

Accrual of earnings on equity in the SNA

CAPITAL INJECTIONS, SUPERDIVIDENDS AND REINVESTED EARNINGS

Topic 1 of Working Group 2 —
Task Force on Harmonization of Public Sector Accounting (TFHPSA)

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Table of content

Capital Injections, Superdividends and Reinvested Earnings	1
Executive Summary	4
I. Context.....	4
II. Current statistical recording	5
A. The 1993 SNA	5
Dividends, subsidies and capital transfers	5
Subsidies and capital transfers	5
Debt assumption / cancellation	5
Dividends	6
Quasi-corporations.....	7
Reinvested earnings	7
Privatization	8
B. The ESA 1995 Manual on Government Deficit and Debt	8
The ESA 1995.....	8
The Manual on Government Deficit and Debt (MDD)	9
Dividend.....	9
Capital injection.....	9
Other issues.....	10
C. The GFSM 2001	11
Distribution to government.....	11
Injection by government	12
Subsidies and other expenses.....	12
Debt assumption, cancellation, guarantees	12
Public corporations net worth.....	12
Debt operations and notion of effective claim.....	13
D. Conclusions.....	14
III. Accounting Rules.....	15
A. Terminology and consolidation rules in GAAP.....	15

Notion of accounting consolidation.....	15
Impact on the accrual of earnings of the subsidiary/associate.....	17
Analogy with statistics.....	18
IV. Reinvested earning.....	19
A. The SNA recording for reinvested earning.....	19
B. Conceptual attraction.....	19
C. How it would work.....	20
Basic description.....	20
More complete numerical example.....	21
Additional choices to make.....	23
D. GFS interest.....	23
Compelling reasons.....	23
Difficulties.....	24
Compilation difficulties.....	24
Artificial construct.....	24
Impact on the accounts.....	25
E. Rest of the SNA.....	25
Extension to all instruments and all sectors.....	25
Extension to other sectors <u>or</u> to other instruments.....	26
F. Threshold versus across the board generalization.....	26
V. Conclusion.....	28
Recommendation 1: need for additional SNA entries.....	28
Recommendation 2: two options for the SNA review.....	28
Option 1: Expanding on and strengthening current rule.....	28
Option 2: Applying reinvested earning.....	28

Acronyms

BOP	Balance of Payment
DFI	direct foreign investments
<i>ESA 1995</i>	<i>European system of accounts 1995</i>
<i>GFSM 2001</i>	<i>Government Finance Statistics Manual 2001</i>
MDD	<i>ESA 1995 Manual on Government Deficit and Debt</i>
ROW	Rest of the world
<i>1993 SNA</i>	<i>1993 System of National Accounts</i>

SNA categories

B.2	operating surplus
B.9	net lending / net borrowing
D.3	subsidies
D.319	other subsidies on products
D.41	interest
D.42	distributed income of corporations
D.421	dividends
D.422	withdrawals from income of quasi-corporations

D.43	reinvested earnings on direct foreign investments
D.9	capital transfers
D.99	other capital transfer
AN	non-financial assets
F.2	currency and deposits
F.3	securities other than shares
F.5	shares and other equity
K.11	nominal holding gains/losses (revaluation)

EXECUTIVE SUMMARY

SEE DOCUMENT ATTACHED

I. CONTEXT

1. The relationship between public corporations and governments is a cause of concern for statistical recording, and more generally between corporations (and quasi-corporations) and their controlling shareholders: this raises the question of the **income—revaluation boundary**.
2. The issue is the classification of lump sums paid by Government to public corporations or the reverse.
 - a. Governments seek to classify lump sums paid by public corporations to government as revenue, because those are undistinguishable from dividends and have the attraction of improving, at will, the balance of the period. However, such lump sums do not meet the revenue test, as the net worth of government is left unchanged: other things being equal, the value of the public corporations falls by the same amount. The lump sums are fundamentally portfolio-reshuffling events: they are financial transactions.
 - b. Governments seek to classify lump sums paid to public corporations as financial transactions, because such recapitalization is net worth neutral and does not meet the expense test. However, such a recapitalization occurs because the government lets public corporations incur regular losses that are not covered by subsidies of similar size during the period. It is suggested that strict criteria be applied, failing which, capital injections would be recorded as transfers (expenses). However, an accrual system would seemingly require that those losses be booked at time they accrued, not at time they are covered or financed.
3. Such recordings implicitly rely on **an asymmetric set of rules**, where lump sums paid by government are generally expensed but those received are financial transactions, whilst **both are in fact net worth neutral**. It seems that many statisticians would be willing to support such an asymmetric rule in order to prevent abusive recordings.
4. More generally, the question arises as to what is the true originator of the revenue or expense for government.
5. Specific rules may be required for indirect privatizations, for relationships with central banks, and lump sums in kind. In addition, operations may involve public corporations' debt cancellations or assumptions.

6. Public corporations are those corporations that are controlled by government, directly or indirectly. Control is generally established with 50% ownership, but sometimes can be exercised by other means, such as special legislation. Control is established directly or indirectly.

7. An important and interesting case is where the government is the sole owner. The presumption is therefore that the relationship between the 100%-owner and its subsidiary is unencumbered with other considerations due to minority shareholders. Transactions between them are therefore not necessarily at arms length.

II. CURRENT STATISTICAL RECORDING

A. The 1993 SNA

8. The 1993 SNA is rather not very prescriptive as to the treatment of transactions between government and its public corporations in general. However, interestingly, the 1993 SNA has comparatively longer texts on quasi-corporations and direct investments.

Dividends, subsidies and capital transfers

Subsidies and capital transfers

9. SNA 10.141 foresees recording as other capital transfer (D.99) transfers from government units to publicly or privately owned enterprises to cover large operating deficits accumulated over two or more years.

10. SNA 7.78c. foresees that regular transfers paid to public corporations which are intended to compensate for persistent losses—i.e. negative operating surpluses (B.2)—which they incur on their productive activities as a result of charging prices which are lower than their average cost of production as a matter of deliberate government economic and social policy, be recorded under D.319 *Other subsidies on products*.

11. Hence, public corporations that run quasi-fiscal activities impact government expense at time of transfer of funds, instead of at time the event occurs, which seems clearly not in line with the accrual principle. The classification as subsidy (D.3) or as capital transfer (D.9) depends on the frequency of the event, which seems somehow odd. The classification under *subsidies on products* instead of on *production* may also be debatable (with an impact on GDP).

Debt assumption / cancellation

12. Government may have lent funds to its public corporation and may later decide to cancel the loan (debt cancellation). Government may also assume loans granted by a third party to public corporations, when the latter cannot repay it (debt assumption).

13. SNA 10.139 and 12.52 indicate that debt cancellation by mutual agreement is treated as a capital transfer. It remains silent on the definition of mutual agreement and on possible different treatment for units with equity links.

Dividends

14. The 1993 SNA does not particularly or specifically suggest whether D.42 *Distributed income of corporations* ought to be limited to a specific amount. Dividends are a form of property income to which shareholders become entitled as the result of placing funds at the disposal of corporations (SNA 7.113). SNA 7.114 indicates that “it encompasses all distribution of profits by whatever name they are called”, underlying the usual substance over form position of the 1993 SNA, but also emphasizing the reference to “profit” (SNA 7.117 too).

15. However, SNA 7.114 mysteriously indicates that whilst “dividends may occasionally take the form of an issue of shares”, “issue of bonus shares which represent the capitalization of own funds in the form of reserves and undistributed profits are not included.” This could be interpreted as suggesting that the same event: the distribution of shares to shareholders is treated differently when the intention is to distribute the profit of the year from when there is distribution of reserves. More satisfactorily, ESA 4.54 and 5.93 clarifies that “bonus shares” are remittance of new shares to shareholders **in proportion to their holdings**. Usefully, ESA 5.93 refers to splits, which by the same token are not transactions (ESA 6.56 prescribes that possible increases in market value due to split, owing to liquidity considerations, are revaluations).

16. The 1993 SNA does not mention shares and other equity in the Revaluation chapter, and does not discuss the fact that the observed fall in values on the market in quoted share on the day of the distribution of a dividend is recorded as a revaluation (K.11) rather than a transaction. It is however debatable whether such a fall in value represent a price change (what price did change?) instead of a volume change. SNA 3.99 recognizes that “the level of dividend is not unambiguously attributable to a particular earning period....”

17. In addition, SNA 8.15 indicates that in the economic literature “income is often defined as the maximum amount that a household, or other unit, can consume without reducing its real net worth” and that “disposable income is better interpreted in a narrower sense as the maximum amount that a household or other unit can afford to spend on goods or services during the accounting period without having to finance its expenditure by reducing its cash, by disposing of other financial or non-financial assets or by increasing its liabilities”.

18. Interestingly, SNA 7.93 defines D.41 Interest, a type of property income, as “the amount that the debtor becomes liable to pay to the creditor over a period of time without reducing the amount of principal outstanding”.

Quasi-corporations

19. Quasi-corporations are unincorporated entities or enterprises that function as if they were corporations (SNA 4.49), even though they do not formally meet the institutional unit definition spelt out in SNA 4.2. To be a quasi-corporation, full sets of accounts must be available. The equity stake of the owner in the quasi-corporation is such that the net worth of the latter is always zero (SNA 13.73).

20. Property income is the income receivable from a financial asset in return for providing funds (SNA 7.88). The income that the owner of quasi-corporations withdraws from them is analogous to the income withdrawn from corporations by paying out dividends to their shareholder (SNA 7.89).

21. SNA records the property income received by the owners of quasi corporations within a separate subcategory D.422 *Withdrawal from income of quasi-corporations* of the category D.42 *Distributed income of corporations*, separate from D.421 *Dividends*.

22. SNA indicates that the amount recorded under D.422 has to be explicitly identifiable (SNA 7.116) and that it will depend largely on the size of the entrepreneurial income (SNA 7.117).

23. D.422 excludes withdrawal of funds realized by the sale or disposal of the quasi-corporations assets or of large amounts of accumulated of retained earnings, or other reserves (SNA 7.118).

24. Conversely, funds provided by the owner for the purpose of acquiring assets or reducing liabilities should be treated as transaction in equity, unless it is to cover persistent operating deficits as a matter of deliberate government economic and social policy (SNA 7.118).

25. In conclusion, for quasi-corporations, the *1993 SNA* explicitly prescribes retreating superdividends as financial transactions, and capital injections designed to cover losses as capital transfers.

Reinvested earnings

26. The *1993 SNA* foresees (in line with the *Balance of Payments Manuals*) a specific treatment of property income on equity stakes / shares held in the form of direct foreign investments (DFI). A DFI enterprise is where a foreign investor owns a sufficient stake in a corporation to have an effective voice in its management (SNA 7.119). SNA 14.152 defines DFI as an “incorporated or unincorporated enterprise in which an investor ... owns 10% or more of the ordinary shares or voting power ... or the equivalent...”.

27. The system requires that retained earnings of a DFI be treated as if they were distributed to the foreign direct investors and then reinvested back (SNA 7.120).

28. The rationale is that since a direct foreign investment enterprise is subject to control or influence by a foreign direct investor, the decision to retain some of its earnings within the enterprise must represent a conscious deliberate investment decision on the part of the foreign direct investor (SNA 7.121).

Privatization

29. Cash receipts resulting from the disposal of equity stakes in public corporations being privatized are recorded as transaction in equity (F.5)—below the line. However, the disposal by government of non-financial assets (AN.) reduces net lending / net borrowing (B.9).

B. The ESA 1995 Manual on Government Deficit and Debt

30. Whilst the ESA 1995 is an adaptation of the 1993 SNA, with minimal departures, the Eurostat *ESA 1995 Manual on Government Deficit and Debt* (MDD) has developed a substantial jurisprudence to the effect of providing reasonably solid guidance in the context of the European fiscal multilateral surveillance arrangement (Excessive Deficit Procedure).

The ESA 1995

31. The ESA 1995 retains a similar, if not identical, approach to that followed in *1993 SNA*.

32. Noteworthy differences are [to be completed]:

- ESA 6.27d indicates that when the debtor unit is controlled by the creditor unit “the writing-off or writing-down of debt not due to bankruptcy is recorded in the accumulation accounts” as a capital transfer (instead of an other change in volume). Hence, this paragraph adds the control criteria for deciding on the classification of flows. It would be interesting to see whether such a criteria would be extended to debt assumptions.
- ESA 4.58 refers to “trading profit” instead of “entrepreneurial income” and ESA 5.61 mentions “withdrawal of capital” defined as partial or total liquidation of one’s equity to be treated as “withdrawal from equity in the financial account”.

33. In addition specific treatments for debt assumption / debt cancellation are provided. ESA 4.165f specifically mentions debt assumptions in addition to debt cancellation. Further it prescribes:

- a. Recording the event as a financial transaction when the beneficiary is a quasi-corporation or when it is a public corporation taking part of an ongoing process of privatization to be achieved in a short-term perspective.
- b. Recording the event as an Other change in volume, when the beneficiary disappears.

34. ESA 4.165g specifically indicates that proceeds of indirect privatization, whereby a public corporation sells whole or part of a subsidiary and forwards the proceeds to government, are treated as a financial transaction (F.5) instead as a capital transfers (D.9).

The Manual on Government Deficit and Debt (MDD)

35. Whilst the ESA 1995 is a legal act (a European Parliament and Council Regulation), the MDD has no specific legal status. However, the MDD is particularly important in Europe as far as it lays a body of rules, established by Eurostat, which intends to provide an interpretation of ESA 1995 to compilers.

36. Ninety-six pages of the MDD (or nearly half of the 243 pages of the Manual) are dedicated to its Part II *Relation between the government and public enterprises*. The chapters are:

- II.1 Overview of Principle
- II.2 Sales of assets (privatization)
- II.3 Capital Injection
- II.4 Government and public enterprise debt
- II.5 Government and the financial sector

Dividend

37. The MDD indicates that “it is understood that streams of payments made by an enterprise to its owner from its income should keep its net assets constant” (II.1.1.4.a). The “resources from which the dividends have to be paid should neither include the proceeds of sales of assets nor the revaluation gains.” “Revaluation proceeds as well as assets sale’s proceeds are not distributable as income.” While dividend smoothing is legitimate, a “large and exceptional payment out of reserves—significantly reducing the own funds of the corporation—is different. It should rather be treated as transaction in shares and other equity (capital withdrawal).” (II.1.1.4.b).

38. The MDD concludes in II.1.2.1: “Dividends arise from the government ownership of the unit. They, apply to payments 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, even if they are called dividend.” “Withdrawal of equity 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 realized capital gains.”

Capital injection

39. Capital injections refer to situations where the owner “recapitalizes” its enterprise by way of transferring assets or discharging it from its liabilities. The central question is whether the capital injection should be booked as a capital transfer (expense) or as an equity injection (transaction in equity). The MDD chapter II.3 focuses on this sole aspect.

40. When the government, acting for public policy purposes, provides funds to a corporation without receiving financial assets and without expecting property income, the capital injection is to be recorded as a capital transfer. II.3.1.2

41. When the government, acting as a shareholder, provides funds receiving financial assets and expecting dividends in return, the capital injection is to be recorded as a financial transaction in shares and other equity. II.3.1.2

42. A capital injection made to cover expected future losses, as well as repetitive losses, should be recorded as capital transfer (D.9), even if shares (or equivalent) are issued. II.3.1.2.3. This statement enforces the substance over form approach taken by the 1993 SNA.

Other issues

Central banks

43. The MDD clarifies that lump sum payments, in excess of operational margins, by Central banks to government should be recorded as capital withdrawal (or equity withdrawal), not as government revenue.

44. Central banks earn most of their operating profits from the difference between the interest received on their assets (foreign reserves and lending to the banking sectors or government) and the interest paid on their liabilities (banknotes (zero interest), banks' deposits, and sometimes foreign borrowing). The net result of those operations, also net of operating costs, is the amount distributable under dividend (D.42).

45. Quite separately, Central banks net reserve assets positions, such as gold or foreign exchange, have tended to generate holding gains over time (for those countries with higher inflation than the inflation observed in countries whose liabilities constitute others countries' reserve assets). Those gains are often booked as "reserves" in Central banks accounts. The MDD indicates that lump sum payments corresponding to the distribution of those reserves, regularly or irregularly, or to the distribution of the proceeds of the sale of those assets, is to be treated as a financial transaction. II.5.1.2-a and -b.

46. The MDD indicates that the amounts distributed by Central banks to government in excess of the amounts distributable (as measured above) are to be recorded as a financial transaction (II.5.2.c).

Indirect privatization

47. The MDD clarifies that in cases where public holdings keep privatization proceeds to engage into expenses of a government nature: to "support loss making activities as part of government economic and social policy" or to "give grants and subsidies outside the group", transaction should be rerouted via government accounts.

C. The *GFSM 2001*

48. The *GFSM 2001* generally aligns on the *1993 SNA*, although it may at time incorporate additional guidance and rarely deviations. The IMF Government Finance Division intends to provide additional guidance notes to be regrouped in the form of a Companion Material.

Distribution to government

49. GFSM 5.87 and 6.74 specifically and explicitly recognize the important boundary between dividend (non financial transactions, i.e. government revenue) and capital withdrawal (financial transaction, i.e. financing) and the fact that dividends distribute the income of the period, exclusive of holding gains and losses of the year or of the distribution of previous years income (distribution of reserves). A tolerance is provided for cases where dividend payments are smoothed by the corporations and may exceed the income of the period. The GFSM 5.87 states: “When payments are received from public corporations, it can be difficult to decide whether they are dividends or withdrawals of equity. Dividends are payments a corporation makes out of its current income, which is derived from its ongoing productive activities. A corporation may, however, smooth the dividends it pays from one period to the next so that in some periods it pays more in dividends than it earns from its productive activities. Such payments are still dividends. Distributions by corporations to shareholders of proceeds from privatization receipts and other sales of assets and large and exceptional one-off payments based on accumulated reserves or holding gains are withdrawals of equity rather than dividends.”

50. GFSM 10.17 recognizes that distribution of dividends reduces the net value of corporations (improperly called net worth in this paragraph), to be recorded as a holding loss. (revaluation account).

51. GFSM 9.38 prescribes the recording of privatization¹ proceeds direct or indirect as financial transactions.

52. Interestingly, GFSM 9.35 indicates that the disposal of whole government units is also booked as a transaction in equity, on presumption that a quasi-corporation was constituted just immediately prior the sale. “Government units also can be privatized. If the assets disposed of as a single transaction constitute a complete institutional unit, the transaction should be classified as a sale of equity. The government is assumed to have converted the unit to a quasi-corporation immediately prior to disposal by means of a reclassification of assets, which is an other economic flow. If the assets disposed of do not

¹ Privatization is sometimes reserved for disposals of (controlling) equity stakes by government in public corporations (see the entry “privatization” in the ECB Monthly Bulletin Statistical Annex Table 6.3.2). Sometimes, it extends to the disposal of government non-financial assets, which then requires possibly different recordings.

constitute a complete institutional unit, then the transactions should be classified as a disposal of the individual nonfinancial and/or financial assets.”

Injection by government

53. The *GFSM 2001* does not refer to capital injections as such, nor to recapitalization. However, it provides guidance on the recording of transfers of resources from government to public corporations.

Subsidies and other expenses

54. GFSM 6.61, 6.57 and 4.30 indicate that transfers intended to compensate for operating losses are recorded as subsidies, unless they cover losses accumulated for two years or more in which case they are recorded as other expense. GFSM 4.30 states: “***Subsidies*** are current transfers that government units pay to enterprises either on the basis of the levels of their production activities or on the basis of the quantities or values of the goods or services that they produce, sell, or import. Included are transfers to public corporations and other enterprises that are intended to compensate for operating losses.” Transfers of funds to public corporations designed to facilitate public investment are recorded as other expense, according to footnote 17 of Chapter 4. GFSM 6.60: “Subsidies also include transfers to public corporations and quasi-corporations to compensate for losses they incur on their productive activities as a result of charging prices that are lower than their average costs of production as a matter of deliberate government economic and social policy. If such losses have been accumulated over two or more years, the payments are classified as *miscellaneous other capital expense* (2822).” GFSM 6.57: “Payments to enterprises to finance their capital formation, to compensate them for damage to non-financial assets, or to cover large operating deficits accumulated over two or more years are *miscellaneous other capital expense* (2822).”

55. “Regular transfers to quasi-corporations to cover persistent operating deficits are subsidies, and regular withdrawals from the income of quasi-corporations are property income”(GFSM 9.36).

Debt assumption, cancellation, guarantees

Public corporations net worth

56. To start with, it is worth noting that GFSM 7.140 suggests that the net worth of public corporations other than those that are quoted should be set at zero: their equity liability should be set equal to their net assets. This treatment extends the 1993 *SNA* treatment for quasi-corporations to such public corporations. GFSM 10.19 concludes “that the holding gain is equal to the change in the total value of this measure of the equity, taking into account additions to and withdrawals from equity that may have occurred.”

57. An essential consequence is that operations between government and the public corporations tend to lead to automatic changes in equity positions. The question is then: does such a change arise from a transaction or from a revaluation?

Debt operations and notion of effective claim

58. The Appendix II of the *GFSM 2001* focuses on debt operations, including guarantees, debt assumption, debt cancellation, and debt for equity swaps. Public corporations can be the beneficiary of such events.

59. Appendix II puts an emphasis on the “claim” that government received in exchange for the debt operation in question, and whether the claim is “effective” or not. The claim is “effective” when “there is a realistic probability that it will be paid” (Appendix II #5) or will yield benefits in future. When an effective claim is acquired, the claim is recognized on balance sheet by way of transaction: the event is a financial transaction for government and does not give rise to an expense. Otherwise the event is expensed. The question is complicated on account of who is the beneficiary.

60. Whence the beneficiary is a private corporation, a debt operation gives rise to an expense when:

- Government does not acquire claim: government exchanged something against nothing and its net worth has decreased.
- Government acquires a claim that is not effective: the net worth has also decreased because the market value of that claim is minimal or even zero.

It is worth noting that in both cases the net worth of the corporation has increased.

61. When the beneficiary is a public corporation (100% owned), such debt operations are neutral for government, as the increased value of the beneficiary just exactly and automatically compensates for the adverse impact of the debt operation in government accounts. Should the event be expensed?

62. Appendix II is not completely clear (when no effective claim is acquired):

- (a) In the case of debt assumption², “the assumption amounts to an increase in the equity owned by government” when the beneficiary is an on-going public corporation,³ whilst it gives rise to a capital transfer when it is a bankrupt public corporation (para 6).

² Para 4 of the Appendix II restricts cases of debt assumptions to cases of activation of guarantees. This generally seems unnecessarily restrictive.

³ This sentence can either be generously interpreted as a tautology, which imparts no recommendation of recording regarding the flow in question; or it can be interpreted as

- (b) In the case of debt payments on behalf of other units, an expense (subsidy) is booked when the beneficiary is a corporation (para 8).
- (c) Debt forgiveness is the cancellation of debt by mutual agreement. It always involves an expense (Para 9).
- (d) Debt-for-equity swaps are cases where the abandoned debt is exchanged against an equity stake. The difference in market value between the debt and the equity stake is recorded as a transfer where a debt forgiveness took place, and is not expensed otherwise (para 15).
- (e) A write off without bilateral agreement, such as in case of bankruptcy or when a public corporation is insolvent and is liquidated, is recorded as an “Other economic flow” likely to be an other change in volume (para 12). A unilateral write down is treated similarly to a partial write off.

63. The rules set in the Appendix II seem not completely coherent with the core of the system or between themselves.

- (a) and (b) differ in expensing, whilst only the timing of the event differs.
- (a) and (e) differ in expensing for bankrupt corporations.
- (c) and (d) differ in expensing for the amount corresponding to the difference in market value between the acquired claim and the part of the debt that is not covered by a forgiveness arrangement.
- Whilst (b) and (c) are consistent with the subsidy and capital expense treatments seen in the core of the text, (a), (d) and (e) are not.

D. Conclusions

64. Statistical systems have tried to establish rules to the effect:

- a. of avoiding transforming holding gains into income as well as cherry picking the time of recording of government revenue; and
- b. of avoiding that quasi-fiscal operations be carried out without being expensed ever.

65. The jurisprudence established by Eurostat and the *GFSM 2001* has been reasonably successful in sketching broad principles designed to avoid undue fiscal beautification. However, this has not been an unmitigated success. A charge can be made of massive asymmetric bias and cherry picking:

- a. Asymmetry: the distributed profits are booked for the amount earned during the period—“too bad” for earlier undistributed profits. Injections are in contrast booked as expense more systematically and for the whole amount,

meaning that the change in quasi-corporation equity is a revaluation, which supposes that the debt assumption is not expensed.

even long time after the event (the loss). Injections in the form of debt operations are even recorded in various ways, opening the gates to substantial adverse statistical incentives.

- b. Cherry picking: injections are to be classified according to the expected performance, a judgment for which the statisticians may be ill-equipped.

66. Two other serious charges are that the rules do not tackle head-on two large deviations to the spirit of the system: accrual principle and the net worth neutrality of revenue/expense:

- a. Expense and revenues are defined as transactions that change the net worth (*GFSM 2001*). Nevertheless dividends from, and capital injections in, public corporations are net worth neutral: they are fundamentally in the nature of a financial transaction, decreasing (or increasing, respectively) the public corporation liquidity to the advantage (or to the disadvantage) of the government liquidity; they are not revenue/expense.
- b. The accrual principle suggests recording amounts at the time the underlying event occurs: dividends are distribution of profits, and superdividends are simply distribution of mainly past periods' profits to be recorded at time of profit earned (instead of at time of distribution). In the same vein, capital injection is deemed to cover for past losses and ought to be booked at time losses were incurred, not at time of recapitalization.

67. The next section looks at an alternative treatment which has the potential to redress those weaknesses.

III. ACCOUNTING RULES

A. Terminology and consolidation rules in GAAP

Notion of accounting consolidation

68. Traditionally, GAAP focuses on the establishing of financial statements of groups of entities, which are under same control (then called **economic entity**): **the consolidated financial statement**, in addition to the **separate financial statement** that the controlling entity would establish.

69. In other words, it is the control criteria that decides on the coverage, in contrast to the statistical world where sector or sub-sector coverage is determined on other criteria (mainly economic behavior of entities). Hence the use of the term consolidation is extremely misleading as it carries a specific meaning in terms of coverage for accountants, whilst not for statisticians. It is hence recommended to specify in future discussion whether the consolidation referred to is of statistical or accounting sort.

70. Hence, under GAAP (such as IFRSs or IPSASs), the accounting for ownership relationship of an investor in an investee requires first establishing whether consolidation is required and if not whether influence is established. Eventually, such an accounting can follow four modalities depending on the type of established link.

71. **Full consolidation** (see IPSAS 6 and IAS 27). When an investor exercises control on the investee, the accounts of the **controlled entity** (the **subsidiary** in IAS 27) are added to those of the **controlling entity** (the **parent** in IAS 27). Control is the power to govern the financial and operating policies of another entity so as to benefit from its activities; control hence encompasses two aspects: power and capacity to benefit – though the latter may simply reflect “the ability to direct the other entity to work with it to achieve its objectives, see IPSAS 6/27). Control is defined in IPSAS 6/ 25 and 36; it is often, but not exclusively, associated to cases of ownership of 50% or more. Whilst revenue, costs, assets, and liabilities of the former are added to that of the latter, reciprocal links are eliminated. In addition, a position minority interest in both profit and shareholder equity appears.

72. **Proportionate consolidation** (see IPSAS 8 and IAS 31). When a group of investors – the **venturers** – have established a binding arrangement (IAS: contractual arrangement) to jointly control operations or assets or of entities, GAAP foresees a different treatment. The accounts of jointly controlled entities⁴ are added to the accounts of the venturer on a prorata basis, either aggregated line-by-line or under specific entries. No minority interest occurs. IPSAS 8 permits but does not recommend using equity accounting to venturers.

73. **Equity method** (see IPSAS 7 and IAS 28). When the investor exercise “sufficient influence” in the investee, the latter is then an **associate**. Sufficient influenced is described in IPSAS 16, included cases of representation to the board, participation to policy-making, interchange of managerial personnel or provision of essential specification. In case of ownership above 20% (and below 50%) it is often presumed, pending justification of the contrary, that significant influence is established. Investors accounts for associate by applying the equity method, where the former recognizes in its income statement (in its balance sheet) its prorated share in the profit (in the net assets/equity) of the latter.

74. In other case, when no control, joint control, or significant influence is determined, the equity stakes are booked using usual investment rules, often at cost, with the implication that distribution to shareholders scores as revenue of the investor. Investor do not account under full consolidation or proportionate consolidation or equity method, when the investment is held exclusively with a view to its disposal in the near future or operates under severe long-term restrictions that significantly impair the ability of the investor to extract meaningful benefits.

⁴ There is no specific need for jointly controlled operations or assets not involving a jointly controlled entity, as the separate financial statements of the venturers will already have accounted for each share of assets, liabilities, revenue, or expense.

Impact on the accrual of earnings of the subsidiary/associate

75. It is worth noting that all three accounting approaches (full consolidation, proportionate consolidation and equity method) have the same impact on the income and equity of the owner (although each follows different level of netting category by category):

- a. profits and losses of the subsidiary/associate are captured in the income statement of the parent/investor;
- b. the prorated equity position of the subsidiary/associate appears in the equity of the parent/investor.

76. This contrasts sharply with the recording of other equity participation (at least when no mark-to-market is implemented): the equity stake of the owner stays captured at the acquisition price (eventually reduced for impairment) and income is recognized only at time and for the amount of dividend.

77. One may note that implementing market valuation in GAAP will cause this fundamental divergence between the consolidation and the no consolidation approaches to blur.

78. The following table summarizes the issue:

Impact on the net worth or profit and loss of the investor of profit and loss of the investee or the distribution of dividends - presented according to accounting method				
	Type of event			
	Impact of profit and loss of investee in the investor's		Impact of distribution of of dividends in the investor's	
	net worth	profit and loss	net worth	profit and loss
Type of accounting				
full consolidation	Yes	Yes	No	No
proportionate consolidation	Yes	Yes	No	No
equity method	Yes	Yes	No	No
investment accounting	No	No	Yes	Yes
mark-to-market	Yes	Yes	No	Likely not
Realization: Ph de Rougemont July 12, 2004				

GAAP rationalization

79. IPSAS explicitly indicates that the equity consolidation is necessary because significant influence (e.g., stake of more than 20%), would not meaningfully allow dividends to be recognized as income.

- a. IPSAS 7/19: “The recognition of revenue on the basis of distributions received may not be an adequate measure of the revenue earned by an investor.... As the investor has significant influence over the associate, the investor has a measure of responsibility for the associate’s performance and, as a result, the return on its investment. The investor accounts for this stewardship by extending the scope of its consolidated financial statements to include...”.
- b. IPSAS....

Analogy with statistics

80. In contrast to accounting, statistics do not enforce full or partial consolidation accounting but instead prescribes equity accounting (but more exactly market value accounting) in the sense that, other things being equal, a profit of the subsidiary will immediately increase the net worth of the owner, whether a dividend is distributed or not.

81. Market value accounting arguably adds to the change in equity value due to accrued operational profit, other changes in value reflecting holding gains/losses on assets and liabilities of the investee or other independent changes in value reflecting the perception of investors (the market”) towards the investee. It seems useful to declare the first type of changes volume changes, and the two latter price changes.

82. However, in *1993 SNA* the direct impact of the profit/loss of the investee on the net worth of the investor does not transit via income, but via revaluation, except for the Rest of the World account. Following the equity accounting example, the BOP books the whole earnings of subsidiaries when held at more than 10%: using the 1993 SNA categorization, this amounts to complementing the position D.42 by an item D.43 *reinvested earnings on direct investment*.

83. It is worth noting that analogies between accounting and statistics have a fundamental limit, in so far as:

- Statistics distinguish between income and revaluations, in contrast to accounting; and
- Statistics use market valuation.

84. Hence, caution needs to be exercise when invoking such analogies.

IV. REINVESTED EARNINGS

85. This part enquires on the option of extending the recognition of income to “accrued earnings”, e.g., extending the “reinvested earnings” treatment, foreseen in the *1993 SNA* for foreign direct investments (see section II.A), notably to public corporations.

A. The SNA recording for reinvested earning

This section repeats, for convenience, the text in II.A

86. The *1993 SNA* foresees (in line with the *Balance of Payments Manual and Guides*) a specific treatment of property income on equity stakes / shares in the form of direct foreign investment (DFI). DFI enterprises encompass corporations where a foreign investor owns a sufficient stake to have effective voice in its management. SNA 7.119.

87. The system requires that retained earnings of a DFI be treated as if they were distributed to the foreign direct investors and then reinvested back. SNA 7.120.

88. The rationale is that since a direct foreign investment enterprise is subject to control or influence by a foreign direct investor, the decision to retain some of its earnings within the enterprise must represent a conscious deliberate investment decision on the part of the foreign direct investor. SNA 7.121.

89. The *Balance of Payments Manual fifth edition* recommends classifying as direct investments, holdings of more than 12.5% in a given corporation.

B. Conceptual attraction

90. The recording of reinvested earning has a considerable attraction because it avoids the anomaly of booking dividends as property income with its adverse counterpart booking of a matching holding loss in equity.

91. This recording instead accrues property income continuously over time, in recognition that profits are earned continuously over the period. This recording is similar to that of interest on a bond: the *1993 SNA* does not equate interest with coupon payments; and the fall in bond price at time of payment of coupon is not a holding loss but reflects a partial redemption in bond (redemption of its accrued interest component).

92. Shares increase in value over time because of systematic holding gains over the long run due to some kind of long term “inflation”. However the value of shares also increases over time because companies tend to retain a substantial fraction of their earnings, in view of expanding their operations (such as buying equipment) or repaying their debt: this trend change in value of shares hence reflects an increase in their “volume”, not in their “price”. This is similar to a zero coupon bond or to an old wine maturing: the change in value has a component that is solely due to time passing. (SNA 12.110).

93. It would seem essential to recognize that increases in value due to accumulation of retained earnings are not price changes and do not generate holding gains. However, currently in the *1993 SNA* this increase is recorded as a change in price in the revaluation accounts. A more appropriate recording as a change in volume would require that a property income be deemed to be distributed and immediately reinvested on the instrument, similar to zero coupon bonds.

94. Such an apparent “fiction” of distribution immediately reinvested is exactly what shareholders decide when they vote on the coupon rate during the Annual General Meeting. Instead of voting a full distribution, and then regularly voting new share issues, they leave part of their income in the kitty. This fundamental choice made by the shareholder is explicitly recognized in the *1993 SNA* for direct investment (7.121), but unfortunately only for cross border relationships.

C. How it would work

95. To show how the reinvested earning approach operates, one describes three simple events, looking at the books of government. The extension of the reinvested earning recording relies in practice on a few technical choices to be listed later below.

Basic description

96. Government would record, in addition to the dividend (D.421), the reinvested earnings of profitable public corporations (D.43.1), with a counterpart as addition to equity (F.5 transaction). The change in the net value of public corporations due to operating profits would be recorded, in the books of the government, as a transaction (in equity). Conversely, the loss making companies would yield an expense/subsidy (D.34.2—or, alternatively, a negative property income, D.43.2) with a counterpart entry in reduction in equity (F.5 transaction).

97. Hence, changes in their net value would be recorded, in the books of government, as a transaction (in equity). On the other hand, capital injections would be recorded as transactions in equity: against cash if realized in cash, or against an incurrence of a liability in case of debt assumption.

98. The fundamental change is that the **change in equity position observed in the books of the owner** (say, from 100 to 117), originating (other things being equal) on account of the part that is not distributed (10) of the profit on operations during the year (15), **is now in part a revenue (transaction) instead of a revaluation (as it is currently the case)**. Another 7 in change in equity originates from price changes in assets or liabilities of the investee. Then, we have:

		Current SNA	Proposed SNA
Revenue		5	15
of which: dividend	D.421	5	5
of which: reinvested earnings	D.43		10
Financing			
Cash	F.2	5	5
Equity	F.5		10
Revaluation			
Equity	K.11	17	7
Opening assets		100	100
cash	AF.2		
equity	AF.5	100	100
Closing asset		122	122
cash	AF.2	5	5
equity	AF.5	117	117

19/07/2004 12:35

99. It is worth noting that the balance sheet is unchanged: what is new is the type of economic flow under consideration to explain those changes: revaluation (K.11) or transaction (F.5). Hence revenue/expense accounts and its balance (within the “Statement of government operations” in GFSM 2001) do differ.

100. The proposal does not eliminate revaluations in the equity stakes of government: it only eliminates that part of the changes in value in equity stakes that reflects the operational profits and losses of the investee (subsidiary/associates). Revaluations in equity arises from other changes in the value of assets of the investee not reflected in its operational profit/losses as well as other change in value assigned by the market to the equity of the investee.

More complete numerical example

101. This section uses a more complete example. Assume that government owns three corporations A, B, C. Public corporation A earns 10 (also equal to its change in net assets) and distributes 4. Public corporation B losses 25 (also equal to its changes in net assets). Government transfers 3 to B. Government assumes 30 of debt originally owed by C, which had 0 in net profit for the year.

Reinvested earnings: numerical example

Government accounts with three public corporations (A, B, C)

	Proposed				Currently			
	A	B	C	Total gov	Total gov	A	B	C
Expense	0	25	0	25	3	0	3	0
D3 Subsidy			3		3		3	
D.43.2 Reinvested losses			22	0	22			0
Revenue	10	0	0	10	4	4	0	0
D.42 Dividend	4				4	4		
D.43.1 Reinvested earnings	6			0	6			0
B.9 Balance	10	-25	0	-15	1	4	-3	0
Balance	10	-25	0	-15	1	4	-3	0
Transaction assets	10	-25	30	15	1	4	-3	0
F.2 Cash	4	-3		1	1	4	-3	
F.5 Equity	6	-22	30	14	0			
Transaction liabilities	0	0	30	30	0	0	0	0
F.3 Debt			30	30	0			
Net impact				0	-16			
Revaluation assets (+OCV)	0	0	0	0	14	6	-22	30
AF.2 Cash				0	0			
AF.5 Equity	0			0	14	6	-22	30
OCV (+transaction) in liabilities	0	0	0	0	30	0	0	30
AF.3 Debt				0	30			30
Change in net worth	10	-25	0	-15	-15	10	-25	0
Change in assets	10	-25	30	15	15	10	-25	30
Cash	4	-3	0	1	1	4	-3	0
Equity	6	-22	30	14	14	6	-22	30
Change in liabilities	0	0	30	30	30	0	0	30
Debt	0	0	30	30	30	0	0	30

2/2/2004 22:16

102. One observes that the change in government net worth is -15 (because A gains 10 and B loses 25). This is fully booked as surplus/deficit of government *under the proposed recording*. Currently in the 1993 SNA, a surplus of 1 is booked (somehow reflecting a cash approach), and holding losses of 16⁵.

⁵ unless the debt assumption would be booked as a transfer (as perhaps would be the case following the MDD, but not necessarily the GFSM 2001) in case of which the deficit would be -29 and holding gains 14.

103. This examples illustrates two major difficulties:
- a. the deficit/surplus is very sensitive to the classification decision of the event.
 - b. Revaluation entries occur that do not seem to relate to changes in any “price” on the market.

Additional choices to make

104. For the application of the reinvested earnings model, there are some choices to be made:
- a. Expense losses, or alternatively book them as negative revenue.
 - b. Book reinvested earnings (in addition to dividends) or full earnings (of which dividends can be shown). This is largely a presentational issue.
 - c. Clarify the measure of the profit to distribute. It could be net saving, as currently D.43 is geared at doing (SNA 7.122), or a wider or more flexible criteria (as an example, banks systematically write-off impaired loans as part of their normal activities, but those are recorded as Other changes in volume of assets—it would be normal to incorporate those in the measure of earnings). Whatever is decided, it would have to relate to *1993 SNA / ESA95* concepts and measurements.

D. GFS interest

Compelling reasons

105. GFS has a strong interest in applying reinvested earnings at least for company fully under government control, in particular those 100% owned. The case for public corporations is more compelling than for foreign direct investments, particularly for 100% owned public corporations:

- The government control is often complete or predominant.
- The owner is also an entity well aware of being measured by statisticians.

106. The other compelling arguments for such an application are:

- The tightening of the definition of expense and revenue this would impart, and the significant improvement in the definition and meaning of the revaluation account.
- The improvement in the accrual recording, with measuring the amounts at the time the underlying event occurs (the profit, the loss).
- Symmetry and comprehensiveness, with treating at par profits and losses, that is encompassing the whole public sector activities: those public corporations, which make losses and those, which make surpluses.

- Simplicity, with avoiding the judgmental (cherry picking) approach required now under the MDD and the *GFSM 2001* rules.

107. It is expected that the explanatory power of fiscal indicators would considerably improve as quasi-fiscal operations would be captured at the time of their impact on the economy (i.e. the public corporation loss) rather than at time of rescue (i.e. recapitalization). The property income distributed by public corporations is arguably neutral in terms of aggregate demand: it is adequate that they be neutral on fiscal main aggregates.

108. The fiscal indicators would considerably gain in international comparability. Currently, some governments carry out considerable quasi-fiscal operations via their public corporations, whilst others do not. In this context, international comparisons can currently be particularly misleading.

109. The quality of the stock-flow articulation would be considerably improved.

110. Statistical incentives that currently exist would disappear, helping government to focus more exclusively on management issues instead of on accounting issues. It is plausible that the more direct statistical impact of the headline figure of the results of public corporations may create incentives for government to work on the improvement of their finance. This may lead to a useful bias in favor of increasing public services prices, whereas the only existing biases are all in favor of their decrease.

Difficulties

Compilation difficulties

111. Against the compelling reasons stated above, one difficulty would be that compiling the reinvested earning components could be burdensome for compilers.

112. However, governments ought to keep sufficient records on the activity of their public corporations, which would allow statisticians to compile aggregates. Nonetheless, where the “balance” that is followed by public corporations supervisors deviates from the concept preferred by statisticians, flexibility may be advisable, with a view to focus the statistical resources on capturing the most relevant/largest operations.

Artificial construct

113. Another argument raised might be that such reinvested earnings are artificial in nature and would engender additional imputations in the accounts, never a satisfactory perspective. However, the issue here **is merely a question of classification of flows: the change in balance sheet is observed**, and the question is only whether the flow in question is a transaction or a revaluation. In this respect, one can hardly talk of an imputation.

114. Negative entries in reinvested earnings may not be appealing, and a proposal would be to record “accumulating losses” as expenses amongst the category “subsidiaries” (D.34), instead of under property income (D.43).

Impact on the accounts

115. It may happen that the net impact of implementing the reinvested earnings approach would be to reduce the deficit of some governments, as the full earnings of healthy public corporations would be accounted now as government revenue (instead of merely the distributed part) while few public corporations would be recording losses. Such an impact is not really problematic and in fact welcome. It relocates flows recorded as revaluation under transaction and more appropriately represents the property income on the assets of government. It reduces incentives for government to tap the capacity of its public sector to stimulate by stealth the economy.

E. Rest of the SNA

116. An extension of the application of reinvested earnings recordings does not have to be limited to public corporations: it may also extend to other equity stakes or to other sectors.

Extension to all instruments and all sectors

117. A case can be made that reinvested earnings could be generalized to all equity and shares. Indeed, many corporations in the USA and now in Europe have more and more geared, over the past decade, their distribution policy in relation to fiscal considerations: dividends may be taxed “twice” in contrast to holding gains; and dividends are “imposed” income to all shareholders, while the shareholder/taxpayer may be able to minimize overall taxation by choosing the moment of sale (under a buy-back scheme).

118. More and more corporations, including large multinationals, have skipped altogether the dividend and replaced it in full by “share buy-backs”, while others have reduced it, or increased it less than otherwise would have been the case, by way of sponsoring substantial share buy-backs programs.

119. Under this condition, there is a serious risk that income series be distorted. Perhaps households’ domestic income could be underreported, both on account of direct ownership and of indirect ownership via holdings in pension funds, life insurance, or mutual funds (when a transparency rule on property income applies). The household saving rates could be hence noticeably underestimated.

120. Conversely, a noticeable resumption of dividend distribution, owing to changed fiscal rules, is liable to distort the pattern of macroeconomic time series.

Extension to other sectors or to other instruments

121. Such an extension of reinvested earnings to all instruments and all sectors may be rather radical. A more modest approach would be an extension to all other direct investment within the economy, on account that the direct investor makes a deliberate decision regarding the distribution policy.

122. Another type of approach would be to extend the reinvested earnings approach to all instruments concerned by the sector in question: rest of the world and, as suggested in this part of this paper, government accounts.

F. Threshold versus across the board generalization

123. The question can be seen hence on two axes: (1) the threshold above which reinvested earnings apply and (2) the sector, which applies it.

124. The thresholds can be thought of:

- 100%: cases where the owner and its subsidiary is undoubtedly “one”. In those cases, the owner can engage into events that are not at arms’ length, with major classification difficulties. It would seem essential for GFS that solid rules be put in place.
- 50%: cases where the majority owner can truly “influence” events. There is clearly control, although the existence of minority shareholders tends to provide guarantees against events not at arms’ length.
- 20%: the traditional threshold for associates used in accounting.
- 10%: traditional direct investment threshold in balance of payments statistics.
- 0%: application of reinvested earnings to all equity stakes: direct investment or portfolio investment. As seen above, this option reflects the notion that the no distribution of profits increases the volume of the company, rather than the importance of control.

125. The sectors can be:

- Rest of the World;
- General Governments; and
- Corporations.

126. We can hence summarize the situation the following way:

	Sector		
	RoW	General Government	Corporations
100% ownership			
50% ownership			
20% ownership			
10% ownership		??	
0.1% ownership			

- Current SNA
- Possible vertical extension
- Possible horizontal extension

2/2/2004 23:05

127. Although not an absolute requirement, national accountants prefer when rules apply across the board to all sectors. Occasionally, the 1993 SNA encompasses sector specific rules, but this is rare⁶. We can conclude that it would be an advantage if any rule followed would be applied across the board. In this respect, the 100% threshold is attractive because applying the reinvested earning treatment seems compelling including for (all) 100% owned corporations.

128. Another consideration is that one may wish that all shareholders of the same enterprise be treated identically. This suggests using either the 0% or 100% thresholds (or not apply reinvested earnings altogether). However, the 1993 SNA does not enforce such a rule, whilst there may be ground to treat large shareholders differently. It is worth noting that on the market, transactions in very large blocks are realized at significant premiums (and occasionally discounts) to the market price (in some jurisdictions, the purchases of blocs above a certain level creates an obligation to launch an open offer).

129. GFS interest would be to apply reinvested earnings to 100% owned corporations at the very least, but also to 50% owned, or alternatively to all equity holdings. The 20% threshold is appealing to the extent that it harmonizes with accounting standards. The 10% threshold is not particularly appealing except that it is an established convention amongst statisticians.

130. Some balance of payments statisticians would like to reexamine the reinvested earnings treatment, and one option would simply be to increase the threshold (without necessarily changing the 10% threshold defining direct investment, an essential feature of balance of payments statistics).

⁶ FISIM on deposits and loans recognized for financial intermediaries only; D.43 for Rest of the world; perhaps: output measured at cost for nonmarket producers.

V. CONCLUSION

Recommendation 1: need for additional SNA entries

131. A first conclusion is that the relationship between government and public corporations provides a vast field of opportunities for misreporting of the fiscal situation, with difficulties related to both payments made by corporations as well as received by corporations.

132. The Eurostat (ESA 1995) and the IMF Statistics Department (*GFSM 2001*) have gradually developed a jurisprudence to the effect of:

- a. preventing booking revenue in one period related to other elements than to income of the period; and
- b. forcing the expensing of the recapitalization of public corporations.

133. Therefore the SNA review would be an opportunity to provide additional language with a view to address the issue.

Recommendation 2: two options for the SNA review

Option 1: Expanding on and strengthening current rule

134. One option is to enshrine in the reviewed SNA the efforts described above, and to strengthen them, with a view to limit to a maximum unsound recording.

135. Particular attention ought to be given in relation to recapitalization of bankrupt public corporations or of corporations being privatized or recapitalization effected by way of debt operations.

136. However those efforts, whilst time consuming and liable to accusation of arbitrariness, do not tackle basic difficulties associated to the fact that dividends and capital injection are net worth neutral and therefore, do not meet the expense/revenue criteria. It also leads to recordings that essentially depend on the time of actual operations, hardly an accrual perspective of the world. Those weaknesses would have to be acknowledged in the updated SNA text.

Option 2: Applying reinvested earnings

137. Another option is to explore the reinvested earning approach. While it would be a change in the way statisticians have compiled government accounts, the method is already in use in the field of BOP statistics.

138. This method rightly focuses on the control of the government on public corporations and on changes in net worth. It considerably purifies the revaluation accounts and reinforces the accrual principle. It upholds symmetrical recording and comprehensiveness of coverage, whilst not prey to arbitrariness. The method is simple.

139. In addition, recording reinvested earnings of public corporations as income of government reinforces the analytical strength of fiscal account and bolster international comparability, currently gravely impaired.

140. One important consideration would be the threshold that GFS statisticians would feel would be most appropriate (100%, 50%, 10%, 0%), whilst considering at the same time the threshold that other statisticians in BOP and national accounts would be willing to contemplate.