Task Force on Harmonization of Public Sector Accounting

DRAFT

Government/Public Sector/Private Sector—Delineation Issues

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ACRONYMS

GBE	Government business enterprise
GFSM	*Government Finance Statistics Manual 2001*
ESA 95	*European System of Accounts 1995*
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standard
IPSAS	International Public Sector Accounting Standard
NPI	Nonprofit institution
PPP	Public private partnership
PSC	Public Sector Committee
SNA	*System of National Accounts 1993*
SPV	Special purpose vehicle
TFHPSA	Task Force on Harmonization of Public Sector Accounting
WGI	Working Group I, TFHPSA
WGII	Working Group II, TFHPSA

Executive Summary

A. Introduction

The Task Force on Harmonization of Public Sector Accounting (TFHPSA) is examining the possibilities of harmonizing the economic and financial accounting approaches to general purpose reports of the economic activities and classification of public sector organizations. The economic and financial accounting reports produced for the general public summarize the same economic events, but the two types of reports are different and are used for different purposes. Users of the reports are likely, however, to be confused when two reports about the same activities of the same entities are different and not obviously reconcilable. Thus, it is highly desirable to eliminate unnecessary differences and to explain clearly the necessary ones. Moreover, macroeconomic statistics are, for the most part, derived from financial accounting reports. Minimizing methodological differences obviously will facilitate the compilation of economic statistics.

This paper investigates two questions about public sector entities. Is the collection of all public sector statistical units in economic statistics the same as the collection of all the reporting entities in financial accounting? Within the public sector, do economic and financial accounting standards identify the same units as being **engaged** primarily in either commercial or governmental activity?

B. The Public Sector

The public sector is defined in both *System of National Accounts 1993* (the SNA) and International Public Sector Accounting Standards (IPSASs) as the national, regional, and local governments plus related governmental entities. Differences arise in relation to identification of related governmental entities.

In general, a related governmental entity is included in the public sector if it is controlled by a government, which means it is important to use the same definition of control for economic statistics and financial accounting. The entities under consideration are institutional units in the SNA and reporting entities in financial accounting. Although the difference between institutional units and reporting entities is not material for defining the public sector, further clarification in both the SNA and IPSASs on these units is recommended. A related governmental entity might be an entity that can be a source of financial gain to the government that controls it because it produces goods and services and sells them at market prices (referred to as corporations in the SNA) or it might be an entity that cannot be a source of financial gain to the government regardless of the prices for which it sells the goods and services it produces (nonprofit institutions). Governments exert control over these two types of entities differently.

Control of corporations

In the SNA, a government controls a corporation if it has the ability to determine the general corporate policy. In the IPSASs, a government controls a corporation if it has the power to govern its financial and operating policies so as to benefit from its activities. Having the ability to control general corporate policy is stated more generally but is essentially the same as being able to govern the financial and operating policies. The power to receive a benefit from the controlled entity is not part of the SNA definition. **It is recommended that the definition of control in the SNA be extended to include the power to receive a benefit.** Benefits, in the case of government, do not include the receipt of tax payments. **Development of a decision tree on establishing control of another entity in the SNA is recommended.**

The difference in the definitions is relevant to corporations for which the government involvement is as a fiduciary, such as pension funds for government employees.[1] Such units are included in the public sector in the SNA but not in the IPSASs. **The proposed change to the SNA definition of control will result, correctly, in the classification of these units to the private sector.**

The public sector in the SNA includes only resident institutional units. The IPSASs are not restricted in this way. If a public corporation has a foreign subsidiary, the latter will not be part of the public sector in the SNA, except as an equity asset. A foreign subsidiary will be part of the public sector in the IPSASs. **Separate records of domestic and foreign subsidiaries should be maintained in the financial accounting data so that the correct economic statistics can be derived.**

A government typically exerts control over a corporation by appointing the corporation's directors. If the government is the only owner or owns a majority of the voting shares, control can be exerted directly. However, there are other ways of exerting control and both the SNA and the IPSASs would benefit from additional guidance to insure uniform identification and treatment of controlled units. In the IPSASs, for example, it is explained that the power to control must be presently exercisable and not contingent on a future event. That is, the entity must already have had this power conferred on it by legislation or some formal agreement. It is also explained in the IPSASs that the general regulatory or purchase powers of government do not imply control of the assets deployed by the entities being regulated. **These useful elaborations of the definition should be added to the text of the SNA.** Both the SNA and the IPSASs acknowledge that specialized legislation, as opposed to general regulatory powers, can imply control. For example, a government may have the legal right to appoint directors regardless of the number of shares it owns. **In general, more elaboration of the definitions of control is needed in both the SNA and the IPSASs to insure uniform treatment.**

Special purpose vehicles have become important, particularly for securitization operations, but they can be used for a wide variety of purposes.[2] There is no guidance for the treatment of special purpose vehicles in either the SNA or the IPSASs. **Common guidance should be developed jointly for both standards.**

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[1] An electronic discussion group (EDG), hosted by the International Monetary Fund (IMF) is examining pension schemes, http://www.imf.org/external/np/sta/ueps/index.htm.

[2] Working Group II (WGII) of the TFHPSA has an interest in these units as part of its consideration of privatization.

It is possible for a government to form a joint venture with a private entity. By definition, control of these ventures is shared so that the units are neither public nor private. According to IPSAS 8 (joint ventures), proportional shares of all of the assets, liabilities, and transactions of a joint venture are included by the government partner in its financial reports. Units cannot be partitioned in economic statistics. **As there is no guidance in the SNA, the statistical treatment of public-private joint ventures needs to be established**.

Corporations jointly controlled by several government units or other public corporations, within an economic territory, are public corporations in the SNA, **although more specific guidance should be added to confirm that assertion.** It is not clear how such corporations would be reported with the IPSASs. They could be independent, uncontrolled reporting entities or they could be considered joint ventures, in which case a proportional share of their assets, liabilities, and transactions would be included with each government participating in the venture. **Clarification should be added to the IPSASs.**

Control of nonprofit institutions

Nonprofit institutions do not have owners and therefore control cannot be exerted by owning shares. The ability to govern the general organizational policies or the financial and operating policies of a nonprofit institution can be obtained by having the legal power to appoint directors or other special legislation. Because a government cannot receive a financial gain from the activities of the nonprofit institution, it is not clear how a government obtains the benefit required for control according to the IPSAS definition. In the SNA, a nonprofit institution that does not sell its output for market prices must be both controlled and mainly financed to be part of the public sector. The SNA, however, does not explain what mainly financed means, and it does not indicate if finance is a means of obtaining control of a nonmarket nonprofit institution or whether it is a separate factor that must exist in addition to control. Thus, it is not clear which nonmarket nonprofit institutions are part of the public sector in economic statistics or financial accounting. **Further clarification is required in both the SNA and the IPSASs.**

C. General Government Sector

Once the coverage of the public sector is clearly defined and harmonized between economic statistics and financial accounting, **there is a need to classify public sector entities as either engaging in market or nonmarket production, i.e., as being in the public corporations sector or general government sector respectively**. In the SNA, an institutional unit is a market producer if it charges economically significant prices for all or most of its output. The definition of an economically significant price is, however, quite vague and has been the subject of debate ever since the SNA was published. **There is a great need to explain more fully the concept of economically significant prices so that it can be applied in practice more uniformly.** In the IPSASs, the nearest equivalent is a government business enterprise (GBE). Its definition, however, requires that the enterprise be a separate legal entity and that it sell its output for a profit or full cost recovery. The separate legal entity requirement eliminates any major components of government ministries or other reporting entities that sell their output for a profit and otherwise act as independent commercial enterprises. The requirement to sell at a profit eliminates municipal transportation enterprises and other government entities that act as market producers but regularly sell their output for less than the cost of production. **Thus, there is a need for research and clarification of how entities of the public sector are classified. A relaxation of the IPSAS' definition of a GBE would materially reduce the differences between whole-of-government financial reports and economic statistics for the public sector.**

Consolidation

Financial accounting and economic statistics have different goals, which lead to different decisions about the entities that should be combined and whether they should be combined by aggregation or consolidation. Financial accounting consolidates the "whole of government" capturing and consolidating all government controlled entities, which is equivalent to economic statistics for the overall public sector. **To reflect a consolidated accounting picture of all market activities in the public sector, distinct from nonmarket government activities, would require a change in accounting consolidation methods.** Furthermore, economic statistics of the public sector are largely derived from financial accounting reports. **To facilitate the compilation of economic statistics, it is desirable to maintain financial accounting data in sufficient detail to meet the needs of economic statistics.**[3]

Economic statistics are compiled in reference to institutional units, so it is desirable to relate reporting entities to institutional units. Unfortunately, the definition of an institutional unit, especially its application to government, is sufficiently vague that it can be difficult to identify individual government institutional units. If the data for those units are consolidated, then individual identification is unimportant. In the SNA, however, data for separate units are aggregated rather than consolidated. In the government finance statistics, consolidation is a central concept, and **therefore the position of the SNA should be reconsidered. Data on individual public corporations should be retained and information should be available to compile economic statistics for public nonfinancial corporations and for public financial corporations.**

D. *Government Finance Statistics Manual 2001*

The *Government Finance Statistics Manual 2001* (*GFSM*) is identical with the SNA with regard to the identification and grouping of institutional units. For this reason, this paper

[3] Following a recommendation from Working Group I (WGI) of the TFHPSA, the International Federation of Accountants Public Sector Committee, who is responsible for the development of the IPSASs, agreed at its March 2004 meeting to allow and encourage the disclosure of information for the general government sector A draft project brief was discussed at the PSC meeting in July 2004 and an updated project brief is to be presented to the PSC's next meeting in November 2004.

refers only to the SNA. Any changes to the SNA should, of course, be considered with the needs of the *GFSM* in mind and implemented in a revised *GFSM*. The one difference between the SNA and the *GFSM* relevant to this paper is that the *GFSM* uses consolidation for all combinations of the data for individual units. **If sufficient details are retained to support the *GFSM*, however, the information necessary for the SNA will exist.**

E. Conclusion and Recommendations

In order to harmonize economic and financial reports for the public sector, it is recommended that the SNA definition of control be extended to align with the financial accounting definition of control in the IPSASs. As the international accounting standard on consolidation (IAS 27), which underpins the IPSAS on consolidation (IPSAS 6), is currently under review, it is recommended that the drafting of an extended definition of control for the SNA be undertaken once the outcome of that review is known.

There are many areas in both the SNA and the IPSASs where guidance on the identification and treatment of units is absent or insufficient, leading to interpretation and inconsistency of treatments across countries. It is recommended that additional guidance or further elaboration be included in the SNA and the IPSASs.

The main recommendations are:

Public sector boundary:

- Change the definition of control in the SNA to include:
    - The power to receive a benefit from the controlled entity
    - Explanation that the power to control must be presently exercisable and that regulatory powers do not imply control
    - Use of a decision tree
- Clarification and elaboration in the SNA of:
    - Definition of an institutional unit
    - Classification of nonprofit institutions
    - Distinction between foreign and domestic operations of public corporations
- Guidance in the SNA on how to evaluate and classify:
    - Special purpose vehicles
    - Public joint ventures
    - Public-private joint ventures
- Clarification and elaboration in the IPSASs of:
    - Definition of the reporting entity

    - Definition of control
    - Classification of nonprofit institutions

- Guidance in the IPSASs on how to evaluate and classify:

    - Special purpose vehicles
    - Public joint ventures
    - Public-private joint ventures

General Government Sector:

- Clarification and elaboration in the SNA of:

    - Concept of market/nonmarket production
    - Economically significant prices

- Disclosure (encourage or allow) in the IPSASs of financial information about the general government sector[4]

[4] See footnote 3.

I. INTRODUCTION

1. The Task Force on Harmonization of Public Sector Accounting (TFHPSA) is examining the possibilities of harmonizing the economic and financial accounting[5] approaches to general purpose reports of the economic activities and classification of public sector organizations. On one hand, these reporting entities are responsible for the prudent use of public resources and, on the other hand, they are the instruments by which a country's fiscal policy is implemented. Both aspects require comprehensive and comprehensible financial and economic reports to be available to the general public.

2. The economic and financial accounting reports produced for the general public summarize the same economic events, but the two types of reports are used for different purposes; it is not surprising that a given event may be accounted for differently, different classifications and valuations might be employed, and degrees of emphasis given to events may differ. Users of the reports are likely, however, to be confused when two reports about the same activities of the same entities are different and not obviously reconcilable. Thus, it is highly desirable to eliminate unnecessary differences and to explain clearly the necessary ones. Moreover, macroeconomic statistics are, for the most part, derived from financial accounting reports. Minimizing methodological differences obviously will facilitate the compilation of economic statistics.

3. Even if all concepts regarding the treatment of economic events and the definition, classification, and valuation of assets and liabilities are identical for economic statistics and financial accounting, the two types of reports will differ if the organizational entities that are the subjects of the reports differ. This aspect of reporting to the public should be the least controversial. That is, when one speaks about the economic activities or status of the government of a country, region, or city, there should be a common understanding of what is meant by "the government." Unfortunately, such an understanding is frequently lacking. In addition, governments often play several different economic roles, which suggests that economic and financial reports should be disaggregated to show the results of the separate major activities. Any such disaggregation requires a similar understanding of which entities engage in which types of activities.

4. The scope of economic and financial reports about the public sector is defined in terms of organizational entities. In economic statistics, these entities are referred to as units or statistical units. In financial accounting, they are referred to as reporting entities. The public sector is both the universe of governmental statistical units and the universe of

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[5] "Economic statistics" and "economic accounting" are used here as interchangeable terms for macroeconomic statistics and the methodological foundation underlying them. The principal manual reflecting the goals and methodological standards of macroeconomic statistics is *System of National Accounts 1993*, which will be referred to as "the SNA." The *Government Finance Statistics Manual 2001* (*GFSM*) is identical with the SNA with regard to the identification and grouping of institutional units. The one difference between the *GFSM* and the SNA relevant to this paper is consolidation.

governmental reporting entities. In the SNA, the public sector is defined rather obliquely as the units of the general government, public non-financial corporations, and public financial corporations sectors. [SNA 19.37][6] This definition leaves open any questions or uncertainties about which units are included in each of those sectors. In financial accounting, the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC) states that the public sector "refers to national governments, regional (e.g., state, provincial, territorial) governments, local (e.g., city, town) governments and related governmental entities (e.g., agencies, boards, commissions and enterprises)."[7] This definition leaves open any questions or uncertainties about what a government is and, more likely, what a related governmental entity is.

5. This paper investigates two questions about public sector statistical units and reporting entities:

- Is the collection of all public sector units in economic statistics the same as the collection of all public sector reporting entities in financial accounting? If not, can the two definitions of the public sector be revised so that the two sets of organizational entities are the same, or are there sufficient reasons to maintain a difference?

- Governments often engage in commercial activities by producing goods and services and selling them at market prices. For both macroeconomic analysis and accounting for the use of public resources, it is desirable to separate these commercial activities from the more typical nonmarket governmental activities. Within the universe of public sector entities, do economic and financial accounting standards identify the same units as being engaged primarily in either commercial or governmental activities? Obviously, if the definitions of the public sector differ, then there must be some difference in classifying the entities of the public sector in this manner. Even if there is no difference in the definitions of the public sector, there could be differences in this classification. If so, the same questions about resolving the differences apply here also.

6. When differences are identified and the conclusion is reached that some should remain, an additional question is raised: can a common database be designed so that the differing needs of economic statistics and financial reporting can be satisfied and the relationship between the two sets of entities can be explained easily to users?

7. This paper relies on the descriptions of public sector entities in the SNA and the PSC's publications. The SNA has considerably more material defining statistical units and

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[6] References to the SNA will be given as [SNA x.y], where x is the number of the chapter and y is the number of the paragraph in chapter x. References that do not follow quotations are paraphrases of the cited paragraphs.

[7] International Federation of Accountants, *Handbook of International Public Sector Accounting Standards, 2003 edition*, p. 10.

describing the various types than do the PSC publications, and the space devoted to those topics reflects that difference. Although the levels of detail differ, the importance attributed to each does not.

II. Sectors

8. In the SNA, institutional units are aggregated into sectors according to the similarity of their economic objectives, functions, and behavior and the types of units that may control them. There are many ways to classify these characteristics and, as a result, there is no unique way to construct sectors. The SNA suggests two sectors that are relevant to this study—the public sector and the general government sector.

A. The Public Sector

9. Institutional units can be classified as being public or private units or being owned or controlled by public or private units. The grouping of all public units and units owned or controlled by public units is referred to in the SNA as the public sector. It consists of all government units, all nonprofit institutions (NPIs) controlled and mainly financed by government, and all public corporations.[8] Statistics on the public sector provide information on the total resources controlled by governments and the purposes and efficiency with which those resources are employed.

10. The scope of financial reports is defined in terms of reporting entities. A reporting entity can be an individual entity or a group of entities (economic entity) comprising a controlling entity and one or more controlled entities. For government, the economic entity is the public sector. The general government sector, as defined in the SNA, does not meet the definition of a reporting entity as not all controlled entities are fully consolidated when compiling data for this sector.

11. The public sector is defined in both the SNA and the International Public Sector Accounting Standards (IPSASs)[9] as the national, regional, and local governments plus related governmental entities. Determining exactly what is meant by the public sector in the two standards is part of the first question raised in paragraph 5. , which can be paraphrased as: Is the public sector as defined in the SNA the same as the public sector as defined by financial accounting standards? The difficulty lies with the definition of control and,

[8] This definition is equivalent to the definition cited in paragraph 4. because all corporations are either financial or nonfinancial corporations and in chapter IV of the SNA it is clear that the phrase "units of general government" includes NPIs controlled and mainly financed by government.

[9] The IPSASs are drawn primarily from the International Accounting Standards (IASs), which are modified, into the public sector context. The PSC has a policy of updating the IPSASs in line with IAS updates.

therefore, with related governmental entities. As will be seen in section III.A, there is some uncertainty about the exact meaning of some of the terms used to define government units, NPIs controlled and mainly financed by government, and public corporations.

B. The General Government Sector

12. Institutional units also can be classified as being either market or nonmarket producers. Such a classification is important for economic analysis because units subject to market forces behave differently than units not subject to market forces. Many units engage in both market and nonmarket production, but usually one type of production predominates so that a classification of mixed units is not needed. It is sufficiently accurate to treat each unit as being either a completely market producer or a completely nonmarket producer.[10]

13. All corporations and some NPIs are predominantly market producers. All government units and most NPIs are predominantly nonmarket producers. Within nonmarket producers, some units finance their activities primarily through taxes and other compulsory transfers, and other units finance their activities primarily through voluntary transfers. The first group consists of all government units and NPIs controlled and mainly financed by government. This group is referred to in the SNA as the general government sector.

14. Determining exactly what is meant by the general government sector in the SNA is part of the second question raised in paragraph 5. As will be seen in later sections, there is some uncertainty about the exact meaning of some of the terms used to define institutional units and the exact definition of economically significant prices.

15. Economic reports for the general government sector are intended to provide identification of all units that implement the country's fiscal policy and a measure of their activities. These units may control units engaged in market production and their decisions may be affected by the activities and status of those units, but combining the two types of activity would disguise the effectiveness with which the public resources are used and make it harder to estimate the impact of a country's fiscal policy on the total economy. To the extent that public corporations exist, however, the assets, liabilities, and economic activities controlled by governments will be split between the statistics of market and nonmarket producers.

16. The activities of public corporations obviously affect the status of their parent government units. Any transaction between public corporations and their parent units, such as operating subsidies or dividends, are recorded appropriately along with all other transactions of the government units. In addition, the net worth of a public corporation is an

[10] As will be discussed in section IV, this statement is not quite accurate. If a unit is sufficiently mixed in its production to hamper economic analysis, a synthetic unit—the quasi-corporation—is created. Once all quasi-corporations have been created, each unit can be treated as a completely market or a completely nonmarket producer.

asset of the owning government unit. Any change in the net worth of the corporations will be reflected in the balance sheet of the relevant government units.[11]

Subsectors of the general government sector

17. It is often necessary or desirable for analytic reasons to disaggregate the statistics of the general government sector. Depending on the administrative and legal arrangements, there may be more than one level of government within a country, and statistics should be compiled for each level. In the SNA, provision is made for three levels of government: central; state, provincial, and regional; and local. In addition to levels of government, the existence of social security funds and their role in fiscal policy may require that statistics for all social security funds be compiled as a separate subsector of the general government sector.

III. The Public Sector

A. The Reporting Entities of Economic Statistics

Institutional units

18. The heart of the statistical system of the SNA is a set of accounts that presents (1) stocks of assets and liabilities in a balance sheet for the total domestic economy and its major sectors at the beginning and end of an accounting period and (2) the principal economic activities occurring within the accounting period in several flow accounts. All changes in the balance sheet from the beginning to the end of the accounting period are explained by the economic activities recorded in the flow accounts. A statistical unit known as the institutional unit is used for the compilation of these accounts. The total domestic economy is the aggregation of all domestic institutional units, and each sector is an aggregation of certain domestic institutional units with specific characteristics.

19. An institutional unit is "an economic entity that is capable, in its own right, of owning assets, incurring liabilities and engaging in economic activities and in transactions with other entities." [SNA 4.2] Such a unit "is able to take economic decisions and engage in economic activities for which it is itself held to be directly responsible and accountable at law," including entering into contracts. [SNA 4.2] Because an institutional unit can engage in economic activities on its own account, it can buy and sell goods and services, own assets, and incur liabilities in its own name. Another implication is that either a complete set of accounts reflecting the unit's activities exists or it must be possible and meaningful to compile such a set of accounts. [SNA 4.2] Finally, an institutional unit must be resident in the domestic economy.

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[11] Working Group II (WGII) of the TFHPSA is examining government transactions with public corporations including accounting for income from public corporations on an equity basis.

20. An institutional unit is either (1) a household or (2) a legal or social entity whose existence is recognized by law or society independently of the persons or other entities that may own or control it. [SNA 4.3] For the purpose of this study, only legal or social entities are of interest. Three main types of legal or social entities are identified in the SNA: government units, corporations, and nonprofit institutions. [SNA 4.5]

21. The implications of the definition of an institutional unit will be explored in the following sections. It will be seen that the definition is sufficiently vague that a list of domestic institutional units cannot be drawn up without additional guidance and the definition is sufficiently elastic to permit practical interpretations that support various analytical objectives.

Government units

22. Government units are “legal entities established by political processes which have legislative, judicial or executive authority over other institutional units within a given area.” The principal economic functions of government units are (1) to assume responsibility for the provision of goods and services to the community or to individual households at prices that are not economically significant, and (2) to redistribute income and wealth by means of transfer payments, financing both of these activities primarily from taxation or transfers from other government units. [SNA 4.104]

23. In order to apply the general definition of an institutional unit to identify government units, the SNA offers the additional guidance that a government unit must:

- Have funds of its own, either (1) raised by taxing other units resident in or engaging in economic activities in its area of authority or (2) received as transfers from other government units; [SNA 4.104(a)]

- Be able to own assets [SNA 4.125] and incur liabilities by borrowing on its own account; [SNA 4.104(a)]

- Have the authority to disburse at least some of its funds in the pursuit of its policy objectives; [SNA 4.104(a)] and

- Be able to appoint its officers, independently of external administrative control. [SNA 4.125]

24. These requirements appear to go beyond the definition of an institutional unit. There is no explanation in the SNA whether this extension of the definition of an institutional unit is intentional or these requirements of government units are simply interpretations of the definition. The requirement to raise funds by taxation or transfers is part of the definition of a government unit and does not conflict with the definition of an institutional unit. The requirement to be able to borrow on its own account could be different from the ability to incur liabilities in that borrowing can be seen as incurring a specific type of liability. The last

two requirements suggest a degree of autonomy of decision is required to be a government unit. In other cases, however, no autonomy of decision is required. The practical significance of these additional requirements probably is small, **However, it should be clarified in the SNA whether the definition includes these requirements or whether they are provided for guidance only. In addition, the requirements should be reviewed to avoid inconsistencies in interpretation.**

25. The organization of central, regional,[12] and local governments generally includes a central group of executive departments plus various judicial and legislative bodies. In addition, there may be agencies, commissions, boards, operating authorities, or other specially designated entities that are to some degree accountable to or controlled by a government, but operate with considerable independence. The central group of executive, judicial, and legislative entities are all part of a single primary government unit. The other entities associated with a given government may also be part of the primary unit or they may be separate units, depending on their specific characteristics. [SNA 4.119]

26. The individual executive, judicial, and legislative entities of the primary unit may be responsible for considerable amounts of expenditure, but each department or other entity cannot own assets, incur liabilities, and engage in transactions independently of the government as a whole. [SNA 4.119] That is, most governments borrow money only with the authorization of the legislature or approval by the general electorate. The finance or treasury department borrows on behalf of the entire government rather than each individual department issuing bonds or other securities. Similarly, the finance or treasury department collects income, sales, and other general taxes on behalf of the entire government. The funds acquired from issuing debt, collecting taxes, and other sources are then allocated to each executive, judicial, and legislative entity through a budget process. Similarly, fixed assets and land may be used by individual entities, but they usually are acquired by a central procurement authority for the benefit of the entire government and can be shifted administratively among entities. Legal actions generally are initiated (or defended) by one executive department on behalf of the entire government regardless of which department was involved in the events leading to the action. Thus, only the primary government as a whole undertakes many of the activities meaningful for economic analysis. A complete set of accounts for the individual executive, judicial, and legislative entities, if possible, would not be useful for economic analysis.

27. A government unit, like other institutional units, is not limited in its geographic location. For example, the individual executive, judicial, and legislative entities of the primary government unit may be deliberately dispersed throughout the area of the government's jurisdiction. They remain, nevertheless, part of the same institutional unit. Similarly, a ministry may maintain branch offices or agencies in many locations to meet local needs. These offices and agencies are part of the same institutional unit. [SNA 4.120]

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[12] Regional governments are described in the SNA as state governments.

Embassies, consulates, military bases, etc. located in other countries also are part of the primary government unit. (See section III. B.)

28. A government unit is defined partially in terms of the territory over which it has authority. The central government obviously has authority over the entire country. Not all countries have regional governments. If regional governments exist, they have authority over a specified portion of the country. There will be a primary government unit for the central government and one for each region. A region may or may not be divided into a set of disjoint localities and municipalities that exhausts the area of the region. It is also possible for local governments to have overlapping areas of authority. Thus, the number of primary local governments in a region may not be obvious.

29. Many government units obtain their funds from taxes, but it is possible for a government unit to receive its funds as transfers from other government units. The donor can restrict the use of some of those funds to specific purposes without violating the requirement that a government unit have the authority to disburse some its funds in the pursuit of its policy objectives. [SNA 4.125] If, however, an entity that otherwise would be an institutional unit is entirely dependent on funds from another government unit and if the donor government unit also dictates the ways in which those funds are to be spent, then the entity should be treated as a component of the donor government unit rather than as a separate institutional unit. [SNA 4.125]

30. Some government entities have a separate legal identity and substantial autonomy, including discretion over the volume and composition of their expenditures and a direct source of revenue, such as earmarked taxes. Such entities are often established to carry out a specific function, such as operating airports or managing recreation facilities. These entities should be treated as separate institutional units if they maintain full sets of accounts, own goods or assets in their own right, engage in activities for which they are held accountable at law, and are able to incur liabilities and enter into contracts. [SNA 4.119] Note that substantial autonomy is required, which is not part of the general definition of an institutional unit.[13]

31. A social security fund is a government unit that operates and manages a social security scheme. Social security schemes are social insurance schemes imposed and controlled by government units that cover the community as a whole or a large section of it. They generally involve compulsory contributions by employees and/or employers, and government units determine the terms on which benefits are paid to recipients. The schemes can cover a wide variety of programs, such as providing benefits in cash or in kind for old age, invalidity, death, sickness, maternity, work injury, unemployment, and health care. Usually there is not a direct link between the amount of the contribution paid by or on behalf of an individual and the risk to which that individual is exposed. [SNA 4.111] If the entity

[13] See paragraph 24 for discussion and recommendations on the definition of government units.

operating and managing one or more social security schemes is separately organized from the other activities of government units, holds its assets and liabilities separately, and engages in financial transactions on its own account, then it is a separate institutional unit and is referred to as a social security fund. [SNA 4.112] It is, nevertheless, a government unit subordinate to the primary institutional unit of that government.[14]

32. It seems unlikely that the government organization operating and managing social security schemes will be organized with sufficient autonomy that it can be recognized as a separate legal entity that holds its assets and liabilities in its own name and is responsible at law for its actions. Social security schemes often involve large financial flows from contributors and to beneficiaries. The economic analysis of a government's fiscal policy may be materially aided by separating social security transactions from the other transactions of the government. Thus, it appears that the definition of an institutional unit is applied with some creativity to define a social security fund as an institutional unit.[15]

33. Faithfully following the guidelines described in the previous paragraphs could result in several institutional units for a single government depending on how it chooses to organize itself. Unless the various units are engaged in areas of separate analytical interest, such as social security, there is little advantage to having multiple units because the primary difference between several units and one unit is the set of flows between the various government units. These intragovernmental flows are preserved in the statistics only if the units are aggregated and not consolidated. Consolidation is discussed further in section IV.

34. All government units supply most of the goods or services they produce or purchase for resale to consumers free or at prices that are not economically significant. Roughly speaking, economically significant prices can be characterized as market prices. [SNA 4.24(b)] Thus, producers that charge prices that are not economically significant are referred to as nonmarket producers. Despite being nonmarket producers, government units may engage in some market production. By definition, the amount of market production must be less than the amount of nonmarket production, and it usually is much less. The treatment of such market production depends on the organization of the government unit. Economically significant prices and the possible treatments of the market production of a nonmarket producer are discussed further in section IV.

Corporations

35. Corporations are legal entities that are (1) created for the purpose of producing goods or services for the market, (2) collectively owned by other institutional units, (3) intended to be a source of profit or other financial gain to their owners and (4) recognized at law as separate legal entities from their owners. [SNA 4.23 and 4.47]

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[14] See footnote 1.

[15] See paragraph 114 for the discussion on government units controlled in a fiduciary capacity.

36. Producing for the market means that the goods and services produced by the unit are sold or otherwise disposed of at economically significant prices. [SNA 4.24(b)] The definition of these prices is discussed further in section IV.

37. The owners, known as shareholders, can be any type of institutional unit, including households, government units, and other corporations. The total value of a corporation is allocated in some manner among the shareholders, usually in proportion to the number of shares owned.

38. Any profit or other financial gain earned by a corporation belongs directly or indirectly to the shareholders. Financial gains can be passed on directly to the shareholders as a dividend or similar distribution or the corporation can retain them.[16] Any amount retained by the corporation increases the value of the corporation and indirectly the value of the shares. [SNA 4.24] Similarly, any loss suffered by the corporation decreases the value of the shares.

39. As institutional units, corporations must be responsible and accountable at law for their own actions, which implies that they are legally independent of their shareholders. Legal independence implies the ability to buy, sell, lease, and mortgage property in its own name and the power to sue and be sued without recourse to the owners. This independence usually means that the liability of shareholders with respect to the corporation's actions is limited to the amounts invested in the corporation.

40. Legal independence does not mean that corporations make decisions autonomously. In fact, the requirement that shareholders must own corporations means that their activities have to be controlled in some manner by the collective decision of those owners. If there is a large number of owners, each with a small percentage ownership share, then the corporation's decisions will be relatively autonomous. If, however, there is only one owner, then that owner will be able to direct the corporation's activities in whatever detail desired. Nevertheless, even corporations wholly owned and controlled by a single unit are legally responsible for their own actions and, therefore, constitute separate institutional units. [SNA 4.38]

41. In the SNA, the concept of corporations includes companies, partnerships, cooperatives, proprietorships, and other legal forms of organization in addition to organizations formally designated as corporations as long as they produce for the market, are owned by other units, can be a source of financial gain to their owners, and are separate legal entities. [SNA 4.23] Conversely, many entities known as corporations by the governing law are not corporations in the SNA because they do not produce for the market or cannot be a source of financial gain for their owners. [SNA 4.48] For example, many governments and NPIs are legally organized as corporations.

[16] See footnote 11.

42. Corporations are formed in accordance with the laws of a specific locality. A corporation may normally be expected to have a centre of economic interest—i.e., to be resident—in the country in which it is created and registered. . When it also has one or more branches engaged in significant amounts of production over long periods of time in other countries, such branches are treated as quasi-corporations that are separate institutional units resident in the countries in which they are located. [SNA 4.24] The treatment of these nonresident branches is discussed in section IIIB.

Public corporations

43. Corporations can be owned or otherwise controlled by government units as well as by other types of institutional units. Corporations controlled by government units are referred to as public corporations. Control is defined as the ability to determine general corporate policy, typically by appointing appropriate directors. Owning more than half the shares of a corporation usually is sufficient to control the corporation, but other methods of control are possible. For example, a government may be able to control a corporation as a result of special legislation giving it the right to appoint the directors regardless of the number of shares owned. [SNA 4.30]

44. Almost any type of corporation can be subject to control by government units. Typical possibilities are the post office and other communications enterprises, railroads, airlines, municipal transportation enterprises, utilities, and financial institutions. The following paragraphs discuss some particular types of public corporations.

45. The central bank is a public corporation that exercises monetary authority functions as its principal activity. It issues banknotes and sometimes coins, and it may hold all or part of the international reserves of the country. The central bank usually has liabilities in the form of demand or reserve deposits of other depository corporations and government units. [SNA 4.86] Many central banks engage in some commercial banking activities. If so, those activities are included in the same institutional unit. [SNA 4.103] In other words, the central bank is defined on the same basis as other institutional units, not on the basis of its functions or activities.

46. Some monetary authority-type functions may be carried out by agencies of the central government rather than the central bank. Such agencies usually are a component of the primary government unit. [SNA 4.87]

47. Entities that regulate or supervise financial corporations may be a part of a larger government unit or a separate institutional unit. [SNA 4.101] If the latter and if they otherwise satisfy the definition of a corporation, then they are public corporations.

48. Pension schemes can be structured so that they have their own assets and liabilities and they engage in financial transactions in the market on their own account. These schemes,

usually in the legal form of a trust, are separate institutional units. They are referred to in the SNA as autonomous pension funds.[17] If an autonomous pension fund is controlled by a government unit, such as a scheme for government employees, it is a public corporation. Pension schemes do not have to be structured as separate institutional units. For example, employers could maintain accounts associated only with the pension plan separately from their other accounts but still under their control, or employers could simply pay the pension benefits out of their general resources as the payments become due. [SNA 4.98] These types of pension schemes are not separate institutional units.

49. The liability of the owners of a corporation is generally limited to the amounts invested in the corporation (see paragraph 39 *please set automatic update*). If a government is the sole owner of a public corporation, however, it is unlikely that the government can limit its liability in this way.

Nonprofit institutions

50. NPIs are legal or social entities created for the purpose of producing goods and services whose status does not permit them to be a source of income, profit, or other financial gain for the units that establish, control, or finance them. The articles of association by which they are established must be drawn up in such a way that the institutional units which control them are not entitled to a share in any profits or other income they receive. [SNA 4.54] Some NPIs may be created as legal corporations. They are, however, treated as NPIs in the SNA because they cannot be a source of financial gain to the units that establish, control, or manage them.

51. NPIs can be market producers. The term “nonprofit” derives from the fact that the members of the association controlling the NPI are not permitted to gain financially from its operations and cannot appropriate any surplus that it may make. It does not imply that an NPI cannot make a profit from its productive activities. [SNA 4.56] For example, nonprofit universities, hospitals, and credit unions might charge prices that are sufficiently high to be judged economically significant. [SNA 4.58]

52. NPIs that do not charge economically significant prices are nonmarket producers; they must rely principally on funds other than receipts from sales to cover their costs of production or other activities. Their principal source of finance may be investment income, regular subscriptions paid by the members of the association that controls them, or donations from third parties, including government units. [SNA 4.60]

Nonprofit institutions controlled and mainly financed by government

[17] See footnote 1.

53. Some nonmarket NPIs are controlled and mainly financed by government. To be nonprofit institutions, these units must be properly constituted legal entities that exist separately from government. Governments can establish NPIs, reserve the right to appoint the directors and otherwise direct the activities on the NPI, and provide any necessary financing. It is likely that an NPI controlled and mainly financed by a government is carrying out the government's policies using government resources and effectively is a part of that government. Once established, however, the government cannot profit from the NPI's activities or retain a claim on its assets.

54. Governments may find it appropriate to create NPIs to carry out a specific function rather than use a government unit because NPIs are seen as more detached and objective and less subject to political pressures than government units. [SNA 4.62] Possible examples are NPIs engaged in research or development and NPIs that set and/or maintain standards in fields such as health, safety, the environment, accounting, finance, and education.

55. As with corporations, control of an NPI is the ability to determine its general policy or program, typically by having the right to appoint its officers. [SNA 4.62] The SNA does not define "mainly financed." It was previously observed, however, that a nonmarket NPI must rely principally on funds other than receipts from sales to cover their costs of production or other activities, and that one source of these funds can be donations from government units. It is presumed, therefore, that "mainly financed by government" means that a government unit is the principal source of the funds used by a nonmarket NPI to cover its costs of production and other activities.

B. Difficulties in Identifying Public Sector Institutional Units

56. Although the preceding sections present reasonably clear notions of what an institutional unit is and how to classify them as public or private units, there are a number of borderline issues. Not all of them deal with the question of whether a unit is a public or a private unit, but it will be convenient to deal with all borderline issues at the same time.

Control and finance

57. Establishing the definition of control is the most important borderline issue for determining if a unit is a public or private unit. A public corporation is a corporation that is controlled by a government unit, and a NPI is a public unit if it is both controlled and mainly financed by a government unit.

Corporations

58. In many cases, it will be clear that a government unit controls a corporation because it is the sole owner or it has the exclusive right to appoint directors. There easily can be, however, cases in which the government is not the sole owner. In those cases, it may not be obvious that there is a controlling owner. In addition, governments can strongly control the economic actions of corporations by exercising their sovereign powers.

59. A corporation "is collectively owned by shareholders who have the authority to appoint directors responsible for its general management." [SNA 4.23] A public corporation is one that is controlled by a government unit, where "control is defined as the ability to determine general corporate policy by appointing appropriate directors, if necessary." [SNA 4.30] This rule is repeated elsewhere in the SNA with the same generality. **It is recommended that additional guidance be provided on how to implement it.** The IPSASs include some guidance on what is control and this could be considered for use in the SNA. IPSAS 6[18] also includes a decision tree on establishing control of another entity for financial reporting purposes. **Development of a similar decision tree in the SNA is recommended.**

60. The simplest case is where ownership is expressed by possessing a number of shares, all shares have equal standing, owners may own different numbers of shares, and no units can influence the management of the corporation except by owning shares. In this case, "Owning more than half the shares of a corporation is evidently a sufficient, but not a necessary, condition for control." [SNA 4.30] If ownership is diffused among a large number of owners, it is possible for a government unit owning less than half of the shares to control the corporation. Determining when a minority owner controls the corporation is, however, judgment and it is suggested in the SNA that errors should be in the direction of not assuming control: "Nevertheless, because it may be difficult to identify those corporations in which control is exercised by a minority of shareholders, it is recommended that, in practice, corporations subject to public or foreign control should normally be confined to those in which governments or non-residents own a majority of the shares. This recommendation is intended only as a practical guideline, however, to which exceptions can be admitted if there is other evidence of control." [SNA 4.30]

61. Reference is also made in the SNA to slight variations of controlling a corporation by owning shares. A government unit can own shares indirectly as well as directly and the degree of control should be considered the same. "As a practical guideline, therefore, it is recommended that control should normally be attributed to an institutional unit, or organized group of units, only when they own or control (e.g., *through a subsidiary*[19]) more than 50 percent of the voting shares of a corporation…" [SNA 4.70, italics added] For example, a government unit can control one corporation and that corporation can control a second corporation. In theory, a government can control a corporation by owning only a small

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[18] IPSAS 6—Consolidated Financial Statements and Accounting for Controlled Entities.

[19] A corporation (B) is a subsidiary of another corporation (A) when either A controls more than half of the shareholder's voting power of B, or A is a shareholder in B with the right to appoint or remove a majority of the directors of B. Corporation B is an associate of A if A and its subsidiaries control between 10 per cent to 50 per cent of the shareholder's voting power in B so that A has some influence over the corporate policy and management of B.

fraction of its equity indirectly through partial ownership of a long chain of intermediate corporations.

62. The reference to an "organized group of units" in the quotation just cited also suggests that two or more government units acting in concert can control a corporation. For example, within an economic territory, several local governments could jointly establish a corporation to provide regional transportation services. The corporation would be completely owned by government units but is not controlled by any single unit. Nevertheless, it clearly is a public corporation. [SNA 4.70 and 4.84] However, in the case of a corporation located and incorporated in one country, and owned by governments of other countries, the corporation would be classified as a private corporation in the country in which it is located. (See section on Residence below.) **The SNA should make the point more clearly because it indicates that the concept of control is used to determine the way a unit will behave, not to indicate financial responsibility.**

63. Alternatively, a government unit could establish a joint venture with a private unit, in which both owners jointly control and neither is dominant. Such a situation can present a difficult judgment whether the unit is public or private. Current statistical standards require the entire unit to be one or the other; it cannot be partitioned as in financial reporting. **It is recommended that guidance be provided in the SNA on the classification of joint ventures**.[20]

64. Another method of establishing control despite owning a small percentage of the shares is through different classes of shares. For example, there might be Class A and Class B shares, with only the owners of Class A shares having the right to vote for the directors. The value of the Class A shares could be a small percentage of the total equity of the corporation, but the owners of half of the Class A shares would clearly control the corporation.

65. One other method of control is specifically provided for in the SNA: "The government may secure control over a corporation:…(b) As a result of special legislation, decree or regulation which empowers the government to determine corporate policy or to appoint the directors." [SNA 4.72] In some cases, control will be clear. Perhaps the corporation has not issued any formal ownership instruments, but a government possesses and exercises the power to appoint all of the directors. Other cases may not be clear. For example, in return for a charter to a corporation granting monopoly rights to produce some type of goods or services, a government may reserve the right to appoint some of the directors or exercise financial oversight.

66. Legislation other than the specific right to appoint directors can influence a corporation's actions to the extent that control could be considered to have been established.

[20] The Canberra II Group is examining nonfinancial assets including assets of joint ventures.

For example, a corporation could be limited in the type of output it may produce; there may be minimal quality standards or required uses of inputs; and many other types of restrictions are possible. If restrictions of this nature are particularly extensive, then one could conclude that the government is determining general corporate programs and thus has control. General regulatory powers, on the other hand, do not constitute control of corporate policy. For example, industry regulators do not control the corporations that they regulate. There is no guidance in the SNA on this subject beyond the cited statement that control can be obtained by means of special legislation. **As long as the corporation is under the management of privately appointed directors and the benefits of the corporation's activities accrue to private owners, the corporation should be classified as private, but greater specificity in the SNA should be added.**

67. Corporations, which in the SNA include legal forms of organization other than corporations, could be controlled by a government but operated for the benefit of other units or they could not be controlled by a government but operated for the benefit of government. Two special types of organizations of this nature are organizations in which a government acts in a fiduciary capacity for other units and special purpose vehicles (SPVs) created by securitization operations in which a private financial corporation is the trustee acting for the benefit of a government. These cases are discussed in later sections. [SNA 4.84]

Nonprofit institutions

68. NPIs can be controlled by other units just as corporations can be controlled, but the controlling units cannot benefit financially from the operations of the NPI. With regard to market NPIs, it is stated in the SNA that control of nonfinancial market NPIs is determined by the same rules as are used for nonfinancial corporations, [SNA 4.70] and that financial market NPIs should be evaluated according to the same criteria. [SNA 4.84]

69. The classification of nonmarket NPIs as public or private does not follow the same criteria as the classification of corporations. Control of a nonmarket NPI is determined in the same manner: "In this context, control [of a nonmarket NPI] is to be understood as the ability to determine the general policy or programme of the NPI by having the right to appoint the officers managing the NPI." [SNA 4.62] Nonmarket NPIs are classified as public units, however, only if they are both controlled and mainly financed by government. It was deduced above that mainly financed means that a large share of the funds needed for current operations is supplied by government.

70. Although the criteria for determining control of an NPI are the same as for control of a corporation, those criteria may not be applicable to a NPI or not with the same degree of importance. A typical corporation is governed by owners casting votes in proportion to the number of shares owned. Because NPIs do not have owners, this method of selecting directors is not possible. If the NPI is a member-based organization, then the directors likely are elected with each member having one vote, regardless of the member's degree of financial support or other involvement in the NPI. It is unlikely that a government unit, or any other type of unit, could control such a NPI as it would have just one vote. However, if

there were several members from government units, then the government would have several votes and could control the NPI. The directors of other types of NPIs are either self-selecting, in which case the existing directors select new directors to fill a vacancy, or are determined in accordance with the legal documents that created the organization, in which case the directors are usually appointed by a specified government or other sponsoring organization. In either case, a government could dominate the board of directors and control the organization.

71. Because the methods of controlling a NPI differ from corporations, statistical agencies have considered several criteria when deciding if an NPI should be considered a public unit. Some of the criteria that have been suggested are: (1) whether the NPI's budget requires approval by a government, (2) whether its financial results are subject to government audit, (3) whether the NPI's financial results are included in government financial reports, (4) whether the employees are government employees, (5) whether the government is the sole consumer of the NPI's output, and (6) whether the NPI performs a regulatory function. Satisfying one of these criteria is not conclusive, but it does suggest that the government controls the NPI.

72. It is not clear from the current text of the SNA whether the requirement to be mainly financed by government is a supplemental means of establishing control or whether it is an independent requirement. Supplying a large share of the operating funds to a nonmarket NPI certainly creates the opportunity for influence as the donor can severely curtail the NPI's operations by withholding funds unless the directors of the NPI agree to act as directed by the donor. An NPI that is not otherwise controlled, however, retains the option of refusing the funds and operating on a reduced scale unconstrained by the donor-imposed restrictions. A government also could provide funds to an NPI without connecting them with any operating restrictions. The government may feel obligated to provide certain services to its constituents and an existing NPI may already have the know-how to provide those services efficiently. As a result, the government can simply provide sufficient funds to produce the desired volume of output without exerting any control. Thus, it is not obvious that finance provides control.

73. Statistical agencies have answered this question differently. Governments often provide a large share of the operating funds for universities, primary and secondary schools, and hospitals, but do not directly appoint the directors or otherwise interfere with the operating and financial decisions of the institutions. In some cases, governments may impose substantial restrictions about curriculum or standards of health care. Some agencies have decided that the supply of funds and operating restrictions amount to de facto control; other agencies have concluded that the institutions make their own operating decisions and, therefore, are private units.

74. Another possibility is that having control may not be sufficient to force an NPI to carry out the wishes of the controlling unit. A nonmarket NPI must rely principally on funds other than receipts from sales to operate. Presumably the goods and services provided are a type deemed important by the directors of the NPI, and the directors must have an expectation of being able to raise the necessary funds from donors who also think the

services are important. It is not likely that a government could establish a NPI for the purpose of supplying a certain type of services, appoint all of the directors, and then expect the general public to supply the funds. In other words, if a government wishes the NPI to act as an extension of the government, then the government most likely will have to finance as well as control the NPI.

75. ***In summary, more guidelines are required in the SNA on the classification of NPIs as it is not clear which NPIs are part of the public sector. Although the criteria for determining control of NPIs is the same as for corporations, such criteria may not be applicable as the methods of controlling NPIs differ to those of corporations. For non-market NPIs, it is not clear whether the requirement to be mainly financed by government is part of the control definition criteria or an additional requirement. Clarification is recommended.***

Independence and autonomy of decision

76. Institutional units, as defined in section III.A, are independent in the sense that they are able to engage in economic activities, own assets, incur liabilities, enter contracts, and be responsible at law for their own actions. However, their autonomy may be constrained to some extent by other institutional units. For example, the fact that other units must own a corporation means there is a limit on its autonomy. In general, each corporation is treated as a separate institutional unit, even if it is completely owned and controlled by another corporation and has no autonomy of decision.

77. An ancillary corporation is an exception to the rule that each corporation is a separate institutional unit. "An ancillary corporation is a subsidiary corporation that is wholly owned by a parent corporation and whose activities are strictly confined to providing services for intermediate consumption by the parent corporation or other corporations owned by the same parent." [SNA 4.40] Typically, ancillary corporations produce transportation, purchasing, sales and marketing, financial or business services, computing and communications, security, maintenance, or cleaning services. [SNA 4.41] Ancillary corporations are not treated as separate institutional units in the SNA because they are artificial units created to avoid taxes, minimize liabilities in the event of bankruptcy, or secure other technical advantages under the tax or corporation legislation in force in a particular country. [SNA 4.44]

A complete set of accounts

78. A complete set of accounts, including a balance sheet, must exist for an institutional unit, or it must be possible and economically meaningful to construct such a set of accounts. The meaning of a complete set of accounts is not further explained. The specific mention of a balance sheet is somewhat peculiar. It could be that balance sheets were integrated into the statistical system of the SNA for the first time with the 1993 version of the system and there was a desire to call attention to the new feature. Another possible reason is that the balance sheet can serve as the conceptual foundation of the system. Once a balance sheet and the assets and liabilities to be recorded on it are defined, then it is logical that the statistical

system should include the economic flows necessary to explain all changes in the balance sheet of a unit between the beginning and end of an accounting period.

79. Having a balance sheet implies a minimal degree of organizational cohesion, but it does not imply anything about what types of assets and liabilities might be recorded on it. That is, any organizational element of a government department, ministry, agency, or other major organization may have possession of some government-owned assets, but it would not be meaningful to construct a balance sheet for that element unless it is recognized in a budget or other formal document as owning the assets and has formal responsibility for the use of the assets. It was noted in paragraph 26 (*please automate update)* that ministries and departments are not institutional units. They do have balance sheets, however, or it would be meaningful for accountability purposes to construct balance sheets. Thus, a balance sheet is a necessary but not a sufficient condition to be an institutional unit.

80. A complete set of accounts can be constructed by government ministries, departments, agencies, and so forth even though their range of activities, assets, and liabilities may be limited. The clear intent of the SNA, however, is that a complete set of accounts should be meaningful for economic analysis, and a complete set of accounts for ministries does not satisfy this criterion.

81. The definition of an institutional unit only states that it can engage in economic activities, own assets, and incur liabilities. It does not say a unit can engage in all types of economic activities, own all types of assets, and incur all types of liabilities or that, at a minimum, it must be able to own certain types of assets and engage in certain types of activities. Some units are limited in their range of activities by their nature or by force of law, but this type of limitation should not affect the definition of an institutional unit. The general intent of an institutional unit expressed throughout the SNA is that a unit should be capable of engaging in *all* types of activities appropriate for the type of unit, which implies an ability to own *all* types of assets and liabilities. If this is true, then all of the SNA accounts can be compiled for an institutional unit in a meaningful way. **The SNA should be revised to confirm or deny this interpretation of the definition of an institutional unit.**

Residence

82. The overriding goal of the statistical system of the SNA is to measure production taking place within a country. For this purpose, production is defined in terms of the productive activities engaged in by resident institutional units. Within that restriction, however, an institutional unit is not limited in its geographic location. The offices of the primary central government unit are likely to be spread throughout the entire country and may extend outside the country, for example, embassies. When a corporation undertakes economic activity outside its own economic territory, the SNA [4.24] recommends the creation of separate units in each economic territory in which the activity takes place. To show the correct value of the parent unit, a financial asset representing the value of each

foreign subsidiary is added to its balance sheet, but not the individual assets and liabilities of the foreign subsidiaries.

83. In the SNA, an institutional unit is resident in a country when it has a center of economic interest in the economic territory of that country. Residence is not based on nationality or legal criteria because they may not be appropriate for economic purposes. [SNA 14.8]

84. The economic territory of a country consists of the geographic territory administered by a government within which persons, goods, and capital circulate freely, including any clearly demarcated areas of land located in other countries and used by the government that owns or rents them for diplomatic, military, scientific or other purposes—embassies, consulates, military bases, scientific stations, information or immigration offices, aid agencies, etc.—with the formal political agreement of the government of the country in which they are physically located). [SNA 14.19] Conversely, embassies, consulates, military establishments, and other entities of a foreign general government unit are to be considered as extraterritorial by the economy in which they are physically located. [SNA 14.31]

85. Corporations have a center of economic interest in a country when they are engaged in a significant amount of production of goods or services there, or own land or buildings located there. They must maintain at least one production establishment in that country that they plan to operate indefinitely or over a long period of time—a guideline of one year or more is suggested. [SNA 14.22]

86. As the foreign operations of public corporations are nonresident institutional units, they are not part of a country's public sector and their production should be classified as production in a foreign country. However, the net result of their activities will be included in the statistics of the public sector[21] and the net worth of the public sector will be correct. **This requirement for separation of operations into domestic and foreign could be made clearer in the SNA.**

Pension funds and other fiduciary activities

87. Employers and governments often hold funds in a fiduciary capacity for other units. If the holding of these fiduciary funds is organized in a manner that constitutes a separate institutional unit, such as an autonomous pension fund for employees or a joint investment fund for several governments, the units must be classified in the same manner as other institutional units. In this case, a government unit or a public corporation will control the pension or investment fund, and it would be classified as a public unit. Such a classification might be inappropriate because the unit's fiduciary activities are not governmental activities and benefits flow, not to the public sector, but to households.

[21] See footnote 10.

88. Institutional units are capable, in their own right, of engaging in all types of activities, but pension funds generally do not have that capability. The employees managing the funds are usually employees of the parent organization and the capital stock employed usually is the property of the parent unit. Typically, only a summary management fee is charged to the pension fund for the operating expenses. Nevertheless pension funds that are constituted in such a way that they are separate units in the SNA are classified as financial corporations. The current definition of control in the SNA, however, still leaves these units in the public sector when they probably should be private financial corporations.[22] **Extending the SNA definition of control to include the power to receive a benefit from the controlled entity, would exclude units operated in a fiduciary capacity from the public sector, which is desirable.**

Special purpose vehicles

89. SPVs are created for securitization, financing public private partnerships,[23] and other specialized activities where a separation from their nominal owner of assets or the right to future revenue is desired. For example, a government unit might transfer its rights to future taxes of a specified type to a SPV in exchange for a specified sum. The SPV then borrows using the rights to future government revenue as collateral and uses the funds to pay its obligation to the government. It then repays the borrowed funds using the designated taxes as they are received. The SPV usually is created as an independent entity for this single purpose and will go out of existence when the taxes have been collected and all debts liquidated. Often it is a trust under nongovernment administration. As such, it is a separate institutional unit, a financial corporation. Its classification depends on who controls the SPV, which could be the government unit, but more likely is an independent trustee. **There are no guidelines in the SNA about how to evaluate and classify SPVs.**[24] Quite often, they are simply methods for government units to borrow with the SPV providing a fiduciary role, which implies that the SPVs should be public units or an ancillary unit within a government unit.

NPIs controlled and mainly financed by government versus NPIs serving households that obtain all or most of their funds from government

90. Governments and NPIs often serve the same goals of providing social services to selected portions of the population free or at very low cost. Sometimes a government unit will provide the funds to support delivery of the services, but a NPI will actually produce the services or procure them from another producer. When that happens, the classification of the

[22] See footnote 1.

[23] SPVs are specific to individual public private partnership (PPP) projects. A SPV for a PPP is typically a consortium of banks and other financial institutions, set up to coordinate the use of their capital and expertise.

[24] See footnote 2.

NPI depends on the interpretation of government payments to the NPI and the definition of economically significant prices (see section IV).

91. If the payments are interpreted as a purchase of services or as a subsidy on products (i.e., payment is related to the volume of the goods and services produced) to the NPI, then the NPI is classified as a market producer, either public or private depending on the interpretation of the degree of government control. If the payments to the NPI are treated as non-subsidy transfer payments, then the NPI is a nonmarket producer. Being mainly financed by government, it is again a public or private unit depending on the interpretation of control. There have been discussions for many years about the guidelines to be used when classifying government payments to NPIs. **The SNA needs further guidelines in this area.**

C. The Reporting Entities of Financial Accounting

General considerations

92. A reporting entity in financial accounting is any entity for which general purpose financial reports are prepared and distributed to the public. The reporting entity is the closest equivalent to the statistical unit of economic statistics. The guidelines for which entities should issue general purpose financial reports are rather vague. It is also true, however, that there is less need for precision because the use of reporting entities differs from the use of statistical units.

93. The IFAC PSC is developing accounting standards (IPSASs) for public sector reporting entities other than government business enterprises (GBEs). The standards published thus far address the definition of a reporting entity only indirectly through a definition of control for reporting purposes. If a reporting entity controls, directly or indirectly, another entity, then the two entities are combined for reporting purposes and become part of a larger reporting entity.

94. A reasonable starting assumption is that a reporting entity must be an organizational structure that can employ resources at some cost to achieve objectives. Beyond this generality, the identification of reporting entities is a judgment about which entities are sufficiently important that decisions by members of the general public will be influenced if a set of financial reports is published. There is a practical minimum size for reporting entities because an entity should engage in a sufficiently broad set of activities that a financial representation of those activities will be reasonably comprehensive and the financial reports will be meaningful. Thus, the entity should be a cohesive economic unit, which usually implies a unified control structure.

95. Incorporation or a similar legal form of organization is one guide to reporting entities, but it is not foolproof. Many GBEs and many regional and local governments are incorporated, which provides a natural definition of a unit. Sovereign governments are more amorphous in their organization, leading to more ambiguity about the reporting entity.

96. Whether incorporated or not, other considerations need to be applied to define the reporting public sector entities in a given country. Before developing the IPSASs, the PSC published a number of studies about fundamental issues in financial reporting by public sector entities. One of these studies dealt with the definition of the reporting entity.[25]

97. Study 8 states that the overriding objective of financial reporting is to communicate reliable information that will be relevant for decision making. The range of possible users is vast, but the entity should be defined so that the needs of as many users as possible will be met. Some users will be concerned with general economic conditions and the effects of the activities of the reporting entity on those conditions so that they can plan their own activities, much the same as the needs at which economic statistics are directed. Other users include existing and potential creditors of the reporting entity and taxpayers concerned with the proper use of public resources. Creditors will be concerned with the entity that is legally obligated to repay the debts. Taxpayers are concerned with the entity that is accountable to them in general elections. Thus the size and scope of reporting entities can vary considerably depending on institutional arrangements and users.

98. The range of potential users and their needs suggests two general approaches to defining reporting entities. First, a legislature typically approves a budget allocating public funds to various organizational components of the government, and there is a need to verify that the funds have been used as directed. A reporting entity based on the organizations identified in the budget would be appropriate for this need. Second, some organizational components receive resources outside the budget. For example, a GBE may be profitable enough to meet all of its operating and capital needs or it may receive a lump-sum subsidy via the budget. Organizations of this type represent uses of public resources and are used to fulfill the government's objectives. The public has a need for information about all resources controlled by the government and the reporting entity should be one that controls all resources controlled by an elected body.

99. A given organizational entity can be part of more than one reporting entity. For example, the entire central government can be one reporting entity, which would include all of its ministries. Each ministry can be a reporting entity of its own, and it would include all of its subordinate bureaus or other organizational components. Each bureau within a ministry could be a separate reporting entity. Thus, each bureau would be part of three different reporting entities, but duplication is not a difficulty because the financial reports of each level of government provide different, relevant information to different users. In contrast, there is no duplication among institutional units. They are like building blocks that can be sorted and combined at will, a feature that meets the needs of economic statistics.

[25] International Federation of Accountants, Public Sector Committee, *Study 8: The Government Financial Reporting Entity*, July 1996. It is available at http://www.ifac.org/store.

100. A reporting entity can be smaller than an institutional unit, such as a bureau within a ministry, or it can be larger than an institutional unit, such as the whole of government, including its controlled GBEs. A reporting entity must have a complete set of accounts, which implies an ability to own assets and engage in transactions in its own name, but this requirement is less stringent than the equivalent requirement for institutional units. A ministry most likely cannot borrow funds in its own name, as required to be an institutional unit, but it can have a meaningful balance sheet. On the other hand, a reporting entity includes all controlled entities, which could include public corporations, social security funds, or other separate institutional units. **It is recommended that the PSC provide more clarification in the IPSASs on what constitutes a reporting entity.**

Control

101. The reporting entity is indirectly defined in IPSAS 6.[26] With a few exceptions, this standard states that any entity that issues financial reports should issue reports that are consolidated with the reports of all entities controlled by the issuing entity. The reason is to show all resources controlled and for which the entity is accountable.

102. *(Please fix paragraph indenting in remainder of paper)* The PSC defines control as "the power to govern the financial and operating policies of another entity so as to benefit from its activities." [IPSAS 6.8][27] The two parts of the definition are tested separately. [IPSAS 6.26]

103. The power to govern the financial and operating policies of another entity is established if: the entity has: (1) directly or indirectly, ownership of a majority voting interest in the other entity, (2) the power to appoint or remove a majority of the members of the governing body of the other entity, (3) the power to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of the other entity, or (4) the power to cast the majority of votes at meetings of the board of directors or equivalent governing body. [IPSAS 6.35] Even if none of these conditions are present, one entity may still govern the financial and operating policies of another entity. Some indicators that suggest the existence of this power are: (1) the controlling entity has the ability to veto the operating and capital budgets of the other entity, (2) the controlling entity has the ability to veto, overrule, or modify governing body decisions of the other entity, (3) the controlling entity has the ability to approve the hiring, reassignment and removal of key personnel of the other entity,

[26] IPSAS 6 is based on IAS 27—Consolidated and Separate Financial Statements, which is currently being reviewed by the International Accounting Standards Board (IASB). As part of its review, the IASB has been looking at national accounting standards. The IASB regards the New Zealand standard on consolidation (FR37) as the best national consolidation standard.

[27] References to the IPSASs will be given as [IPSAS x.y], where x is the number of the accounting standard and y is the number of the paragraph. References that do not follow quotations are paraphrases of the cited paragraphs.

(4) the mandate of the other entity is established and limited by, legislation, or (5) the entity holds a special class of shares in the other entity that confers rights to govern the financial and operating policies of that other entity. [IPSAS 6.36] If one or more of these conditions is present, judgment must be used to decide if control exists.

104. According to the PSC, having the power to govern the financial and operating policies does not mean that the powers have to be exercised. The controlling entity does not have to have responsibility for the day-to-day operations of the controlled entity. An entity may exercise its power to control another entity only in exceptional circumstances, which may never occur. [IPSAS 6.29] The power must, however, be presently exercisable. If the power depends on the existence of legislation or a formal agreement, that legislation or agreement must be in effect; it cannot be contingent and it cannot require changing legislation or renegotiating agreements. [IPSAS 6.28]

105. One entity may control another entity even if the controlled entity has separate, independent legislative powers. For example, an agency may have the power to issue regulations on a certain topic without approval by any other entities. If another entity otherwise has the power to control its financial and operating policies, it is considered to be controlled by that other entity. [IPSAS 6.31]

106. The second condition for control to exist is the power of one entity to benefit from the controlled entity. Conditions indicating that one entity is able to benefit from another entity are: (1) the benefiting entity has the power to dissolve the other entity and obtain a significant level of the residual economic benefits or bear significant obligations, and (2) the benefiting entity has the power to extract distributions of assets from the other entity, and/or may be liable for certain obligations of the other entity. [IPSAS 6.35] Even if neither of these conditions is present, the power to benefit from another entity may still be present. Other indicators that one entity may benefit from another entity are: (1) one entity holds direct or indirect title to the net assets/equity of the other entity with an ongoing right to access them, (2) one entity has a right to a significant level of the net assets/equity of the other entity in the event of a liquidation or in a distribution other than a liquidation, (3) one entity is able to direct the other entity to co-operate with it in achieving its objectives, or (4) one entity is exposed to the residual liabilities of the other entity. [IPSAS 6.36] This benefit requirement excludes a trustee whose relationship with a trust does not extend beyond the normal fiduciary responsibilities of a trustee. [IPSAS 6.32]

107. Governments can strongly influence other entities through their regulatory powers or a position as the principal buyer of the entity's output or principal provider of its finance. These powers do not constitute control for the purposes of financial reporting. In particular, the power of the legislature to establish the regulatory framework within which entities operate and to impose conditions or sanctions on their operations does not constitute control of the regulated entities. For example, a pollution control authority may have the power to close down the operations of entities that are not complying with environmental regulations, but this power does not constitute control. If an entity retains discretion as to whether it will take funding from, or do business with, a public sector entity, that entity has the ultimate

power to govern its own financial or operating policies and is not controlled by the public sector entity. For example, an NPI may be economically dependent on a public sector entity for most of its funding but retains discretion as to whether it will take funding. It has the power to govern its own financial or operating policies and is not controlled by the public sector entity. [IPSAS 6.33]

108. The description of control in IPSAS 6 is considerably more detailed than the corresponding description in the SNA. It not only adds the requirement that the controlling entity benefit from the controlled entity, but addresses directly several of the questions mentioned above as being uncertain in the SNA. **The requirement to benefit from the controlled entity is just as applicable to economic statistics as to financial reporting and should be added to the SNA definition**.[28] It does, however, leave room for interpretation in the government context, especially regarding NPIs. If a government's objective is to provide certain social services to the public, then contributing funds to an NPI engaged in producing those services will help the government unit obtain its objectives, thereby benefiting from the NPI. The thrust of IPSAS 6, though, is that being the principal or sole source of funds is not control. Indeed, the nature of an NPI seems to preclude a government entity from possessing any of the indicators of benefit listed in IPSAS 6.35 and 6.36. The right to benefit is possibly a necessary but not sufficient condition and a requirement of substantial financing may need to be added. **Thus, the interpretation of control of an NPI or an NPI controlled and mainly financed by government remains uncertain and clarification is required in the IPSASs**.

D. Harmonizing Concepts of the Public Sector

Differing goals

109. Economic statistics and financial accounting have different goals, so it should not be surprising that they produce different results even though they nominally are summarizing the same activities of the same entities by following the same general accounting concepts. For analytic purposes in economic statistics, the resident institutional units that make up an economy are grouped into five mutually exclusive institutional sectors. These are the nonfinancial corporations sector, the financial corporations sector, the general government sector, the non-profit institutions serving households sector, and the households sector, with splits of the corporations sectors into public and private. For the public sector (general government sector and public corporations), the activities and classification of all government units and all other units controlled by government units are summarized by sector. To do that, control is defined to identify the corporations and nonprofit institutions that effectively are a part of a government even if they are not controlled by a single unit. The results for government units that have no relationship to each other are combined, into the general government sector, because they carry out the same type of activities. Similarly,

[28] Benefits, in the case of government, should not include the receipt of tax payments.

the results for unrelated public corporations are combined. In contrast, the interest of financial reporting is to produce information on all of the resources that are under a single command so that a proper assessment of accountability can be made. To do that, control must be defined to identify all entities controlled by a given entity. The range of economic activities engaged in by the collection of controlled entities is unimportant, but the results for unrelated entities are never combined, even if they are carrying out the same economic functions.

110. The definition of a financial reporting entity is intentionally more flexible than the definition of an institutional unit. Government ministries, departments, agencies, commissions, and so forth are all likely to be considered reporting entities, but they will in general be less than institutional units. The whole of government is also a reporting entity and most likely includes several institutional units. The statistical need is for a set of non-overlapping reporting entities that can be combined to produce the general government sector, the public sector, and any desired subsectors. There is more flexibility built into the grouping of units (grouping of institutional units into a reporting unit which is a sector) in economic statistics than the grouping of units (reporting entities) in financial accounting.

Coverage of the public sector

Definition of control

111. Financial reporting and economic statistics have different definitions of control. The two concepts of the public sector are already quite close, but agreeing on a common definition of control would close much of the gap remaining. The SNA definition is less restrictive than the financial reporting definition. The criterion of having the power to govern the financial and operating policies of another entity in the financial reporting definition is essentially the same as the entire definition of control in the SNA. **The power to receive a benefit from the controlled entity is not part of the SNA definition, but should be for corporations. Doing so would exclude units operated in a fiduciary capacity from the public sector of the SNA, which is desirable. The explanations that the power to control must be presently exercisable (i.e., power already conferred by legislation etc.) and that regulatory or purchase powers do not imply control should be added explicitly to the SNA definition of control. Additional guidance on the meaning of "the capacity to determine financing and operating policies" should be provided in both the SNA and IPSASs. The New Zealand standard (FRS 37) could usefully be drawn on.**

112. The IPSASs are drawn primarily from the IASs and the PSC has a policy of updating the IPSASs in line with IAS updates. **As the IASB is currently reviewing IAS 27, the standard underpinning IPSAS 6, it is recommended that proposed drafting changes for the SNA definition of control be prepared once the new International Financial Reporting Standard (IFRS) is issued.** An Exposure Draft is expected in late 2004.

Nonmarket nonprofit institutions

113. It is not clear which nonmarket NPIs are part of the public sector in economic statistics or financial accounting. It is interpreted here that in the SNA "mainly financed" is a separate requirement from "control" when determining if a nonmarket NPI is a public unit and that both conditions are required, but that interpretation is not certain. The interpretation of government payments to NPIs as either purchases of output, subsidies, or a non-subsidy transfer payment is also not clear in the SNA and could affect the status of an NPI as a market or nonmarket producer. Many nonmarket NPIs carry out functions that a government would have to fulfill if the NPI did not exist, so government contributions to such NPIs can be interpreted as providing benefits to the contributing government. In the IPSASs the definition of control does not include a requirement to be mainly financed by government. The focus is more on who can decide how the financing is to be used, rather than the source of the financing (see paragraph 107 *please automate updating*). Control is exerted by the entities that have a claim on the net residual assets of the controlled entity. **However, it is not clear how a government obtains the benefits required for control in the context of NPIs for financial reporting purposes. Thus, there is a need to clarify both the SNA and the IPSASs on this point to insure a common coverage of public sector entities.**

Foreign operations

114. Even with the same definition of control, foreign operations[29] of public corporations will be included in the public sector for financial accounting but should be excluded for economic statistics. In order to measure domestic production, the equity of foreign operations is considered a financial asset in economic statistics and the income earned by them is reported on an equity basis.[30] **If the results of domestic and foreign operations are separately reported in the financial reports, however, then it should be possible to exclude foreign operations for statistical purposes.**

Fiduciary activities

115. Government employee pension funds and other units controlled in a fiduciary capacity by government units currently are part of the public sector in the SNA as interpreted here, but not for financial reporting**. If the financial accounting definition of control were adopted by economic statistics, then these units would be excluded from the public sector in the SNA. Financial results of these units should be reported in some manner for accountability and statistical purposes, but a common treatment should be developed.**[31]

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[29] Foreign operation is used here as it is in IPSAS 1—Presentation of Financial Statements [1.6] to mean "a controlled entity, associate, joint venture or branch of the reporting entity, the activities of which are based or conducted in a country other than the country of the reporting entity."

[30] See footnote 11.

[31] See footnote 1.

Other issues

Special purpose vehicles

116. There is no guidance for the treatment of special purpose vehicles[32] in either the SNA or the IPSASs. **Common guidance should be developed jointly for both standards.** They have become important for securitization operations but they can be used for a wide variety of purposes. Recent work by the IASB[33] and the New Zealand Treasury[34] should be beneficial for this task.

Public joint ventures

117. Corporations jointly controlled by several government units or public corporations, within an economic territory, are public corporations in the SNA [SNA 14.33], although **more specific guidance should be added to confirm that assertion**. They are not treated as international organizations but are considered to be resident corporations or quasi corporations of the economies on whose territories they operate. It is not clear from IPSAS 8[35] how such corporations would be reported for financial reporting. They could be independent, uncontrolled reporting entities, in which case their results can be used directly in economic statistics. They might also be considered joint ventures, in which case a proportional share of their assets, liabilities, and transactions would be included with each government participating in the venture. **Statisticians should be aware of the treatment so that they can make any necessary adjustments.**

Public-private joint ventures

118. By definition, control of these ventures is shared so that the units are neither public nor private. IPSAS 8 governs the financial reporting for joint ventures. In general, each partner includes proportional shares of all of the assets, liabilities, and transactions of a joint venture in their financial reports. **There is no guidance in the SNA**. However a joint

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[32] See footnote 2.

[33] See footnote 26.

[34] The New Zealand Treasury has approached the New Zealand accounting standard setter to consider a clarification change to FRS 37 for special purpose entities. The proposal is for government to consolidate units that have autonomy to act in pursuit of specified objections, but where there are sufficient constraints on those entities to ensure the protection of the government's residual financial interest in them. Control does not require that the government has responsibility over the day-to-day operations of an entity.

[35] IPSAS 8—Financial Reporting of Interests in Joint Ventures.

venture[36] is classified, it would not be partitioned as in financial reporting as partitioning does not exist for a unit in the SNA.

Definition of an institutional unit

119. Institutional units are defined so that they will adequately support macroeconomic analysis. The measurement and analysis of production is perhaps the primary goal of economic statistics, and the classification of institutional units in the SNA into market and nonmarket producers is vital for that goal. A second design aspect is that the variety of possible analytical tasks requires a coherent set of statistics regarding the full range of economic activities. The definition of an institutional unit as a unit that can engage in all types of economic activity is crucial for such a coherent set of statistics. **The current definition needs some elaboration as institutional units cannot be identified without additional guidance and the definition permits practical interpretations that support various analytical objectives.**

a. Having balance sheets, a complete set of accounts, owning assets and incurring liabilities can be done by entities that are not institutional units. **The relationship between these characteristics and the concept of an institutional unit needs to be defined more clearly.**

b. Social security and autonomous pension funds probably are not institutional units if the definition is strictly followed, but the needs of economic analysis are better met if they are classified as institutional units. **The definition of an institutional unit should make it clear why they are so classified.**

c. Some conditions are cited in paragraph 23. for government units that do not appear to be part of the definition of an institutional unit. **The need for these conditions should be stated. (*Please remove bolding on "3".)***

IV. THE GENERAL GOVERNMENT SECTOR

120. The second question in paragraph 5. asks whether, within the universe of public sector entities, economic statistics and financial accounting identify the same units as being engaged primarily in either commercial or governmental activities. As with defining the entire public sector, the objectives of distinguishing commercial and governmental units are different for economic statistics and financial accounting. For economic statistics, the desire is to group units subject to market demands separately from units not subject to market demands because they behave differently. For financial accounting, different accounting standards apply. Units engaged primarily in commercial activities (GBEs) are subject to the

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[36] See footnote 2.

requirements of the IFRSs and the earlier IASs issued by the IASB. Governmental units are governed by the IPSASs issued by the PSC.

121. Economic statistics use the concept of economically significant prices to distinguish between commercial and governmental units. This nebulous concept is discussed in section IV.A. Improvements can undoubtedly be made in the definition, but the goal of a precise operational definition will remain elusive. It was previously asserted that all units are either predominantly market or nonmarket producers. **As will be seen, this generalization is not quite true; the possibility of mixed units should be admitted.**[37] The treatment of such units is discussed in section IV.B. The definition of a GBE in the IPSASs, discussed in section IV.C, is more easily applied, but it probably is too rigid. Mixed units would be classified as governmental units under the IPSAS definition, but there are still possibilities for flexible financial reporting that would satisfy the needs of economic statistics. This topic is the subject of section IV.D.

A. Economically Significant Prices

122. A publicly controlled institutional unit could be either a government unit or a public corporation in the SNA depending on the prices for which the unit sells or otherwise disposes of its output. Market producers sell most or all of their output at prices that are economically significant. Prices are economically significant when they have a significant influence on the amounts the producers are willing to supply and on the amounts purchasers wish to buy. Universities and hospitals, for example, are market producers when they charge fees based on their production costs that are sufficiently high to have a significant influence on the demand for their services. Even if they generate persistent operating losses, they are market producers as long as their fees are determined mainly by their costs of production and are high enough to have a significant impact on demand. [SNA 6.50]

123. Nonmarket producers are producers that provide most of their output to others free or at prices that are not economically significant. A price is not economically significant when it does not have a significant influence on the amounts the producers are willing to supply or on the amounts purchasers wish to buy. Such prices are likely to be charged in order to raise some revenue or achieve some reduction in the excess demand that may occur when services are provided completely free, but they are not intended to eliminate such excess demand. Once a decision has been taken on administrative, social or political grounds about the total amount of a particular nonmarket good or service to be supplied, its price is deliberately fixed well below the equilibrium price that would clear the market. The price merely deters those units whose demands are the least pressing without greatly reducing the total level of demand.

[37] Mixed units are units that are engaged in both market and non-market production.

124. Applying the definition of an economically significant price can only be a matter of judgment. The title is unfortunate, but should not be allowed to impede the adoption of sensible guidelines. Any price, including a price of zero, has economic significance and will affect the amounts demanded. More realistically, the definition is an attempt to describe situations in which the producer is selling its output for a market price or something close to it and responds to changes in market prices in ways similar to responses expected by private producers. This behavior is quite different from a nonmarket producer that supplies outputs for which there is not an effective market, such as public safety, or which a government or nonprofit institution feels members of its community should have access to but may be too expensive for many, such as shelters for the homeless. These producers will produce according to their capacity or what they feel is socially needed; any receipts from customers will be secondary.

125. The two extremes are fairly clear. Between them is a vast range of uncertainty. If a price permits an enterprise to generate continuously a positive operating surplus and the price is determined by current supply and demand conditions, it is a price that would be charged by a private corporation and is economically significant. Both the producer and the consumers will adjust to changes in the price. Two general cases can be imagined in which one of the conditions just described is absent, but one would most likely conclude that the price is economically significant. First, the price may not generate a positive operating surplus and there may be no reasonable hope that any price would generate a surplus. Municipal transportation enterprises are typical examples. In most cases, the profit-maximizing price will produce a loss. Receipts that cover 50 to 75 percent of costs are common. Governments perceive a social necessity to provide public transportation and will subsidize it to maintain some desired level of service. As long as the transportation enterprise acts like a market producer by adjusting its level of output and prices in response to demand and seeks to minimize costs, then this type of enterprise should be treated as a market producer. Second, a government may produce a product that could be sold at a profit-generating price, but adopts a public policy of selling it at a lower price to make it affordable to certain portion of the community. Perhaps there is a public unit that is the monopoly producer of electricity in a local market and the controlling government decides to set the price at 80 percent of the cost of production. Although a subsidy will be required, the enterprise is still acting as a market producer.

126. There have been several efforts since the publication of the SNA to divine what an economically significant price is, either attempting to develop general rules[38] or by examining individual cases. There cannot be any greater hope of defining an operational definition here than has been achieved elsewhere. In order to retain flexibility in the SNA, it is recommended that some additional background guidance, not rules, be developed and the

[38] The European System of National Accounts (ESA 95) adopts a 50 per cent rule to determine the type of producer and the sector for private NPIs.

relationship with the definition of a GBE may be examined. The *ESA 95* could be considered in developing further guidance.

127. Most of the efforts to define an economically significant price center on the percentage of cost of production that the price represents. The higher the percentage, the more likely the price is economically significant. These analyses have revealed a need to better define price, sale, subsidy, and transfer payment.

128. There are three different definitions of price used in the SNA: basic, producers', and purchasers' prices. Basic prices are generally favored for valuing output. The basic price is the amount receivable by the producer from the purchaser for a unit of a good or service minus any tax payable and plus any subsidy receivable as a consequence of its production or sale. [SNA 6.205] If a government unit pays a subsidy calculated as an amount per unit, then the basic price includes that amount in addition to the amount paid by the purchaser. Thus, a product can be very heavily subsidized, but have a basic price that more than covers the cost of production. If the subsidy is paid to a private producer, then there is little question that the producer is a market producer. If the subsidy is paid by a government unit to a putative controlled public corporation, then there is no difference between this arrangement and one where the government simply sells the product for a minimal price. That is, an institutional organization should not be usable to convert a sale at a price that is not economically significant into a sale at an economically significant price.

129. Defining a sale is difficult when a government is involved. One of the economic functions of government is to supply goods and services to the community for free or at prices that are not economically significant. It can accomplish this supply by producing the goods and services or by insuring their supply by a third party. If the government chooses to involve a third party, it can purchase the items from a market producer at a market price and distribute them to the community or it can provide funds to a nonprofit organization engaged in that business. In the latter case, is the payment to the NPI a purchase of the output, which the government then gives to members of the community according to its criteria, is it a subsidy per unit of production, or is the payment a lump-sum donation to the NPI so that it can produce and distribute the output?

130. Other general guidelines concern the unit's behavior and how subsidies are distributed. For example, how is the price established? Is it a true market price? Are there private producers competing with the public unit? Does the unit respond to changes in the market in the same manner as a private producer? If so, then the prices probably are economically significant. When answering these questions, one should consider the actual price paid by the consumer rather than the basic price.

131. Are the subsidies provided to the unit available to private producers on the same basis, such as a subsidy for employing certain people, or is the subsidy the amount necessary the cover the unit's operating deficit, whether estimated in advance or after the fact. Some observers have suggested that certain types of activity are inherently commercial or

governmental. There is sufficient variation among countries in how production is organized, however, this type of rule has attracted little support.

132. Does the consumer have a choice? If there is only one bridge across a river and the government establishes a separate unit to operate it as a toll bridge, the unit has little incentive to act as a market producer. A higher standard should be applied when deciding if the toll is an economically significant price, than if there were many competing toll bridges.

133. In summary, **there is no precise definition of economically significant prices that is applicable in the real world**. It is clear that the SNA permits prices that are substantially less than the cost of production to be economically significant. The interest of the SNA in this regard is to group units together that behave similarly. **Thus, considerable flexibility is allowed if the producer in question is clearly acting like a market producer. The less market-like the producer acts, the higher the price should be relative to production costs to be classified as economically significant.**

B. Quasi-corporations and Market Establishments

134. It is possible for any government unit to sell some of its output for economically significant prices. These sales may constitute only a very minor part of the unit's activities, such as selling government-published pamphlets in a large office otherwise devoted to nonmarket activities. These incidental sales do not affect the unit's classification as a predominantly nonmarket producer and a government unit or the valuation of its output.

135. Sometimes, however, an entire section of an otherwise nonmarket unit is engaged in market activities. Institutional units consist of one or more establishments, where an establishment is located in a single location and at which only a single productive activity is carried out or in which the principal productive activity accounts for most of the value added. [SNA 5.21] If there are two or more establishments in the institutional unit, then by definition none of the establishments meets the requirements to be an institutional unit. Because a government unit is a nonmarket producer, most of its establishments will deliver all or most of their output to consumers for free or at prices that are not economically significant. Some establishments might sell their output for economically significant prices, such as an office that produces publications and sells them for market prices or a municipal swimming pool that charges market entrance fees. If it is possible to identify a market establishment within a government unit, then the output of that establishment is valued at the applicable market prices and the net operating surplus will in general not be zero.

136. Of interest here is the possibility that one or more market establishments within a government unit may constitute a cohesive unit that functions as if it was a public corporation. If so, then the SNA requires that the government unit be divided into two units, with the market producing portion designated a quasi-corporation and the nonmarket portion remaining a government unit. In other words, a government quasi-corporation is an unincorporated enterprise owned by a government unit that operates as if it were a separate corporation and whose de facto relationship to its owner is that of a corporation to its

shareholders. [SNA 4.49] Quasi-corporations are treated as if they were corporations: that is, as separate institutional units from the units to which they legally belong. [SNA 4.50] The intent behind the concept of a quasi-corporation is to separate from their owners those unincorporated enterprises that are sufficiently self-contained and independent that they behave in the same way as corporations. [SNA 4.51] Indeed, the requirement that a quasi-corporation act like a corporation almost requires it to be a separate reporting entity, and that requirement could be added to the SNA definition.

137. A quasi-corporation must have its own value added, saving, assets, liabilities, and so forth. It must be possible to identify and record any flows of income and capital that are deemed to take place between the quasi-corporation and its owner. The amount of income withdrawn from a quasi-corporation during a given accounting period is decided by the owner, such a withdrawal being equivalent to the payment of a dividend by a corporation to its shareholder(s). A balance sheet is also needed showing the values of the quasi-corporation's fixed assets, inventories, financial assets, and liabilities. [SNA 4.52]

138. In order to be treated as a quasi-corporation, the government must allow the management of the enterprise considerable discretion not only with respect to the management of the production process but also the use of funds. Government 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 their owners implies that their operating and financing activities cannot be fully integrated with government revenue or finance statistics in practice, despite the fact that they are not separate legal entities. [SNA 4.108]

139. An example of a government quasi-corporation might be a major administrative division of a ministry or department that produces and sells electricity for market prices. The division is expected to cover its costs of production, including its cost of capital. The relationship between the division and the rest of the ministry in the budget approved by the legislature might only be a single line item for the net flow of resources to or from the division, and the division might issue separate financial reports. The division might need to borrow large amounts to acquire its fixed assets and it might be restricted to borrowing from the government. The division does not quite qualify as an institutional unit under the general definition because it does not really borrow in its own name and the government remains financially responsible for the actions of the division. Nevertheless, it acts so much like a market producer that economic analysis is improved by classifying the division as a quasi-corporation.

140. It is quite possible that a quasi-corporation will be a reporting entity for financial accounting, in which case the financial results will be available for compiling economic statistics. The previous section about economically significant prices applies with equal validity when deciding if a quasi-corporation exists because it must sell its output for those prices. **The fact that a quasi-corporation does not meet the general definition of an**

institutional unit suggests that the SNA should include more guidance in assessing the economic significance of the prices of possible quasi-corporations.

C. Definition of a Government Business Enterprise

141. The equivalent to a public corporation in financial accounting is a GBE. It is an entity that: (1) has the power to contract in its own name; (2) has been assigned the financial and operational authority to carry on a business; (3) sells goods and services, in the normal course of its business, to other entities at a profit or full cost recovery; (4) is not reliant on continuing government funding to be a going concern (other than purchases of outputs at arm's length); and (5) is controlled by a public sector entity. [IPSAS 6.8]

142. GBEs include both nonfinancial enterprises, such as utilities, and financial enterprises. They are, in substance, no different from entities conducting similar activities in the private sector. They generally operate to make a profit, although some may have limited community service obligations under which they are required to provide some individuals and organizations in the community with goods and services at either no charge or a significantly reduced charge. [IPSAS 6.13]

143. The definition of a GBE is more stringent that the SNA requirements to be a public corporation or quasi-corporation. The requirement to be able to contract in its own name most likely requires a separate legal identity, which would eliminate all quasi-corporations. More important, a GBE is required to sell at a profit or full cost recovery, which is a much higher standard than selling at economically significant prices. Selling at a profit appears to eliminate most government airlines, railroads, municipal transportation enterprises, and post offices because they typically operate at a loss. Most of these enterprises would be judged as public corporations in the SNA.

144. The difference between selling at a profit and selling at economically significant prices appears to be a major difference between the definitions of public corporations and GBEs. As long as the entities classified as public corporations in the SNA are separate reporting entities in financial accounting, the information needed for economic statistics will still be available. Summary reports for the whole of government, however, might indicate larger differences than exist in fact. **A relaxation of the definition of a GBE would materially reduce this difference.**

D. Internal Service Units and Ancillary Corporations

145. Some governments establish organizations that serve only the other components of the same government, but do so on a commercial basis. For example, a central motor pool may be established to provide vehicles to other components on a rental-equivalent basis or a department may be established to manage all of the buildings owned by the government and to rent them to other departments. Such organizations can be simply an administrative

division within a larger ministry or department or they may be formally incorporated as a separate legal organization.[39]

146. Although these internal service units and ancillary corporations appear to be market producers, they are not subject to market pressures. Their prices can be set administratively and there is little reason for the consumers to demand lower prices. The overall results of the government are not affected by the prices charged by these units. Internal service units and ancillary corporations should be consolidated with the units that own them or are administratively superior. When consolidated, all of the sales of these units and the purchases of the rest of the larger government unit will be eliminated. **In other words, internal service funds and ancillary corporations should be treated as ordinary internal service providers that all units must have to some degree.**

E. Consolidation

147. In the SNA, the statistics for individual institutional units are aggregated rather than consolidated when units are grouped. That is, there are no eliminations between units within a group, for example, subsectors or sectors, with payments from one government unit to a second government unit are shown as an expense of the first unit and revenue of the second unit, even if the two units belong to the same government. There is general agreement that it is analytically useful to present data for the general government sector and possibly the public sector on a consolidated basis because total revenue, total expense, and total debt are often compared to GDP or some other indicator and these totals should not be inflated simply because of the way governments choose to organize themselves. At least some statistical offices consolidate the data for the general government sector and any subsectors for their national accounts despite the generalization in the SNA that such data should not be consolidated. In the *GFSM*, the statistics for individual institutional units are consolidated, not aggregated.

148. As is well known, consolidation is a method of presenting statistics for a set of units as if they constituted a single unit. It involves eliminating transactions and reciprocal stock positions among the units to be consolidated. Consolidation has the effect of only measuring transactions or stocks of the consolidated units with units outside the boundary. Consolidated aggregates will not reflect economic interaction within the grouping, but only those transactions or stocks that involve interactions with all other institutional units.

149. The issue to consider here is which units to consolidate, not how to accomplish consolidation. As has been mentioned several times, economic statistics and financial accounting have different purposes. Those differences are reflected in the units that each chooses to consolidate. Financial reporting follows its principal of control. Any reporting entity should consolidate all controlled entities in its financial reports, including separate

[39] It was noted earlier that these ancillary corporations are not considered separate institutional units despite being corporations.

legal organizations and subordinate administrative units. Investments in associates, i.e., where an entity exercises significant but not dominant control, should not be eliminated on consolidation and reported as equity assets.

150. Because financial reports are used to compile economic statistics but the reverse is not true, the only consideration here is to insure sufficiently detailed financial reports. Depending on the entities that have been consolidated, the results may be desirable or undesirable for economic statistics. Public corporations and quasi-corporations should not be consolidated for use in economic statistics. Further, if there is more than one corporation or quasi-corporation, separate data should be retained for each because they generally are not consolidated for the national accounts.

151. It was asserted above that most social security entities are not institutional units when the definition of an institutional unit is strictly applied. For analysis, however, it is often helpful to keep social security entities separate from the other entities of the same government. PSC *Study 8* was cited as suggesting that the definition of reporting entities could be based on whether they are identified in the budget. Although not mentioned in the SNA, some types of fiscal analysis make use of this distinction.

152. Foreign operations and joint ventures cause difficulties. Foreign operations of public corporations are nonresident units and should be excluded for the national accounts. Information on foreign operations of corporations needs to be separately identified in financial reports to enable these operations to be excluded from the SNA. Joint ventures are partitioned for financial accounting and consolidated with the accounts of each partner in the joint venture. They should not be consolidated for the SNA. Joint ventures controlled only by other public units generally can be associated with a level of government—central, regional, or local. For the SNA, such a unit would be aggregated or consolidated with other government units at that same level. Thus, there is no need to partition the unit. Statistics for the parent unit would still need to be collected without the partitioned joint venture.

153. Reporting entities are not unique. A given entity at the lowest level of reporting could be included in several higher level financial accounting reporting entities. For coordination with the statistics agency, the classifications needed for statistics need to be retained at only one level. That level is a matter of operational convenience and communication between the financial accounting community and the statistics agency.

154. Once all of the reporting entities are defined with their corresponding classification in economic statistics in mind, the producers of financial accounts are not concerned with their use by the statistics agency. There will of course be technical concerns, such as identifying transactions and positions to be consolidated, insuring common valuation and timing, and other matters, but those subjects are beyond the scope of this paper.