfavourable trends. A further situation is where government introduces or modifies legislation, which leads to a de facto compensation of the securitisation entity.
38. At the time compensation is decided, the event is recorded as a simultaneous purchase by government of the assets securitised, against an incurrence of a government liability (loan) towards the securitisation entity. This should be equal to the amount of the securitisation entity's outstanding debt securities issued to finance the acquisition of the securitised assets.
39. If the market value of the purchased asset is lower than the liability incurred, a capital transfer is recorded from government to the securitisation entity for the difference.
40. A purchase of a financial asset will not affect the net lending/net borrowing of general government (B.9), unless the market value of the assets acquired is lower than the debt incurred.
41. A purchase of a non-financial asset increases any government deficit (and reduces surplus) by the amount of the debt incurred because the acquisition of non-financial assets impacts on net lending / net borrowing (negative GFCF).
42. The same rule applies when there is no contractual clause for the substitution of assets (see paragraph 37), but it is observed in practice that a significant amount of the securitised assets are replaced by others of higher market value. The incurrence of a government liability should be imputed against a repurchase of the asset at the time the substitution is decided.

¹²² It does not necessarily take the form of an explicit guarantee on the debt issued by the securitisation unit (thus not enforceable by third parties) but it may be a specific clause in the contract.

43. These rules do not apply if compensation is paid by government to the securitisation entity as a result of an actual or potential court decision arising from government breaking the terms and conditions of the sale contract.

Restriction to subsequent sales

44. Any restriction to on-selling the acquired assets, or other rights to future cash flows, would provide evidence that economic ownership has not been transferred.

V.5.2.8 Classification of the securitisation entity

45. ESA10 5.108: "It is essential to establish, in particular, whether the financial corporation engaged in the securitisation of assets actively manages its portfolio by issuing debt securities, rather than simply acting as a trust that passively manages assets or holds debt securities. When the financial corporation is the legal owner of a portfolio of assets, issues debt securities that present an interest in the portfolio, has a full set of accounts, it is acting as a financial intermediary classified in other financial intermediaries. Financial corporations engaged in the securitisation of assets are distinguished from entities that are created solely to hold specific portfolios of financial assets and liabilities. The latter entities are combined with their parent corporation, if resident in the same country as the parent. However, as non-resident entities they are treated as separate institutional units and are classified as captive financial institutions." If the securitisation entity has no autonomy of decision concerning the management or disposal of the transferred assets or concerning its liabilities, the securitisation entity is not a separate institutional unit according to national accounts criteria (as stated in ESA10 2.12).

46. Where the securitisation entity has been established to serve a government unit, a lack of autonomy of decision could be indicated, among other factors, by:

- actual management of the securitisation entity's debt by government;
- absence of the right or capacity to actively manage its assets in response to market conditions, such as government having the right to approve any significant disposal;

47. In most cases a securitisation entity will be formally set up by a private (financial) institution to purchase and securitise government assets. In these cases, if the securitisation entity does not have autonomy of decision (see above), it is classified within the government sector to the extent that the government initiates the transaction is entitled to take make significant decisions during the life of the securitisation.

48. If the securitisation entity meets the conditions to be considered as a separate unit, i.e. it places itself at risk and the securitisation and fully controls assets and liabilities during their life time, it is classified as a financial corporation (S.12). Notably, ESA10 2.90: "Financial vehicle corporations engaged in securitisation transactions (FVC) are undertakings carrying out securitisation transactions. FVC that satisfy the criteria of an institutional unit are classified in S.125. Conversely, it is not because a securitisation unit has been considered by supervisory authorities as an FVC, submitted to the reporting and regulatory obligations of this category of financial units, that it should be automatically excluded from the general government sector. The analysis for national accounts purpose must be totally independent from such considerations.

V.5.3 Recording rules

V.5.3.1 Recording as a sale of an asset

49. The transaction with the securitisation entity is recorded as a sale of a general government asset outside the general government sector if the three conditions set out in paragraph 9 above are met:

50. When the transaction is recorded as the sale of an asset, there is no direct impact on government debt. There would be an indirect (downward) effect if the proceeds from

the securitisation were used directly to reduce government debt or as a substitute to required borrowing for financing an excess of expenditure.

Financial assets

51. The sale of a financial asset to the securitisation entity will not affect the government net lending/net borrowing (B.9). In some cases the government unit, in return for a fixed fee, acts as an “arms-length” agent for the collection of debt repayments and property income from the sold financial assets, which it passes to the purchaser. This would be recorded as government output.

Non-financial assets

52. The sale of a non-financial asset to the securitisation entity will improve the government net lending/net borrowing (B.9). However, some non-financial assets may continue to be used by government. As an example, in the case of the sale of residential buildings, the securitisation entity will typically acquire such buildings for the purpose of their resale. However, during the time between their acquisition and their resale, the buildings frequently continue generating income in the form of rentals. Assuming that all the conditions relating to the transfer of ownership are fulfilled, the fact that the securitisation entity has the economic ownership of the securitised buildings implies that, in national accounts, the operating surplus that they generate is recorded with the securitisation entity (see chapter 6.3 of this manual on sale and leaseback operations for further guidance).

53. The production process consisting of operating the buildings for residential purposes may be allocated directly to the securitisation entity. This treatment should be adopted when the entity takes on board all the daily management of the buildings and has a full access to the rentals generated by the buildings. If the former owner, i.e. the government unit, keeps the daily management of the securitised buildings, and retains as management fees a part of the rentals generated by the buildings, most of the income should still be allocated to the securitisation entity.

The price fixed in the securitisation arrangement

54. In national accounts, the disposal of assets should be recorded at the market price that prevails at the time the transaction takes place. It is generally the observed sale price, the price agreed in the contract. However, if there is evidence that the observed sale price is lower than the market value:

- it may indicate that the operation is not carried out on a pure commercial basis and that there is an implicit support of the securitisation entity. In such a case, it is necessary to record a capital transfer from government to make up the difference between the observed price and the market value as the sale is recorded at market price in national accounts; (see ESA10 5.21)
- it may be associated with the existence of DPP clauses (see above) and the transaction should not be recorded as a sale but as government borrowing.

55. If there is no obvious market price for specific assets, then, in order for an arrangement to be recorded as a sale, there should be a process by independent bodies to determine an equivalent market price, on the basis of the usual valuation methods used in business areas.¹²³ The absence of such a process could be interpreted as a lack of autonomy of the securitisation entity, such that it should be classified to government.

V.5.3.2 Recording as government borrowing

56. If the securitisation operation does not fulfill the criteria necessary for it to be recorded as a sale of assets in national accounts, the securitisation proceeds collected by government should be recorded as the incurrence of a government liability, with an

¹²³ “Adjusted book value”, “capitalised adjusted earnings”, “discounted future earnings”, “cash flow method”, “gross revenue multiplier”, “Capital Asset Pricing Model”, “Weighted average cost of capital”, “Market comparisons techniques”, “option pricing approaches”, etc.

impact on the government debt. If the securitisation entity is classified to the government sector, the securities (AF.33) it issues are part of government debt. If the securitisation entity is not classified to the government sector: either no sale is recognised, and the securities (AF.33) the securitisation entity issues are not directly part of government debt, and instead a loan is imputed from the securitisation entity to government is part of government debt; or a true sale is recognised, and there is no entry in government debt. This is particularly the case when the securitisation has been set up in another country where markets for such transactions are more developed and/or efficient.

57. The cash flows generated by the securitised items (such as the rental income generated by buildings), first received by government and then passed over to the securitisation entity, continue to be recorded in the government accounts, as if no securitisation operation had occurred: as revenue, or as the disposal of a nonfinancial or financial asset, as appropriate. Payments made by government to the securitisation entity, when government continues to manage the assets, are recorded as government servicing its loan liability; these are imputed flows of interest and loan repayment. Any fee retained by the securitisation entity to cover its operating costs is recorded as intermediate consumption of government. This holds even if the fee is paid up-front, reducing the funds provided to the government unit, in which case an imputation is to be made.

V.5.3.3 Recording at the end of the arrangement

58. If at the end of the operation the payments made by government to the securitisation entity, when government continues to manage the assets, exceed the government liability, no further redemption of government debt can be recorded, and payments to the securitisation entity are recorded as a current transfer expenditure of government.
59. If payments made to the securitisation entity terminate before extinction of the government liability, for example because of the depletion of the assets, the remaining liability is removed from the government balance sheet in national accounts by way of another change in volume.
60. When the securitisation arrangement is treated as government borrowing and the securitisation entity subsequently sells the (recognised) underlying assets to a non-government unit with a full transfer of ownership rights, the sale is recorded as a disposal of assets by general government and the securitisation is simply deemed to act as an agent of government. The effect of such an arrangement is to postpone the disposal/sale of assets by the government from the time of securitisation to the time of actual sale by the securitisation entity. The correct time of recording is particularly important when non-financial assets are involved due to the impact on government net borrowing (B.9).

V.5.3.4 Securitisation by non-government units of receipts from government

61. In some cases, a non-government unit will, for its own purposes, securitise regular receipts from government.
62. When this occurs, the contractual obligations of government must be examined to check whether the substance of the transaction is such that the government has incurred a new outright obligation to provide sufficient funds to finance the borrowing of the non-government unit.
63. If the securitisation by the non-government unit has no impact on the government's contractual obligations to make future payments, there should be no impact on the government sector accounts as a result of the securitisation.
64. If there is in effect a new government liability, a capital transfer should be recorded from government to the non-government unit equivalent to the net present value of all the promised future payments; and a loan of the same size recorded from the non-

government unit. The future government payments are recorded as interest and loan repayments.

V.5.4 Rationale of the treatment

V.5.4.1 Recognising a transferable asset in national accounts

65. Transfers, i.e. unrequited distributive transactions, are not generated by assets. For instance, the capacity of governments to raise taxes does not constitute an asset recognised in national accounts. Expected future receipts of international transfers, lottery tickets, licence fees or fines are not classified as assets. The future flow of these transfers does not meet the definition of assets in ESA10 7.15. It is not possible to record a transaction in assets if the asset does not exist in the national accounts balance sheet to start with. So, as the assets are not recognised in national accounts, only a government borrowing can be recorded for securitisation of these items.
66. Future streams of income on assets - which will be recorded in P.1 and D.4 when they accrue - also do not constitute assets by themselves according to ESA10. Unless the ownership of the underlying assets is deemed to have been transferred, the securitisation of such flows can therefore not be recorded as a sale of assets in national accounts.
67. Similarly, a sale cannot concern a limited set of several future periods of use of an asset, for instance several future streams of property income to be earned on financial assets, or several future streams of rentals/rents to be derived from the use of non-financial assets, unless the corresponding assets are wholly sold themselves.

V.5.4.2 The case of fiscal claims

68. Taxes are uniquely established by the taxing powers of governments and can only be raised by governments or international organisations. Taxes are also subject to specific valuation rules, following Regulation 2516/2000. One must distinguish securitisation of future taxes from securitisation of tax receivables (fiscal claims).
69. Securitisation of taxes that will accrue in the future, on future income or on future events, cannot give rise to a disposal of an asset because no asset exists in national accounts. Therefore they must be considered as borrowing. Securitised taxes that accrue in the future must be attributed to general government in the national accounts system, whatever the specific collection arrangements under a securitisation.
70. Fiscal claims, which reflect taxes accrued in the past but not yet settled because they are either not yet due or in arrears, are financial assets and are recorded as AF.8 in national accounts. However, they cannot be transferred to non-tax-raising units given that – by convention- in ESA10 only general government, the institutions of the European Union or the Rest of the World can levy taxes (ESA10 4.14 and 4.77). In ESA10, social contributions may be considered the resource of any sector. Nonetheless, given the proximity between taxes and social contributions, securitisations of all fiscal claims follow the same rule (recording as borrowing), be they tax receivables or social contributions receivables to be collected by government, private units or by other non-government units (at least for compulsory social contributions).

V.5.4.3 Transfer of risks and rewards

71. One condition for a securitisation to be recorded as a sale in national accounts is that the risks and rewards associated with the asset are transferred to the securitisation entity. According to ESA10 7.10, “an economic asset is a store of value representing the benefits accruing to the economic owner by holding them or using them over a period of time.” Furthermore ESA10 rules on financial leasing, that corresponds to a situation in which “all risks and rewards of ownership are, de facto though not de jure, transferred from lessor to lessee” (See chapter 15) indicated that economic ownership is determined by the allocation of risks and rewards of ownership.

72. The economic reality rather than legal formalities determines ownership in national accounts. Most guarantees, substitution clauses, last tranches or DPPs indicate that the risks and rewards associated with the asset have not been transferred. In those cases government borrowing is recorded. Furthermore, any restriction imposed by government on the securitisation entity's right to subsequently sell the assets on to a third party is regarded as strong indication that there is not a sale since it could give the government exposure to potential rewards from the asset.

V.5.4.4 Risks and rewards associated with financial assets

73. Economic benefits that may be derived from financial assets consist of the property incomes that are earned through holding them and of the holding gains that accrue on them, which may be realised when assets are sold. Symmetrically, holding losses are also possible and are thus part of the risks associated with ownership.

74. Usually the most important risk associated with financial assets in the context of securitisation is the credit risk. Credit risk refers to possible defaults on payments due, which may be distinguished between payment of interest and repayment of principal. The economic owner of a financial asset is the unit that, ultimately, bears the credit risk associated with these assets. The economic owner may subsequently acquire insurance or derivatives to offset that risk, but that does not change the ownership.

V.5.4.5 Risks and rewards associated with non-financial assets

75. The rewards that are associated with non-financial assets consist of the operating surpluses that accrue from the operation of fixed assets, and net rents derived from renting non-produced assets. In addition, non-financial assets may generate holding gains and losses, which is an important feature when they are acquired for resale. The owner bears costs in order to avoid the non-performance of the assets in terms of generating income, by undertaking their maintenance, or buying insurance for compensation in case they accidentally degrade, deplete or destruct. Attributes of ownership include deciding:

- the level of the rentals/rents;
- the time at which assets are sold.

V.5.4.6 Classification of the securitisation entity

76. Concerning the sector classification of the securitisation entity when it is an SPV, ESA105 paragraph 2.90f states that it should be classified within "Other financial intermediaries" (S.125). "This is based on the assumption that such "vehicles" are institutional units and they conduct financial intermediation (or other auxiliary services).

77. To be a separate institutional unit, the criteria stated in ESA10 2.12 must be met. In order to be classified to S.125, the SPV should have autonomy of decision in respect of the management of the debt securities that it issues: indicators of this are issuance rhythm, debt management, repayment strategy, etc. It should be clear that the SPV does not act on behalf of government. It should also have complete autonomy concerning the management and disposal of its assets. Otherwise the SPV should not be recorded as separate institutional unit.

78. Concerning the recognition of when an institutional unit is a financial intermediary, ESA10 2.57 states that "a financial intermediary does not only act as an agent for these other institutional units but places itself at risk by acquiring financial assets and incurring liabilities on its own account".

79. Concerning the classification of new financial assets resulting from a securitisation, ESA10 5.104 states that securities issued in the context of securitisation are classified under AF.3 "debt securities".

V.5.4.7 Securitisation by non-government unit of receipts from government

80. In some cases a non-government unit will, for its own purposes, securitise receipts from government. Though these unilateral actions might have at first sight no consequence for government sector accounts, the arrangement must be examined to correctly identify the contractual obligations of government. It is necessary to check whether the contract promising the future payments commits the government to pay a sufficient amount to service the debt of the non-government unit receiving these payments.
81. If the government takes an obvious commitment to pay a sufficient amount to cover the debt servicing or other commitments of the non-government unit, the operation should be classified as government borrowing. Government borrowing is not recorded when the government's obligations are conditional on the performance of the non-government unit in delivering the government's policy objectives.

IV.5.5 Accounting examples

The examples only show those transactions with an impact on the government accounts.

Example 1: Building sold with DPP

Government sells buildings to a private sector bank that intends to resell them in the following year as market conditions improve.

Data

The buildings are estimated to be worth 100

Government:

- receives 90 immediately for the sale of the buildings
- also has a DPP agreement such that, if the bank receives more than 90 for the resale of the buildings, the receipts above 90 shall be given to government up to a maximum of 25

The bank, via an SPV it owns and sets up, issues bonds to the value of 90

In the second year the buildings are resold for 120:

- the government receives an additional payment of 25 in DPP
- the bank makes a profit of 5 after the SPV has repaid its borrowing

Analysis and national accounts treatment

The transaction is judged not to be a genuine sale because of the existence of the DPP.

- it has to be recorded as government borrowing in year 1 of 90
- the building is shown as a negative GFCF by government in year 2, when sold at a market price
- the bank's profit is recorded as bonus interest earned on the imputed loan which is shown as being redeemed when the arrangement is completed. For simplicity of recording this is shown as being retained in the SPV at the end of year 2.

YEAR 1							
General government				SPV			
Opening balance sheet (before the arrangement)							
A		L		A		L	
AN.11	100			AF.2	0		
Non-financial accounts							
U / ΔA		R / ΔL		U / ΔA		R / ΔL	
B.9	0			B.9	0		
Financial account							
ΔA		ΔL		ΔA		ΔL	
		F.4	+90	F.4	+90	F.3	+90
F.2	+90			F.2	0		
		B.9	0			B.9	0
Closing balance sheet							
A		L		A		L	
AN.11	100	AF.4	90	AF.2	0	AF.3	90
AF.2	90			AF.4	90		

YEAR 2							
General government				SPV			
Opening balance sheet							
A		L		A		L	
AN.11	100	AF.4	90	AF.2	0	AF.3	90
AF.2	90			AF.4	90		
Current accounts							
U		R		U		R	
D.41	5					D.41	5
B.8	-5			B.8	5		

Capital account

ΔA		ΔL	ΔA		ΔL
P.5	-120	B.8		B.8	5
B.9	+115		B.9	+5	

Financial account

ΔA		ΔL	ΔA		ΔL	
F.2	+25		F.2	+5	F.3	-90
		F.4	F.4	-90		
		B.9			B.9	+5

From the sale to the market, government receives 25 and the SPV receives 95; the SPV then uses 90 of AF.2 to repay its bonds (AF.3).

Revaluation account

ΔA		ΔL	ΔA		ΔL
AN.11	+20				

Closing balance sheet

A		L	A		L
AN.11	0	F.4	0	AF.3	0
AF.2	115		F.2	5	

Example 2: Building sold without a DPP

Government sells buildings to a private sector bank that intends to resell them on the market in the following year.

Data

The buildings are estimated to be worth 100 and are sold for that price.

The bank transfers the buildings to an SPV that it sets up and owns:

- the SPV issues 5-year bonds for 100
- there is no DPP, nor are there any guarantees
- the SPV services the debt interest from rental income and sells the buildings for 110
- the bank extracts profit of 10 from the SPV

Analysis and national accounts treatment

This is recorded as a sale - negative GFCF - by government since government is no longer exposed to the risks and rewards of ownership.

YEAR 1			
General government		SPV	
Opening balance sheet (before the arrangement)			
A		L	
AN.1	100		
		A	
		AF.2	100
Capital account			
ΔA		ΔL	
P.5	-100		
B.9	+100		
		ΔA	
		P.5	+100
		B.9	-100
Financial account			
ΔA		ΔL	
F.2	+100		
		B.9	+100
		ΔA	
		F.2	0
		F.3	100
		B.9	-100
Closing balance sheet			
A		L	
AF.2	100		
		A	
		AN.11	100
		AF.3	100

Example 3: a company securitises subsidies from government

Data

A government unit promises to pay future subsidies of up to 20 per year to a private company over 5 years so that it can provide public transport services.

With government approval the unit establishes an SPV to receive the future subsidies:

- the SPV issues bonds to the value of 60 which it passes to the company to finance the purchase of a fleet of buses
- the SPV uses the subsidy receipts firstly to finance its debt, and passes the remainder to the company which it uses as a contribution to operating the buses.

Part of the government subsidy payments are unconditional in that a minimum of 15 must be paid each year to the SPV even in the event of the company failing to supply public transport services and/or becoming insolvent. The remaining payments, up to 5 per year, depend on the performance of the bus service. In the example, the full amount is paid each year.

Analysis and national accounts treatment

The transaction would be classified as a capital transfer to the bus company and borrowing of the same amount, in respect of the minimum guaranteed payments of 15, and annual

subsidies for the remaining amounts paid. The 15 is split into 12 repayments of capital, and 3 of interest. For simplicity the transactions between the SPV and bus company are not shown in the tables below.

YEAR 1							
General Government				SPV			
Opening balance sheet (before the arrangement)							
A		L		A		L	
AF.2	100						
Current accounts							
U		R		U		R	
D.41	3	D.3	-5	D.3	-5	D.41	3
B.8	-8			B.8	8		
Capital account							
ΔA		ΔL		ΔA		ΔL	
		B.8	-8			B.8	8
		D.99	-60			D.99	+60
B.9	-68			B.9	+68		
Financial account							
ΔA		ΔL		ΔA		ΔL	
		F.4 new	+60	F.4	+48	F.3	+48
F.2	-20	F.4 repay	-12	F.2	+68		
		B.9	-68			B.9	+68
Closing balance sheet							
A		L		A		L	
AF.2	80	AF.4	48	AF.2	68	AF.3	48
				AF.4	48		

YEAR 2							
General government				SPV			
Opening balance sheet							
A		L		A		L	
AF.2	80	AF.4	48	AF.2	20		
				AF.4	48		
Current accounts							
U		R		U		R	
D.41	3	D.3	-5	D.3	-5	D.41	3
B.8	-8			B.8	+8		
Capital account							
ΔA		ΔL		ΔA		ΔL	
		B.8	-8			B.8	+8
B.9	-8			B.9	+8		
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.2	-20	F.4	-12	F.2	+20		
				F.4	-12		
		B.9	-8			B.9	+8
Closing balance sheet							
A		L		A		L	
AF.2	60	AF.4	48	AF.2	40		
				AF.4	36		

Example 4: Building sold, guarantees payments after the sale

Data

In year 1 government sells an office building with a market value of 100 to an SPV for 100. The SPV issues bonds to the value of 100.

In year 2 the demand for office accommodation falls sharply and the rentals are insufficient to service the bonds. The market value of the building falls to 80. Government fears a collapse of the financial institutions that finance property deals and so pays the interest of 5 due on the SPV's bonds, even though it had no contractual obligation to do so.

The receipts of building rentals and interest on the bonds are ignored for the sake of simplicity.

Analysis and national accounts treatment

By activating an ex-post guarantee, it is demonstrated that the debt of the SPV should have been attributed to government, and that the building should not have been treated as sold by the government to the SPV.

Therefore the entire outstanding debt of the SPV, and the associated building, are transferred to the government balance sheet in year 2, along with capital transfers of 5 and 20, to reflect respectively the interest paid by government and the difference in value between the SPV debt and the building.

YEAR 1							
General government				SPV			
Opening balance sheet (before the transaction)							
A			L	A			L
AN.11	100			AF.2	0		
Non-financial accounts							
A			L	A			L
P.5	-100			P.5	+100		
B.9	+100			B.9	-100		
Financial account							
A			L	A			L
F.2	+100	B.9	+100	F.2	0	F.3	+100
						B.9	-100
Closing balance sheet							
A			L	A			L
AN.11	0			AN.11	100	AF.3	100
AF.2	100			AF.2	0		

YEAR 2

General government

SPV

Opening balance sheet

A		L		A		L	
AN.11	0			AN.11	100	AF.3	100
AF.2	100			AF.2	0		

Capital account

A		L		A		L	
P.5	+80			P.5	-80	B.9	-105
D.9	+20			D.9	-20		
D.9	+5	B.9	-105	D.9	-5		

D.9: 5 cash compensation;

20 imputed for the difference between the value of building and outstanding bond debt

Financial account

A		L		A		L	
F.2	-5	F.4	+100	F.2	+5		
		B.9	-105	F.4	+100	B.9	+105

Revaluation account

A		L		A		L	
				AN.11	-20		

Closing balance sheet

A		L		A		L	
AN.11	80	AF.4	100	AN.11	0	AF.3	100
AF.2	95			AF.2	5		
				AF.4	100		

The SPV's cash would be used to pay the interest on the bonds.

V.6 Low interest loans and sale of government low interest loans to third parties

V.6.1 Background of the issue

1. As a part of public policy activities, governments provide loans at a lower interest rate than the market rate observed at the time of loan issuance (sometimes called "concessional loans").

V.6.2 Recording of low interest loans at inception

2. A granting of low interest rate loans is a specific public policy activity carried out by government, which frequently results in transactions not undertaken at market conditions. Such loans directly provided by government to students at low interest rate, real estate loans provided to households in specific circumstance, loans to newly created companies, etc.
3. When government provides a loan to households or companies at a lower interest rate than the market rate in order to support their activities, the operation implies a benefit for the debtor. The benefit reflects the difference between the contractually agreed interest rate and the market interest rate that would have been paid by the debtor if the loan was granted at the market interest rate.
4. The ESA10 rules do not require to record in national accounts the implicit benefit element, i. e. the difference between the market interest rate and the interest rate contractually agreed, in order to reflect all transactions undertaken by government by reference to market conditions. As set out in ESA10, the amount of interest recorded on an accrual basis follows the contractual interest rate agreed at inception between the creditor and the debtor.
5. It must be stressed that the impact on deficit is already reflected implicitly in national accounts as a difference between the cost of government financing and the low interest revenue received from the loans granted by government in the context of its public policy.
6. In this context, the interest has to be recorded on the basis of the contractually agreed interest rate. Consequently, no implicit benefit for the debtor is recorded in national accounts.

V.6.3 Recording of sales of low interest loans

7. The issue refers to the cases when well-performing loans, provided by government under public policy activities, are sold to a third party at discount (i.e. below their nominal value). Such operation is related to liquidity management (refinancing purpose) and is not part of public policy as the original beneficiary is not at all involved. At the time of the sale of the loan, the discount reflects the difference between the current market interest rate (that the purchaser of the credit could have charged on its own lending operations) and the lower interest rate contractually agreed between the debtor and the original creditor at time the loans had been granted. From this point of view, as far as recording revaluation effect is concerned, sales of loans not granted by government at market conditions for public policy purpose are treated similarly to loans granted by financial intermediaries for commercial purpose at prevailing market rates and further resold on the basis of different market rates.
8. Paragraph 6.58 in ESA 10 indicates that "...when an existing loan is sold to another institutional unit, the write-down of the loan, which is the difference between the

redemption price and the transaction price, is recorded under the revaluation account of the seller and the purchaser at the time of transaction."

9. In the case of sale of low interest rate loans to a third party below the nominal value, the discount as a difference between the nominal value and sales price, has to be recorded as revaluation. This concerns only the sales of loans that are not a subject to any rescheduling or other change in the contractual obligations of the debtor.

V.7 Keywords and accounting references

Capital account	ESA10, 8.46
Contingent assets	ESA10, 5.08-11
Entrepreneurial income	ESA10, 8.26-28
Equity	ESA10, 5.151 and following
Financial account	ESA10, 8.50
Financial transaction	ESA10, 5.16 and following
Head offices and holding corporation	ESA10, 2.14 and 20.35
Market/non-market units	ESA10, 2.19-34
Non-financial non-produced assets	ESA10, 7.24
Non-financial produced assets	ESA10, 7.22
Other changes in volume of assets account	ESA10, 8.53
Privatisation	ESA10, 20.210-213
Rearranged transactions	ESA10, 1.72-78

VI

Leases, licences and concessions

Part VI Leases, licences and concessions

VI.1 Overview

VI.1.1 Background on general principles

1. Among government receipts are rents, rentals, licence fees, tolls, administrative charges and royalties, some of which may arise under leasing contracts, concessions, public-private partnerships (PPPs) or franchises given by government. They cover different types of transactions in national accounts, explained in various chapters in ESA10, principally in chapter 15 and, for a part, in chapter 20.
2. Part 1 of this manual considers when payments between public sector units can be recorded as sales of services. Part 3, 4 and 5 explain how to record proceeds from the sale of assets and payments from public corporations, including the central bank. This part highlights the problem of distinguishing between output of government (sales of goods or services), taxes, rent, and sales of assets. The analysis is categorised as follows:
 - a) Receipts from sale of goods and services produced by government (that could be supplied by other units in the economy).
 - b) Receipts for the use of a produced asset owned by government.
 - c) Receipts for the use of a non-produced asset owned by government.
 - d) Receipts in return for permission from government to undertake an activity.

Terminology

3. The development of various forms of long-term contracts between government units and corporations, notably under the wording of "public-private partnerships", requires a clarification of the terminology used in the context of national accounts. This terminology may be used differently here than it is elsewhere.
4. Concessions: these are commonly contracts for infrastructure equipment that can be subject to commercial exploitation. In this type of long-term contract, the corporation (or group of corporations) is responsible for the building, operating and maintenance of the equipment and is predominantly remunerated by the final users (households, corporations etc.) of the equipment who pay tolls or other fees. Chapter VI.4 deals with the accounting recommendations related to this type of contracts.
5. PPPs: in a growing number of countries, government units have used the services of private corporations (or group of corporations or specific vehicles) to build, operate and maintain equipment designed to render some public services, not typically subject to commercial activity: public hospitals, schools and universities, prisons, etc. It is recommended to use the term PPPs in national accounts only for those contracts where government is the main purchaser of the service. Chapter VI.5 in this Manual deals with this type of contracts.

VI.1.2 General treatment in national accounts

VI.1.2.1 **Government receipts for goods and services (that could be supplied by other units)**

6. The receipts could be less than, the same as, or more than the costs of production: it does not affect the classification.
7. **Treatment:** record as a sale – output (P.1), notably market output (P.11) if the prices charged are economically significant.

Examples: receipts for provision of training; fees charged for advice to businesses or for research contracts, or testing the ability of somebody to carry out an activity (e.g., drive a vehicle).

VI.1.2.2 Government receipt for the use of a produced asset

8. The receipts could be less than, the same as, or more than the costs of production: it does not affect the classification.

9. Two sub-categories of receipts may be distinguished depending on the time period.

- i. Receipts are made **each time the asset is used, or there is a single receipt allowing use of the asset for a period of time less than one year** (and this is not part of a contract requiring receipts for use over a longer period).

Treatment: record as a sale – output (P.1), notably market output (P.11) if the prices charged are economically significant.

Examples: rental of a government-owned building; road and bridge tolls; vignette for use of specific roads for a certain length of time; charges for use of a sports centre or swimming pool; entry fee to a public building.

- ii. The receipt payment is part of a contract that allows use of the asset for a **period of more than one year, but for less than the economic life** of the produced asset, e.g. in concession or PPP-type contracts. One or several individual payments might be required under the contract. It is the time period of the contract that matters, not the number of receipts.

Treatment: apply the operating lease/finance lease test (ESA10 15.11 and 15.16-18I) and in the case of PPPs, the assessment of the distribution of risks (see chapter VI.5). Although it is unlikely that government would see itself as being in the business of providing financial leasing, it could be appropriate to record the sale of the existing asset by government when the purchasing unit assumes most of the risks and rewards of ownership for the period of the contract.

Operating lease and PPPs where government is judged as the economic owner of the assets: record as rentals – P.1 (in the case of one initial receipt it would be necessary to accrue over the period of the contract and record the prepayment as a financial advance, F.8)

Examples:

A single up-front receipt from a company to occupy a government-owned building for five years: record as rentals (P.1), accrue it over the five years, and record a financial liability in F.8.

VI.1.2.3 Government receipts for the use of natural resources

10. Government natural resources (AN.21) include land, sub-soil assets, and other tangible natural assets over which ownership rights of government have been enforced, either through legal ownership or international agreement or convention, which may or may not be owned and traded by other units in the economy. This category excludes the following:

- government receipts for the use of natural resources if such revenue arises from special legislation giving government the right to demand such payments when it is not the legal or economic owner of the assets;
- government receipts when it is not the economic owner, or when economic ownership is not established and it is not credible to regard government as the economic owner of the assets;
- “environmental assets” which are not regarded as economic assets in ESA10 – see chapter 7, annex 7.1.

- indirect revenue from the natural resources, for example dividends from public corporations exploiting natural resources and corporate tax from corporations exploiting natural resources (ESA10 15.30).
11. Revenue for the use of natural resources includes the following two types of receipts:
 - Those made each time the asset is used, or there is a single receipt allowing use of the asset for a finite period of time.
 - The natural resource is made available by government through a lease, licence or permit, for a limited period of time.
 12. Treatment: record as rent (D.45), in the case of one initial receipt, it is necessary to accrue it over the period of the contract and to record the prepayment as a financial advance liability, F.8.

Example: government receives royalties paid for the extraction of oil.
 13. If, for example, there is a single receipt from a company to exploit offshore oil reserves for five years: record as rent (D.45) accrued over the five years and record a prepayment in F.8. Note that a non-produced asset (AN.22: "contracts, leases and licences") will appear on the balance sheet of the lessee company if subsequently the market rent rises above the rent agreed in the contract, and the company has the right to transfer the rights to a third party (a transferable lease).
 14. If the government receipt for use of its natural resources covers a period equal to or longer than the rest of its economic life, then it is recorded as the sale of a non-produced asset (NP.1). For example, government is economically acting in the same manner as if selling land when it grants an infinite lease for its use. This situation may be rare for finite leases, since natural resources do not "depreciate" in the same manner as produced assets and hence often have infinite economic life lengths, but it is possible in cases such as depletion of oil reserves and technological obsolescence.

VI.1.2.4 Note on non-produced assets AN.22

15. Acquisitions or disposals of non-produced assets (NP.1-3) are to be recorded only in certain defined circumstances. In general, payments for using assets made under leases, franchises, or concessions are recorded as sales of services ("rentals" P.1) or rent (D.45), or the economic sale of the asset being exploited (P.51 in a finance lease, NP.1 in a resource lease), as described above.
16. ESA10 6.06g describes the case where a transaction in a non-produced asset should be recorded: when a unit (the second party) has a right to buy services or rent at a particular price from a first party, and that price is lower than the current market price, and it transfers that right to another unit (the third party). Such assets arise, for example, when the price to be paid for the consumption of services is agreed, or paid, in advance under a contract for a number of years, and subsequently the actual market price becomes higher than the contract price.
17. Example: a unit (Unit B) buys five years' worth of services from another unit (Unit A) at the market value at the time the contract is agreed. Unit B pays in advance. The accounts of unit B would record regular payments for the services and a financial asset in F.8, in respect of the prepayment, which is gradually reduced over the contract period. Suppose that after two years unit B transfers the rights to the services to a third unit (Unit C) for an amount greater than it would have had to pay itself (the value of its remaining prepayment financial asset). The accounts of Unit B show the receipt split between an amount to purchase the AF.8 prepayment financial asset and the sale of a non-produced asset (AN.22), which arose in the accounts of Unit B under K.7 holding gains and losses (if a transferable value was present at the inception of the contract, then the AN.22 asset initially appears via K.1 "Economic appearance of assets") in the "Other changes in volume of assets accounts" and was recorded in the balance sheet of Unit B as an AN.22 asset ("contracts, leases and licences"). The sale of the AN.22 non-produced non-financial asset is recorded under NP.2. The purchaser (Unit C) now

has both the financial asset and the non-produced asset on its balance sheet, and will record payments for services, at the original contract price (corresponding to the financial asset), while, assuming the market value remains constant, the amortisation of the non-produced asset is recorded over time in the accounts of Unit C under the item K.2 “Economic disappearance of non-produced assets” (see ESA10 6.07).

18. It is also possible to record the sale of non-produced assets in other cases, such as that described in paragraph 36 below.

VI.1.2.5 Government receipts in return for granting permission to undertake an activity

19. This category excludes receipts for the use of an asset owned by government – these have already been described above. The receipts under consideration might involve those associated with an asset owned by the payer, an asset owned by neither the payer nor the government, or no assets at all. The key point is that legally the activity requires permission from government, and so it is not a payment that could be demanded by other units in the economy. In addition to the administrative procedures required to give the permission and enforce the rules, the government may (or may not) provide a service to the payer, or to society (assessment of conformity, quality checks etc.). This is recorded as a sale of a service (case a) or tax (case b), depending on the circumstances as described below and in ESA10 4.23e and 4.79d, or in specified circumstances as the sale of a non-financial non-produced asset (case c).

Treatment:

a. Sale of service

20. Record as sale of a service – output (P.1) if the government undertakes work specifically related to the payer (typically to assess whether the payer should be granted the permission requested) and the receipt is deemed to only cover an amount up to equal to the cost of the work undertaken by government.
21. The calculation of costs, to assess whether they are in proportion, should include all costs that a private company would need to cover when setting a price and so includes compensation of employees, intermediate consumption, capital consumption and other taxes on production (see ESA10 3.33), directly associated with the service performed. A government unit might provide a range of similar services but price them differently to reflect the different costs required, for example, in order to influence demand in a way that allows the service to be delivered more efficiently the price might be higher at certain times of the day when demand is normally highest), or the price of a service delivered over the internet might be lower than a more personal delivery of the service. If there is, by design, a surplus compared to the cost of the service, then, the whole payment should be considered as taxes. Although ESA10 allows for partitioning of some transactions in paragraphs 1.76 and 1.77, this does not apply as taxes are recorded gross of any service element. The term, used in ESA10 4.79, “Out of all proportion” is not specified but in this instance covers situations whereby the unit deliberately charges prices to generate a surplus over costs as a whole to provide funds for government to be used for other purposes. The receipt payment is for a service, and not a permission, so should be recorded at the time when the work is undertaken irrespective of the length of time the permission is granted for.
22. ESA10 4.79d describes this in more detail.

b. Tax

23. Record as a tax if the conditions above do not apply (when fees charged exceed the cost of any service received directly in return associated with the granting of the permission).
24. The tax would be recorded as D.29 if paid by corporations, or D.59 if paid by households. A capital tax D.91 would be recorded if it were an infrequent levy on

permission to own an asset, or a levy on the increase in value of an asset as a result of government permission - perhaps to construct a building on a particular piece of land (see ESA10 4.149b on betterment levies).

25. *Examples:* annual permission to use a motor vehicle irrespective of where and when it is used; a licence to fish or shoot that is required wherever the hunting and fishing takes place; a charge on the use of buildings when the government does not own them; charges for the permission to own particular types of assets; fees levied on industries to fund consumer protection or research where the work is undertaken to benefit consumers and/or the industry in general rather than funding services delivered directly to the individual business paying the levy. (ESA10 15.32).

c. Sale of non-produced non-financial asset

26. In some cases, when government receipt involves the granting permission to undertake an activity (unconnected to an asset owned by government), the permission is given exclusively to one unit or to a restricted number of units, creating a monopoly or near-monopoly for the holders of the permission. Other units cannot obtain government permission to undertake the activity, and government ensures that the restriction is enforced. This exclusion of other units may give rise to a non-financial non-produced asset on the balance sheets of the units that have the permission. ESA10 15.37 states four conditions to recognise such asset: no use of a government asset; no qualifying criterion for the permission; limited number of permits leading to monopoly (oligopoly) profits; and the possibility to sell the permit to third party.
27. The appearance of an AN.223 asset in the government balance sheet needs to be accounted for through other flows before the sale takes place. If the permission granted is time limited, the balance sheet of the asset holder would show a decrease in the value of the non-produced asset using K.2 "other flows" (amortisation of the asset). (ESA10 15.34)
28. When no government asset is used and if the other three conditions mentioned above are not met, the receipts are recorded as taxes (ESA10 15.32).

VI.1.3 Rationale of the general treatment

VI.1.3.1 Government receipts from sale of goods and services (that could be supplied by other units):

29. The treatment is always to record an output (P.1) of government. The only difficulty might be to distinguish between market output (P.11) and payments for non-market output (P.131). The distinction refers to the notion of economically significant price (see ESA10 20.19-20.34 and part I of this Manual).

VI.1.3.2 Government receipts for the use of a produced asset:

30. The main distinction is to be made between operating lease (output, P.1) and financial lease (sale of an asset, P.51). According to ESA10 chapter 15:
- 1) An operating lease of an asset or a durable good
 - covers a certain period of time which may be long or short and not necessarily settled in advance
 - implies no transfer of economic ownership, the legal owner retains the risks and rewards, one indicator being that he provides repair and maintenance
 - 2) A financial lease
 - covers a predetermined and protracted period of time, usually all, or most of, the economic lifetime of the asset¹²⁴

¹²⁴ However ESA10 15.18 stresses that the length of the lease should not be the predominant criterion for the classification of the contract.

- risks and rewards from using the asset are transferred from lessor to lessee, one indicator being that the lessee provides repair and maintenance.
31. In a finance lease, economic ownership of the good has been transferred. The lessor's role is purely financial. National accounts recognise the economic reality behind financial leasing as the equivalent to the lessor providing the lessee with a loan enabling them to purchase an asset, of which the lessee becomes the de facto owner.
 32. In the specific case of concessions under public law for financing and exploiting public infrastructure and PPPs, see further VI.4 and VI.5, respectively.

VI.1.3.3 Government receipts for the use of a non-produced asset:

33. A distinction is made between the usual case of using (or exploiting) a non-produced asset (natural resources like land, sub-soil assets or other natural resources – ESA10 4.72 to 4.76) for a limited time (D.45 rent) and the availability to use until depletion of the economic value of the asset (sale of the asset).

VI.1.3.4 Government receipts for permission granted to undertake an activity:

34. A distinction is to be made between the recording of a tax and of sale of services (output, P.1).

Distinction between taxes and sales of services

35. ESA10 4.79 d- mentions the criteria to distinguish taxes and sales of services:
The distinction between taxes and purchases of services from government is defined according to the same criteria as those used in the case of payments made by enterprises namely, if the issue of licenses involves little or no work on the part of government, the licences being granted automatically on payment of the amounts due, it is likely that they are simply a device to raise revenue, even though the government may provide some kind of certificate, or authorisation, in return; in such cases their payment is treated as taxes. If, however, the government uses the issue of licences to organise some proper regulatory function (such as checking the competence, or qualifications, of the person concerned), the payments made are treated as purchases of services from government rather than payments of taxes, unless the payments are clearly out of all proportion to the cost of providing the services.”
36. Government acts in an economy in two relevant ways:
Civil commercial law
37. Under civil commercial law government undertakes economic transactions that can also be undertaken by other units. For example, it employs staff, consumes goods and services, rents land, owns fixed capital assets, and sells the output of services using assets, and so on. For government transactions under civil law, ESA10 chapter 3 is applied to classify the productive activity of government; chapter 4 is relevant for classifying the compensation of employees and property income.
38. ESA10 3.39 explains that it is possible for government revenue from selling goods and services to be classified as either market output or as payments for non-market output. Under ESA10 3.26, a non-market institutional unit can have market output, but the major part of the output is provided for free or at not economically significant prices. ESA10 4.73 explains that charges for the use of produced fixed assets situated on land are treated as sales of services, not rent, and also what to do when the charges cover both land and buildings and cannot be distinguished. ESA10 chapters 6 and 15 describe when to record transactions in contracts, leases and licences.

Public law

39. Under public law, government undertakes economic transactions that are unique to it. For example, in the context of government receipts, government can raise taxes, enforce social security schemes, grant permissions/licences, and impose fines.

40. The paragraphs in ESA10 chapter 4 on taxes and social security contributions are relevant here. Paragraphs 4.23e and 4.79d explain the differences between sales of services and taxes.
41. ESA10 4.79d concerns payments by households for the use of assets (vehicles, boats, and aircraft) owned by the payer or hired to the payer. It does not apply to charges for the use of assets owned by government: this is either output (for sale of a service) or rent, not tax.

Allocation of mobile phone licences

1. In most European Union Member States, mobile phone licences (in most cases UMTS - Universal Mobile Telecommunications System, “3G”, then more recently “4G”) have been allocated to operators from 1999 onwards, through diverse methods according to country, including for free. Eurostat took a specific decision in 2000 (News Release n°81:2000, 14 July 2000).¹²⁵
2. Initial payments to government had to be recorded as rent (D.45) if the contract applied to a period by convention of five years or less, or if the contract did not name the total price of the disposal, depending, at least for a part, on the economic performance of the corporation for a large part of total payments over the life time of the contract.
3. The electromagnetic spectrum (the radio waves) satisfied the definition of an asset in national accounts. The associated licence (permit to use the spectrum for a time period), except in the above-mentioned cases, was recorded under ESA95 as an “intangible non-produced asset (AN.222, “leases and other transferable contracts”).
4. Under ESA10, the radio spectrum is explicitly identified as a natural resource (AN.2151). There is no specific mention for UMTS or mobile phone licences but chapter 15 (15.23 to 15.30) covers leases on natural resources. It is specified that if government issues a permit which gives the control on the natural resource asset to its holder during an extended period, bearing associated risks and rewards, it may be recorded as a new asset (AN.222 “permits to use natural resources”) provided that “the transfer of risks and rewards results in a separate and transferable permit with a realisable value.” (15.28)
5. Thus, the permit/licence holder must be able, over the lifetime of the licence, to realise value from the permit if it wished to exit from the activity. The licence must be transferable to a third party. Generally, these transactions have to follow a specific procedure. Similarly to other cases of licences or concessions/PPPs, this may require a government authorisation, notably in order to assess the technical capacity of the acquirer to undertake the related activity, together with its financial strength. The contract may also foresee that the transaction must only take place through government and not directly between the agents involved in the transaction. Under these conditions, the licence could be considered as transferable and, thus, recognised as an asset.¹²⁶ On the contrary, if the government has the right to oppose the transfer for any reason, or if the contract requires the permit holder to keep the licence until its extinction, the licence should not be recognised as an asset and payments to government would be recorded as rents (See ESA10 tables 15.3).

¹²⁵ <http://www.cmfb.org/main-topics/includes/edp6.pdf>

¹²⁶ There is no mention in ESA10 of “de facto transferability” through possible acquisition of the holder of the permit by another unit.

VI.2 Sale and leaseback

VI.2.1 Background to the issue

1. A sale and leaseback transaction is a linked arrangement whereby the owner of an asset sells that asset and immediately leases it back from the purchaser. The subject of the sale and leaseback is usually a building, but may be another fixed asset. In an attempt to improve the management of its assets and to increase its cash holdings, government - at any level, local, state or central - may be involved in such arrangements.
2. From the national accounts point of view, the implementation of sale and leaseback by government raises two questions, which are actually linked together:
 - What is the unit involved in this transaction with the government and what is its relevant sector classification?
 - What is the overall intention behind the arrangement: is it to really "privatise" the management of these assets or to achieve a reorganisation within the public sector?
3. Depending on the way these questions are answered, the reality of the "sale" may be questioned, and the "transaction" recorded in very different ways.
4. The principles relating to the classification of the purchasing unit are similar to those applied to Special Purpose Entities (see ESA10 20.47) set up to acquire securitised assets.

VI.2.2 Treatment in national accounts

5. Three cases may be distinguished depending on the nature of the unit involved in a leaseback arrangement with the government:
 - the unit is created on purpose by government,
 - the unit is an existing public corporation,
 - the unit is a private operator.

VI.2.2.1 **The unit is created on purpose by government**

6. The main issue in this case is a classification issue.
7. As long as the main activity of the involved unit is to provide rental facilities to the government which created it, it is classified in the general government sector.
8. If its only activity is to provide services to a single government unit which created it, it is considered to be engaged in an ancillary activity (see ESA10 2.26. It is thus not considered as a separate unit from its government parent. No transaction in national accounts has to be considered: neither a transaction on assets when created, nor later any transactions in goods and services - output and intermediate consumption.
9. The unit may be a separate institutional unit, if this unit provides services to several units belonging to general government. If the unit results from the split of another unit its creation is recorded in the other changes in volume of assets accounts, under changes in classification and structure. Nevertheless, if the unit actually purchases the asset from its own financial resources - by borrowing in its own right, for instance - the acquisition could be treated as a sale of assets, usually gross fixed capital formation (GFCF, P.51), from one part of general government to another. There would thus be no impact on net lending/net borrowing of general government on a consolidated basis.

Any payments made afterwards by government to the unit are recorded as D.72 (current transfers inside general government).

10. This unit will remain classified inside the general government sector as long as most of its activity is devoted to provide services to government. For a possible reclassification outside the general government sector, one has to follow the rules guiding the market/non-market distinction and definitions of control.

VI.2.2.2 The unit is an existing public corporation

11. There seems to be two conditions for a transfer of fixed assets from government to an existing public corporation to be treated as a sale of assets under GFCF (having an impact on net lending/net borrowing):

- the corporation must be an actual one, not set up specifically for the transaction under review; it must be usually involved in this type of activity, showing evident competence in the management of such assets; its size must be adequate to the transaction; as a practical criterion, the value of the assets which are transferred should not significantly exceed the current value of the existing assets already owned by the corporation;
- the corporation finances the acquisition of the assets from its own resources (or own borrowing on the market).

12. However, if one of these conditions is not fulfilled, the whole process could be considered as a restructuring of assets within the public sector, leading to a more efficient management of these assets. The transfer of assets would be recorded in the other changes in the volume of assets accounts. If there is an actual "sale" payment to government that was previously financed by a loan by government, the overall operation should be broken into two parts:

- first, the transfer of assets (the buildings for instance), increasing the equity capital of the unit, to be recorded in the other changes in the volume of assets account,
- then, financial transactions: the borrowing (F.4) by the unit, and the payment to government analysed as an equity withdrawal (F.5).

13. As a result, in the context of such a restructuring of assets, there is no impact on net lending/net borrowing of general government.

VI.2.2.3 The unit is an existing private operator

14. In this case, a transaction in fixed assets (GFCF) will usually be recorded, improving the general government net lending/borrowing. The legal transfer would not be recorded as an economic sale if the arrangement were judged to be a financial lease (private operator, as lessor and government as lessee), in which case the asset would remain on the government balance sheet, i.e. if government remains considered as the economic owner of the asset. This must be assessed from the conditions in the contract which could show very specific clauses (such as the length of the contract) compared to normal business activity; government could also have a right to unilaterally renew the contract not observed in commercial transactions.

VI.2.3 Rationale of the treatment

VI.2.3.1 The unit is created on purpose

15. The same line of reasoning should be applied to the case of ancillary units created by the government for identical purposes (solely providing services to government). Then, all transactions between government and such units should be consolidated when compiling national accounts.

16. If, however, such a unit is considered to be a full institutional unit, payments made by government for rental services provided by this unit would not be considered as market output because:

- in order to be a sale, a payment must be in a position to have a significant influence on supply and/or demand;
- in this case, in which government creates a unit which manages public buildings and provides housing services to government departments, payments made by these departments cannot, in general, be considered as sales since they are unlikely to have a significant influence on the demand made by government services, even if rentals are fixed by reference to market prices. Moreover, such payments are likely to imply only entries in Treasury bookkeeping records, without any actual flow of funds. The financial counterpart of such a payment is quite a « notional » financial transaction.

17. Of course, this does not mean that such an arrangement is not efficient for the management of the public buildings. But it will lead, at best, to a reallocation of public buildings among government departments, and probably to a situation where some public buildings will be left by government departments, being thus available for private use. (In this latter case, payments made by private users will of course be treated as sales or rentals). This rearrangement of assets within the government sector does not however correspond to a market activity.

18. Being non-market, the unit has thus to be classified in the general government sector, at least as long as payments made by government departments constitute its main resources.

VI.2.3.2 The unit is an existing public corporation

19. In the simple case of an existing public corporation buying non-financial assets from government at market price, with no other associated transactions between government and the corporation, it is appropriate to record the sale of non-financial assets in the capital account (GFCF, P.51), improving government net borrowing/net lending.

20. However, in some cases of this type, there are other events taking place. For example, the transfer of assets can be associated with a major change in the function of the corporation such that it takes on new activities and responsibilities previously the function of government. The transfer of assets might not be at the market price; or there might be no payment at all; or the purchase might be financed by a loan or equity injection from government.

21. In these cases, the whole process could be considered as a restructuring of assets within the public sector, aiming to a more efficient management of these assets. By difference with a straightforward sale transaction on the market, this type of transfer of assets, like in the context of corporate restructuring, is to be recorded as other flows in the other changes in the volume of assets account. (For more details, see "capital injections in kind", II.3.2).

VI.2.3.3 The unit is an existing private operator

22. The unit would be classified as a private corporation (in S.11002) if it is an existing private sector unit (or backed on existing corporations) and if there is no change in how it is controlled or in its purpose. If it is a new unit, it would be private if set up and controlled by other private units who have invested equity in it. Classification as a private corporation should be questioned in cases where:

- government appoints some of the directors of the unit;

- there is no private equity at risk;
 - government guarantees the debts of the unit.
23. It is not possible to give specific rules here to cover all eventualities since such cases vary greatly. The structure of the unit and its operations must be considered as a whole to determine whether classification as a public or as a private corporation is most credible.
24. Government might enter into a sale and leaseback operation with a private unit for a number of reasons including:
- to reduce the risks associated with ownership of the asset;
 - to obtain the benefits of private sector management;
 - to one-off reduce its debt.
25. An operation with a private unit must be recorded through transactions and not as a restructuring of assets in other flows. The main question to address is whether the leaseback is a finance lease - in which case the sale of the asset would not be recorded since it would remain on the government balance sheet - or as an operating lease, according to ESA10 chapter provisions.

VI.3 Contracts with non-government units related to fixed assets (excluding private public partnerships)

VI.3.1 Background to the issue

1. Governments' contracts with corporations to finance, design, construct and operate public fixed assets, such as gas, water, electricity and telecommunication networks, roads, railway tracks, waterways, airports and buildings such as hospitals, schools, prisons, etc., may take various forms. The most common different types of long-term contracts are:

VI.3.1.1 “Traditional procurement” contracts for capital assets

2. In this case, the non-government party is only committed to build an asset and deliver it to government, according to its requirements (normally checked by a third party). The asset will be used by government fully under its own responsibility. The impact on the government capital expenditure may be “one-off” only for assets that are built and completed during the same fiscal year. Otherwise, as infrastructures or buildings are “unmovable” assets, ESA103.55 states that uncompleted structures and buildings under a contract of sale/purchase (which means that government is committed to take over the assets, provided they meet the agreed requirements) are acquired, even in an incomplete state, on a continuous basis, according to the accrual principle. In practice, the value of the gross fixed capital formation may be approximated by stages (milestones) payments and, in their absence, be based on the costs to date. This does not exclude an ancillary provision of services (that can be separately specified and which are treated adequately in national accounts). Such services are strictly related to the assets, such as technical maintenance work.

VI.3.1.2 Traditional procurement of goods and services

3. Government is only purchasing services over a given long-term period but without fixing specific requirements as regards the assets, i.e. different from general regulatory standards. This contractual link may be important to ensure continuity in supplying, both in quantitative and qualitative terms. The treatment in national accounts, based only on flows occurring in one fiscal year, does not raise any specific issue.

VI.3.1.3 Equity stakes

4. Such arrangements involve the creation of a new unit (frequently referred as to “joint-venture”) in which both government and non-government partners have equity stakes in a company managing a given infrastructure, or the private sector is taking control of an existing public undertaking. ESA10 rules, as supplemented by the Manual on government deficit and debt, give quite explicit provisions, notably as regards the treatment of flows between government and this unit. A “pure” joint-venture market entity with a strict equality in equity stakes is classified as a public corporation when government is judged to exercise a control over the general policy of the unit. (See I.7 in this Manual).

VI.3.1.4 Leases

5. Government is the user, during a given period, of an asset that is legally owned by a non-government unit. According to analysis of the “risks and rewards” borne by each party (that is the basis of the concept of “economic ownership”), the lease is considered either as an “operating lease” or as a “financial lease”, which gives rise to different treatments in national accounts (see ESA10 chapter 15). This concerns also cases of “Cross border leases” (which take the form of a set of interlinked lease agreements commonly referred to as “head” and “sub” leases). If government enters

- into a financial lease agreement, its deficit and debt would be impacted for the market value of the assets at the time government takes economic ownership of the assets.
6. Chapter 15 in ESA10 explains the distinction between financial leases and operating leases. This is based on whether the lessor or the lessee is exposed to most of the risks and rewards inherent in the asset, and stresses the economic reality of these arrangements, rather than their legal features. Different criteria are proposed in national accounts in order to decide on whether the lease must be considered as an operating lease or a financial lease. Their relevance must be judged for each particular case.
 7. In this context, a close correlation between the term of the contract and the expected economic life of the asset is a strong indication of a financial lease, as the lessor would not be in a position to lend the good to another lessee or to use it otherwise at the end of the contract, with similar efficiency (without refurbishment expenditure).
 8. Similarly, where government pays directly for most of the maintenance of the asset – and insurance in case of some types of durable goods - and is bearing the risk of variations in such costs, this also suggests a financial lease. It would be also the case if government was committed for repayment of the corporation's debt in the event of early termination of the contract.
 9. On the contrary, an operating lease is considered where the leasing corporation has significant and on-going power on how to fulfill the contract, makes the key decisions on the design and construction of the asset, and decides how it is to be operated and maintained to provide the services required.
 10. In addition, the nature of the partner could give an indication for classification where government enters into a lease contract with units that are clearly specialised either in operating leases or in financial leases. Examples are units providing only operating leases for equipment such as transport equipment, computers or, on the contrary, institutions specialised in financial leasing either in the form of property leasing (offices occupied by government units) or in equipment leasing. In all cases, it is also important to check whether government is contracting according to normal commercial/market conditions (such as length of the lease, price indexation, contract breaking notice, renewal, dispute settlement, etc.).
 11. If the non-government party is the legal owner of the assets (the lessor) and the government user (the lessee) is judged to be the economic owner, then a finance lease is recorded. The asset provided through a finance lease is recorded in the balance sheet of government, and the economic transfer of the asset is recorded as gross fixed capital formation of government (P.51g). This creates a financial asset in the balance sheet of government, as an imputed loan (AF.4). The regular payments to the lessor are regarded as the amortisation of the imputed loan and are into two transactions: financial for the reimbursement of the principal (F.4) and non-financial for interest (D.41). There may be a service component (FISIM) where the lessor is classified within the financial sector. (See for more detail ESA10 chapter 15) After the transaction transferring the legal ownership of the asset, the balance sheet of government includes the produced non-financial asset, valued at market price, which here is equal to the residual market price of the asset.¹²⁷

VI.3.1.5 Concessions

12. This term is used in national accounts for government contracts with a corporation, which may be public or private, generally after a competitive procedure, to operate¹²⁸

¹²⁷ Example: a single payment by government to use a building for 20 years, after which it reverts to government, with government assuming most of the benefits, costs, risks and rewards of ownership during the 20 years: record as a sale of the building (P.51) at market value. See also VI.3 on sale and leaseback, VI.4 on public infrastructure financed and exploited by the corporation sector and VI.5 on Public-Private Partnerships (PPPs).

¹²⁸ This covers the current management, the maintenance, the collection of fees, etc. Some of these tasks may be sub-contracted to other operators under the responsibility and the control of the concessionary.

over a long-term period (frequently 30 years or more) an asset, which may be either existing (and possibly to be renovated) or to be constructed, where the corporation charges the final users. For example a corporation might build a road or a bridge and levy tolls on vehicles using it. Usually, the assets are transferred to government at the end of the concession, after which government could exploit them itself, either directly (charging users for it, possibly under services contracts) or creating a new concession arrangement for it. Thus, the main issue here is the economic ownership of the assets (based on risks and rewards) during the contract, which can be allocated either to the concessionaire (the most frequent case), or to government.

13. Under concession contracts, the major part of the partner's revenue comes from a direct sale of goods or services to a variety of units under fully commercial conditions (tolls, fees paid by sub-contractors, etc.). In such arrangements, the concessionaire bears more of the commercial risk, which depends both on external factors (demand from end-users, their "willingness-to-pay"), its own performance in managing and maintaining the assets. It is possible that the corporation has to operate under specific government requirements (sometimes compensated by government in the form of subsidies). It may also be the case that the price charged to end-users is fixed by the bidding documents rather than freely set by the partner, and only adjusted upon the occurrence of certain events and adjusted to inflation. The concession may be granted for free or may involve payments from the corporation to government. If the asset is judged to be economically owned by government, these receipts are recorded according to standard rules for operating lease. Where the asset is judged to be economically owned by the non-government government receipts may occur initially (recorded as government permission, tax or service – see ESA10 15.37) or regularly during the lifetime of the contract (rents, specific taxes, etc.). All receipts are subject to usual accrual time of recording.
14. A clear distinction should be drawn between concessions and Public-private partnerships (PPPs) in national accounts. In the context of this chapter, the term "concession" is used solely to describe long-term contracts, where the majority of the partner's revenue comes from the final users of the service, i.e. in which government makes no regular payments to the partner or such payments are a minority of the partner's revenue. In contrast, in PPPs arrangements the majority of the partner's revenue under the contractual arrangement comes from government payments (e.g. shadow tolls).
15. Chapter VI.3 describes the statistical treatment of concessions; the recording of PPPs is discussed in chapter VI.4.

VI.3.1.6 The key issue in national accounts

16. In a concession-type contract, a corporation might, for example, build a road or a bridge and levy tolls on vehicles using it. Government may or may not get receipts from the corporation.
17. The key questions are as follows:
 - Which party is the economic owner of the asset? (i.e. in whose balance sheet is the asset recorded on during the period of exploitation?)
 - How should the receipts linked to the contracts be recorded, and what is their impact on government net lending/net borrowing?
18. The corporations involved in these operations can be either public or private sector. If a public enterprise is involved, the first question to ask is whether it is genuinely a market unit, a public corporation or whether it is classified in general government. (See Part I of this Manual) The economic and financial plans of the concession should be available in order to carry out the assessment on the forecasted costs and sales in future years. Moreover, it is important to examine any amendment, revision,

renegotiation during the concession period that could have an impact on the statistical treatment, and notably in case the concessionaires ceases to be considered as a market producer, which would result in a reclassification of the assets to government assets and the concession considered as a management contract. Close consideration should be given to any provision relating to early termination of the contract due to a defaulting performance by the corporation. (See further explanation in VI.5.3.4) Specific attention should be given to cases where government is the unique shareholder of a corporation which is involved in only one concession contract. When judging the degree of autonomy of this corporation, it might be a case of considering it as an ancillary unit of government. The remainder of the chapter discusses only the cases of concessions between government and units classified outside of general government.

VI.3.2 Treatment in national accounts

19. In cases of such concessions where government receipts in cash or in kind are the minority of the corporation's revenue under the contracts, either directly or indirectly, the asset is recorded in the corporation's balance sheet during the period of exploitation.
20. However, if government is financing, under various forms (including investment grants), the majority of the construction (or refurbishment) cost, the asset should be recorded in the balance sheet of government. Any revenue obtained by the corporation during the operating phase (net of management fees) should be rerouted to government, the corporation acting in this case "on behalf" of government.¹²⁹ A similar rule should apply if government is providing an explicit guarantee¹³⁰ covering more than 50% of the debt raised by the concessionaire specifically ear-marked for financing the asset, such that government bears the majority of the risks associated with the asset.¹³¹
21. Moreover, if, in the initial contract or in the course of its lifetime, government provides a minimum revenue guarantee (such as a minimum volume of traffic) or, in some cases, a minimum level of profitability of the concessionaire (for instance in terms of Return on Equity), government should be considered as bearing the majority of the economic risks and the assets should be recorded on government balance sheet. Under this perspective, the main distinction between concessions and PPPs falls. In this case, the contract should be split between a "traditional" procurement contract for the construction of the assets and a management/maintenance contract after the completion. As far as the reasons to provide a support to the partner, Eurostat, as it is the case in many contracts, favours an exhaustive list of contingent events considered as resulting from "force majeure", thus excluding any responsibility of the partner in the deterioration of its financial situation, by opposition to an "open" formulation which could lead to a disputable interpretation and de facto an insufficient transfer of risks.¹³² In any case, this should exclude economic risk linked to business cycles and endured by producers in their field of activity. However, in the context of exceptional and

¹²⁹ If the unit is government- controlled, and the concession is its only activity, then it should be reclassified to the general government sector. If the unit is a private corporation, the concession contract should be seen as a management contract. The flows, actual or imputed, between the corporation and government would be recorded according to the exact nature of the flows (for instance, rents, dividend, subsidies, etc.).

¹³⁰ As a reminder, explicit guarantees mean that the holders of the debt have a direct (unconditional and at first demand in most cases) recourse on the guarantor. This is quite different from an implicit guarantee, for instance where there are strong expectations that is very likely, if not certain, that government would provide support to the defaulting corporation, due to the crucial usefulness of the infrastructure. In the case, the extent of the protection to creditors is uncertain.

¹³¹ It may happen that the assets are not transferred for free to government at the end of the concession contract, instead for a payment to be made by government. In this case, the calculation of the 50% threshold should take into account the value of the foreseen payment. In addition, it should be checked whether the payment, when it takes place, corresponds to the market value of the assets when they enter government's balance sheet.

¹³² This could mean that, at inception of the contract, the assets would be considered as government assets.

dramatic unfavourable economic conditions, a temporary and limited support provided by government might not lead necessarily to a reclassification of the assets.

Case 1: a new asset is built by the corporation

22. When the asset is a new one built by the corporation, it is recorded as GFCF of the corporation with no impact on government accounts.
23. If at the end of the period of exploitation the asset is sold to government, it enters the government's balance sheet through GFCF at its market value (the value used should be assessed by an independent body, which could be government unit acting independently). If the amount paid by government differs from the market value, the difference shall be recorded as a capital transfer (D.99). In cases when the asset is given for free to government, the capital transfer ("Other capital transfers" D.99) has the same value as the GFCF so there is no overall impact on government net lending/net borrowing (B.9).
24. When payments are made by the corporation to the government during the contract, they should be recorded either as rents (D.45) if the government makes available to the corporation a non-produced asset (such as land upon which the infrastructure is built) or as rental payments (output P.1) if government provides a produced asset. They should be recorded as taxes ("Other taxes on production" D.29) if government does not provide anything in return for the payment. If government demands a payment for the right to undertake the operation and the corporation can transfer the right to other parties, this must be considered as the payment for the acquisition of a non-produced asset (AN.22), if the conditions of ESA10 15.37 are satisfied.

Case 2: an existing produced asset is transferred by government to the corporation

25. It may happen that government transfers an existing infrastructure to the corporation at the start of the concession period. If, in exchange, government acquires equity in the corporation of equal value, this is recorded as a capital injection in kind in the other changes in volume of assets account, with no impact on government net lending/net borrowing. It is an exchange of a non-financial asset for a financial one (government's equity in the corporation, AF.5), to be recorded according to the rules defined in chapter III.4 of this Manual. If government acquires nothing in exchange, the transfer of the asset is recorded as a negative gross fixed capital formation, compensated by expenditure under the form of an investment grant.
26. If the infrastructure returns to government at the end of the period of exploitation, for no cash, this is recorded as the acquisition of the asset by government, marched by capital transfer revenue, with no impact on government net lending/net borrowing.
27. In the case where government holds equity in the concessionaire corporation to the government, distributions of profits (after tax) to government during the contract should be recorded as dividends (D.421).

VI.3.3 Rationale of the treatment

28. In all cases, the corporation is producing a service by means of the asset. This output is consumed by users of the asset, through the payments made to the corporation (such as tolls). It is thus relevant to record the asset in the corporation's balance sheet during the period of exploitation, with the exceptions mentioned above.

Case 1 a: new asset is built by the corporation

29. Receipts by government from the corporation to government can arise because:

- i. Government provides something in exchange:

The classification of the revenue will depend on what government provides. Typically government will provide the land upon which the asset is built. In this case, the revenue from the corporation should be classified as rent (D.45).

Or:

- ii. Government receipt for allowing the corporation to undertake the operation:

If there is no restriction on transferring the permission license by the corporation, and other conditions in ESA10 15.37 are met, this is recorded as the disposal of a non-produced asset (AN.223).

However, in most cases, the permission is not transferable or there are strong restrictions (such as government approval). In this case, the payment should be classified as other taxes on production (D.29), as mentioned in ESA10 4.23. This amount has to be recorded on an accrual basis over the whole concession period, independently of practical cash payment arrangements.

30. If the infrastructure is given for free to government at the end of the period of exploitation, the GFCF recorded in government's accounts at the end of the concession period is balanced by a capital transfer ("Other capital transfers" D.99).

Case 1 b: an existing produced asset is transferred to the corporation

31. When government transfers an existing asset to the corporation it is recorded as a capital injection in kind matched by a disposal of the assets, with no impact on B9. However, this may be regarded as an exchange of a non-financial asset for a financial one (government's equity in the corporation, AF.5), depending on the rights acquired by government. If government receives in exchange no right, the transfer of the asset is recorded as a negative gross fixed capital formation, compensated by a capital transfer.

32. Where such equity exists, it is relevant to classify payments from the corporation to the government as dividends (D.421), even though part of them could be regarded as rents.

33. Reversion of the asset to government without cash is recorded as a government acquisition of the asset (P.51) matched by capital transfer revenue. If equity has been recognised as asset of government, the transfer is recorded only in the other changes in volume account.

VI.3.4 Accounting examples

Accounting treatments related to the two cases are presented below.

The full sequence of government and corporation's accounts is not provided: only those accounts, which are relevant for the cases involved, are shown.

Case 1 a: the new asset is built by the corporation

- The asset is built by the corporation for 250
- Rents/taxes are paid by the corporation to government (payments are 100 the first year)
- The asset reverts to government at the end of the period of exploitation for no cash (it has a market value of 200).

Construction and first year of exploitation

General government				Corporation			
Non-financial accounts							
U/ Δ A		R/ Δ L		U/ Δ A		R/ Δ L	
		D.45/D.29	+100	D.45/D.29	-100		
B.9	+100			P.51	-250		
				B.9	-100		

Reversion of the infrastructure at the end of exploitation

General government				Corporation			
Capital account							
Δ A		Δ L		Δ A		Δ L	
P.51	+200	D.99	+200	P.51	-200	D.99	-200
B.9	0						

Closing balance sheet

A		L		A		L	
AN.11	200						

Case 2: an existing produced asset is transferred to the corporation

- The asset is transferred by government to the corporation at the beginning of the exploitation (for an amount of 1000)
- An equity held by government is recognized
- The asset reverts to government at the end of the period of exploitation (at this time it has a market value of 200).

Initial transfer of the asset

General government		Corporation	
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Opening balance sheet

A		L		A		L	
AN.11	1 000						

Other changes in volume of assets account

ΔA		ΔL		ΔA		ΔL	
AN.11(K.61)	-1 000			AN.11(K.61)	1 000	AF.5(K.61)	1 000
AF.5(K.61)	1 000						

Closing balance sheet

A		L		A		L	
AN.11	0			AN.11	1 000	AF.5	1 000
AF.5	1 000						

First year of exploitation of the asset

K.1 = 40

General government		Corporation	
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Capital account

ΔA		ΔL		ΔA		ΔL	
				K.1	-40	B.10.1	-40

Revaluation account

ΔA		ΔL		ΔA		ΔL	
AF.5(K.7)	-40					AF.5(K.7)	-40
		B.10.3	-40			B.10.3	+40

Closing balance sheet

A		L		A		L	
AF.5	960			AN.11	960	AF.5	960
		ΔB.10	-40			ΔB.10	0

Reversion of the asset to government at the end of exploitation

General government

Corporation

Other changes in volume of assets account

ΔA		ΔL		ΔA		ΔL	
AN.11(K.61)	+200			AN.11(K.61)	-200	AF.5(K.61)	-200
AF.5(K.61)	-200						

Closing balance sheet

A		L		A		L	
AN.11	200						

VI.4 Public-Private Partnerships (PPPs)

VI.4.1 Overview

1. The term “Public-Private Partnerships” (PPPs) is widely used for many different types of long-term contract between government and corporations for the provision of public assets. In partnerships government agrees to buy services from a non-government unit over a long period of time, resulting from the use of specific “dedicated assets”, such that the non-government unit builds a specifically designed asset to supply the service. It is usually the case that the asset equipment is used in the provision of public services, such as health (hospitals), education (schools and universities), and public security (prisons) or for the use of some communication structures. The services bought by government might also be to meet its own needs (such as an office building).
2. In the context of this chapter, the term "PPP" is exclusively used to describe those long-term contracts in which government is paying to a partner all or a majority of the fees under a contractual arrangement, thus covering most of the total cost of the service (including the amortisation of the assets). In national accounts, this aspect distinguishes PPPs from concessions (see chapter VI.3); in a concession, government makes no regular payments to the partner, or such payments do not constitute a majority of fees received by the partner. In a PPP contract, as covered by this chapter the final users do not pay directly (i.e. proportionally to the use and clearly identified for this only use), or only a minor part (and generally for some particular uses of the asset¹³³), for the use of the assets, at the origin of a given service.
3. The key statistical issue is the classification of the assets involved in the PPP contract – either as government assets (thereby immediately influencing government deficit and debt) or as the partner’s assets (spreading the impact on government deficit – and possibly indirectly on debt - over the duration of the contract). This is a similar issue to distinguishing between operating leases and finance leases, as explained in ESA10 chapter 15 (see notably table 15.1).
4. As a result of the methodological approach followed, in national accounts the assets involved in a PPP can be considered as non-government assets only if there is strong evidence that the partner is bearing most of the risks attached to the asset (directly and linked to its use) of the specific partnership. Therefore the analysis of the allocation of risk between government and the private partner is the core issue. Here, the notion of risk refers to the impact (on revenue or profit) of evident actions by one party (related to construction, maintenance operations, provision of service for which it has been given clear responsibility) and/or the result of the behaviour of other economic agents for which the activity is carried out (such as a shift in the demand for the service, by a government unit or by end-user). Bearing the risk implies to be entitled to take actions in order to prevent them or mitigate their impact.
5. In this context, guidance on how to assess the risk is, in a first step, based on three main categories of risk:
 - “construction risk”: covering events like late delivery, respect of specifications and additional cost;
 - “availability risk”: covering volume and quality of output (performance of the partner);
 - “demand risk”: covering variability of demand (effective use by end-users).
6. As a basic rule, together with other conditions mentioned below (financing, guarantee, early termination), the PPP assets are classified in the partner's balance sheet and not on government balance sheet, if both of the following conditions are met:

¹³³ Example is payments for using sporting facilities in an educational establishment for non-learners.

- the partner bears the construction risks;
 - the partner bears at least one of either availability or demand risk, as designed in the contract¹³⁴, and, in some cases (see below §38), jointly availability and demand risks.
 - the following important features should also be considered: financing, guarantees and early redemption clauses.
7. If these conditions are met, it is also important to consider other mechanisms in place (such as a guarantee or grantor financing) in order to check whether there could be an allocation of these risks to government, in which case the treatment of the contract is similar to the treatment of an operating lease in national accounts; it would be classified as the purchase of services by government.
 8. If the conditions in 6 are not met, or if government assumes the risks through another mechanism, then the assets are to be recorded in the government's balance sheet. The treatment is in this case similar to the treatment of a financial lease in national accounts requiring the recording of government capital expenditure and a financial liability.

VI.4.2 Background to the issue

VI.4.2.1 The development of PPPs

9. PPPs imply a long-term relationship (by convention, at least three years) in the framework of contracts, where the obligations and rights of each partner are clearly specified.
10. In addition to using the corporation's skills and competence to improve the quality of public services and reduce their cost, PPPs may also be motivated by budget constraints which push governments to look for alternative resources for developing collectively-used equipment. Usually, such contracts allow for a spread of the cost of new assets over the time they are used, thus avoiding a large initial government capital expenditure and a corresponding use of cash that would have occurred if government has used a direct procurement procedure.
11. It is not the role of statisticians to examine the motives, rationale and efficiency of these partnerships, or to voice an opinion about the “economic viability” and the “financial viability” of the underlying projects, notably by comparison with other kinds of investment approaches. Their role is to provide clear guidance on their treatment in national accounts and, in the context of the excessive deficit procedure, their impact on general government deficit and debt. It is important to develop general national accounts principles in this domain in order to ensure homogeneity of government statistics in all EU Member States, such that deficit and debt figures are fully comparable.¹³⁵
12. Similarly, it is not up to the statisticians to provide a very detailed definition of PPPs, as the expression is widely used to describe various arrangements, whereas a too much restrictive definition would not be appropriate in a context of complexity and innovation. Instead, they should spell out the basic criteria which are mentioned above and easily allow national accountants to clearly distinguish the different arrangements that may be observed.

¹³⁴ In most contracts only one kind of risk triggers the whole (or almost) payment; either it is based on availability indicators of the equipment, or it is based on use/attendance of the equipment. The latter case is only observed when this depends on the final users and not on the paying government unit itself (see for instance the difference between hospitals, stadiums, roads, possibly schools, on the one hand, and prisons, barracks on the other hand).

¹³⁵ The guidance below related to the treatment in national accounts is based on a risk and rewards approach, which may result in a different classification of the assets under other accounting frameworks (such as IFRS or IPSAS). As a matter of principle, Eurostat focuses its verification on the respect of the criteria developed in this chapter for cases where the PPP assets are classified off government balance sheet by the statistical authorities of a Member State.

VI.4.2.2 Characteristics of PPPs

13. This term refers more specifically to the forms of partnerships (referred to as “Public-Private Partnerships” - PPPs) designed to provide public services, when government payments constitute a majority of the fees received by the partner under the contract. The Eurostat decision of 11 February 2004 covered explicitly and exclusively this case (see News release 18/2004).
14. In practice, PPPs occur in areas of activity where government usually has a strong involvement (e.g. transport, education, health, security, etc.). Government contracts with one or several experienced commercial partners, directly or through a special purpose entity set up for the specific purpose of the PPP, for the delivery of services derived from a specific asset.
15. This type of contract mentions specifically-designed assets, which either need a significant initial capital expenditure or major renovation or refurbishment (which is precisely why government uses such arrangements in many instances), and the delivery of agreed services, requiring the use of these assets, although the contract may also cover services not directly linked to them¹³⁶, and according to given quality and volume standards that are specifically defined in the contract. It is the service component that makes PPP contracts differ from leases.
16. The contract may refer either to a new asset or to significant refurbishment, modernisation or upgrading of existing assets, initially owned and operated by government. If the contract is for renovation, etc., this work must represent a majority part of the value of the asset after completion. If it does not, (less than 50%), the contract is not viewed as a PPP, as defined in this chapter, and, instead, is split into an asset procurement contract and a services contract, the asset remaining recorded on the balance sheet of the government unit.¹³⁷
17. A key feature of PPPs is that government is the main purchaser. It is in this respect that they differ from “concessions”, as defined for national accounts purposes (see chapter VI.3), where the main risk depends on the “willingness-to-pay” of final users. In PPPs, government purchases the service through making regular payments once the assets are supplied by the partner, irrespective of whether the demand originates directly from government itself or from third party users (as for health and education services, and some types of transport infrastructures). There is no need to specify a given threshold between government and third party demand on this point. Although it only needs to be just above 50%, in reality it is usually much higher, generally above 90%, because most contracts refer to “typed” economic models. The expression “shadow tolls” is frequently used, notably in the case of transport infrastructure assets, and refers to remuneration by government for a given volume usage of the asset.
18. The use of the assets is specifically defined in the contract, possibly through a “dialogue process”, and there are limitations in the way in which the assets can be used by the partner. For example, the partner cannot dispose of them at will, and, where applicable, has to give priority to government users over other possible users. Note that many contracts do not rule out payments by “third parties”, when applicable, but these are likely to represent a minor (even negligible) part of the partner’s revenue and frequently refer to a secondary activity associated with the dedicated assets (for instance “private” use of some sportive, educational or cultural infrastructure in a given period or fees collected for laying telephone cables along, or under, a motorway).

¹³⁶ For instance, cleaning as part of the maintenance or catering as part of building management.

¹³⁷ For some assets there is no observed market price as transactions do not exist or the assets are too specific to allow a comparison method for valuation. In this case, the value must be based on the “re-valued acquisition costs less accumulated write-downs”. In addition, this value must take into account the exact shape of the assets, which can result in low value where there is a strong need for renovation. Another problem is that it may happen that the refurbishment/renovation expenditure will increase the value of the full assets, even for the parts not at all renovated, above the expenditure incurred. This effect is difficult to measure. A practical rule is to check whether the foreseen capital expenditure exceeds at least the current value of the assets before renovation.

19. In addition, it must be stressed that “government” in this context refers to the whole government sector (“General Government”, sector S.13 in ESA10). Different government units, even classified in different sub-sectors of government, may take part in the contract to various degrees.

VI.4.2.3 The key issue in national accounts

20. In national accounts, long-term contracts such as PPPs raise questions about which sector's balance sheet the related assets are included in. This refers to the initial (a priori, when the construction starts, or enters into force for existing assets) recording of the assets involved, either in the government's balance sheet or in the partner's balance sheet. A recording in the government's balance sheet may have important consequences for government statistics, both for government deficit (the capital expenditure is recorded as government gross fixed capital formation in the non-financial account, under the category P.51g), and government debt (the financial account matches the capital expenditure by an imputed government liability, which increases gross debt when recorded as imputed loan (AF.4), which is part of the “Maastricht debt” concept).
21. Moreover, according to national accounts rules (see ESA10 3.148b3), when the assets (in the form of buildings or other structures) are considered government assets, the capital expenditure is recorded on an accrual basis as the works proceeds, and not at the end of the construction/refurbishment period. For practical reasons, the existence of phased payments (instalments) received by the constructor or manufacturer may be used as a proxy for indicating the appropriate time of recording. This is by definition applicable for GFCF under PPP contracts. (See ESA10 3.55 related to the case of construction of other structure.)
22. There are also consequences as regards the recording of the flows that are observed between government and the partner during the lifetime of the contract. If an imputed loan has been recorded in the government's balance sheet, the redemption of the corresponding principal must be spread over the entire period (with no impact on government net lending/net borrowing), while imputed interest must also be calculated and included in government expenditure together with the costs of services charged to government in the context of the contract, both expenditure impacting on government net lending/net borrowing.

VI.4.3 Treatment in national accounts¹³⁸

VI.4.3.1 Sector classification of the partner

23. The partners involved in long-term contracts with government, and more specifically in the case of PPPs as described above in VI.5.2.2, can be either public or private sector. If it is a public unit, it means that according to national accounts rules, government or a public unit determines the general corporate policy of this unit.
24. The public partner should be classified as non-financial corporation as long as it acts as a market unit (meeting the 50% test) and payments by government may be considered as sales (counterpart of the provision of services).
25. However, specific attention should be given to cases where the public corporation is 100% government-owned (or at a level close to 100% with other very minor shareholders not in a position to exert a significant influence)¹³⁹, and thus there is an absence of private sector investors in the public corporation who would exercise a significant influence to ensure commercial profitability and efficiency. In cases where payments by government under this contract are a predominant part of the partner's revenue, these payments should be analysed to determine if they can be classified as

¹³⁸ PPPs issues are more briefly treated in ESA10 20.276-290.

¹³⁹ It does not matter whether it is the contracting government unit that owns the shares or another government unit, which may even be in another government sub-sector.

- sales, particularly if this contract alone results in a significant change in the size or nature of its activities. Following the application of the rules described in part I of this Manual, this corporation could be reclassified as a government unit.
26. As regards PPP contracts where the partner is a special unit, created on purpose (frequently referred to as a Special Purpose Entity – SPE, otherwise known as SPVs), the only case to be considered is where such a unit is created mainly by government and is fully controlled by it.
 27. Finally, whenever government deliberately provides support to a partner classified outside the government sector as compensation for events that were not mentioned as clear commitments when the contract was signed with the partner, this support must be recorded as a transfer affecting government net lending / net borrowing at the time the decision to provide the support is taken or implemented, unless it falls under the restrictive list of event which can be considered as “force majeure”.
 28. A reclassification of the assets on the government’s balance sheet will result from the reclassification of the partner unit into general government. This may occur if a recurrent support results in a shift of a public unit from a market entity to a non-market entity (i.e. no longer satisfying the criteria as to be considered as engaged in market activity)

VI.4.3.2 Assessment of the risks borne by each contracting party

General principle

29. In national accounts, the assets involved in a long-term contract between a government unit and a non-government unit can be considered as non-government assets only if the non-government partner is bearing most of the risks attached to the asset all over the contract.
30. ESA10 20.283 states that a majority of the risks and rewards must be transferred. It is not required to transfer “all” of them. In reality, it is usually observed in partnerships a share of risks between government and the partner. As mentioned further, it may be seen as normal that some risks might be taken by government (for instance in the case of very exceptional events or for government action that changes the conditions of activity that were agreed previously) but the risks incurred by the private partner must have a significant impact on its profitability, and possibly in some cases on its solvency, under normal circumstances where there is a clear link between the realisation of these risks and the actions (or absence of actions) taken by the partner. Therefore, this analysis of risks borne by the contractual parties is the core element as regards classification of the assets involved in the contract, to ensure the correct accounting of the impact on the government deficit and debt of this type of partnerships.
31. It has to be noted that these arrangements deal with a single asset or a set of assets that are not contractually divisible. Because of the features of the contracts, PPP assets should not be split in national accounts. The assets should be recorded in the balance sheet of just one of the parties involved, economic agent, for its total value.
32. For the purpose of classifying PPPs in national accounts, in order to simplify the analysis, three main categories of risks have been selected:
33. “Construction risk” covers events related to difficulties face during the construction and to the state of the involved asset(s) at the commencement of services. In practice it is related to events such as late delivery, non-respect of specified standards, significant additional costs, legal and environmental issues, technical deficiency, and external negative effects (including environmental risk) triggering compensation payments to third parties.
34. “Availability risk” covers cases where, during the operation of the asset, the responsibility of the partner is called upon, because of insufficient management (“bad performance”), resulting in a volume of services lower than what was contractually agreed, or in services not meeting the quality standards specified in the contract.

35. “Demand risk” covers the variability of demand (higher or lower than expected when the contract was signed) irrespective of the performance of the private partner. In other words, a shift of demand cannot be directly linked to an inadequate quality of the services provided by the partner. However, the quantitative and qualitative shortfalls have an impact on the effective use of the service and in some cases exert an eviction effect, but this primarily result from a bad management of the availability risk. Instead, it should result from other factors, such as the business cycle, new market trends, a change in final users’ preferences or technological obsolescence. This is part of a usual “economic risk” borne by private entities in a market economy.
36. Normally, the demand risk is not applicable for contracts where the final user has no free choice as regards the asset-dependent service provided to them by the partner (thus excluding “secondary” services falling under the “third parties” revenue). For example, this applies to assets such as prisons. It may also be the case for hospitals or schools under certain conditions and in some cases sporting and cultural infrastructures assets but, in this case, this reinforces the required unquestionable transfer of the construction and availability risks.
37. In addition, some contracts may be designed so that government payments are mainly linked to the effective use of the assets (volume indicators), whatever the extent of final user's own initiative and although the volume is frequently closely correlated with the performance of the private partner related to the availability and the quality of the asset.
38. Some contracts may combine regular (unitary) payments related to the availability of the assets and other regular (unitary) payments linked to the actual use of the assets (demand), both being identifiable. The partner may be seen bearing several risks.. Where neither of the separate payment types of payments does not exceed 60% of total government unitary payments, both availability and demand risks must be assessed separately; they have to be jointly transferred (in addition to the transfer of the construction risk which is as such an imperative condition) in order to classify the asset off government's balance sheet. If it appears that one type of payment is the predominant part, higher than 60% of the total, the analysis should focus on the corresponding risk as a priority. However, the other component paid by government should not be neglected and it should be checked as to what extent it could mitigate the impact of the occurrence of the predominant risk on the income/profits of the partner.¹⁴⁰
39. In all cases, the analysis of the risks borne by each party must assess which party is bearing the majority of the risk in each of the categories, under the conditions mentioned above, and taking into account the other contractual features mentioned below.
40. However, this assessment does not consider risks that are not closely related to the asset(s) and that can be separated from the main contract, as is the case where part of the contract might be periodically renegotiated, and where there are performance or penalty payments that do not significantly depend on the condition of the main assets or on service quality.¹⁴¹
41. The assets involved in such PPPs are recorded in the partner's balance sheet, and therefore recorded "off-balance sheet" of government, only if both of the following conditions are met:
- the private partner bears the construction risk, and
 - the private partner bears at least one of either availability or demand risk, as designed in the contract.

¹⁴⁰ For instance, if the “minor component” foresees some mechanisms that could guarantee in any case a minimum revenue or profit to the partner, even in case of penalties for the “major component”, this should be taken into account in the global assessment of the contract.

¹⁴¹ This could be the case for some “accessory” for which a defaulting performance should of course not lead to a reclassification of the assets.

42. Therefore, if the construction risk is borne by government, or if the private partner bears only the construction risk and no other risks, the assets are recorded in the government's balance sheet.
43. A key criterion is the possibility for government to apply penalties in cases where the partner is defaulting on its service obligations. Application of the penalties should be automatic (i.e. clearly stated in the contract and not subject to bargaining) and should also have a significant effect on the partner's revenue/profit and, therefore, must not be purely symbolic. Should the asset not be available for a significant period of time, the government payments for that period would be expected to fall to zero. As a corollary, if the partner is in a position to perform its obligations, according to the contractual provisions, better than expected (by higher productivity, lower costs of input, lower financial conditions, etc.), it should be entitled to keep the subsequent profit.
44. Furthermore, any other mechanisms by which government re-assumes the majority of risks of the project (e.g. termination, majority financing or guarantees - see below VI.5.3.4 to VI.5.3.6) determine that the asset is recorded on government's balance sheet, independently of the analysis of the risks above mentioned. In other words, the assets will be classified as government assets if one of the provisions below related to guarantees, financing or early termination is not strictly met.¹⁴²

VI.4.3.3 Allocation of the assets at the end of the contract

45. An analysis of the clauses relating to the disposal of the PPP assets described at the end of the contract can be used as a supplementary criterion for determining overall risk transfer, notably where the risk analysis mentioned above, does not give clear conclusions (for instance if risk distribution is estimated as balanced or is based on fragile hypotheses). The conditions in which the final allocation of the assets would be carried out might give, in some cases, additional strong insight into risks among the contract partners as such clauses might help to assess whether a significant risk remains with the private partner. In the context of very long-term contract, the economic value of assets at the end of the contract may be quite uncertain (due notably to unpredictable obsolescence), while any payment from government at this stage would be a very minor part of the total payments made by government all over the lifetime of the contract. As a result, this issue cannot by itself be considered as a decisive criterion in deciding the classification of the assets.
46. If the assets remain the property of the partner at the end of the project, whatever their economic value at this time (but frequently their future economic life remains quite significant, notably in cases of infrastructure that has only slightly depreciated over time), then recording the assets in the partner's balance sheet would have an additional justification.
47. In some contracts government holds an option to buy the asset at one or several points of time. If this option must be exercised at the market value of the asset, properly assessed at the time of the purchase, the partner bears the risks associated with the continued demand for the asset and its physical condition during the contract period. This also reinforces the recording of the assets in the partner's balance sheet during the contract period.
48. In some contracts, government has the firm obligation to acquire the assets at the end of the contract at a pre-determined price, usually set where the contract is signed.
49. The following cases strongly reinforce the analysis of other characteristics of the contract and indicate recording the assets as government assets:

¹⁴² As mentioned in ESA10 20.285, in case of very complex arrangements (type of assets, design of the contractual obligations), the analysis on the basis of the criteria listed above and below would not be conclusive, the degree of involvement of government in the determination of the assets and the services to be produced could be considered as additional criterion.

- the pre-determined price is fixed as a remaining part of the initial cost of capital, without any reference to the asset's expected market value at the end of the contract;
 - the pre-determined price is obviously higher than the expected market value of the assets at the end of the contract;
 - the pre-determined price is lower than an expected market value at time of the transfer (or even nil) but government effectively prepay for the acquisition of the assets throughout the contract by making regular payments that reached a total amount very close to the full market value of the assets (see also VI.4);
 - if it is not specified in the contract that there should be a thorough check by an independent body of the exact condition of the assets ("rendezvous" clauses) a few years before final termination such that government is entitled to ask for supplementary expenditure and/or reducing the pre-determined price where necessary.
50. Note that, in some cases, at the end of the contract, the partner is wound up, or is absorbed by government. In such cases, the assets enter government's balance sheet at the end of the contract through K.61 "change in sector classification and structure" in "other change in volume".

VI.4.3.4 Termination clauses and change in the nature of the contract

51. PPP contracts include termination clauses in the event that government or the partner cannot fulfill the contract or they persistently fail to meet their contractual obligations. In addition, government may use its exceptional sovereign right. There may be different causes of the termination before the maturity of the contract. Special attention must be given to the case where the termination is triggered by a default of the partner, for instance showing recurrent bad performance or no longer being in a position to provide services at the agreed contractual conditions¹⁴³. When the partner defaults, the assets are transferred to government (see the conditions below) at the time of the termination, except in the case where there is an immediate transfer to a new partner. Any new contracts require a new analysis.
52. Termination clauses will often require the government to acquire the asset and take on board part or all of the partner's PPP-related debt, and pay the partner compensation. This is because the PPP asset is often a "dedicated asset" with limited resale value on the market for the partner and because government usually wants to retain a major influence on the conditions in which services are provided from the asset. As a matter of principle, any compensation in the context of an early termination due to a default by the partner must take into account any insufficient performance by the partner and, therefore, must be different to a compensation payment resulting from an early termination at the initiative of government.
- If the termination is due to the partner's default during the construction phase, generally the contract will require just a refund by government based on the capital costs (or operation). In addition, in the absence of penalties charged to the partner for any possible negative consequences of the default (delays, cost overruns), the construction risk is deemed to be borne by government.
 - If the default takes place during the operating phase, the contract should explicitly mention that the compensation due to the partner, if any, at the time government takes over the asset from the partner, should not exceed the current market value (as defined in ESA10 chapter 7) of the asset (taking into account the likely cost required to bring the asset to an adequate condition), as reliably estimated by independent experts. In the conditions are not met (e.g. compensation based on the present value of future flows foreseen in the contract or some amounts not

¹⁴³ It could also decide to withdraw from the business even without default.

reflecting the current value of the asset), the transfer of (availability or demand) risks to the partner is deemed to be insufficient.

When assets are reclassified into government's balance sheet at the time of the termination, the GFCF of government is recorded at that time, as the exact market value of the assets. Government will usually take over an equivalent amount of debt but it may happen that government assumes a higher amount of debt than the value of the assets. Any excess is recorded as a capital transfer, with an impact on government net lending/net borrowing.

53. Significant amendments to contracts or renegotiations have been observed in the course of the life of many PPP contracts. In many cases, they can be considered as cancelling the previous contract and creating a new one, when changes introduced in the contract are substantial and if they alter the distribution of risks between government and the partner. Notably a compensation clause may be added in order to maintain the economic equilibrium of the contract (profitability of the partner) when it appears that outcome is diverging from the initial expectations. Thus, the reasons for the revision to the contract must be closely considered by statisticians. Only if it results from a change in the environment of the contract clearly beyond the responsibility of the partner, as in the example mentioned above (and especially in the case where government takes specific actions affecting the contract implementation) can the revision be neutral on the analysis of the transfer of risks. As a matter of principle, however, the compensation to the partner should be strictly in proportion to the impact on partner's revenue.

54. As a specific case of contract amendments, it may be foreseen that the final users will pay directly for the use of the asset (such as in the case of road tolls) to government. Even if these contracts are still in current terminology referred to as PPPs contracts, under the methodology developed in this Part they are no longer considered as PPPs for national accounts if the final users are those mainly paying for the use of the assets. As a matter of rule, the assets should be reclassified as government assets if – and only if – these payments (recorded on a gross basis, including any collection fees kept by the partner) by final users are higher than 50% of the total cost related to the asset (consumption of fixed capital, maintenance and repair, etc.) which are mainly covered by the unitary payments made by government to the partner.

If the amended contract foresees that the 50% ratio should be reached in a relatively short period (defined as less than two years), the transfer of the assets must take place at the time the new contract enters into force.

If the amended contract foresees a progressive change in the relative amount of payments between government and final users (for instance, involving successive stretches of transportation infrastructure), the transfer should take place as soon as the 50% threshold is reached. Similar clauses related to payments by final users could also be envisaged in contracts at inception for new projects but, in this case, the assets should be classified as government assets at the start of the construction phase in any case, independently of the progressing to the 50% threshold.

VI.4.3.5 Government financing

55. Normally, an important aim of government's long-term partnerships with non-government units is to spread the recording of capital expenditure and related financing over a long period of time.

56. However it may be that government itself takes part in the financing. This is different from a possible capital injection into a given structure in the form of an equity stake. Frequently a private partner is not able to borrow at the same rate of interest as government, thus increasing the cost of the project.

57. Therefore, government may offer a certain level of financing for the PPP project, to entice greater interest by private sector entities in the project, to reduce the total cost of financing, and/or simply to ensure the viability of the project.
58. If the total capital cost is predominantly covered by government (in various forms, e.g. investment grants, loans, etc.), government is deemed to bear the majority of risks and the asset is classified of its balance sheet. If this situation is foreseen in the initial contract, any capital expenditure will be recorded as government GFCF. If government involvement is originally a minority level (the assets being classified in the balance sheet of the partner) but then increases to a majority level in the course of the construction phase for various reasons, this triggers a reclassification of the assets to government's balance sheet at the time of the increase. This applies only to financing from national government units, therefore excluding any financing from international entities resulting from inter-governmental agreements, such from EU funds that are granted to non-government units.¹⁴⁴ In this case, as it is not the domestic government which is paying for the capital expenditure, there is no rationale to allocate the assets only to the national government, even if the final risk of the private partner may be mitigated and even not be borne by it in majority.

VI.4.3.6 Government guarantees

59. Government may also provide an explicit guarantee¹⁴⁵, partially or fully covering the project-related borrowing of the partner. Generally, this helps the partner to raise funds at lower cost on markets and improve its credit rating.
60. In some cases, a debt guarantee can trigger a classification of the partner's debt as government debt, such as the existence of legal provisions transferring to government all or part of the debt service, or where there is an obvious inability of debt servicing by the partner.
61. Moreover, because guarantees have an impact on the distribution of risks between the parties, guarantees should be used in the analyses of risks in PPPs, especially where the majority of the value of the PPP assets (including any refurbishment cost) results from a transfer of the assets from government.
62. The scope of a guarantee, including case where it covers not only a specific project-related debt instrument¹⁴⁶, may influence the recording of the PPP assets. It may result in the re-assumption by government of some of the risks analysed above in this chapter.
63. In PPPs, government guarantees can be granted to the partner to cover the repayment of the debt and/or to ensure a return on equity. For instance, government could ensure a given return on equity, whatever the performance of the partner or the effective level of demand from final users. The government guarantee could also cover the clear majority of the project-related debt.
64. If at inception or during construction, government guarantees cover a majority of the capital cost of the PPP project, the asset is recorded in the government's balance sheet. It would be the same if a given return is assured for the partner in all circumstances.
65. In addition to the straightforward case of an explicit debt guarantee, the guarantees to consider when analysing the risk distribution between government and the partner take into account guarantees provided to the creditors or to the partner, in various forms, such as by way of insurance or derivatives, or any other arrangements with similar effects.

¹⁴⁴ On the contrary, if some direct expenditure by government is reimbursed by the EU, this does not fall under the provision mentioned in this paragraph as this is just a means to cover the government expenditure in the PPP contract.

¹⁴⁵ Direct means that it is enforceable, in most cases unconditionally and at first demand, directly by the debt holders, as soon as a default is observed or in some cases following the assessed of some bodies (such as ISDA).

¹⁴⁶ For instance, government provides a guarantee to a corporation engaged in various activities, and not only the PPP project, for all debt issued by the unit. The rule is fully applicable in this case.

66. For the evaluation of the risk distribution between government and the partner, both tests for majority financing and guarantees in relation to the capital costs of the PPP project must be done jointly. It might well be the case in PPP contracts, that government provides a minority of the total capital costs, but then guarantees a major part of the remaining project finance (directly relating to the partner loan liabilities or indirectly, e.g. through guaranteed availability payments). In this case, the combined effect of the government's support would represent more than a majority of capital costs, leading to the conclusion that a majority of risks rest with government. Additionally, in the cases where a PPP is majority financed by equity, a special analysis needs to be undertaken assessing the impact on the risk distribution between government and the partner from the contract provisions relating to the equity stake.
67. Finally, when a guarantee is effectively called, there may be a change to the economic ownership of the assets and its reclassification (at their remaining value), especially if this event profoundly changes the share of risks borne by the parties. This could be the case if government takes control of the partner, and pays no longer on the basis of the asset availability and demand, but mainly on the basis of operating costs.

VI.4.3.7 Classification of some transactions between a corporation and government

68. When government makes regular payments to the partner corporation, the treatment depends on which balance sheet the asset is recorded.
69. If the asset is included in the partner's balance sheet, the corporation provides a service to government that constitutes government intermediate consumption expenditure, valued by the payments to the corporation.
70. If the asset is included in the government balance sheet, the service to the community is provided using government asset. The acquisition of the asset by government is recorded as in a "standard" financial leasing contract. Government payments to the partner over the whole life of the contract are split between redemption of principal (F.4), payment of interest (D.41) and, possibly, purchase of services for the tasks performed by the corporation and purchased by government (P.2).

VI.4.4 Rationale of the treatment

VI.4.4.1 Sector classification of the partner

71. A special case of PPP between government and a public corporation should fulfill certain conditions.
72. The public corporation should show the usual required competence in the area of activity covered by the PPP (directly or in the case of creation, from the unit(s) controlling it), and the PPP contract with government should be one among several commercial activities of the public corporation.
73. In the case of a 100%-owned public entity, in which the contract with government is almost exclusively the source of its revenue, a reclassification as a government unit is not required if there is evidence that market-oriented payments (meaning of a similar kind to that observed between other market units) are made to the corporation, and if government bears only risks that a commercial entity would not normally be expected to bear (very high political or security risks, for instance). Otherwise, this will indicate an ancillary activity.
74. In some contracts, the execution of the contract takes place under the legal umbrella of a Special purpose Entity (SPE). Normally, such a legal entity has a finite life limited to the length of the PPP contract, or just to the construction period. It can be expected to have been created solely for legal purpose.
75. If one or several private partners that are the operational contracting parties collectively control this unit, there is no question as regards its classification as a non-government unit. This may be observed in the case of building innovative and complex assets that need the close cooperation of firms in different technical areas. The SPE is the

organisation created to represent them as a consortium. The SPE may also take the form of a pooling of banks where the financing requirements are quite significant. Therefore, an SPE generally does not itself play an operational part in the execution of the contract, neither as a project manager, nor as the builder or operator of the PPP asset.

76. Complications arise when such a special unit partner is created by government or by a public corporation. In this case it must be closely checked whether the unit can be considered as an independent institutional unit according to national accounts, and whether the unit is a true market producer. The unit must have the capacity to acquire assets and incur liabilities in its own right, and to enter into contracts with non-government units. Otherwise, it could be a case of classifying it within the government sector (possibly as an “ancillary” unit - see ESA10 2.26 or according to rules for Special purpose entities of general government – see ESA10 2.27-28, such that it might be more appropriate to say that the fees paid by government are not the revenue of a “real partner”, but instead transfers within the general government sector.

VI.4.4.2 Assessment of the risk

77. The core issue is the share in all risks that are associated to the contract and are directly related to the state of the assets involved or depends on some management tasks that must be carried out by the partner in the framework of its contractual obligations. This refers to the concept of “economic ownership”, clearly distinguished in national accounts from “legal ownership”, used in most accounting standards (both national accounts and business accounting purposes); The analysis of risk sharing must rely both on the potential effect on profits of the partner (lower income and/or higher costs) and on the probability (even roughly estimated) of occurrence of the risk, by analogy to the “mathematical expectancy” concept (or the notions of “Probability of default” and “ Loss given default” in financial risk models) . Thus, it should not be acceptable that the partner bears only risks with highly potential damageable effects but with a very low reasonable likelihood.
78. As regards **the construction risk**, government’s obligation to start making regular payments to a partner without taking into account the effective condition of the assets that are delivered is evidence that government bears the majority of the construction risk and is acting as the *de facto* owner of the assets since inception. This is also true where payments are made by government to cover systematically any additional cost, whatever their justification.
79. The magnitude of the different components of this risk can be estimated by the amount that each partner would be obliged to pay if a specific deficiency were to occur. This risk might be quite significant where the assets involve major research and development or technical innovation, whereas it could be more limited for conventional structures. An important point is that government should not be obliged to pay for any event resulting from a default in the management of the construction phase by the partner, either as a direct supplier or only as a coordinator/supervisor.
80. By contrast, the partner need not be responsible for unexpected exogenous events, not normally covered by insurance companies, or that it was not reasonably possible to estimate before the beginning of the works.¹⁴⁷ This risk must not be confused with the appropriateness of the “design” of the assets, where the degree of initiative of the partner may be very limited. The main point here is that a partner normally would not agree to bear risks relating to the construction, if government’s requirements are unusual, and alter the commercial viability of the asset. In addition, the partner should not be taken as responsible in case of a government action such as changing specifications in the course of the construction or modifying some standards requirements. A specific case to be considered is where the partner receives an existing government asset as a necessary part of the project (either as an element or

¹⁴⁷ This may be the case for environmental and archaeological risks.

for a significant refurbishment). The construction risk applies only to the new capital expenditure under the responsibility of the partner, whatever the conditions in which the asset has been transferred. The partner may also not be responsible for over-costs and delays that could result in legal risks resulting from an inadequate regulation/legislation by government.

81. As regards **the availability risk**, government is assumed not to bear such a risk if it is entitled to reduce significantly its periodic payments, like any "normal customer" would require if certain performance criteria are not met. Under these conditions, government payments must depend on the effective degree of availability ensured by the partner during a given period of time. This would mainly apply where the partner does not meet the required quality standards, resulting from a lack of performance. It may be reflected in non-availability of the service, in a low level of effective demand by final users, or low level of user satisfaction. This is generally reflected in performance indicators mentioned in the contract, for instance, an available number of beds in a hospital, of classrooms, of places in a prison, of lanes of a highway opened to traffic, etc. Normally, the partner is assumed to be in a position to avoid the occurrence of this risk. In some cases, the partner could invoke an "external cause", such as a major policy change, additional specifications by government, or "force majeure" events. But such exceptions should be accepted only under very restrictive conditions and be explicitly stated in the contract and covering a large set of factors having an impact on the costs incurred by the partner and/or its ability to meet contractual requirement, under the conditions mentioned in paragraph 87.
82. The application of the penalties where the partner is defaulting on its service obligations must be automatic and must also have a significant effect on the partner revenue/profit. They must affect significantly the operating margin of the unit and could even exceed it in some cases, so that the partner would be heavily financially penalised for its inadequate performance. It may also take the form of an automatic renegotiation of the contract and even, in an extreme case, of dismissal from the contract of the original partner.
83. It is important to check that penalties for inadequate performance are not purely "cosmetic" or symbolic. The existence of marginal penalties would be evidenced by a reduction in government payment far less than proportional to the amount of services not provided, and such a situation would be contrary to the basic philosophy of a significant transfer of risks to the partner. Furthermore, the existence of a maximum amount or percentage of penalties that could be applicable in the event of defaulting performance would also suggest that this risk has not been significantly transferred to the partner. In the case of no availability of the asset for a significant period, it would be expected that the government's payments would fall to zero.
84. As regards **the demand risk**, government is assumed to bear this risk where it is contractually obliged to ensure a given level of payment to the partner independently of the effective level of demand expressed by the final users, rendering irrelevant the fluctuations in the level of demand on the partner's profitability. However, the variability of demand is not due to the behaviour (management) of the partner, which is already covered by the provisions above. In other words, the availability standards stated in the contract are fulfilled. Therefore this risk covers a direct change in final users' behaviour due to factors such as the business cycle, new market trends, direct competition or technological obsolescence. In other words, bearing such economic risks is a normal feature of the partner's activity.
85. For the asset to be recorded in the partner's balance sheet, when there is an unexpected decrease in the partner's revenue, the partner must be able to manage the situation by various actions under its own responsibility, such as increasing promotion, diversification, redesign, etc. In this respect, the partner is carrying out its activity in commercial manner. Thus, the existence of contractual clauses allowing the partner to use the assets for purposes other than those that have been agreed with government

(of course, within certain limits) is frequently an indication that the partner is effectively bearing the demand risk, as defined here.

86. Where the shift in demand results from an obvious government action, such as decisions by government (and thus not necessarily only by the unit(s) directly involved in the contract) that represent a significant policy change, or such as the development of directly competing infrastructure built under government mandate, an adjustment in the regular payments or even a compensation payment to the partner would not imply the recording (or the reclassification) of the assets in the government's balance sheet.
87. Finally, like for the previous category of risks, some exceptional "external" events (often referred to as "force majeure") might have a significant impact on the level of the demand. Such risks can be retained by government without requiring the classification of the asset on its balance sheet. They must be considered under very restrictive conditions (a precise list, excluding any "macro-economic" risks normally borne by economic agents) and should be limited to those for which insurance coverage is not available on the market at reasonable price or is limited to a fixed amount which could be out of proportion with the potential real costs of the damages. Normally, the partner is contractually required to subscribe to an insurance policy. However, for some events, the insurance may foresee a maximum claim. Government might take over costs but this would have no impact on the classification of the assets, provided that there is no specific arrangement for the PPP contract under review.
88. As regards other mechanisms by which government may assume the risk of the risk of the project, the presence of government financing and guarantees on the private sector financing should be analysed. One could argue that this "financing risk" is an integral part of "construction risk", since the absence of suitable financing means that the asset cannot be created, or cannot be created to required standards. In addition, as the financing risk depends on the performance of the partner which could result in less revenue from government, such guarantees would finally water down the risks borne by the partner.
89. In those cases where government finances a part of the PPP and also guarantees all or part of the partner's equity and/or debts, these actions should be seen as cumulative from the aspect of risk analysis. Such an analysis should be made in relation to the capital cost of the project, to discover if government is covering a majority of the capital cost through these mechanisms.

VI.4.5 Accounting examples

The PPP asset is recorded in the partner's balance sheet

- The asset, of value 1000, is constructed by the partner in year 1.
- Government makes regular payments to the corporation during the period of exploitation according to availability (payment is 100 in year 1)
- The infrastructure is purchased by government at the end of the period of exploitation (for an amount of 200).

Year 1

General government		Partner	
Current accounts			
U	R	U	R
P.2	100		
B.8	-100	B.8	1 060
			P.11 100

Capital accounts

ΔA		ΔL		ΔA		ΔL	
		B.8	-100	P.51	1 000	B.8	100
B.9	-100			B.9	900		

Year n: Purchase by government at the end of exploitation**General government****Partner****Capital account**

ΔA		ΔL		ΔA		ΔL	
P.51	200			P.51	-200		
B.9	-200			B.9	+200		

Closing balance sheet

A		L		A		L	
AN.11	200						

The PPP asset is recorded in the government's balance sheet

- The asset, of value 1000, is fully constructed in year 1 by the partner.
- Government makes regular payments to the corporation during the period of exploitation. (Payment is 100: 50 interest D41, 30 service fees P.2, 20 amortisation of imputed loan F.4)
- The asset is worth 950 at the end of the year.

Year 1 Capital expenditure (recorded as finance lease)

General government			Partner		
Capital account					
ΔA		ΔL	ΔA		ΔL
P.51	1 000				
B.9	-1 000				

General government			Enterprise		
Financial account					
ΔA		ΔL	ΔA		ΔL
		F.4	F.2	-1 000	
		B.9	F.4	+1000	B.9
					0

Closing balance sheet					
A		L	A		L
AN.11	1 000	AF.4	AF.4	1 000	

Year 2

General government			Corporation		
Non-financial account					
U		R	U		R
				P.11	30
D.41	50			D.41	50
P.2	30				
B.8 net	-80		B.9	+80	

Financial account

ΔA		ΔL		ΔA		ΔL	
F.2	-100	F.4	-20	F.2	100		
		B.9	-80	F.4	-20	B.9	+80

Closing balance sheet

ΔA		ΔL		ΔA		ΔL	
AN.11	960	AF.4	980	AF.4	980		

VI.5 Emission trading allowances

VI.5.1 Background to the issue

1. Governments are increasingly turning to the issuing of emission allowances as a means of controlling total emissions of polluting materials into the environment, and as an alternative to direct taxation of pollution.
2. Such emission permit schemes may operate in different ways, and may be either domestic or multi-country schemes. In the case of greenhouse gas emissions, the worldwide framework for control of such emissions was established in the United Nations Framework Convention on Climate Change, and notably in the setting of emission targets for participating countries in the Kyoto Protocol, adopted in 1997. This established binding national emission targets for participating countries (including the European Union) for the period 2008-2012.
3. The Kyoto Protocol established three market-based mechanisms through which countries may reach their targets. The main mechanism allows trading between countries of "Assigned Amount Units" (AAUs), which were originally allocated based on 2008-2012 commitments. The other mechanisms (Clean Development Mechanism and Joint Implementation) allow the creation of new types of instruments – interchangeable with AAUs – that reflect emission-reducing projects in developing and eligible countries respectively.
4. In the European Union the principal scheme for emission allowances is the Emission Trading System (ETS). Launched in 2005, the ETS works on the "cap and trade" principle. This means there is a "cap", or limit, on the total amount of certain greenhouse gases that can be emitted by the factories, power plants and other installations in the system. Within this cap, companies receive emission allowances which they can sell to or buy from one another as needed. The limit on the total number of allowances available ensures that they have a value, and the number of allowances is reduced over time so that total emissions fall.
5. At the end of each year each company must surrender enough allowances to cover all its emissions, otherwise heavy fines are imposed. If a company reduces its emissions, it can keep the spare allowances to cover its future needs or else sell them to another company that is short of allowances.
6. The huge volume of emission allowances issued and traded in the European Union, and the increasing number of auctions of allowances by EU governments, have led to the need for clarity on the statistical recording of such allowances.

VI.5.2 Treatment in national accounts

7. The payments for emission allowances, issued by governments under cap and trade schemes, should be recorded as other taxes on production (D29), on an accrual basis in the year of surrender of the allowances. Allowances issued for free do not give rise to entries in government accounts.
8. The timing difference between the cash payments received by government for the allowances and the time of recording of the tax revenue in national accounts gives rise to a financial liability (accounts payable – AF89) for government and a financial asset (accounts receivable – AF89) for the holder.
9. In the absence of precise information on individual allowances (including their original sale price), the level of tax revenue to be recorded in any particular year shall be determined by a model as follows:

$$\text{Tax revenue} = [\text{Number of allowances surrendered}] \times [\text{Associated auction price of stock of allowances}]$$

10. The average auction price of stock of allowances, calculated using data (on total relevant stock of AF89 payable and number of "live" domestically issued allowances)

as close as possible to (but before) the surrender date for allowances, is determined as follows:

Average auction price = [Total stock of AF89 payable relating to sales of allowances]

divided by

[Total number of domestically-issued allowances which have not yet been surrendered]

11. It is necessary that the sum of the tax revenues recorded over time in the accounts should be equal to the sum of auction proceeds received by government (ensuring that emission allowances issued for free do not have an impact on the government accounts). If it becomes apparent that the number of surrendered allowances is significantly above or below the number of issued allowances (leading either to a rapidly growing or shrinking stock of AF89 payables for government), entries should be made in other changes in volume of assets to increase or reduce the stock of AF89 payables to bring the model back into balance. This re-assessment should take place at the end of each phase of the ETS, or earlier if the remaining stock of AF89 payable falls below zero.
12. The difference between the pre-paid tax value of the permit and the market value of the permit represents a marketable contract (non-produced non-financial asset) for the holder, and has no implications for government accounts. The trading of allowances between non-government parties has no implication for the government accounts beyond helping establish market values for government auctions.
13. In the case of transactions of governments in Assigned Amount Units (AAUs), these should be recorded as purchases and sales of non-produced non-financial assets (transaction code NP) at the time at which they take place.

VI.5.3 Rationale of the treatment

14. Neither ESA95 nor SNA 1993 contained specific guidance on the statistical recording of emission allowances. The SNA 2008 (paragraph 17.363) mentions the issue as follows:

“Governments are increasingly turning to the issuing of emission allowances as a means of controlling total emissions. These allowances do not involve the use of a natural asset (there is no value placed on the atmosphere so it cannot be considered to be an economic asset) and are therefore classified as taxes even though the permitted “activity” is one of creating an externality. It is inherent in the concept that the allowances will be tradable and that there will be an active market in them. The allowances therefore constitute assets and should be valued at the market price for which they can be sold.”

15. Following a Eurostat/OECD Task Force in 2009-2010, the ISWGNA made recommendations which were subsequently endorsed – after a consultation of the Advisory Expert Group on national accounts – by the United Nations Statistical Commission and published in SNA News numbers 30/31 and 32/33. This section is based on the agreed worldwide recording for emission allowances under cap and trade schemes.
16. The starting principle for the worldwide agreement was that payments for emission allowances issued under cap and trade schemes should be recorded as taxes recorded at the time that the emission took place. More specifically it is considered that such payments should be recorded as other taxes on production.
17. The detailed treatment, as described in the SNA News and Notes, is as follows:

The payments for emission allowances, issued by governments under cap and trade schemes, should be recorded at the time the emissions occur as taxes, specifically other taxes on production (D29), on an accrual basis. The timing difference between the payments received by government for the allowances and the time the emission occurs gives rise to a financial liability (accounts payable) for government and a financial asset (accounts receivable) for the holder. The difference between the pre-paid tax value of the

permit and the market value of the permit represents a marketable contract (non-produced non-financial asset) for the holder. The creation and disappearance of the non-produced non-financial asset are recorded as another change in volume of assets.

18. Whilst the time of recording to be applied to the tax revenue – respecting the accrual principle – should be when the economic activity generating the pollution takes place, the worldwide agreement allows for a simplification, which prevents the potential complications associated of revenue flows when there is a delay between time of pollution and time of surrender:

In practice, however, it can be assumed, for simplicity, that the time the permit is surrendered is the same as the time that emissions occur, as long as there is no significant lag between the two events and the lag is constant.

19. Within the EU Emission Trading System, allowances are surrendered within around four months of the end of the year to which they relate, and therefore the time lag is relatively short. At the same time - in the absence of a ground-breaking pollution reduction technology - the difference between emissions in one year and the next may not be so significant, and therefore surrendered allowances in any year could potentially be taken as a reasonable proxy for emissions in that year. For the purposes of harmonised recording across countries, this Manual therefore proposes to use the surrender date time of recording.
20. In theory the recording should be applied at the level of the individual permit. Nevertheless, it is clear that the required information for such a treatment is rarely, if ever, available, particularly in a multinational scheme where allowances may be freely traded across national borders, and surrendered in another country from where they were issued. At the same time, there are potential complications with measuring cross-border flows. The international agreement, as described in SNA News and Notes, therefore introduced two practical simplifications:

The approach to accruing payments for emission allowances should be based on the underlying assumption that allowances issued by a particular country are more likely than not to be surrendered in that country.

In the simple case of a pure national scheme, the taxes should be accrued in the following way. The tax recorded for any single permit surrendered in relation to emissions that occurred in period t is equivalent to the total stock of relevant other accounts payable divided by the total number of active allowances issued (and remaining in circulation) at time t . The relevant other accounts payable should in theory exclude any allowances that were surrendered after time t in respect of emissions that occurred before time t . Equally, the total number of active allowances (and remaining in circulation) at time t , should also exclude these allowances.

21. The approach in this Manual, as described above, is therefore based on these simplifications. There are in principle no cross-border flows to be recorded for taxes on production in relation to emission allowances. It is also consistent with the principle described in section II.2 of this manual that the impact on general government net lending/borrowing of taxes shall be equivalent over a reasonable period of time to the corresponding amounts actually received.
22. As SNA News and Notes acknowledges, in a multinational scheme it is possible that over time the number of allowances issued and surrendered in any country may deviate. Two approaches are suggested to deal with this:
- In countries that issue more allowances than are surrendered ... in practice it is easier to ignore these flows and instead write off the allowances (at the end of the permit's lifetime) in the issuing country's accounts as another change in volume of assets, (K22), as if they were unused.
 - For those countries where fewer allowances are surrendered in the country than issued, payments received exceeds taxes recorded. Setting aside the issue of recording flows of taxes on production from the R.O.W, the scope for payments received to exceed taxes recorded remains as not all allowances will necessarily be surrendered, especially those purchased by environmental groups. Moreover for

countries that issue significantly more allowances than are expected to be surrendered in that country, a strong case can be made for considering the difference between payments received and taxes recorded as a windfall of sorts, akin to another change in volume of assets, even if theoretically they should be recorded as a tax on production from the R.O.W.

23. In order that this re-assessment is made in an orderly manner, it is appropriate to undertake it at the end of the last year of each “phase” of the EU Emissions Trading Scheme, which is the point at which new allocations are established for emission allowances and new rules may also enter into force. If the stock of AF89 payable entries falls below zero in any year, it will also be necessary to address the model to ensure that tax revenues continue to be equivalent over time with auction proceeds. The reassessment should be made to ensure the principle that tax revenues recorded should be equivalent over time to auction proceeds.
24. With regard to the quarterly recording of the revenues arising from emission allowances, it is recommended that an investigation is made on the availability of data on quarterly emission, which can then provide a quarterly path for the annual calculation described above. Where these data are not available, it is possible to use a suitable proxy for the quarterly path, such as quarterly gross value added for the economy, where it can be considered to have some relationship to emissions.
25. The statistical recording of Assigned Amount Units is complicated by the fact that they were initially assigned for free to countries, are not subject to surrender as emissions are made, and cover a multi-year period. Nevertheless some governments (and some non-government units) are prepared to purchase AAUs from other governments, and therefore there are transactions to be recorded. By considering AAUs as non-produced non-financial assets, and by analogy with the treatment for market price changes of emission allowances described above, such transactions are to be recorded as purchases and sales of non-produced non-financial assets. At the end of the life of such AAUs, when a Treaty target date is reached, they are to be removed from national accounts balance sheets through other changes in volume of assets.

VI.5.4 Accounting examples

1. The impact of auctioned emission allowances

- **Government auctions emission allowances which are then surrendered over the following two years**
 - The prevailing market price of allowances in the whole of year t is one unit per permit.
 - The existing stock of emission allowances (all issued for free in previous periods) at the start of year t is 1000 (1000 units multiplied by the prevailing market price).
 - Government auctions 1000 allowances in year t for 1000 currency units.
 - The market price of allowances rises to 1.50 units each in year $t+1$.
 - Enterprises surrender 100 allowances in year $t+1$

Year t

General government				Enterprises			
Opening Balance sheet							
A		L		A		L	
		AF.8	0	AN.2	1000		
AF.2	0			AF.8	0		
				AF.2	1000		
Current accounts							
U		R		U		R	
		D.29	0	D.29	0		
B.9	0			B.9	0		
Financial accounts							
ΔA		ΔL		ΔA		ΔL	
F.2	1000	F.8	1000	F.2	-1000		
B.9f	0			F.8	1000		
				B.9f	0		
Closing Balance sheet							
A		L		A		L	
		AF.8	1000	AN.2	1000		
AF.2	1000			AF.8	1000		
				AF.2	0		

Explanatory text: The opening stock of 1000 for AN.2 for enterprises reflects that 1000 allowances with a market price of 1 unit each are held by enterprises – since these allowances were issued for free, all of their value is recorded as AN.2. The auction of allowances for 1000 in cash is recorded as a financial transaction (with counterpart F.8) as the relevant revenues will only be recorded in future years when the allowances are surrendered.

Year t+1

General government

Enterprises

Opening Balance sheet

A		L		A		L	
				AN.2	1000		
		AF.8	1000	AF.8	1000		
AF.2	1000			AF.2	0		

Current accounts

U		R		U		R	
		D.29	50	D.29	50		
B.9	50			B.9	-50		

Financial accounts

ΔA		ΔL		ΔA		ΔL	
F.2	0			F.2	0		
		F.8	-50	F.7	-50		
		B.9f	50			B.9f	-50

Revaluation Account

A		L		A		L	
				AN.2	950		

Other changes in volume

A		L		A		L	
				AN.2	-50		

Closing Balance sheet

A		L		A		L	
				AN.2	1900		
		AF.8	950	AF.8	950		
AF.2	1000			AF.2	0		

Explanatory text: The average auction price of a permit at the start of year t+1 is the total auction proceeds from allowances (1000) divided by the number of live allowances (2000), which is 0.5 units. Since 100 allowances are surrendered in year t+1 the value of other taxes on production to be recorded is $100 \times 0.5 = 50$ units. The counterpart of these revenues for government is a reduction in other accounts payable. After surrender there are 1900 allowances still live at the end of the year – at a market price of 1.5 units per permit, the total value of the represented assets is $1900 \times 1.5 = 2850$. Of this 2850, 950 units are represented by an AF.8 asset (the remaining previous auction proceeds) and the remainder is an AN.2 asset. For completeness, the changes during the year in the AN.2 asset are to be recorded as other economic flows (a combination of other changes in volume for the surrendered allowances and revaluation for the remaining change).

2. The impact of the sale of Assigned Amount Units

- **Government A** sells Assigned Amount Units to Government B for 200 in year t.

Year t

General government A				General Government B			
Opening Balance sheet							
A			L	A			L
AN.2	X			AN.2	Y		
Capital accounts							
ΔA			ΔL	ΔA			ΔL
NP.2	-200			NP.2	200		
Financial accounts							
ΔA			ΔL	ΔA			ΔL
F.2	200			F.2	-200		
Closing balance sheet							
A			L	A			L
AN.2	X-200			AN.2	Y+200		

Explanatory text: Assigned amount units are considered as non-financial non-produced assets (see explanation above). They are therefore to be included in the stock of such assets (AN.2) and their sale (purchase) for Government A represents a disposal of (acquisition of) non-financial non-produced assets (NP.2). Government B should record a symmetric purchase (acquisition) of non-produced non-financial assets.

VI.6 Keywords and accounting references

Economic asset	ESA10, 7.15-18
Economic disappearance of non-produced assets (K2)	ESA10, 6.07
Financial leases/operating leases	ESA10, 15.04 and following
Non-financial non-produced assets	ESA10, 7.24 and annex 7.1
Other current taxes	ESA10, 4.79-80
Other taxes on production	ESA10, 4.23
Output	ESA10, 3.14 and following
Property income	ESA10, 4.41
Rent	ESA10, 4.72-76
Time of recording flows	ESA10, 1.101
Transaction in non-produced assets	ESA10, 3.184 and following

VII

Debt related transactions and guarantees

Part VII Debt related transactions and guarantees

VII.1 Overview

1. This part of the manual deals with the treatment of debts owed to government (government assets) rather than debt as a liability of government (see part VIII). Sometimes governments, because of policies to do with social and economic development, or international relations, relieve some economic agents from all or part of their debt obligations. This has an impact on government net lending/borrowing since it is a voluntary transfer of wealth (thus to be recorded as a capital transfer).
2. Government might cancel the debts of a corporation it owns in order to secure a higher price when selling the corporation immediately after. In this case, the debt cancellation may be recorded as a financial transaction. The debts might also be cancelled because the debtor no longer exists not only on paper but also on practice. In this case, the debt cancellation may, under some conditions, be recorded as an "other flow" under some conditions. In principle, neither of which would affect net lending/borrowing directly.
3. In some cases, for example sovereign debt rescheduling through the Paris Club, rather than debts being cancelled the profile of required repayments is changed. Guidance is given on the treatment of these cases.
4. The final chapter looks at how to record guarantees given by government. This is notably where government pledges to repay certain debts of a non-government unit in the event of that unit not being able to pay (so called "one-off guarantees").
5. It is made clear that, even though the debt operations examined here concern mainly corporations or foreign governments, the basic principles apply to the relationship of the general government with all institutional sectors (including households and NPISH).

VII.2 Debt assumption and debt cancellation

VII.2.1 Background to the issue

1. Debts assumptions and redemptions, by general government, of liabilities of public and possibly private corporations, are important issues. It is worthwhile to first clarify the terminology.
 - Debt assumption (see ESA10 20.222) is a trilateral agreement between a creditor, a former debtor and a new debtor, under which the new debtor assumes a former debtor's outstanding liability to the creditor. The new debtor – here the government – takes the place of the former one vis-à-vis the creditor, and is liable for repayment of the assumed liability. After it has been assumed, the debt instrument, which was originally a liability of the former debtor, becomes a liability of the new one. This happens notably when the debt of the former debtor is guaranteed by the new debtor and when the guarantee is called see chapter VII.4 on government guarantees.¹⁴⁸
 - In some cases (See ESA10 20.232), a debt assumption includes a transfer of non-financial assets, such as fixed assets, from the unit benefiting of the debt assumption – for instance a public corporation managing public infrastructure (i.e. railways), public transportation etc. – to the government entity taking over the debt. This might also involve other non-financial assets, like land.
 - Debt cancellation or forgiveness (See ESA10 20.225) is a bilateral agreement between a creditor and a debtor to cancel (or to "forgive") part or all of a liability outstanding, incurred by the debtor to the creditor. As a consequence of the debt cancellation, the liability of the debtor and the related asset of the creditor do not exist any longer
 - Write-downs and write-offs does not require a bilateral agreement and are observed when a creditor recognises, unilaterally and normally without any notification to the debtor, that a claim can no longer be collected, mainly because of bankruptcy of the debtor. The creditor removes the claim from the asset side of his balance sheet.

VII.2.2 Treatment in national accounts

VII.2.2.1 Mutual Agreement

2. The counterpart transaction of a debt assumption and a debt cancellation, as a matter of principle, is a capital transfer.
3. Thus, when government assumes a debt of a corporation or cancels a claim it has against a corporation, the counterpart transaction of the financial flows recorded in the financial accounts is a capital transfer (other capital transfer D.99), an expenditure which has a negative impact on the net lending/net borrowing (B.9) of general government.
4. In many cases, general government takes the initiative of a debt cancellation or a debt assumption. The acceptance of this action by the corporation, unlikely to refuse such "gift", and the continuity in activity, is deemed to result from mutual agreement.

¹⁴⁸ In § 223 ESA10 chapter 20 makes mentions also the case of "debt payments on behalf of others" where not all the debt is assumed. This must be treated similarly to assumptions.

VII.2.2.2 Other cases

5. There are three exceptions to the mutual agreement treatment: as a result, in these cases, the debt assumption/cancellation has no impact on government net lending/net borrowing and there is no non-financial transaction.

VII.2.2.2.1 Debt of a quasi-corporation

6. ESA10 5.37 mentions that if the owner of a profitable quasi-corporation (by definition public in the case of government), assumes or cancels debt, this does not give rise to the recording of a capital transfer. The counterpart transaction has to be recorded as a financial transaction (transaction in equity F51).
7. However, this is relevant to the extent that the quasi-corporation is profitable in the sense that it has not accumulated losses or does not show an exceptional large loss, which would be covered by the above-mentioned transactions, a capital transfer should be recorded up to the limit of the losses.

VII.2.2.2.2 Operations in the context of a privatisation process

8. ESA10 5.38 points out that when government cancels or assumes debts from a public corporation “as part of a process of privatisation to be achieved in a short-term perspective” (see below), the counterpart transaction is not a capital transfer, but a transaction in equity F.51.
9. Privatisation means giving up control over that public corporation by the disposal of equity, in terms of voting rights in case of multiple voting rights attached to some shares. This increases the own funds of the entity, even in the absence of formal issuance of new equity instruments.
10. This rule should only be applied when there is evidence that the privatisation process has been effectively launched (for instance the appointment of an advisory bank and/or the opinion of a special committee/commissions), so that there are strong expectations that the privatisation will be completed in no more than one year. In any case, the existence of a privatisation plan, or more just intentions, expressed by government, is not in itself sufficient for considering the debt assumption/cancellation “as part of an on-going process of privatisation to be achieved in a short-term perspective”.
11. Moreover, the flow of debt assumed or cancelled is to be recorded as a financial transaction only up to the limit of the privatisation proceeds. Amounts assumed or cancelled by the government in excess of this limit are to be recorded according to the general rule, as a capital transfer expenditure of government.

VII.2.2.2.3 Write-offs

12. There may be cancellation of claims held by government against a corporation in the context of a liquidation process of the corporation. In principle, the liquidation should be assessed from an economic point of view and not from a legal point of view as the corporation normally legally continues to exist until the very end of the process but may have lost its financial substance and its main economic function.¹⁴⁹
13. The write-off of such claim is normally recorded under ESA10 as another change in volume of assets, with no impact on net borrowing/net lending, but a capital transfer might be recorded in some specific cases.

VII.2.2.2.4 Debt assumption including a transfer of non-financial assets

14. There may be two ways to describe and to record the economic event, both having the same impact on the net borrowing / net lending of the general government.

¹⁴⁹ It is important to check whether part of the business is not taken over by third parties, which, in this case, could benefit from the cancellation of the debt which would be recorded as a capital transfer.

"Gross recording" of the debt assumption:

15. The gross recording consists of two simultaneous but separate transactions:
 - The debt assumption, which requires the recording of a capital transfer (D.99) expenditure of government for the exact same amount of the liability assumed (F.3 and/or F.4), similarly to the typical case of a debt assumption.
 - The transfer of assets, which is recorded as gross fixed capital formation (GFCF, P.51). As this transfer is a grant / a gift, it is counterbalanced by a capital transfer in kind (D.92) revenue, making the transfer of assets neutral on the net borrowing / net lending.
16. The "gross capital transfer", equal to the whole liability assumed, has a negative impact on the net borrowing / net lending of the general government.

"Net recording" of the debt assumption:

17. One can also consider that what impacts the net borrowing / net lending of the government is the difference between the liability assumed and the value of the assets transferred: this is the "net capital transfer". However, since there is a simultaneous increase of the gross fixed capital formation (GFCF, P.51), the final impact on the net borrowing / net lending of the general government - net capital transfer plus GFCF - is exactly the same as in the "gross" recording.

VII.2.2.2.5 Time of recording, amounts to be recorded

18. Debt assumption and debt cancellation have to be recorded when the liability is actually removed from the debtor's balance sheet, and the corresponding entries (positive or negative) made in the government balance sheet. The recording of accrued interest should in addition be consistent with this time of recording.
19. Moreover, the recording of debt assumption / cancellation has to be made in one time: in particular, the successive dates of repayment, which were previously foreseen in the context of the former debt, are not relevant.
20. The amount to be recorded – the capital transfer expenditure - is the full amount of the outstanding debt, which is assumed or cancelled. In the special case (VII.2.2.2.4), capital transfer revenue is recorded at the same time equal to the value of non-financial assets transferred.

VII.2.3 Rationale of the treatment**VII.2.3.1 Mutual agreement**

21. In case of such a transaction, made by mutual agreement, the rule is to record a capital transfer. This stems from the definition of other capital transfers in ESA10 4.164): "other capital transfers (D.99) cover transfers [...] which do not themselves redistribute income but redistribute saving or wealth among the different sectors or sub-sectors of the economy or the rest of the world".
22. By assuming or cancelling a debt of a public enterprise, the general government is transferring to this enterprise, not income, but a part of its own wealth. As the change in government liabilities (debt assumption) or the change of government financial assets (debt cancellation) is a one-way transaction – representing a deliberate and voluntary transfer of wealth - the counterpart transaction is a capital transfer.

VII.2.3.2 Other cases

23. **Quasi-corporation:** to consider an exception for profitable quasi-corporations is based on their specificity as units: a quasi-corporation is a market producer which may not be legally independent from its owner, especially from the point of view of assets and liabilities, but is regarded as fulfilling sufficient criteria to be considered an institutional unit in the system of accounts. There is a kind of unity of wealth between a quasi-corporation and its owner, so that a transfer of wealth between a quasi-

corporation and its owner may be considered as something questionable. This results also in the convention that the net worth of a quasi-corporation is normally equal to zero. As a consequence, a transfer of assets between a quasi-corporation and its owner may be directly reflected in the value of its equity. However, in the case where a public quasi-corporation is regularly making losses, in coherence with the ESA10 provisions that covering these losses represent government transfers (subsidies) and with the chapter on capital injections (see III.3), the recording of debt assumption or cancellation should be in accordance with the general rule (a capital transfer).

24. **Privatisation:** the exception made for transactions occurring as parts of an on-going process of privatisation to be achieved in a short-term perspective is an ESA10 convention based on the assumption that the cost of the debt forgiveness will be fully recovered in the sale price achieved in the privatisation. It is therefore recorded as an injection of equity (F.5) – the same instrument as the receipts from the privatisation. However this treatment would not apply if the value of the debt cancellation exceeds the expected privatisation receipts. .
25. **Write-off:** The general definition of transactions (ESA10 1.66) gives the rule for delineating the cases when, respectively, a capital transfer or another change in the volume of assets has to be recorded. This rule is based on the assumption of mutual agreement between parties (see above VII.2.2.1). This is why a write-off cannot be considered as a transaction, in particular in the case of an actual disappearance of the public corporation. The write-off of debt of a disappearing unit may thus be recorded as another change in the volume of assets.

VII.2.3.3 Debt assumption with transfer of non-financial assets

VII.2.3.3.1 The acquisition of non-financial assets as expenditure

26. In principle, an acquisition of non-financial assets has a negative impact on the net borrowing / net lending (B.9) of the government entity, since it has to be recorded as an increase of the gross fixed capital formation (GFCF, P.51), on the expenditure side of government. In the case of a transfer / acquisition made on a free basis, as a gift, the impact is neutral (see below).
27. Whilst the immediate impact of such a transaction on the net borrowing / net lending is negative, it may have a positive impact in the future, to the extent that the acquired assets have a real market value, have "service potential" and can be regarded as a source of future revenue. However, at the time of acquisition, the GFCF is expenditure as it normally creates a net borrowing for the acquirer. If the acquisition of assets is due to a grant, i.e. with not future financial obligations for the beneficiary, the GFCF may be counterbalanced by a capital transfer in kind, making it neutral on the net borrowing / net lending (gross recording). Alternatively, where the acquisition takes place in the context of a debt assumption / cancellation, its value may be deducted from the capital transfer representing the "cost" of the debt assumption (choice of the net recording, see below). But in all cases, the GFCF (assessed on the basis of usual business methods), as such is recorded for its full value on the expenditure side of the acquirer of assets.

VII.2.3.3.2 The final impact on B.9

28. Gross recording: from an analytic point of view, the clearest way to analyse the economic event is to recognise it as two distinct transactions, which occur in the same accounting period:
 - the transfer for free of fixed assets, which is neutral on the net borrowing / net lending (B.9), as described above;
 - the debt assumption which negatively affects the net borrowing / net lending (B.9) for the amount of the capital transfer, exactly like in the general case.

29. Net recording: the debt assumption might also be viewed as a means of payment by government to acquire the fixed assets. In this case, the "gift" component – recorded as capital transfer - would be the difference between the liability assumed and the value of the assets. However, the final impact on the B.9 is the same as in the gross recording pattern, due to the full recording of GFCF (P.51).
30. **NB:** A debt assumption organised by the government in favour of public corporations is not to be recorded through other change in the volume of assets (K.61), as in the case of flows due to "corporate restructuring" outside of government control targeted by ESA10 6.19. The direct involvement of the government, having as a major objective to ease the debt burden of a public corporation, implies that the debt assumption is recognised as a transaction, made by mutual agreement even though there might have been a restructuring or reorganisation of the public corporations at the same time.

VII.2.4 Accounting examples

VII.2.4.1 Recording a capital transfer

In the following examples, capital transfers are assumed to result, in a first step, in an increasing of the public corporation net worth. In a second step, it would be possible to assume that this increasing of net worth is "absorbed" by an equivalent increasing of the equity of government in the public corporation, via the revaluation account: this second step is not described here. Moreover, in the closing balance sheets, only the changes in net worth are shown.

Debt assumption

Assume that a financial corporation has made a long-term loan (F.42) to a public non-financial corporation. Before maturity, general government assumes the long-term loan outstanding from the public non-financial corporation.

General government				Public corporation			
Opening balance sheet							
A		L		A		L	
AF.5	100				AF.42/S.12		30
					AF.5		100
Capital account							
ΔA		ΔL		ΔA		ΔL	
		D.99	-30		D.99		+30
B.9	-30	B.10.1	-30	B.9	+30	B.10.1	+30
Financial account							
ΔA		ΔL		ΔA		ΔL	
		F.42	+30		F.42		-30
		B.9	-30		B.9		+30

Closing balance sheet

A		L		A		L	
AF.5	100	AF.42/S.12	30		AF.42/S.12		0
					AF.5		100
		ΔB.90	-30		ΔB.90		+30

Debt cancellation

Assume that the general government has made a long-term loan (F.42) to a public non-financial corporation. Before maturity, general government cancels its claim (the long-term loan outstanding).

General government**Public corporation****Opening balance sheet**

A		L		A		L	
AF.42/S.11	30				AF.42/S.13		30
AF.5	100				AF.5		100

Capital account

ΔA		ΔL		ΔA		ΔL	
		D.99	-30		D.99		+30
B.9	-30	B.10.1	-30	B.9	+30	B.10.1	+30

Financial account

ΔA		ΔL		ΔA		ΔL	
F.42	-30				F.42		-30
		B.9	-30		B.9		+30

Closing balance sheet

A		L		A		L	
AF.42/S.11	0				AF.42/S.13		0
AF.5	100				AF.5		100
		ΔB.90	-30		ΔB.90		+30

VII.2.4.2 Recording a financial transaction

This recording applies for the case of quasi-corporations not making losses and of a debt assumption/cancellation occurring in an on-going process of privatisation to be achieved in a short-term perspective. Recordings are the same in both cases: they imply transactions in shares and other equity (F.5).

Debt assumption

General government				Public corporation			
Opening balance sheet							
A		L		A		L	
AF.5	100				AF.42/S.12	30	
					AF.5		100
Financial account							
ΔA		ΔL		ΔA		ΔL	
		F.42	+30		F.42		-30
F.5	+30				F.5		+30
		B.9	0		B.9		0
Closing balance sheet							
A		L		A		L	
AF.5	100+30	AF.42/S.12	30		AF.42/S.12		0
					AF.5		100+30
		Δ B.90	0		Δ B.90		0

Debt cancellation

General government				Public corporation			
Opening balance sheet							
A		L		A		L	
AF.42/S.11	30				AF.42/S.13	30	
AF.5	100				AF.5		100
Financial account							
ΔA		ΔL		ΔA		ΔL	
F.42	-30				F.42		-30
F.5	+30				F.5		+30
		B.9	0		B.9		0

Closing balance sheet

A		L		A		L	
AF.42/S.11	0			AF.42/S.13	0		
AF.5	100+30			AF.5	100+30		
		ΔB.90	0	ΔB.90	0		

VII.2.4.3 Recording another change in volume of assets

This recording applies for debts of public corporations towards government, which are written off by the latter (the debtor is bankrupt or liquidated).

General government				Public corporation			
Opening balance sheet							
A		L		A		L	
AF.42/S.11	30				AF.42/S.13	30	
AF.5	100				AF.5	100	
Other changes in volume of assets account							
ΔA		ΔL		ΔA		ΔL	
K.10 on AF.42	-30				K.10 on AF.42	-30	
		B.10.2	-30		B.10.2	+30	
Closing balance sheet							
A		L		A		L	
AF.42/S.11	0				AF.42/S.13	0	
AF.5	100				AF.5	100	
		ΔB.90	-30		ΔB.90	+30	

VII.2.4.4 Special case: debt assumption including a transfer of non-financial assets

Gross recording of the debt assumption with assets

General government				Public corporation			
Opening balance sheet							
A		L		A		L	
				AN.11	20		
						AF.42/S.12	30
AF.5	100					AF.5	100
Capital account							
ΔA		ΔL		ΔA		ΔL	
GFCF(P.51)	+20	D.92	+20	P.51	-20	D.92	-20
		D.99	-30			D.99	+30
B.9	-30	B.10.1	-10	B.9	+30	B.10.1	+10

Financial account

ΔA		ΔL	ΔA		ΔL
	F.42	+30	F.42		-30
	B.9	-30	B.9		+30

Closing balance sheet

A		L	A		L
AN.11	20		AN.11	0	
		AF.42/S.12	AF.42/S.12		0
AF.5	100		AF.5		100
		$\Delta B.90$	$\Delta B.90$		+10

Net recording of the debt assumption with assets**General government****Public corporation****Opening balance sheet**

A		L	A		L
			AN.11	20	
					AF.42/S.12
AF.5	100				AF.5
					100

Capital account

ΔA		ΔL	ΔA		ΔL
GFCF (P.51)	+20	D.99	P.51	-20	D.99
		-30+20			+30-20
B.9	-30	B.10.1	B.9	+30	B.10.1
		-10			+10

Financial account

ΔA		ΔL	ΔA		ΔL
	F.42	-30	F.42		-30
	B.9	-30	B.9		+30

Closing balance sheet

A		L		A		L	
AN.11	20			AN.11	0		
		AF.42/S.12	30			AF.42/S.12	0
AF.5	100					AF.5	100
		ΔB.90	-10			ΔB.90	+10

VII.3 Debt rescheduling

VII.3.1 Background to the issue

1. Debt rescheduling may be an alternative arrangement to debt cancellation or a step in a process leading to debt cancellation.
2. This transaction is often set up by government with foreign transactors, in particular from developing countries, but may also concern domestic public corporations, notably in the financial area. Foreign debtors may be government units themselves or non-government units, such as public corporations. The Paris Club is dedicated to public debt negotiations. The London Club is dedicated to private (banking) debt negotiations but is practically no longer active. In the following, “government” is only used to describe the creditor government (Treasury or special agencies, excluding specialised financial institutions classified in sector S.12).
3. The issue is how to record the rescheduling of claims and liabilities. What amount has to be recorded on the asset side of the government balance sheet, when the terms of the debt contract have changed, following a rescheduling arrangement, and at what time?

4. Case under review

The case is when government has directly extended a loan to the government of a foreign country, and the debtor is defaulting and suspending all or part of its committed payments:

- as a first step there is a negotiation to reschedule the debt;
- as a second step, the debt may be cancelled, or even sold.

Only loans are considered.

The case of credit insurance is not dealt with.

VII.3.2 Treatment in national accounts

5. It is only if the outstanding principal amount of the claim (generally loans), recorded at its nominal value, is diminished, that a capital transfer has to be recorded in favour of the defaulting debtor, for the amount of the claim which is cancelled: this amounts to a debt cancellation (see 7.2 in this Manual).
6. It is not necessary in the other cases, in particular:
 - if the payment of the claim is only delayed or rescheduled
 - if only the amount of interest is renegotiated.

VII.3.2.1 Recording of a loan

7. The amount of the debtor’s liability to the creditor at any point of time is the principal outstanding: it is the amount that the debtor must repay to discharge the liability and thereby extinguish the creditor’s claim over the debtor. It is the principal outstanding which has to be recorded in balance sheets of both creditor and debtor.
8. Loans may take various types (see VII.3.2.5 below on [Recording of loans \(principal and interest\): technical note](#)). Nevertheless, whatever their type the total annual payments, principal and interest, is contractually agreed and can only be changed by contract. The future series of interest flows is not recorded as a claim of the creditor in national accounts.
9. The interest rate may be fixed or it may be revised - cases of floating rates, revised rates, and step-up rates are included. The loan contract gives provisions for the application of the reference.

10. If, at some point in time, some previous payments have been defaulting, the corresponding amounts have to be added to the present principal outstanding. These amounts also include interest that has been accrued and added to the principal in the national account balance sheet but have not been paid in due time (usually referred as to interest arrears).
11. In any case, possible provisions made by the creditor are not recorded in national accounts.

VII.3.2.2 Rescheduling of the loan: ordinary cases

12. In ordinary cases, the outstanding claim will not be changed in the rescheduling arrangement: the payment of the claim is only delayed, rescheduled, and/or the amount of interest is renegotiated.
13. There are three main ways for rescheduling a loan:

- 1) It is possible to change the maturity of the principal. As, in general, the aim is to lighten the annual burden of repayment, the duration is likely to be lengthened. However, even though the interest rate is unchanged, the total interest charge will be increased (see example).

This does not change the nominal value of the outstanding principal but has an impact on the “market value” of the debt instrument, notably in case of occasional transactions on secondary market. The consequence is a new schedule of annual repayments, which will differ from the original one.

- 2) It is possible to change the interest rate of the contract. This will have only an impact on the series of interest payments. The initial principal outstanding does not change. If the interest rate does change it is likely that the required regular payments will change.

A particular arrangement of this type may include the cancellation, by the creditor, of the future stream of interest payments, with various alternatives for the repayment of the principal. There is no change to the amount of principal outstanding in balance sheets: it is similar to a revision of the interest rate of the loan, with the new interest rate being nil.

It is possible to delay payments of principal during a grace period. There is generally a corresponding increase in duration. The original outstanding amount is unchanged. Interest during the grace period may be paid every year, or capitalised and added to the principal that will be amortised after the grace period. (See II.5 in this Manual).

VII.3.2.3 Determining the new amount outstanding

14. In order to determine whether it is necessary to record a capital transfer, and calculate its value, the difference between the outstanding amount of the claim before and after the rescheduling must be known. Normally, the new amount outstanding would be mentioned in the rescheduling agreement. But in some rare cases it might not be. In these cases, it should be calculated from the stream of future annuities and interest rate quoted in the new agreement (see formula in box). If the rate of interest is not given, the value of the outstanding amount should be calculated as the net present value of the future annuities using a discount rate equal to the interest rate that applied to the initial agreement.
15. In other words:
 - if, at any point of time, the principal outstanding of a loan has a given value V ,
 - and if a rescheduling arrangement, implemented at this point of time, leads to a situation in which the present value of the annuities - calculated with the interest rate after arrangement - after rescheduling, is different from the above principal outstanding V ,

- this means that, in fact, there is a change in the principal outstanding value to be recorded under AF.4 in the balance sheets of both creditor and debtor,
16. As, in this case, it is likely that the new principal outstanding be lower than the previous one, a capital transfer - in kind (D.99) - has to be recorded from the creditor to the debtor, since there is a de facto partial debt cancellation.

VII.3.2.4 Cancellation of a debt following a rescheduling arrangement

17. It may happen that, despite a rescheduling arrangement been implemented, the creditor government cancels the remaining claim. A capital transfer has thus to be recorded from government to the debtor, at the time of the cancellation agreement. The amount of the capital transfer (normal treatment of debt cancellation in ESA10) is equal to the principal outstanding of the loan after rescheduling.

Sale of a loan

18. It may happen that, after a rescheduling arrangement, government sells a loan, to a financial institution for instance. It may also happen that, because of the difference between the contractual rate of interest prevailing on the loan and the corresponding market rate for the same kind of loan, the sale takes place for an amount of principal far below the principal outstanding as contained in the rescheduling arrangement.
19. In this case, the difference between the principal outstanding after rescheduling and the principal outstanding as traded in the sale has to be recorded as a holding loss in government revaluation account (ESA10 6.58).
20. **NB:** In case the debtor would go refunding its debt to the first creditor, the transaction between the two creditors would not be regarded as the sale of a claim (the loan) but as a new loan granted by the new creditor to the former one.

Box 1

Recording of loans (principal and interest): technical note

1. At inception, the principal outstanding is equal to the amount, which has been lent. It is also equal to the present value of all the annuities, using the interest rate of the loan contract as discounting rate: see formula (1) in the box.
2. At any point of time, the outstanding amount of principal is equal to the present value of the remaining annuities, still using the interest rate of the loan contract as discounting rate: see formula (2) in the box for case when all previous annuities have been paid.
3. The amortisation table of a loan may be shown as follows:
 - V_0 being the amount of the loan at inception
 - r the interest rate of the contract
 - n the length of the loan

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	V_0	F_1	D_1	A_1
...
p	V_{p-1}	F_p	D_p	A_p
...
n	V_{n-1}	F_n	D_n	A_n

The following numerical relations may be observed for a given period p :

$$A_p = D_p + F_p$$

$$F_p = r V_{p-1}$$

$$D_p = V_{p-1} - V_p$$

$$V_n = 0$$

4. Three main kinds of conventional loans - excluding index-linked ones, for instance - exist in practice:

1. Loans with a final repayment:

$$D_p = 0, \forall p \neq n$$

$$D_n = V_0$$

$$F_p = F = r V_0, \forall p$$

2. Loans with constant amortisation:

$$D_p = D = \frac{1}{n} V_0, \forall p$$

3. Loans with constant annuities:

$$A_p = A, \forall p, A \text{ being calculated using the formula given below.}$$

Basic formulae:

5. Whatever the type of loan could be, the various components may be calculated using the following basic formula - V_0 , n , and r being given:

$$V_0 = \sum_{p=1}^{p=n} A_p \frac{1}{(1+r)^p} \quad (1)$$

This means that the present value - using the interest rate of the loan contract as discounting rate - of all the annuities is equal to the amount which is lent, whatever these annuities could be.

6. Moreover, at any point of time, the outstanding amount of principal is equal to the present value of the remaining annuities. Thus, after the $p-1$ annuities have been paid, the following formula holds:

$$V_p = \sum_{m=1}^{m=n-p} A_{p+m} \frac{1}{(1+r)^m} \quad (2)$$

7. If no payment occurs from the beginning until $p-1$ being included -, V_0 is recorded under AF.4 at the end of period p . Moreover, there is a liability corresponding to the unpaid amounts of interest, equal to:

$$\sum_{m=1}^{m=p} F_m \quad (3)$$

VII.3.3 Rationale of the treatment

VII.3.3.1 Recording of a loan

21. The values to be recorded under AF.4 in the balance sheets of both creditors and debtors are the amounts of principal that the debtors are contractually obliged to repay

the creditors, even in cases where the loan was traded at a discount or premium (ESA10 7.70).

VII.3.3.2 Rescheduling of a loan

22. There is no real guideline for treating such a case in ESA10. Mention is only made of debt restructuring in ESA10 20.236 which states the same principle related to the difference in value (without specifying that it is in nominal terms). It is mentioned in SNA2008 but in a rather descriptive way indicating only in 20.107 b that it “may or may not result in a reduction in present value terms” whereas there is no mention of a possible capital transfer. Therefore, this manual brings a necessary clarification and in useful practical guidance for national accountants.
23. The main point is that a loan is a contractual arrangement. The split between repayment of the principal and payment of interest is determined in the loan contract, even for loans with floating rates, and can only be changed by contract.
24. It has particularly to be noted that a loan has no market price: see ESA10 6.581. The changes which may occur on financial markets for interest rates for similar loans has thus no direct impact on the principal outstanding of existing loans. Moreover, such changes may have no influence on the future amounts of interest, and thus no influence on the split between principal and interest.

VII.3.3.3 Debt cancellation

25. See II.4.1 in this Manual).

VII.3.3.4 Sale of a loan

26. ESA10 discusses the case a loan is traded (ESA10 5.122). In the present case, the difference between the redemption « price » and the transaction « price » is recorded in the revaluation account (ESA10 6.58).

VII.3.4 Accounting examples

VII.3.4.1 Common features

Case a: recording a loan

Amount of the loan = 10 000; duration = 5 years; interest rate = 6 %

1. Loan with a final repayment

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	0	600
2	10 000	600	0	600
3	10 000	600	0	600
4	10 000	600	0	600
5	10 000	600	10 000	10 600
Total		3 000	10 000	13 000

2. Loan with constant amortisation

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	2 000	2 600
2	8 000	480	2 000	2 480
3	6 000	360	2 000	2 360
4	4 000	240	2 000	2 240
5	2 000	120	2 000	2 120
Total		1 800	10 000	11 800

3. Loan with constant annuities

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	1 774	2 374
2	8 226	494	1 880	2 374
3	6 346	381	1 993	2 374
4	4 353	261	2 113	2 374
5	2 240	134	2 240	2 374
Total		1 870	10 000	11 870

VII.3.4.2 Numerical example of rescheduling

Case b1: maturity is lengthened

The loan over 5 years is transformed into a loan over 8 years; the rate of interest is unchanged

1. Loan with a final repayment

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	0	600
2	10 000	600	0	600
3	10 000	600	0	600
4	10 000	600	0	600
5	10 000	600	0	600
6	10 000	600	0	600
7	10 000	600	0	600
8	10 000	600	10 000	10 600
Total		4 800	10 000	14 800

2. Loan with constant amortisation

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	1 250	1 850
2	8 750	525	1 250	1 775
3	7 500	450	1 250	1 700
4	6 250	375	1 250	1 625
5	5 000	300	1 250	1 550
6	3 750	225	1 250	1 475
7	2 500	150	1 250	1 400
8	1 250	75	1 250	1 325
Total		2 700	10 000	12 700

3. Loan with constant annuities

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	1 010	1 610
2	8 990	539	1 071	1 610
3	7 919	475	1 135	1 610
4	6 783	407	1 203	1 610
5	5 580	335	1 276	1 610
6	4 305	258	1 352	1 610
7	2 952	177	1 433	1 610
8	1 519	91	1 519	1 610
Total		2 883	10 000	12 883

Case b2: change in rate of interest

The loan at 6% is transformed into a loan at 4%

1. Loan with a final repayment

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	400	0	400
2	10 000	400	0	400
3	10 000	400	0	400
4	10 000	400	0	400
5	10 000	400	10 000	10 400
Total		2 000	10 000	12 000

2. Loan with constant amortisation

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	400	2 000	2 400
2	8 000	320	2 000	2 320
3	6 000	240	2 000	2 240
4	4 000	160	2 000	2 160
5	2 000	80	2 000	2 080
Total		1 200	10 000	11 200

3. Loan with constant annuities

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	400	1 846	2 246
2	8 154	326	1 920	2 246
3	6 234	249	1 997	2 246
4	4 237	169	2 077	2 246
5	2 160	86	2 160	2 246
Total		1 231	10 000	11 231

Case b3: Grace period

Three years of grace period are agreed for the principal (with interest capitalised)

1. Loan with a final repayment

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	(600)	0	0
2	10 600	(636)	0	0
3	11 236	(674)	0	0
4	11 910	714	0	714
5	11 910	714	0	714
6	11 910	714	0	714
7	11 910	714	0	714
8	11 910	714	11 910	12 624
Total		3 570	11 910	15 480

2. Loan with constant amortisation

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	0	0
2	10 600	636	0	0
3	11 236	674	0	0
4	11 910	715	2 382	3 097
5	9 528	572	2 382	2 954
6	7 146	429	2 382	2 811
7	4 764	286	2 382	2 668
8	2 382	143	2 382	2 525
Total		2 144	11 910	14 054

3. Loan with constant annuities

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	10 000	600	0	0
2	10 636	636	0	0
3	11 236	674	0	0
4	11 910	715	2 113	2 827
5	9 797	588	2 240	2 827
6	7 558	453	2 374	2 827
7	5 184	311	2 516	2 827
8	2 667	160	2 667	2 827
Total		2 227	11 910	14 137

Case c1

The new interest rate is 4%. The new schedule of annuities is available. We derive the new principal that is unknown

1. Loan with a final repayment (four first annuities = 300)

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	7 500	300	0	300
2	7 500	300	0	300
3	7 500	300	0	300
4	7 500	300	0	300
5	7 500	300	7 500	7 800
Total		1 500	7 500	9 000

Capital transfer recorded at the time of the new agreement: 2 500

2. Loan with constant amortisation (total annuities = 9 000)

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	8 036	321	1 607	1 929
2	6 429	257	1 607	1 864
3	4 822	193	1 607	1 800
4	3 214	129	1 607	1 736
5	1 607	64	1 607	1 671
Total		964	8036	9000

Capital transfer recorded at the time of the new agreement: 1 964

3. Loan with constant annuities (total annuities = 9 000)

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	8 013	321	1 479	1 800
2	6 534	261	1 539	1 800
3	4 995	200	1 600	1 800
4	3 395	136	1 664	1 800
5	1 731	69	1 731	1 800
Total		987	8 013	9 000

Capital transfer recorded at the time of the new agreement: 1 987

Case c2: new interest rate unknown

The new interest rate is unknown. The new schedule of annuities is available. We derive the new principal which is unknown by using the original rate of 6%.

1. Loan with a final repayment (four first annuities = 415)

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	6 923	415	0	415
2	6 923	415	0	415
3	6 923	415	0	415
4	6 923	415	0	415
5	6 923	415	6 923	7 338
Total		2077	6 923	9 000

Capital transfer recorded at the time of the new agreement: 3 067

2. Loan with constant amortisation (total annuities = 9 000)

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	7 627	458	1 525	1 983
2	6 102	366	1 525	1 891
3	4 576	275	1 525	1 800
4	3 051	183	1 525	1 708
5	1 525	92	1 525	1 617
Total		1 373	7 627	9 000

Capital transfer recorded at the time of the new agreement: 2 363

3. Loan with constant annuities (total annuities = 9 000)

Time period	Principal at the beginning of the period	Interest of the period	Amortisation of the period	Annuity (total annual payment)
1	7 582	455	1 345	1 800
2	6 237	374	1 426	1 800
3	4 811	289	1 511	1 800
4	3 300	198	1 602	1 800
5	1 698	102	1 698	1 800
Total		1 418	7 582	9 000

Capital transfer recorded at the time of the new agreement: 2 418

VII.4 Government guarantees

VII.4.1 Background to the issue

1. In many European Union Member States, government, usually at central level but also at State or local level, provides guarantees (unconditional or conditional, alone or with other units - possibly "joint and several", i.e. enforceable to any of the guarantors) on the borrowing of certain corporations or other entities, both in the public and in the private sector. Generally, this allows the beneficiary unit to borrow at a lower interest rate¹⁵⁰, and even in some cases this support is needed in order to have access to borrowing markets. There are different ways in which a guarantee may be exercised (realisation of guarantor's obligations), but the most frequent case is generally when the guarantee call is activated by the creditors of the borrowing unit, often at first demand. Usually three parties are involved in such calls: the unit that borrows (the debtor, for example a public corporation), the unit that lends (the creditor, for example a bank) and the guarantor, in this chapter a government unit).
2. Government may also provide guarantees on assets held by some entities as part of their normal business or in the context of government policies. In this case, government takes the commitments to cover losses related to a decrease in value of the assets or shortfalls in the recovery, with, also in this case various ways, of activating the guarantor's obligations. When guarantees on assets are granted to financial institutions holding significant problematic assets, the issue is also treated in this Manual on "financial defeasance".
3. This chapter does not consider the case of implicit guarantees, as opposed to formal guarantees that are generally laid down in legal contracts (for instance in the case of guaranteed issuance of securities). Implicit guarantees may come from government's role as shareholder, or controller of the units, where it is thought that government will intervene in any case if problems are observed. Implicit guarantees may also relate to economic activity considered as integral to the economy, where it is assumed that government would intervene to prevent a failure. This chapter also does not cover formal guarantees commitments which are rather very close to insurance schemes. For instance, government may "guarantee" some payments by households (e.g. housing rentals) or grant guarantee for some specific events (e.g. art exhibitions).
4. Government may provide three kinds of guarantees:
 - in the form of derivatives (such as Credit Derivative Swaps) which fall under the normal treatment of derivatives and do not require specific provisions in this Manual for government transactions on this market;
 - in the form of standardised guarantees (new distinction in SNA2008 and ESA2010);
 - in the form of "one-off" guarantees.
5. ESA10 5.190 provides a clear definition of standardised guarantees which "are issued in large number, usually for fairly small amount, among identical lines". Briefly, they show their main features: issued for the benefit of several financial institutions granting credits under a precise framework, related to the assets of the benefiting financial institutions (the guarantee trigger does not come from a default of the lending unit on its own debt), granted in the context of public interest policy. Main examples are student

¹⁵⁰ This guarantee may result in a credit enhancement as rating agencies generally attribute to the debt of the borrowing unit the rating of the guarantor where higher.

loans (notably where university tuition is high) real estate households (generally for low-income borrowers) and export credit.¹⁵¹

6. For their part, one-off guarantees are provided on a case by case approach, generally for rather significant amounts and under individual contractual arrangements. They are not offered under a general framework and imply a close follow-up by government, on an individual basis and not globally. In addition, it is frequent that they are subject to an examination of their impact by competition authorities.
7. ESA10, similarly to SNA2008, insists on another difference between standardised guarantees and one-off guarantees. In the first case guarantors should be in a position, when they grant the guarantee, to estimate the average loss based on available statistics by using a "probability-weighted risk of call". In the case of one-off guarantees, on the contrary, guarantors generally would be not able to make, at inception, a reliable estimate of the risk of calls, which is not really predictable.
8. As far as guarantee fees are concerned, as a general principle, fees that government receives in its role of guarantor are classified as service fees (P.131 non-market output), with total non-market output (P.13) recorded on the basis of the sum of the production cost. The receivable fees are deducted from the final expenditure. According to the accrual principle, this revenue should be spread over the life of the guarantee. This treatment does not concern the fees that are in fact equivalent to insurance premiums, notably under export credit schemes, and must, thus, be treated according to the rules stated in ESA10 for non-life insurance.

However, in the case of specific one-off guarantees, the amount of fees paid might be considered as highly out of proportion with the production cost of operating the guarantee. In this case, the difference between the amount of fees and their estimated "pure" service component is normally recorded as a current transfer (D.75), the later component being recorded once when due to be paid. If the "service component" is judged to be very marginal (as in the case of one-off guarantees of significant amount) and/or the information of the exact cost of the services is not available or not reliable, it is recommended to rather record all the fees as current transfer.

VII.4.2 One-off guarantees

VII.4.2.1 Treatment in national accounts

VII.4.2.1.1 General Case

9. Generally, a government guaranteed debt is recorded solely as the borrowing of the borrower and an asset for the lender, whether or not the guarantee concerns specific borrowing (e.g. one particular loan) or the whole corporate debt. For the government, it is a contingent liability which is not recorded in ESA balance-sheet (but may be shown as memorandum item or a footnote).
10. If the guarantee, for the full amount or part of it, is called, then government takes over the borrower's debt through a "debt assumption", which is recorded as a capital transfer (D.99) from government to the borrower corporation for the amount called. This has an impact on deficit. The capital transfer is offset by a financial transaction, the financial liability transferred from the borrower to government. Government may, either immediately or subsequently, enter a separate financial transaction where it repays the outstanding debt to the lender, both the principal (with no impact on deficit) and the

¹⁵¹ The term "export credit" is used here in a narrow sense: guarantees on loans/credits to foreign purchasers, or loans to domestic suppliers, but excluding any form of insurance (such as prospection insurance, political risk, etc.). In other words, only a credit risk incurred by lending institutions is covered by the guarantee. Although listed in ESA10/SNA08 as an example of standardised guarantees, within the EU, most export credit guarantees are rather considered as insurance. The operations referred in this chapter are covered by the OECD "Arrangement on Officially Supported Export Credits" (last updating in January 2013).

interest accrued, but not paid at the time of the assumption and which have been reinvested in the instrument.

11. In the public accounts balance sheet, the guaranteed debt will usually not be recorded until the guarantee is activated. However, it is expected that information is made publicly available on government guarantees. It is, in addition, usual that the Parliament has to approve a cap amount of guarantees government could grant over a fiscal year.

Partial calls

12. A "partial call" of the guarantee (sometimes referred to as "cash call") – occurs when government pays one instalment. The actual payment by government is recorded as a capital transfer (D.99) expenditure, balanced by a decrease in cash and deposit (F.2) (see the decision tree diagram). Conceptually, there is a transfer of the financial liability to government and immediate settlements of this amount to extinguish the liability, there is no obligation to record such transactions. However, it may be the case that government is legally obliged to automatically assume all the remaining debt (guarantees at first demand) as the result of an initial case. For cases of "repeated calls", see the following section (VII.4.2.1.3).

VII.4.2.1.2 Where it is known government will repay the debt

13. In some cases, it is known with certainty that, despite the borrowing being legally carried out by the corporation, it will be government that repays the borrowing. This may occur for newly issued debt or for existing debt which government had started to guarantee.
14. In straightforward cases, evidence is provided in legal documents, or a government liability is recognised in the public accounts or in similar documents, such as the budget. In such cases the debt is considered to be sequentially first issued by the corporation and then assumed by government. This assumption may happen immediately, for example in the case where it is obvious at inception that the debt will be assumed by government, so that, in national accounts, the debt may never be recorded in the balance sheet of the corporation in any accounting period. The debt assumption is recorded as described in VII.4.2.2.1.

VII.4.2.1.3 Where it is judged that government is repaying or will repay the debt

15. In other cases, documented evidence may not be available to show that government has legally assumed the debt but other indicators point that government has de facto has assumed it. Evidence of this case may include:
 - repeated calls: government is observed to be repaying the debt each year¹⁵², either directly (by calls, see below) or indirectly, through recurrent payments to the borrower, which allows the corporation to repay all or part of its debt obligations. Such payments¹⁵³ result in providing the unit with the means necessary to repay its creditors without formally activating the guarantee or avoiding a roll-over of the debt (including by a financial advance from government). If such support becomes a common occurrence¹⁵⁴, it is considered as a "disguised or indirect call,"¹⁵⁵ which would trigger a reclassification as government debt.

¹⁵² In some cases, several calls could be observed during the same year under the same guarantee arrangement. They are accounted for a single call in the implementation of the rule.

¹⁵³ Any transfer from government would be counted in this regard, except subsidies on products D31 (but including D.319).

¹⁵⁴ By consistency with the "3 calls rules", mentioned below in § 18, this could be assessed if the support was observed at least during three consecutive years.

¹⁵⁵ In practice it may be difficult to assess such indirect call because of the multiple sources of profits of the corporation and the possible variety of government support. Therefore, this provision would apply only if such situation would be observed continuously over several exercises and not exceptionally. The cases where government would systematically provide funds to the corporation for the payment of a large part of the interest burden should also be closely examined as it might be an indication that the corporation would not be able to redeem the principal of its debt. Anyway, on an individual approach, this should give rise to specific examination by national statisticians, in cooperation with Eurostat.

- a provision has been recorded in public accounts or similar documents that shows that the probability that government will repay the debt is very high and has been already recognised by government, beyond the usual prudential practice.
16. In this case, the outstanding amount of debt, or the relevant part of it, is assumed by government in the time period it is judged to have de facto assumed it.
 17. Specific examples where judgement is needed include when there are repeated calls on the guarantee (or where equivalent payments - like repeated capital injections - are made to the borrower corporation to prevent a call being necessary). In the latter case, government effectively repays the debt even though it has no legal requirement to do so and does not formally record it as such in public accounts.
 18. As practical guidance, if government repayments of the debt occur during three years (this is referred to as the “three calls rule”) through actual or de facto payments (see indirect calls above), then the debt is to be considered as automatically assumed. An exception is the case of strong indications that the situation would not continue. This would mean that a fundamental restructuring of the guaranteed unit has been decided and it should be assessed in the business plan to be provided that the entity would be in the future in a position to face its debt obligations.¹⁵⁶ The debt would normally be assumed in its entirety (although this could be reduced to only the proportion government is expected to repay, if there is evidence of that). The debt assumption should be recorded at the time of the event triggering the economic judgement of the debt assumption, for example the time of the third annual payment. The debt assumption is to be recorded as described in VII.4.2.1. When government is guaranteeing more than one debt instruments issued by a single entity, the rule should apply on the basis of calls on any of the guaranteed liabilities. Therefore, in the event that a judgement is made that a debt will be assumed in its entirety, all the government-guaranteed debt of that entity is assumed at the same time.

VII.4.2.1.4 Where assumption of liability includes a claim on a third-party asset¹⁵⁷

19. A guarantee on liability may be exercised, possibly at the initiative of the creditors, where the guaranteed unit cannot meet its debt obligations on due time and not because of problems with the underlying solvency of the guaranteed unit. An example of this could be temporary liquidity difficulties. When a debt assumption includes a claim on a third party asset¹⁵⁸, for example when the guaranteed borrowing is secured by specific assets (case of covered bonds), the market value of the asset which could be transferred to government (as this may be foreseen in guarantee arrangements)¹⁵⁹ can be deducted from the capital transfer, provided it is very likely that government will realise the value of the asset in rather short term. If such value is not observed, a fair value may be estimate, on the basis of usual business estimation methods/models.
20. Another possibility is that the claim acquired by government could be a non-financial asset rather than a financial asset, such as a real estate property. Here, in case of default, the government assumes the debt of the guaranteed borrower and also takes the ownership of a given property. The recording would be similar to the case mentioned in the previous paragraph and the value of the transferred asset should be deducted from the capital transfer, and totally off-set it, if the value of the asset is equal to the value of the debt assumption. As the offsetting transaction is a non-financial one

¹⁵⁶ An exception is the case of strong indications that the situation would not continue. This would mean that a fundamental restructuring of the guaranteed unit has been decided and it should be assessed in the business plan that the entity would be in the future in a position to face its debt obligations.

¹⁵⁷ The case of guarantees on assets held by financial institutions at stress is treated in the chapter IV.5 in this Manual.

¹⁵⁸ Third party means that the asset is not a claim of the guaranteed unit but on another unit, which is not part of the guarantee arrangement. In the cases of financial claims held by the guaranteed unit, such asset could be transferred (possibly due to contractual obligations) by the debtor to this unit (its default may have triggered the activation of the guarantee) and then retransferred to government. It would be de facto a claim on a “fourth party”.

¹⁵⁹ If such value is not observed, a fair value may be estimated by independent bodies, on the basis of usual business estimation methods/models.

there would be an impact on government net lending/net borrowing due to the increase in assets. When government immediately disposes of the asset at market value, in order to get the cash for repaying the liability, the final impact on government net lending / net borrowing will be neutral if government resells the asset at least for the value recorded at the time of the debt assumption.

VII.4.2.1.5 Where assumption of liability includes a claim on the corporation

21. When government assumes debt through a guarantee call, it may also at the same time acquire a financial asset that is a liability of the guaranteed corporation, such as a claim – generally recognised in the public accounts – on any recoveries that it can subsequently make.
22. In the most common case, where government is judged to assume debt from a public corporation facing a difficult situation, it is considered that any new claim of government on the corporation, possibly recorded in public accounts, would have a very uncertain value. In this case, no such claim is recorded and therefore no simultaneous capital transfer revenue for government. In case of later repayments from the public corporation, these would be recorded as capital transfer revenue of government (see also below in VII.4.2.6). In the case the guaranteed borrowing unit would be fully private, government could consider holding a claim which would, at last resort, incurred by the shareholders. However, in case the borrowing unit shows accumulated losses, and more particularly, a negative net equity, no claim on the unit should be recorded in national accounts.

VII.4.2.1.6 If circumstances change after a debt assumption

23. After government has been economically judged to assume debt it guaranteed (see VII.4.2.3), it may happen that the financial performance of the company improves to the extent that it starts making debt repayments and can resume its legal obligations for the liability. Here, the previous economic assessment is now obsolete and the corporation is deemed to assume the debt back from government. This is recorded as a capital transfer from the corporation to government, offset by a financial transaction where the liability is transferred from government to the corporation.
24. When the recovering entity is a public corporation, the transaction recorded in favour of the government should be subject to the super-dividend test, part of the payment possibly being partitioned as an equity withdrawal (F.5).
25. To avoid instability in government debt statistics, any debt economically assumed should remain as a liability of government until payments from the entity to government or to the creditor actually occur, and there is strong evidence that they will continue in the future. In other words, the improvement in the financial situation of the entity must be viewed as permanent and not due to temporary factors.

VII.4.2.1.7 On-lending

26. If government borrows on the market on its own name, but with the explicit purpose to specifically allocate the funds to corporations that are contractually obliged to repay government for both principal and interest, the debt is recorded as government debt at issuance and a corresponding loan is recorded to the corporations. The loan is analysed according to rules on capital injections in public corporations (see chapter 2.2). Therefore it may, or may not, have an impact on the government net lending / net borrowing according to the capital injection test.
27. Government may guarantee a unit for its borrowing on the market, and then finances corporations engaged in large public sector infrastructure and other projects. If the entity is recognised as an institutional unit, the borrowing is re-routed so that government borrows and lends to the entity. However, more frequently, the entity is not recognised as an institution unit (when it appears to just be undertaking the role of a “pass-through” entity), so the borrowing is recorded as direct government borrowing,

with the proceeds used to lending to the corporations engaged in the infrastructure work.

VII.4.3 Rationale of the treatment

VII.4.3.1 General case

28. The general principle is that guarantees of payments granted by third parties are considered as contingent assets/liabilities.
29. ESA states that, "as they do not give rise to unconditional obligations, contingent assets and liabilities are not financial assets and liabilities" (ESA10 5.08).
30. As a result, contingent liabilities are not recorded in the ESA balance sheet and are excluded from government debt. Similarly, the granting of contingent asset and liabilities is not considered as a transaction in national accounts. In the general case, the action of granting a guarantee only leads to the recording of transactions for the fees and when the guarantee is activated, i.e. when the guarantor replaces an original borrower (or in some cases compensates the holder of some identified assets) due a default that triggers the exercise of the guarantee. In some cases, a judgment must to be made that the guarantee has effectively been activated despite it not legally being fully activated. The exercise of the guarantee leads to debt assumptions, or in some cases, to "pure" capital transfers. In a debt assumption the amounts recorded are the payment obligations made by the guarantor on behalf of the original borrower.
31. Any call of a guarantee, whether full or partial, is thus equivalent to a debt assumption by government.

VII.4.3.2 Where it is known government will repay the debt

32. In the case of new guaranteed debt where it is certain that government, as guarantor, will repay it, this is the economic equivalent to government borrowing directly from the creditor, and hence taking on the obligation to service the debt. In this case, the proceeds of government borrowing would then be used to fund the corporation but, as government would not expect to receive anything in return from the borrowing unit, this transaction would not be a loan and should be recorded as a distributive transaction, a capital transfer, with impact on government net lending / net borrowing.
33. In the case where government guarantees an existing debt and it is known with certainty that government will repay it, this is similar to a debt assumption for benefit of the guaranteed unit.

VII.4.3.3 Where it is judged that government is repaying or will repay the debt

34. This case is equivalent to an informal call of the guarantee. The recording reflects the concept of economic substance being recorded rather than legal features or administrative form (See ESA10 1.25). In such cases government is viewed as having assumed the debt from the corporation.
35. Cases where government makes debt repayments every year instead of the corporation without any formal call of a guarantee have been observed and must be carefully analysed to judge whether they are an effective call of the guarantee. These payments are indications that, in practice, government is expected to assume the debt. Recording the liability as government debt is the result of judgement on the economic reality that government will continue to assume the liability on a regular basis, in which case the liability is economically considered as belonging to government.
36. For the purpose of national accounts, economic reality must always prevail over legal form. An ambiguous situation where a further reclassification of the debt could occur in the future should be avoided.

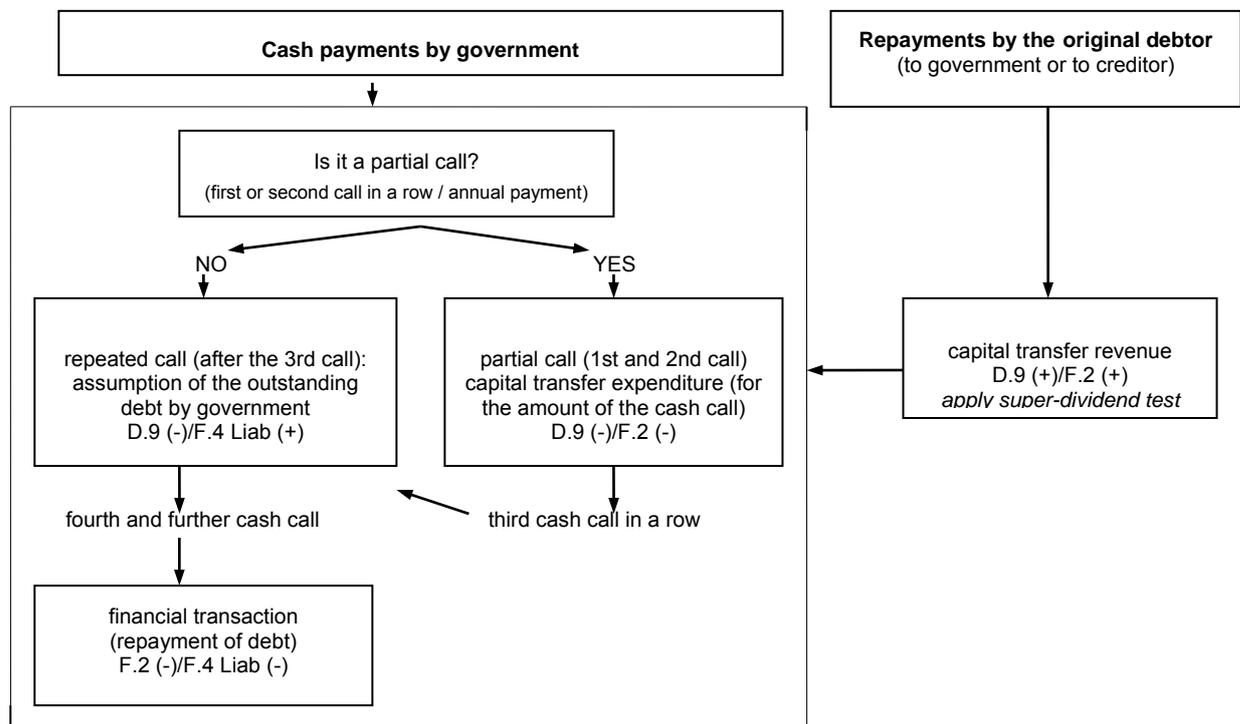
VII.4.3.4 Where assumption of liability includes a claim or a third-party asset

37. A major issue is when a government guarantee is called and, in return, government records a claim. This claim is to be recorded in national accounts, off-setting the amount of capital transfer, only if it has a positive and certain value, i.e. it may be recognised as an effective claim. The notion of "effective claim" is referred to in several commercial accounting texts (notably in IPSAS19) as well as in the IMF's GFSM2001. This excludes the case where government receives a claim on the guaranteed unit, which could be not considered as an effective claim because of the need to activate the guarantee, in connection with the inability to face its own debt obligations. (See below).

VII.4.3.5 Where assumption of liability includes a claim on the corporation

38. When a guarantee is called, government may receive from the guaranteed unit an asset in the form of equity. An assessment is needed of the effectiveness of the claim. For example, if government receives a claim on a loss-making public corporation, what government is receiving is worthless and no effective claim is to be recorded.
39. If the claim is recorded in the public accounts as a loan to a private corporation¹⁶⁰, then the case for viewing the financial transaction as a loan needs to be analysed if the corporation faces financial difficulties (accumulated losses, negative equity, no access to market), so that then its real value is zero or close to zero and is not an "effective claim". Here, the option to record an equity injection would generally be inappropriate while the claim is not an effective claim and the transaction related to the activation of the guarantee would be recorded as a capital transfer rather than a loan.

Decision tree for guarantee cash calls



¹⁶⁰ For public corporations, the paragraph 22 above states that in any case no claim is recognised.

VII.4.4 Standardised guarantees

VII.4.4.1 Treatment in national accounts

VII.4.4.1.1 General principle

40. The general principle in national accounts for the treatment of standardise guarantees is based on the analogy with non-life insurance. The treatment is described in ESA10 chapter 16 and in SNA2008 chapter 17)
41. The treatment of non-life insurance in national accounts is based on the assumption that the unit provided such standardised guarantees will be acting for commercial purpose, i.e. with the aim to make a profit and, in any case, such that the activity will not be at loss. It might however happen that the size of the premiums and/or the investment income would not cover the claims in case of exceptional losses. In the EU, the insurance activity is closely regulated by Supervision Authorities in order to prevent such situations (see “Solvency II” requirements). However, granting only standardised guarantees is not as such considered as a core insurance activity subject to the EU Regulation and Supervision.
42. Therefore it would not be totally unlikely that an EU government could grant standardised guarantees for commercial purposes, even if it is doubtful that it will compete with non-government units in this activity. As a matter of principle, if such guarantee activity may be profitable, it would rather be carried out only by non-government units. However, from a theoretical point of view, if this was observed, i.e. government charging fees deemed to be “economically significant” covering most of the expected calls plus the administrative costs,¹⁶¹ It would result in a treatment in national accounts similar to non-life insurance as mentioned above.
43. When government organises standardised guarantees as a general principle, a liability, classified as AF.66 under ESA10, has to be recorded in government’s balance sheet. Basically, it is equal to the present value of the expected calls under the guarantees, net of any recoveries that the guarantor could expect to receive from the defaulting borrowers¹⁶². In setting up such liability there is some analogy with recording a provision in a business accounting framework (including IPSAS), which requires to make reliable but conservatives estimates on the basis of some evidence (past experience, forecasts in case of a new activity).¹⁶³ As such, these expectations are not linked to the market (profitable) or non-market nature of this specific guarantee activity. If government charges fees under the conditions mentioned in §42 (most of the cost “paid” by the beneficiaries of the guarantee), there will be an entry in the financial accounts equal to the fees received less the calls of existing guarantees. Therefore the counterpart of the liability is a cash payment (part of the fees retained to build up reserves and part of the revenue of investments not used to pay claims).¹⁶⁴

¹⁶¹ Note that, in this case, the government unit engaged in this activity could be considered as a financial quasi-corporation (under the conditions set up in ESA10 chapter 2 and in part I in this Manual), and thus classified outside government sector, so that only flows between this unit and government would appear in government accounts.

¹⁶² This refers to the possible late repayments that a debtor could make after the guarantee had been called. The debtor may be still legally committed but, in many cases, for various reasons, its debt may be irremediably considered as fully unrecoverable after the activation of the guarantee.

¹⁶³ Note that it is called in SNA 2008 and in ESA2010 “provisions for calls under standardised guarantees” but it must be stressed that it is not similar to provisions in Business accounting which are recorded only in the accounts of the unit setting up the provisions whereas, in national accounts, it is considered as a financial instrument and thus recorded both as liability (in guarantor accounts) and reciprocally as asset (in accounts of policy holders).

¹⁶⁴ It may be “re-adjusted” by other change in volume when the expectations of claims (calls) on the entire risk portfolio are upwards or downwards re-estimated.

If government charges no fees (or at a level far from covering the total costs of the scheme for government¹⁶⁵, the counterpart of the incurrence of this liability is not a flow of cash but is a non-financial transaction, i.e. a transfer from government.

VII.4.4.1.2 Recording a special liability in the case of non-commercial activity

44. From a practical point of view, each time a principal amount of loans (covering multiple debtors) is granted under a government standardised guarantee schemes during a given period, a certain percentage amount would be recorded as liability AF.66 in government balance sheet, with a capital transfer as counterpart.¹⁶⁶ In national accounts, this capital transfer is to the benefit of the policy holders, i.e. the financial institutions which grant the loans and have a contractual recourse to the guarantor government, rather than the economic agents which were granted loans by the financial institutions, although they get of course advantage from the existence of the guarantee scheme organised by government for them. This may be analysed as an anticipation of the net cost of the effective calls that are expected. Because of their assumed likelihood, there is an impact at inception in government accounts. By definition, depending of the degree of risk, government is expected to lose money in the scheme.

When a provisioned amount is actually used, at the time a transfer of cash to the financial institutions due to exercising the guarantee, there is no impact on government deficit. It is of course not conceivable that the provision AF.66 could be equal to the full amount of a loan (such 100% risked loan would never be granted) and may be re-adjusted, thus, it seems useful to keep record of the total amount of loans (or other assets) that are covered by a government standardised guarantee, similarly to the case of one-off guarantees which are recorded for the full amount of the underlying guaranteed instrument, independently from any estimation from the probability of default.

45. The recording of the liability AF66 is, in SNA2008 17.223, conditional to the recognition of a provision in the own accounts of the government units (based on an accounting framework different from national accounts). The general case should be that, in this case, national accountants should record this liability on the basis of the estimates made by government. As a principle, national accountants should not diverge from this estimate, as it is doubtful that they could by themselves be in a better position to make reliable estimations of expected losses. It must also be pointed out that, under public accounting rules, more and more adopted by government units (IPSAS or equivalent), setting up adequate provisions for any risky activity is a strong requirement, provided that it is possible to make reliable estimates of the impact of the risk.¹⁶⁷

However, not all government have adopted in their public accounts (and this is specifically relevant if one consider all sub-levels of the general government sector) accounting framework which impose to set up provision in order to cover future evidenced risks. One could expect that Member States where central government would directly grant standardised guarantees would have such framework. Where it is not the case, for comparability reasons, national accountants should consider whether they have sufficient elements, such as similar schemes in other MS, in order to estimate the AF.66 liability, after discussing with Eurostat. The case of totally new scheme, with very specific features, however might raise some difficulties.

¹⁶⁵ This situation is considered in SNA2008 (see 17.223) rather than in ESA2010.

¹⁶⁶ It is recorded as a capital transfer, and not a current transfer, because the AF.66 provision is built up for the future defaults (and not defaults observed during the current year) and represents the anticipation of call of guarantees following debtors' defaults, which, under ESA10, are recorded as capital transfer (see 4.165 f).

¹⁶⁷ Usually this depends on two parameters: "Probability of Default" and "loss Given Default". However, it may happen that auditors would not request for provisioning, in case the impact is deemed to be rather negligible for the unit and if the uncertain time of the possible future impact would rather take place in a distant future.

46. The liability could be revised upward in case the risk of default would be further estimated higher and, by consistency with the treatment at inception, a new capital transfer would be recorded under similar conditions, if it assumed that this would be observed for all existing loans portfolio and not only for the new loans which could show a specific default rate. Under another case, the risk could be lower than expected and the liability could be downward adjusted, first by an imputation on the capital transfer related to new operations in the year and, for any excess, by a reverse capital transfer.

However, Eurostat recommends that the downward adjustment should take place only when the improvement in the recovery of the claim is observed over a rather long period and is considered as quite irreversible. It might also happen that government would have to face guarantee calls higher than the “provisions” set in advance at the time the loans were granted. This should be recorded as a new capital transfer. Government will have also in this case to reconstitute the provision for the remaining portfolio of loans under a new capital transfer.

VII.4.4.1.3 Effect of the call of the guarantee in this context

47. As far as the call of the guarantee is concerned, two cases must be distinguished.

In a first case, the compensation paid to the financial institution results in a complete write-off of the defaulting loan in its books. For various reasons, all the debt has been considered as irrecoverable and thus the call has covered the entire guarantee.

In a second case, it is only a partial call and the bank may keep in its book the whole principal outstanding of the loan: the default is considered just as temporary. There would be normally no reason to consider that government would have a claim showing the repayment of the call in case the debtor starts to repay its loan. In this case, a “reverse” capital transfer to government should be recorded at the time of the effective repayment by the guaranteed unit to government. This would finally provide a complete measurement of the effective net cost for government of the scheme.

The bank may also write-down the loan for the compensated part, estimating that there is still some likelihood of repayment for the residual part of the loan. Again, the “provision” in government accounts is set up on a global basis and not at individual level. Therefore, if there is no reason to change the initial global estimates for the anticipated cost of the scheme, such situation should have no impact in government accounts.

VII.4.4.2 Rationale of the treatment

48. The reasons why such guarantees should be treated in national accounts similarly to non-life insurance are given in ESA2010 (see §5.190 and following) and in SNA2008 (see Part3 in chapter 17). An important point is that the small individual amounts covered by the guarantees and the repetition of similar features a large number of times explains the focus on the global treatment of the total guaranteed amount rather than the individual level, which is not managed directly by the guarantor. In case of such government guarantees, their purpose is generally part of permanent public interest policies for a large number of potential beneficiaries, while, generally, one-off guarantees are linked to the specific situation of individual entities or small groups of units.

However, the treatment must be adjusted, where government acts not similarly to a non-life insurer, in the sense that the fees paid by the beneficiaries are not fixed in order to cover all or almost all costs of the scheme, as it is stressed in SNA2008 17.223. In this case, government does not aim for a neutral impact on its income statement by fixing the fees at a level where, on a time-equivalence perspective, they should cover most, if not all, the expected defaults on the underlying assets by its own resources. Government intervention through standardised guarantees schemes takes

place in the context of policies of which the objective is to improve market access for some specific categories of economic agents. In this regards, one can expect an unrequited transaction element behind such arrangements.

VII.4.5 Accounting examples

VII.4.5.1 One-off guarantees: rule of 3 successive calls

Government grants a guarantee of 100 to a public corporation for a debt under the form of loan AF.4. (No fee charged by government).

- 1) At inception, there is no reason to consider that the guarantee will be automatically called. There is thus no record in government accounts. The guarantee is a contingent asset. (By simplification, interests on the debt are not shown in the example.)

GG		PC	
Financial account		Financial account	
ΔA	ΔL	ΔA	ΔL
		F.2 + 100	F.4 +100
Closing balance sheet		Closing balance sheet	
A	L	A	L
		(AF.2)	AF.4 100

- 2) On year t, there is a call of the guarantee for 10. It is similar in year t+2.

GG		PC	
Opening balance sheet		Opening balance sheet	
A	L	A	L
			AF.4 100
Non-financial account		Non-financial account	
U	R	U	R
	D.9 -10		D.9 10
B.9 -10		B.9 +10	

Financial account				Financial account			
ΔA		ΔL		ΔA		ΔL	
F.2	+ 10 -10	F.3	+10	F.2	+10-10	F.4	- 10
		B.9	- 10			B.9F	+ 10

Closing balance sheet				Closing balance sheet			
A		L		A		L	
		AF.3	10			AF.4	90

3) On year t+3, there is a third call of guarantee

GG				PC			
Opening balance sheet				Opening balance sheet			
A		L		A		L	
		AF.3	20			AF.4	80
Non-financial account				Non-financial account			
U		R		U		R	
B.9	- 80	D.9	- 80	B.9	+80	D.9	80
Financial account				Financial account			
ΔA		ΔL		ΔA		ΔL	
F2	+10-10	F.3	+ 10	F.2	+10-10	F.4	- 80
		F.4	+ 70			B.9F	+ 80
		B.9F	- 80				
Closing balance sheet				Closing balance sheet			
A		L		A		L	
AF.3	30						
AF.4	70						

VII.4.4.2 Reclassification as government debt at inception

Government grants a guarantee of 100 to a public corporation for a debt under the form of bullet bonds AF.3. (No fee charged by government).

- At inception, there is strong evidence (corporation with negative own funds, repayment commitment taken by government, etc.) that the debt would be repaid by government and not by the “apparent” legal debtor. The debt is thus considered at inception as government debt. (By simplification, interest on the debt are not shown in the example)

GG				PC			
Non-financial account				Non-financial account			
U			R	U			R
		D.9	-100			D.9	100
B.9	-100			B.9	+100		
Financial account				Financial account			
ΔA			ΔL	ΔA			ΔL
		F.3	+100	F.2	+100	F.3	+100 -100
		B.9	-100			B.9F	-100
Closing balance sheet				Closing balance sheet			
A			L	A			L
		AF.3	100	AF.2	100		

- At final maturity, the public corporation is finally in a position to repay by itself 10 out of a principal repayment of 100.

GG				PC			
Opening balance sheet				Opening balance sheet			
A			L	A			L
		AF.3	100	AF.2	10		

Non-financial account				Non-financial account			
U		R		U		R	
		D.9	10			D.9	-10
B.9	10			B.9	-10		

Financial account				Financial account			
ΔA		ΔL		ΔA		ΔL	
F.2	+10-100	F.3	-100	F.2	-10		
		B.9	+ 10			B.9F	- 10

Closing balance sheet				Closing balance sheet			
A		L		A		L	
		AF.3	0				

VII.4.4.3 Government guarantee on losses related to problematic assets¹⁶⁸

- 1) For a nominal value of problematic assets of 100, losses are reliably estimated at 70. The guaranteed amount is recorded as government expenditure (D.9) and a liability (F.7) of government. Problematic assets remain in the accounts of the financial institution.

GG				FI			
Opening balance sheet				Opening balance sheet			
A		L		A		L	
				AF.3	100	AF.3	100
Non-financial account				Non-financial account			
U		R		U		R	
		D.9	- 70			D.9	70
B.9	- 70			B.9	+70		

¹⁶⁸ See Chapter IV.5 for the definition of the problematic assets, notably §22.

Financial account			Financial account		
ΔA		ΔL	ΔA		ΔL
	F.8	+ 70	F.8	+ 70	
	B.9	- 70		B.9F	+ 70

Revaluation account			Revaluation account		
ΔA		ΔL	ΔA		ΔL
			F.3	-70	

Closing balance sheet			Closing balance sheet			
A		L	A		L	
	AF.8	70	AF.3	30	AF.3	100
			AF.8	70		

- 2) In year t, government transfers cash to the financial institution which has to repay 70 on its debt. Government needs to borrow on markets.

GG			FI			
Opening balance sheet			Opening balance sheet			
A		L	A		L	
	AF.8	70	AF.3/4	30	AF.3	100
			AF.8	70		

Financial account			Financial account				
ΔA		ΔL	ΔA		ΔL		
F.2	(+ 70-70)		F.2	(+70-70)	F.3	- 70	
		F.8	-70		F.8	- 70	
		F.3	+70			B.9F	0
		B.9F	0				0

Closing balance sheet			Closing balance sheet			
A		L	A		L	
	AF.3	70	AF.3	30	AF.3	30

- 3) In year t' , the financial institution has also to redeem its debt for 70 but realised losses on the assets are 60, cash amount transferred by government (from borrowing on markets).

GG				FI			
Opening balance sheet				Opening balance sheet			
A			L	A			L
	AF.8	70		AF.2	x	AF.3	100
				AF.3	30		
				AF.8	70		
Non-financial account				Non-financial account			
U			R	U			R
	D.9	+ 10			D.9	-10	
B.9	+ 10			B.9	-10		
Financial account				Financial account			
ΔA			ΔL	ΔA			ΔL
F.2	(+60-60)	F.8	(-60-10)-70	F.2	(+60- 70)-10	F.3	- 70
		F.3	+60	F.8	- 70		
		B.9F	+10			B.9F	-10
Revaluation account				Revaluation account			
ΔA			ΔL	ΔA			ΔL
				F.3	+10		
Closing balance sheet				Closing balance sheet			
A			L	A			L
	AF.3	60		AF.2	x -10	AF.3	30
				AF.3	40		

VII.4.4.4 Standardised guarantees: case with no fees charges by government

Government grants a guarantee to loans granted by some financial institutions (No fee charged by government – government is not acting on commercial basis and should fees be perceived, they would at the best cover only administrative costs).

At inception of the loans, government set up a liability AF.66 on the basis of an estimated expectation that 20% of the loans will result in a cost of 20 for government for any granted

amount of 100. (For simplification, the costs of production of such guarantee are here considered as nil.)

GG				FI			
Opening balance sheet				Opening balance sheet			
A			L	A			L
						0	
Non-financial account				Non-financial account			
U			R	U			R
		D.9	-20			D.9	20
B.9	-20			B.9	+20		
Financial account				Financial account			
ΔA			ΔL	ΔA			ΔL
		F.66	+20	F.2	-100		
				F4	+100		
		B.9	-20	F.66	+20		
						B.9F	+20
Closing balance sheet				Closing balance sheet			
A			L	A			L
		AF.66	20	AF.66	20		
				AF.4	100		

On year n, there is a call of guarantee due to debtor default (here of 20); government issues bond for the needed cash

GG				FI			
Opening balance sheet				Opening balance sheet			
A			L	A			L
		AF.66	20	AF66	20		
				AF4	100		

Non-financial account				Non-financial account			
U		R		U		R	
Financial account				Financial account			
ΔA		ΔL		ΔA		ΔL	
F2	-20	F.66	-20	F.2	+20		
		B.9F	0	F.66	-20		
						B.9F	+ 0
OCV				OCV			
A		L		A		L	
				AF.4	-20		
Closing balance sheet				Closing balance sheet			
A		L		A		L	
				AF.4	80		

VII.5 Keywords and accounting references

Debt assumption, debt cancellation, write-off	ESA10, 5.36-39, 6.14
Other capital transfer	ESA10, 4.164-167
Contingent asset / liability	ESA10, 5.08-11

Annex 1 Legal texts (references and links)

They can be found here

http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/legal_instruments

European System of Accounts 2010 (ESA10)

[Regulation \(EU\) No 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the European Union](#)

Excessive Deficit Procedure - Statistics

[Council Regulation 479/2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community](#)

[Council Regulation \(EU\) No 679/2010 of 26 July 2010 amending Regulation \(EC\) No 479/2009 as regards the quality of statistical data in the context of the excessive deficit procedure](#)

Other documents

[Code of best practice](#)

[Administrative arrangements](#)

Annex 2 EDP Notification tables

Reporting of Government Deficits and Debt Levels in accordance with Council Regulation (EC) N° 479/2009 and the Statements contained in the Council minutes of 22/11/1993

Set of reporting tables as endorsed by the CMFB on 06/08/2009.

Member state: XXXX

Date: XX/XX/2010

The information is to be provided in the cover page only

Table 1: Reporting of government deficit/surplus and debt levels and provision of associated data.

Tables 2A to 2D: Provision of the data which explain the transition between the national definitions of government balance and the deficit/surplus (EDP B.9) of each government sub-sector.

Tables 3A to 3E: Provision of the data which explain the contributions of the government deficit/surplus and the other relevant factors to the variation in the government debt level, and the consolidation of debt (general government and general government subsectors).

Table 4: Provision of other data in accordance with the statements contained in the Council minutes of 22/11/1993.

Yellow cells: compulsory detail; green cells: automatic compilation; blue cells: voluntary detail.

Not applicable: M ; Not available: L

Table 1: Reporting of government deficit/surplus and debt levels and provision of associated data

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	ESA 95 codes	2006	2007	Year 2008	2009	2010
		(1)	(1)	(1)	(1)	planned
Net borrowing (-)/ net lending (+)	EDP B.9					
General government	S.13					
- Central government	S.1311					
- State government	S.1312					
- Local government	S.1313					
- Social security funds	S.1314					
		(1)	(1)	(1)	(1)	planned
General government consolidated gross debt						
Level at nominal value outstanding at end of year						
<i>By category:</i>						
Currency and deposits	AF.2					
Securities other than shares, exc. financial derivatives	AF.33					
Short-term	AF.331					
Long-term	AF.332					
Loans	AF.4					
Short-term	AF.41					
Long-term	AF.42					
General government expenditure on:						
Gross fixed capital formation	P.51					
Interest (consolidated)	EDP D.41					
<i>p.m.: Interest (consolidated)</i>	D.41 (uses)					
Gross domestic product at current market prices	B.1*g					

(1) Please indicate status of data: estimated, half-finalized, final.

Table 2A: Provision of the data which explain the transition between the public accounts budget balance and the central government deficit/surplus

	Year				
	2006	2007	2008	2009	2010
Member state: XXXX					
Data are in ...(millions of units of national currency)					
Date: XX/XX/2010					
Working balance in central government accounts					
<i>Basis of the working balance</i>	(1)	(1)	(1)	(1)	(1)
Financial transactions included in the working balance					
Loans, granted (+)					
Loans, repayments (-)					
Equities, acquisition (+)					
Equities, sales (-)					
Other financial transactions (+/-)					
of which: transactions in debt liabilities (+/-)					
Detail 1					
Detail 2					
Non-financial transactions not included in the working balance					
Detail 1					
Detail 2					
Difference between interest paid (+) and accrued (EDP D.41)(-)					
Other accounts receivable (+)					
Detail 1					
Detail 2					
Other accounts payable (-)					
Detail 1					
Detail 2					
Working balance (+/-) of entities not part of central government					
Net borrowing (-) or net lending (+) of other central government bodies					
Detail 1					
Detail 2					
Other adjustments (+/-) (please detail)					
Detail 1					
Detail 2					
Detail 3					
Detail 4					
Detail 5					
Net borrowing (-)/lending(+) (EDP B.9) of central government (S.1311)					
<i>(ESA 95 accounts)</i>					

(1) Please indicate accounting basis of the working balance: cash, accrual, mixed, other.
 Note: Member States can adapt tables 2A, B, C and D to their national specificity according to the established practice

Table 2B: Provision of the data which explain the transition between the working balance and the state government deficit/surplus

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year				
	2006	2007	2008	2009	2010
Working balance in state government accounts					
<i>Basis of the working balance</i>	(1)	(1)	(1)	(1)	
Financial transactions included in the working balance					
Loans (+/-)					
Equities (+/-)					
Other financial transactions (+/-)					
of which: transactions in debt liabilities (+/-)					
Detail 1					
Detail 2					
Non-financial transactions not included in the working balance					
Detail 1					
Detail 2					
Difference between interest paid (+) and accrued (EDP D.41)(-)					
Other accounts receivable (+)					
Detail 1					
Detail 2					
Other accounts payable (-)					
Detail 1					
Detail 2					
Working balance (+/-) of entities not part of state government					
Net borrowing (-) or net lending (+) of other state government bodies					
Detail 1					
Detail 2					
Other adjustments (+/-) (please detail)					
Detail 1					
Detail 2					
Detail 3					
Net borrowing (-)/lending(+) (EDP B.9) of state government (S.1312)					
<i>(ESA 95 accounts)</i>					

(1) Please indicate accounting basis of the working balance: cash, accrual, mixed, other.
Note: Member States can adapt tables 2A, B, C and D to their national specificity according to the established practice

Table 2C: Provision of the data which explain the transition between the working balance and the local government deficit/surplus

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year				
	2006	2007	2008	2009	2010
Working balance in local government accounts					
<i>Basis of the working balance</i>	(1)	(1)	(1)	(1)	
Financial transactions included in the working balance					
Loans (+/-)					
Equities (+/-)					
Other financial transactions (+/-)					
of which: transactions in debt liabilities (+/-)					
<i>Detail 1</i>					
<i>Detail 2</i>					
Non-financial transactions not included in the working balance					
<i>Detail 1</i>					
<i>Detail 2</i>					
Difference between interest paid (+) and accrued (EDP D.41)(-)					
Other accounts receivable (+)					
<i>Detail 1</i>					
<i>Detail 2</i>					
Other accounts payable (-)					
<i>Detail 1</i>					
<i>Detail 2</i>					
Working balance (+/-) of entities not part of local government					
Net borrowing (-) or net lending (+) of other local government bodies					
<i>Detail 1</i>					
<i>Detail 2</i>					
Other adjustments (+/-) (please detail)					
<i>Detail 1</i>					
<i>Detail 2</i>					
<i>Detail 3</i>					
Net borrowing (-)/lending(+) (EDP B.9) of local government (S.1313)					
<i>(ESA 95 accounts)</i>					

(1) Please indicate accounting basis of the working balance: cash, accrual, mixed, other.

Note: Member States can adapt tables 2A, B, C and D to their national specificity according to the established practice

Table 2D: Provision of the data which explain the transition between the working balance and the social security deficit/surplus

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year				
	2006	2007	2008	2009	2010
Working balance in social security accounts					
<i>Basis of the working balance</i>	(1)	(1)	(1)	(1)	
Financial transactions included in the working balance					
Loans (+/-)					
Equities (+/-)					
Other financial transactions (+/-)					
of which: transactions in debt liabilities (+/-)					
<i>Detail 1</i>					
<i>Detail 2</i>					
Non-financial transactions not included in the working balance					
<i>Detail 1</i>					
<i>Detail 2</i>					
Difference between interest paid (+) and accrued (EDP D.41)(-)					
Other accounts receivable (+)					
<i>Detail 1</i>					
<i>Detail 2</i>					
Other accounts payable (-)					
<i>Detail 1</i>					
<i>Detail 2</i>					
Working balance (+/-) of entities not part of social security funds					
Net borrowing (-) or net lending (+) of other social security bodies					
<i>Detail 1</i>					
<i>Detail 2</i>					
Other adjustments (+/-) (<i>please detail</i>)					
<i>Detail 1</i>					
<i>Detail 2</i>					
<i>Detail 3</i>					
Net borrowing (-)/lending(+) (EDP B.9) of social security (S.1314)					
<i>(ESA 95 accounts)</i>					

(1) Please indicate accounting basis of the working balance: cash, accrual, mixed, other.

Note: Member States can adapt tables 2A, B, C and D to their national specificity according to the established practice

Table 3A: Provision of the data which explain the contributions of the deficit/surplus and the other relevant factors to the variation in the debt level (general government)

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year			
	2006	2007	2008	2009
Net borrowing(+)/lending(-)(EDP B.9) of general government (S.13)*				
Net acquisition (+) of financial assets ⁽²⁾	0	0	0	0
Currency and deposits (F.2)				
Securities other than shares (F.3)				
Loans (F.4)				
Increase (+)				
Reduction (-)				
Short term loans (F.41), net				
Long-term loans (F.42)				
Increase (+)				
Reduction (-)				
Shares and other equity (F.5)				
Portfolio investments, net ⁽²⁾				
Shares and other equity other than portfolio investments				
Increase (+)				
Reduction (-)				
Other financial assets (F.1, F.6 and F.7)				
Adjustments ⁽³⁾	0	0	0	0
Net incurrence (-) of liabilities in financial derivatives (F.34)				
Net incurrence (-) of other liabilities (F.5, F.6 and F.7)				
Issuances above(-)/below(+) nominal value				
Difference between interest (EDP D.41) accrued(-) and paid ⁽⁴⁾ (+)				
of which: interest flows attributable to swaps and FRAs				
Redemptions of debt above(+)/below(-) nominal value				
Appreciation(+)/depreciation(-) ⁽³⁾ of foreign-currency debt ⁽⁵⁾				
Changes in sector classification (K.12.1) ⁽⁵⁾ (+/-)				
Other volume changes in financial liabilities (K.7, K.8, K.10) ⁽⁵⁾ (-)				
Statistical discrepancies				
Difference between capital and financial accounts (B.9-B.9f)				
Other statistical discrepancies (+/-)				
Change in general government (S.13) consolidated gross debt ^(1,2)				

*Please note that the sign convention for net borrowing / net lending is different from tables 1 and 2.

(1) A positive entry in this row means that nominal debt increases, a negative entry that nominal debt decreases.
(2) Consolidated within general government.
(3) Due to exchange-rate movements.

(4) Including capital uplift
(5) AF.2, AF.33 and AF.4. At face value.

Table 3B: Provision of the data which explain the contributions of the deficit/surplus and the other relevant factors to the variation in the government debt level and the consolidation of debt (central government)

Member state: XXXX Data are in ... (millions of units of national currency) Date: XX/XX/2010	Year			
	2006	2007	2008	2009
Net borrowing(+)/lending(-)(EDP B.9) of central government (S.1311)*				
Net acquisition (+) of financial assets ⁽²⁾	0	0	0	0
Currency and deposits (F.2)				
Securities other than shares (F.3)				
Loans (F.4)				
Increase (+)				
Reduction (-)				
Short term loans (F.41), net				
Long-term loans (F.42)				
Increase (+)				
Reduction (-)				
Shares and other equity (F.5)				
Portfolio investments, net ⁽²⁾				
Shares and other equity other than portfolio investments				
Increase (+)				
Reduction (-)				
Other financial assets (F.1, F.6 and F.7)				
Adjustments ⁽³⁾	0	0	0	0
Net incurrence (-) of liabilities in financial derivatives (F.34)				
Net incurrence (-) of other liabilities (F.5, F.6 and F.7)				
Issuances above(-)/below(+) nominal value				
Difference between interest (EDP D.41) accrued(-) and paid ⁽⁴⁾ (+) of which: interest flows attributable to swaps and FRAs				
Redemptions of debt above(+)/below(-) nominal value				
Appreciation(+)/depreciation(-) ⁽³⁾ of foreign-currency debt ⁽⁵⁾				
Changes in sector classification (K.12.1) ⁽⁵⁾ (+/-)				
Other volume changes in financial liabilities (K.7, K.8, K.10) ⁽⁵⁾ (-)				
Statistical discrepancies				
Difference between capital and financial accounts (B.9-B.9f)				
Other statistical discrepancies (+/-)				
Change in central government (S.1311) consolidated gross debt ^(1, 2)				
Central government contribution to general government debt (a=b-c) ⁽³⁾				
Central government gross debt (level) (b) ^(2, 5)				
Central government holdings of other subsectors debt (level) (c) ⁽⁵⁾				
*Please note that the sign convention for net borrowing / net lending is different from tables 1 and 2.				

(1) A positive entry in this row means that nominal debt increases, a negative entry that nominal debt decreases.

(2) Consolidated within central government.

(3) Due to exchange-rate movements.

(4) Including capital uplift

(5) AF.2, AF.33 and AF.4. At face value.

Table 3C: Provision of the data which explain the contributions of the deficit/surplus and the other relevant factors to the variation in the debt level and the consolidation of debt (state government)

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year			
	2006	2007	2008	2009
Net borrowing(+)/lending-(EDP B.9) of state government (S.1312)*				
Net acquisition (+) of financial assets ⁽²⁾	0	0	0	0
Currency and deposits (F.2)				
Securities other than shares (F.3)				
Loans (F.4)				
Increase (+)				
Reduction (-)				
Short term loans (F.41), net				
Long-term loans (F.42)				
Increase (+)				
Reduction (-)				
Shares and other equity (F.5)				
Portfolio investments, net ⁽²⁾				
Shares and other equity other than portfolio investments				
Increase (+)				
Reduction (-)				
Other financial assets (F.1, F.6 and F.7)				
Adjustments ⁽²⁾	0	0	0	0
Net incurrence (-) of liabilities in financial derivatives (F.34)				
Net incurrence (-) of other liabilities (F.5, F.6 and F.7)				
Issuances above(-)/below(+) nominal value				
Difference between interest (EDP D.41) accrued(-) and paid ⁽⁴⁾ (+) of which: interest flows attributable to swaps and FRAs				
Redemptions of debt above(+)/below(-) nominal value				
Appreciation(+)/depreciation(-) ⁽³⁾ of foreign-currency debt ⁽⁵⁾				
Changes in sector classification (K.12.1) ⁽⁵⁾ (+/-)				
Other volume changes in financial liabilities (K.7, K.8, K.10) ⁽⁵⁾ (-)				
Statistical discrepancies				
Difference between capital and financial accounts (B.9-B.9f)				
Other statistical discrepancies (+/-)				
Change in state government (S.1312) consolidated gross debt ^(1, 2)				
State government contribution to general government debt (a=b-c) ⁽⁵⁾				
State government gross debt (level) (b) ^(2, 5)				
State government holdings of other subsectors debt (level) (c) ⁽⁵⁾				
*Please note that the sign convention for net borrowing / net lending is different from tables 1 and 2.				

(1) A positive entry in this row means that nominal debt increases, a negative entry that nominal debt decreases.

(2) Consolidated within state government.

(3) Due to exchange-rate movements.

(4) Including capital uplift

(5) AF.2, AF.33 and AF.4. At face value.

Table 3D: Provision of the data which explain the contributions of the deficit/surplus and the other relevant factors to the variation in the debt level and the consolidation of debt (local government)

	Year			
	2006	2007	2008	2009
Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010				
Net borrowing(+)/lending(-)(EDP B.9) of local government (S.1313)*				
Net acquisition (+) of financial assets ⁽²⁾	0	0	0	0
Currency and deposits (F.2)				
Securities other than shares (F.3)				
Loans (F.4)				
Increase (+)				
Reduction (-)				
Short term loans (F.41), net				
Long-term loans (F.42)				
Increase (+)				
Reduction (-)				
Shares and other equity (F.5)				
Portfolio investments, net ⁽²⁾				
Shares and other equity other than portfolio investments				
Increase (+)				
Reduction (-)				
Other financial assets (F.1, F.6 and F.7)				
Adjustments ⁽²⁾	0	0	0	0
Net incurrence (-) of liabilities in financial derivatives (F.34)				
Net incurrence (-) of other liabilities (F.5, F.6 and F.7)				
Issuances above(-)/below(+) nominal value				
Difference between interest (EDP D.41) accrued(-) and paid ⁽⁴⁾ (+) of which: interest flows attributable to swaps and FRAs				
Redemptions of debt above(+)/below(-) nominal value				
Appreciation(+)/depreciation(-) ⁽³⁾ of foreign-currency debt ⁽⁵⁾				
Changes in sector classification (K.12.1) ⁽⁵⁾ (+/-)				
Other volume changes in financial liabilities (K.7, K.8, K.10) ⁽⁵⁾ (-)				
Statistical discrepancies				
Difference between capital and financial accounts (B.9-B.9f)				
Other statistical discrepancies (+/-)				
Change in local government (S.1313) consolidated gross debt ^(1, 2)				
Local government contribution to general government debt (a=b-c) ⁽⁵⁾				
Local government gross debt (level) (b) ⁽⁵⁾				
Local government holdings of other subsectors debt (level) (c) ⁽⁵⁾				
*Please note that the sign convention for net borrowing / net lending is different from tables 1 and 2.				

(1) A positive entry in this row means that nominal debt increases, a negative entry that nominal debt decreases.
(2) Consolidated within local government.
(3) Due to exchange-rate movements.

(4) Including capital uplift
(5) AF.2, AF.33 and AF.4. At face value.

Table 3E: Provision of the data which explain the contributions of the deficit/surplus and the other relevant factors to the variation in the debt level and the consolidation of debt (social security funds)

Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year			
	2006	2007	2008	2009
Net borrowing(+)/lending(-)(EDP B.9) of social security funds (S.1314)*				
Net acquisition (+) of financial assets ⁽²⁾	0	0	0	0
Currency and deposits (F.2)				
Securities other than shares (F.3)				
Loans (F.4)				
Increase (+)				
Reduction (-)				
Short term loans (F.41), net				
Long-term loans (F.42)				
Increase (+)				
Reduction (-)				
Shares and other equity (F.5)				
Portfolio investments, net ⁽²⁾				
Shares and other equity other than portfolio investments				
Increase (+)				
Reduction (-)				
Other financial assets (F.1, F.6 and F.7)				
Adjustments ⁽³⁾	0	0	0	0
Net incurrence (-) of liabilities in financial derivatives (F.34)				
Net incurrence (-) of other liabilities (F.5, F.6 and F.7)				
Issuances above(-)/below(+) nominal value				
Difference between interest (EDP D.41) accrued(-) and paid ⁽⁴⁾ (+) of which: interest flows attributable to swaps and FRAs				
Redemptions of debt above(+)/below(-) nominal value				
Appreciation(+)/depreciation(-) ⁽³⁾ of foreign-currency debt ⁽⁵⁾				
Changes in sector classification (K.12.1) ⁽⁵⁾ (+/-)				
Other volume changes in financial liabilities (K.7, K.8, K.10) ⁽⁵⁾ (-)				
Statistical discrepancies				
Difference between capital and financial accounts (B.9-B.9f)				
Other statistical discrepancies (+/-)				
Change in social security (S.1314) consolidated gross debt ^(1, 2)				
Social security contribution to general government debt (a=b-c) ⁽⁵⁾				
Social security gross debt (level) (b) ^(2, 5)				
Social security holdings of other subsectors debt (level) (c) ⁽³⁾				
*Please note that the sign convention for net borrowing / net lending is different from tables 1 and 2.				

(1) A positive entry in this row means that nominal debt increases, a negative entry that nominal debt decreases.
(2) Consolidated within social security.
(3) Due to exchange-rate movements.

(4) Including capital uplift
(5) AF.2, AF.33 and AF.4. At face value.

Table 4: Provision of other data in accordance with the statements contained in the Council minutes of 22/11/1993.

Statement Number	Member state: XXXX Data are in ...(millions of units of national currency) Date: XX/XX/2010	Year				
		2006	2007	2008	2009	2010
		(1)	(1)	(1)	(1)	forecast
2	Trade credits and advances (AF.71 L)					
3	Amount outstanding in the government debt from the financing of public undertakings					
	<i>Data:</i>					
	<i>Institutional characteristics:</i>					
4	In case of substantial differences between the face value and the present value of government debt, please provide information on					
	i) the extent of these differences:					
	ii) the reasons for these differences:					
10	Gross National Income at current market prices (B.5*g)(2)					

(1) Please indicate status of data: estimated, half-finalized, final.
(2) Data to be provided in particular when GNI is substantially greater than GDP.

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