

**Eighteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Washington, D.C., June 27–July 1, 2005**

Reinvested Earnings

**Prepared by the Statistics Department
International Monetary Fund**

BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

OUTCOME PAPER (BOPTEG) # 18

JUNE 2004

(1) Topic: **Reinvested earnings**

(2) Issues – see DITEG Issues Papers 5 and #5A, and BOPTEG Issues Paper # 18

(3) Recommendations:

(i) There was no clear consensus on the preferred conceptual treatment of reinvested earnings. The group agreed that this issue should be part of a broader discussion on the concept of “income”, but were unsure the extent to which such a broad topic could be addressed within the time frame of the new manual. The group noted, however, that the “income” concept should remain in the longer-term research agenda. The group also noted the view of the Advisory Expert Group on national accounts (AEG) that the treatment of reinvested earnings should not be reopened within the review of the *1993 SNA*.

(ii) The group agreed that there are inconsistencies in the system in the treatment of retained earnings. First, direct investment relationship is treated differently from portfolio investment relationship. Second, direct investment type relationship between residents is treated differently from those between residents and nonresidents. And, third, some types of collective investment schemes are treated differently from other portfolio investments. The group noted that the Task Force on Harmonization of Public Sector Accounting is considering an extension of reinvested earning concept to resident direct investment relationship between government and public enterprises.

(iii) Notwithstanding these recognized inconsistencies, several members of the group felt that the present imputation of reinvested earnings between entities in a direct investment relationship (and no imputation for portfolio investment) is a satisfactory outcome. Other members of the group disagreed. Of the latter, some saw advantage in imputing a reinvested earnings flow for portfolio investment, in particular, as the issuance of mutual fund shares with accruing earnings has meanwhile become a widespread practice; while others felt that it was more appropriate not to impute any retained earnings (either for direct investment or portfolio investment) as a transaction.

(iv) The group agreed, however, that, in any event, it would be very difficult to implement an imputation of reinvested earnings on portfolio investment, especially for portfolio investment abroad.

(v) The group agreed that, even if reinvested earnings are the correct conceptual basis, there are serious practical problems in measuring reinvested earnings data on a quarterly, or even annual, basis, for direct investment.

(vi) The group supported the DITEG's decision (regarding DITEG Issues Paper # 5) that reinvested earnings should be recorded at each link of the chain of indirectly-owned direct investment enterprises, noting that the examples given in the Benchmark Definition are confusing and need to be clarified.

(vii) The group agreed that the BOPTEG issues paper # 18 deals with several detailed definitional and practical issues and noted that they should be considered, as appropriate, in either the new manual or a compilation guide.

(4) Rejected alternatives

None.

(5) Questions for the Committee

- (i) *What is the Committee's view regarding the appropriate conceptual treatment of reinvested earnings for entities in a:*
 - (a) *direct investment relationship? Is the present treatment acceptable? Or should reinvested earnings not be treated as a transaction, and be recorded instead as an entry in the other change in assets account?*
 - (b) *portfolio investment relationship? Is the present treatment acceptable? Or should reinvested earnings for portfolio investment be imputed?*
See 3(iii) above.
- (ii) *In view of the position of the AEG and the range of views among balance of payments experts, does the Committee agree that a pragmatic outcome would be to retain the current treatment of reinvested earnings, and put the concept of income on the longer-term research agenda. See 3 (i and iii) above.*

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTG)

ISSUES PAPER 18

DIRECT INVESTMENT – REINVESTED EARNINGS

**Prepared by the Balance of Payments and Financial Accounts Department
De Nederlandsche Bank**

May 2004

BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTTEG)

ISSUE PAPER 18: DIRECT INVESTMENT – REINVESTED EARNINGS

I. Current International Standards for the Treatment of the Issue

According to the current international standards reinvested earnings (RIE) are considered as the income earned and saved by companies. A direct investor is entitled, in proportion to its equity share, to the income generated by its subsidiaries, associates and branches, irrespective whether the income is distributed in the form of dividends (or branch profits) or retained as reinvested earnings. As RIE are calculated as the difference between the company's *earnings* and its distributed *dividends* these two elements of RIE will both be discussed.

Earnings

Both BPM5 and the OECD Benchmark Definition (BMD) recommend the Current Operating Performance Concept (COPC) for measuring the earnings of direct investment enterprises. The COPC is meant to be fully compatible with the concept of income in SNA93 ('value added from production' – SNA 2.112). The definition in §285 of BPM5 is as follows:

'Direct investment earnings are measured on the basis of current operating performance.

Operational earnings represent income from normal operations of the enterprise and do not include any realized or unrealized holding (capital) gains or losses arising from valuation changes, such as

- ?? inventory write-offs; (...)

- ?? write-offs of intangibles, incl. goodwill; (...)

- ?? losses on the write-offs of bad debts; (...)

- ?? abnormal provisions for losses on long term contracts;

- ?? and exchange-rate-related gains and losses.

In the SNA93 (3.62) holding gains are defined as follows: 'Positive or negative nominal holding gains may accrue during the accounting period to the owners of financial and non-financial assets and liabilities as a result of a change in their prices.'

As an alternative to the COPC, both the BMD (§31) and BPM5 (§285) discuss the concept of earnings 'on an all-inclusive basis, when holding gains and losses and other extraordinary income are included in reported earnings'. The all-inclusive concept is clearly not compatible with the concept of income according to the SNA. It would widen the concept of income substantially.

Dividends

Dividends should be recorded as of the date they are declared payable and should be recorded gross of withholding taxes (the latter constitute transfers). With regard to liquidating dividends, §290 of BPM5 prescribes recording in the financial account for the full amount, as these dividends are considered as withdrawals of capital instead of income.

II. Concerns/Shortcomings of the Current Treatment and Possible Alternatives

From a purely theoretical point of view the concept of RIE does not create very serious problems. Most of the concerns/shortcomings are related to limitations to the application of the concept in practice, with far-reaching consequences for the statistics. Moreover, the examples given of items that should be included or excluded from the COPC seem to create as many questions as answers that they try to give.

Definition in the Manuals and textbooks

The concept of RIE is defined in slightly different ways in the current manuals and textbooks. In the following table the various components of the definition of reinvested earnings/income according to BPM5, BOP Textbook, OECD Benchmark Definition (BMD), and the SNA93 are presented. Distinction is made between the ‘basis’ of the concept (some kind of a surplus) and some ‘plus’ or ‘minus’ items to arrive at the total reinvested ‘income from normal operations’.

	<i>BPM5, §278</i>	<i>IMF Textbook, §411</i>	<i>BMD, §28</i>	<i>SNA, 7.122</i>
BASIS	Entrepreneurial income/net operating surplus not distributed as dividends.	Operating profits (= operating revenue minus operating expenses)	Direct investor’s share of the total consolidated profits earned by the company and its subsidiaries and associates in the period covered, after allowing for ... depreciation	Operating surplus
PLUS	+ any income or current transfers receivable	+ current transfers receivable, interest receivable, dividends receivable and the enterprise’s share of reinvested earnings of any subsidiary or associated enterprises	+ after allowing for ... interest ...	+ any property incomes or current transfers receivable
MINUS	- any income or current transfers payable (incl. any current taxes payable on income, wealth, etc)	- taxes due for payments, other current transfers payable, interest payable and dividends payable	- after allowing for tax and interest ... - dividends due for payment to the direct investor on the period even if these dividends relate to profits earned in earlier periods ¹	- any property incomes or current transfers payable (incl. actual remittances to foreign direct investors and any current taxes payable on the income, wealth, etc.)

¹ This definition relates only to subsidiaries and associated companies. For branches, please refer to the definition in §28 of the BMD.

The manuals seem to agree on the time of recording dividends as of the date they are declared payable. Some smaller differences can be discerned with regard to the definitions of RIE:

- First of all, both SNA93 and BPM5 do not explicitly refer to consolidated profits, whilst the IMF Textbook ('enterprises' share of RIE of any subsidiary or associated enterprises') and the BMD do ('share of consolidated profit').
- SNA93, BPM5 and the Textbook include all types of current transfers receivable and payable, whilst the BMD seems less comprehensive as only taxes are explicitly taken into account.
- BPM5 and SNA93 explicitly relates to any (property) income, thus *all* income on *all* property of the enterprise, and to all kinds of transfers (and thus not only interests, dividends and taxes). In this respect, SNA93 and BPM5 are the most comprehensive definitions.

As the Annotated Outline indicates that the new BPM should be aligned with the standards in the SNA, it is preferable to use the same wording of the definitions of income, profits and RIE as in SNA93. However, SNA93 does not indicate that consolidated profits – which are necessary to compile FDI statistics on a fully consolidated basis – should be used for the calculation.

Consolidation

With regard to the issue of reinvested earnings on a fully consolidated basis, national compilers are often confronted with two major (and growing) problems:

1. In case of minority ownership of a foreign direct investment enterprise (i.e. associates) the reporting entity does not consolidate the minority participation and is therefore not always able to provide data on RIE. This can be solved by either changing the 10% criterion of direct investment or accepting the under-recording of income in case of minority ownership.
2. In case of sub-holdings consolidation is mostly not performed at the level of the country where the sub-holding is located! In most cases, consolidation is done at the level of the top-holding. In cases of sub-holdings the compiler is mostly unable to collect the necessary consolidated data on RIE. The impact on the BOP can be very large, especially for countries with a large number of SPEs. A solution for this problem is closely related to the discussion on the inclusion of **in**directly owned investment enterprises and/or their related incomes².

International compilers, like ECB and Eurostat, are also confronted with a problem in the aggregation of national consolidated data on RIE. In the aggregation process they should cancel out (or better: consolidate) the RIE data of the directly owned bilateral direct investment enterprises. In order to properly perform this consolidation, each compiler should be able to separate out the RIE of **in**directly owned direct investment enterprises from the earnings that are directly owned. Otherwise RIE (and direct investment likewise) would be overestimated. Alternatively, it could be considered not to extent the application of the Fully Consolidated System (FCS) to the RIE of indirectly owned entities, or not to apply the FCS at all. This would, however, have impact on the concept of the national income.

² Reference is made here to issue 3 of the Direct Investment Technical Expert Group (DITEG)

COPC

The practical implications of the Current Operating Performance are not defined very clearly in BPM5 and therefore hard to explain to the reporting entities. What are normal operations and what is 'extraordinary income' that should be excluded? In their bookkeeping systems, the enterprises normally make a distinction between operational costs and extraordinary costs. Extraordinary costs in a bookkeeping sense only partially overlap with the statistical extraordinary income that should be excluded from the COPC. Moreover, each enterprise has its own practice and these practices are not stable over time (like the development of the IFRS; see below).

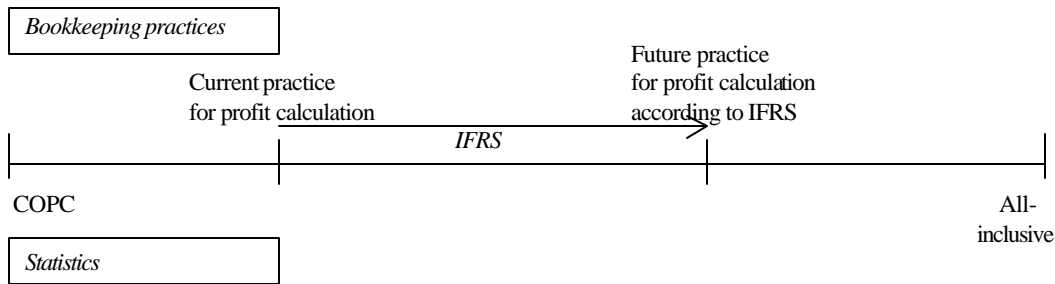
Normal operations are not defined at all in BPM5. What is normal? It could be considered to use a wording in the new Manual like 'all operations that are directly and indirectly related to the current (and future) ongoing business activity of the entity'. Abnormal operations, costs and results could be defined as the outcome of exceptional, unforeseen, circumstances in the external world that can not or can hardly be influenced by the enterprise itself. Also changes in market prices which result in windfall profits or losses for the entity can be regarded as driven by external (market) forces (including write-offs on goodwill etc.).

Defining normal operations and extraordinary income in that way can result in the inclusion of certain write-offs that currently seem to be excluded from the COPC, like the provision for losses and normal inventory write-offs. These definitions would also make clear that incidental costs, which are treated in many cases as extraordinary costs by the enterprises in their bookkeeping practices, like costs for reorganisations, costs for selling subsidiaries, or costs related to acquisitions, could fully be included in the COPC.

International Financial Reporting Standards (IFRS)

As mentioned above, bookkeeping practices differ among companies and are not stable over time. The bookkeeping practices like the International Financial Reporting Standards (IFRS) are steadily evolving in the direction of 'fair value accounting' and 'market prices' as the basic valuation principles which is in line with the current statistical standards for valuation of assets and liabilities. However, the development in the IFRS indicates that revaluation changes, holding gains and losses, should be included in the profit and loss account of the enterprises. In that respect, the IFRS show a development contrary to the standard practice in statistics³. It is therefore expected that the profit calculation of the enterprises will move in the direction of the 'all-inclusive' concept (see diagram below).

³ One exception in statistics, however, is worth mentioning here. Interest income (e.g. coupons) should be calculated on an accruals basis. Currently statisticians discuss the use of either the interest rate at issue of the bond (debtor approach) or the current interest rate (as the market price of capital), which is known as the creditor approach. The latter approach would imply the recording of some part of holding gains/losses as income over the remaining life period of the loan.



The move towards the all-inclusive concept is also caused by the fact that the definition of the extraordinary items in IFRS will change (IFRS 8). Under IFRS 8, only gains and losses which result from transactions or events which rarely occur can be included in the extraordinary items, such as ‘the expropriation of assets or an earthquake or other natural disaster’ (§14, IFRS8). This is based on the assumption that ‘virtually all items of income and expenses included in the determination of net profit or losses for the period arise in the course of the ordinary activity of the enterprise.’ (IFRS8, §12).

It can be concluded from the developments in the IFRS, that it will become even more difficult for statisticians to receive data on a COPC basis, as it is defined in the present manuals.

Dividends

With regard to dividends it was noticed that there seem to be hardly any problems with the treatment of dividends, except for the treatment of very large, extraordinary dividends. These types of dividends are distributed infrequently and can originate from several events, such as:

- The liquidation of a subsidiary or associate
- The revenue of the sale of a subsidiary or associate
- The hoarding up of profits over a couple of years

Dividends originating from the first two events are so-called *liquidating dividends*. As BPM5 §290 indicates, these dividends represent return on capital contributions rather than income and should therefore be recorded in the financial account as withdrawals of capital. These dividends therefore do not have an influence on the reinvested earnings.

However, dividends which are distributed from a *prolonged hoarding up of profits* in the undistributed profits reserve can not be described as liquidating dividends (but rather as ‘super dividends’ or something similar) because they have a different nature. Profits which are added to the undistributed profits reserve are linked to the operational processes of a company. This leads to the assumption that this type of dividends should be recorded in the income account, just like ‘ordinary’ distributions of dividends. In the BOP, large negative reinvested earnings will be recorded which are compensated by the large positive dividend. Hence, total direct investment income would not be influenced.

A problem might arise when the company distributes a liquidating dividend and an ‘ordinary’ dividend at the same time. Suppose a company has a dividend policy to distribute EUR 2 dividend

per share per year. In a certain year it distributes EUR 15 per share. If a strict distinction is made between the different origins of these dividends, the company in question should record EUR 2 in the income account and the remaining EUR 13 in the financial account. This distinction in the recordings might cause practical problems for companies; in theory, however, this split should be made in order to allocate the dividends correctly to the accounts in the BOP.

In conclusion it can be said that once a company distributes a very large, exceptional dividend, it is important to determine the origin of this dividend in order to record the dividend correctly in the BOP (in the financial or income account respectively). A problem might arise, however, when a large, exceptional dividend is distributed at the same time of an ordinary dividend.

IV. Points for discussion

- (i) Do BOPTEG members agree that the definition of RIE should be made fully consistent with SNA93 (and BMD), preferably using the same wording, and should explicitly take into account the aspect of consolidation?
- (ii) Do BOPTEG members agree that the problems of collecting RIE data on a consolidated basis is becoming more difficult due to the establishment of global direct investment networks by the companies, with several sub-holdings in various countries? Would exclusion of indirectly owned entities in the collection of RIE data provide any solution? What are the alternative solutions to this problem?
- (iii) How should RIE of minority ownership direct investment be collected?
- (iv) Do BOPTEG members agree that the development in bookkeeping practices due to IFRS requires a clearer definition of the COPC concept (normal activity/extraordinary income)? Even if this would imply the inclusion of some (minor) elements in the COPC, like inventory write-offs and provision for losses?
- (v) Do BOPTEG members agree that the recording of very large, exceptional dividends requires that the origin of these dividends must be determined? Should the origin of the dividends be decisive for the treatment of the dividends (income account or financial account)?

References

Balance of Payments Manual, fifth edition (BPM5), IMF, 1993
Paragraphs 278, 285, 286, 290 (Chapter XIV)

Balance of Payments Textbook, IMF, 1996
Paragraph 411

Benchmark Definition of Foreign Direct Investment, third edition (BMD), OECD, 1996
Paragraphs 28, 31 (Chapter III)

Foreign Direct Investment Task Force Report, European Central Bank/Eurostat, March 2004,
Chapter 4

System of National Accounts, 1993
Paragraphs 2.112, 3.62, 7.122, 7.2, 8.1, 8.15, 8.3

Annotated Outline of the Balance of Payments Manual, IMF, 2004
Chapters 1, 10 and 11

DIRECT INVESTMENT TECHNICAL EXPERT GROUP
OUTCOME PAPER (DITEG) #5A: REINVESTED EARNINGS

August 6, 2004

(1) Topic: **Reinvested Earnings**

(2) Issues - see DITEG Issues Paper #5A. See also BOPTEG outcome paper #18

(3) Recommendations:

(i) DITEG considered the three broad alternative treatments of reinvested earnings proposed in Issue Paper #5A, as follows:

- (a) Treat saving of direct investment enterprises on the same conceptual basis as the treatment of savings of other resident enterprises, and not impute reinvested earnings as direct investment income in the Current Account and as a transaction in the Financial Account;
- (b) Extend the current treatment of reinvested earnings to all equity investment (i.e. non-resident-to-resident portfolio investment and all resident-to-resident investment relationships); or
- (c) Retain the current treatment, with the possible extension of imputing reinvested earnings for non-resident-to-resident portfolio investment.

(ii) DITEG discussed the relative merits of the alternative treatments being proposed but were unable to reach consensus on the preferred conceptual treatment for reinvested earnings. About half of the experts supported the current treatment of reinvested earnings (i.e. restricted to non-resident-to-resident direct investment relationships). These experts were of the view that the current treatment of reinvested earnings is based on the concept that the direct investor has significant influence in the management of the direct investment enterprise and that the decision to retain some earnings within the enterprise represents a conscious, deliberate investment decision on the part of the direct investors. These experts did not agree to an extension of reinvested earnings to non-resident-to-resident portfolio investment. However, some of the group felt that the treatment of retained earnings of mutual funds in *ESA95* (they are deemed to be distributed and then reinvested — in the same manner as for direct investment) was appropriate.

(iii) A similar number of experts noted the current inconsistency between SNA93 and BPM5/BD3 standards and agreed that this inconsistency needed to be addressed. However, there was no agreement on the preferred alternative conceptual treatment.

(iv) Those in favour of not imputing reinvested earnings argued that this would bring BPM5/BD3 standards in line with the current SNA standards, in that the level of saving by an enterprise is an indicator of the extent to which an enterprise intends to fund accumulation from internal resources. The decision to save rather than to pay dividends is deliberate and similar to other decisions made in the management of the enterprise, such as decisions to invest in fixed capital. The enterprise is considered a separate institutional unit from its owners partly because it can make such decisions, regardless of the level of influence of its shareholders.

(v) These experts noted that there are significant practical difficulties in collecting reinvested earnings data and that in most cases current period quarterly estimates are projections based on the previous year's annual data, and added that it would be even more difficult to develop estimates of reinvested earnings for portfolio investment. Concerns were also expressed about increasing the number of imputed transactions.

(vi) Those in favour of extending imputation of reinvested earnings to non-resident-to-resident portfolio investment and resident-to-resident investment relationships argued that earnings of an enterprise accrue to all investors as they are earned. Dividends are cash payments which may be less than, equal to or more than the earnings accrued. Earnings less dividends accrue to investors in the form of income. As the earnings are available to the enterprise for its use, they are deemed to be reinvested in the enterprise.

(4) Rejected alternatives

None.

(5) Questions for the Committee and WIIS

(i) *What are the Committee's and WIIS views regarding the appropriate conceptual treatment of reinvested earnings for entities in a:*

(a) *direct investment relationship? Is the present treatment acceptable? Or should reinvested earnings not be treated as a transaction, and be recorded instead as an entry in the other change in assets account?*

(b) *portfolio investment relationship? Is the present treatment acceptable? Or should reinvested earnings for portfolio investment be imputed? See 3 (vi) above.*

(ii) *In view of the position of the AEG and the range of views among direct investment statistics experts, does the Committee agree that a pragmatic outcome would be to retain the current treatment of reinvested earnings? See 3 (ii) above.*

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**IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD
WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS**

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUE PAPER # 5A

REINVESTED EARNINGS

The views expressed in this paper are those of staff within the International and Financial Accounts branch and do not necessarily reflect those of the Australian Bureau of Statistics.

**Prepared by International and Financial Accounts Branch
Australian Bureau of Statistics
May 2004**

DIRECT INVESTMENT TECHNICAL EXPERT GROUP

ISSUES PAPER (DITEG) # 5A

REINVESTED EARNINGS

I. Current International Standards for the Treatment of the Issue

The BPM contains the concept of direct investment. Direct investment is the relationship between an enterprise and a foreign investor which owns 10 per cent or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent for an unincorporated enterprise. The internationally accepted OECD Benchmark Definition describes direct investment as an investment which has:

" ... the objective of obtaining a lasting interest by a resident entity in one economy ("direct investor") in an enterprise resident in an economy other than that of the investor ("direct investment enterprise"). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise... "

Earnings of direct investment enterprises which are not distributed as dividends or remitted to direct investors are called reinvested earnings. The BPM5 records reinvested earnings as being distributed to direct investors in proportion to their equity ownership in the enterprise, and then being reinvested into the same enterprise. Reinvested earnings are recorded as Direct Investment Income in the Current Account and as a transaction in equity in the Financial Account.

This treatment of reinvested earnings is not extended to cross-border portfolio investment and the SNA, while reflecting the BPM treatment for international investment, does not recommend the classification of resident-to-resident investment relationships as direct investment, and therefore the BPM treatment of reinvested earnings does not arise.

II. Concerns/Shortcomings of the Current Treatment

Rationale not apparent in the standards

The BPM treatment of reinvested earnings is explained by the fact that the direct investor has significant influence on the management of the direct investment enterprise. Therefore, the decision to retain some earnings within the enterprise represents a conscious, deliberate investment decision on the part of the direct investors.

The underlying rationale for allocating saving to shareholders is not spelt out in the standards. The rationale is that the earnings of an enterprise accrue to investors as they are earned. Dividends are cash payments which may be less than, equal to or more than the earnings accrued. Earnings less dividends accrue to investors in the form of income. As the earnings are available to the enterprise for its use, they are deemed to be reinvested in the enterprise.

Inconsistencies - direct investment vs portfolio investment

Reinvested earnings transactions are not recorded for international portfolio investment, that is, foreign investment where a non-resident investor owns less than 10 per cent of the equity in an enterprise. When recording an enterprise's reinvested earnings in the case of portfolio investment, the reinvested earnings are recorded as the saving of the enterprise and the increase in the value of the enterprise is recorded in the accounts as a revaluation.

The reason given for the different treatment is that portfolio investors are said to have an insignificant influence on the management of an enterprise and therefore have little input into the enterprises' saving decisions. However, the fundamental rationale for the recording of reinvested earnings, that is the accrual of earnings to investors, does not depend on the degree of control, so it is difficult to justify the different treatment accorded to direct and portfolio investment.

Inconsistencies - international vs resident-resident

Direct investment is not a SNA concept, so no distinction is made between investors who own equity in an enterprise resident in the same economy based on the investors' equity holding representing a lasting interest in the enterprise. Reinvested earnings transactions are not imputed for resident-to-resident transactions.

However, the rationale behind the recording of reinvested earnings applies to all investments, including residents who invest in their own economy.

Negative reinvested earnings

Under the current treatment, it is possible for reinvested earnings to be negative in cases where the direct investment enterprise makes an operating loss. Reinvested earnings are then recorded as a negative income payment and disinvestment in the enterprise. There are claims that this makes little sense and creates presentational difficulties. However, the negative income can be seen as offsetting a withdrawal of equity in the enterprise, that is the enterprise takes money from the investors, who in turn take the money out of the enterprise.

III. Possible Alternative Treatments

Saving

The fundamental issue in deciding the merits of the BPM treatment of reinvested earnings is whether enterprises should have their own saving or whether their earnings should be imputed to their owners as they accrue.

Recording saving for an enterprise or group of enterprises has its advantages. The level of saving by an enterprise is an indicator of the extent to which an enterprise intends to fund accumulation from internal resources. The decision to save rather than to pay dividends is deliberate and similar to other decisions made in the management of the enterprise, such as decisions to invest in fixed capital. The enterprise is considered a separate institutional unit from its owners partly because it can make such decisions, regardless of the level of influence of its shareholders.

However, the view that earnings accrue to investors as they are earned implies that enterprises are unable to have savings.

The current treatment means that the saving of enterprises with direct investors is treated differently to the saving of enterprises that do not have direct investors, that is, the amount of saving that is recorded for an enterprise depends on the type of investors that own the enterprise. The saving of a direct investment enterprise is not all recorded, whereas all the saving of an enterprise with similar behaviour but which is owned by portfolio and/or resident investors is recorded.

Some treatments which have been suggested are:

(i) treat dividends payable as the only distribution of the earnings of enterprises, so that there are no imputed transactions for the reinvested earnings of an enterprise. Changes between opening and closing balances in assets and/or liabilities financed by reinvested earnings are recorded as non-transaction changes in value.

Advantages: This would eliminate all inconsistencies relating to the application of reinvested earnings transactions and the saving of enterprises. No imputed flows are necessary.

Disadvantages: The principle that earnings accrue as they are earned would not be observed. Dividend flows, which are variable cash flows not necessarily related to earnings, would be recorded. Revisions to BOP time series would be necessary.

(ii) record reinvested earnings for investors who own 10 per cent or more of the equity in an enterprise, regardless of the residence of the investor

Advantages: This extends the concept of direct investment to resident-resident investment positions and would produce a comparable and consistent treatment of investors who have sufficient equity holding in an enterprise to have a significant influence on its management and saving decisions. The imputation of reinvested earnings transactions allows the accounts to show a return to investors on their investments which can be compared across classes of assets, for example, portfolio and direct equity investments, regardless of whether dividend payments are made or if earnings are reinvested within the investment enterprise.

Disadvantages: This option would result in substantial changes to sectorial saving, and would also require changes in the way countries collect their data. There would still be inconsistencies in the treatment of portfolio investment and enterprise saving, as the accrual of earnings to investors would be recognised only for direct investments. Imputed flows are necessary.

(iii) *impute all enterprise saving to their investors, regardless of the size of the investor's equity holding*

Advantages: The accrual of earnings would be recognised in all cases. Income on all equity investments would be treated in the same manner and the saving of all enterprises would be treated consistently, in that no enterprise would have saving. Other advantages as per (ii) above.

Disadvantages: This option would involve more imputed transactions and it may be difficult for compilers to measure the income receivable on portfolio investments.

If it is accepted that the rationale for the recording of reinvested earnings is the accrual of earnings as they are earned to investors, it is difficult to maintain the different treatment between direct and portfolio investment.

If it is necessary to analyse the saving of the household sector in isolation, it would be appropriate to record reinvested earnings on resident-resident investments. However, for analytical purposes, it may not make much difference if reinvested earnings are recorded for resident-resident investments. Policy makers are interested in national saving, and national private saving can be calculated by consolidating the private sectors of the domestic economy, regardless of the treatment of reinvested earnings.

The possibility of consolidation does not extend to non-resident-resident investments - whether residents or non-residents are saving will vary with the treatment. From a policy point of view, it may be preferable to view the reinvested earnings of enterprises with foreign ownership as reflecting an increase in equity by the non-resident investor rather than as saving by a resident enterprise.

The advantages of recording reinvested earnings has been recognised by the Task Force on Harmonization of Public Sector Accounting, which is investigating the recognition of reinvested earnings as part of a review of the recommendations relating to the recording of transactions between governments and public corporations.

A pragmatic outcome could be the acceptance of the principle that reinvested earnings should be recorded for all equity investments, but that, in practice, the treatment should be extended only to the recording of reinvested earnings to non-resident-resident portfolio investments. If it is not considered possible in practice to record reinvested earnings on portfolio investment, then the *status quo* would be a better outcome than the alternative of not recording reinvested earnings at all, despite the inconsistencies this causes.

IV. Points for Discussion

Do DITEG members agree that the rationale for the recording of reinvested earnings is to show the accrual of earnings to investors?

Do members agree that, in theory, the rationale applies to all forms of equity investment?

Do members agree that, from an analytical point of view, recording reinvested earnings for non-resident-resident investments is more important than for resident-resident investments?

Do members agree that, if practical, consideration should be given to the recording of reinvested earnings on non-resident-resident portfolio investments and that if this is not possible, the status quo should be maintained?

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DIRECT INVESTMENT TECHNICAL EXPERT GROUP

OUTCOME PAPER # 5(B)

August 6, 2004

(1) Topic: Reinvested earnings of indirectly owned direct investment enterprises

(2) Issues – See DITEG Issues Paper #5B and Figure 1 in *OECD Benchmark Definition of Foreign Direct Investment* (p.11)

(3) Recommendations

(i) The group agreed that reinvested earnings should be grossed up, along the chain of indirectly owned enterprises.

(ii) The group agreed that, on a bilateral basis, reinvested earnings should only be allocated to the most immediate counterpart country, regardless of where the reinvested earnings may have originated.

(iii) The group agreed that the new manual and the new *Benchmark Definition* should clarify the treatment of reinvested earnings of indirectly owned enterprises. At present, countries that are applying the methods explained in Figure 1 (of the BD3) may be double counting the reinvested earnings of indirectly owned enterprises; these earnings could be both included in the operating profit of the recipient enterprise and added to the total reinvested earnings passed up the chain of enterprises.

(4) Rejected alternatives

None

(5) Questions for the Committee and the WIIS

(i) Do the Committee and the WIIS agree that reinvested earnings should be grossed up all the way along the chain of indirectly owned enterprises?

(ii) Do the Committee and the WIIS agree that the most immediate country in the chain should be allocated the reinvested earnings, regardless of where the earnings may have originated?

(iii) Do the Committee and the WIIS agree that the revision of BPM5 and the new edition of the Benchmark Definition should clarify the treatment of reinvested earnings of indirectly owned enterprises to eliminate the possibility of double-counting?

**IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD
WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS**

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) #5B

**REINVESTED EARNINGS OF INDIRECTLY OWNED
DIRECT INVESTMENT ENTERPRISES**

Prepared by Marie Montanjees, IMF Statistics Department

April 2004

DIRECT INVESTMENT TECHNICAL EXPERT GROUP

ISSUES PAPER (DITEG) #5B: REINVESTED EARNINGS OF INDIRECTLY OWNED DIRECT INVESTMENT ENTERPRISES

Reinvested earnings comprise the direct investor's share—in proportion to equity held—of earnings that foreign subsidiaries and associated enterprises do not distribute as dividends, and are deemed to provide additional capital to the enterprises.

This paper addresses the possible need to change the present method of calculating reinvested earnings of indirectly owned direct investment enterprises in an extended chain of ownership.

I. Current international standards for the statistical treatment of the issue

- The OECD *Benchmark Definition of Foreign Direct Investment (Benchmark Definition)* recommends that the reinvested earnings of indirectly owned direct investment enterprises be included in the FDI data for each country in proportion to the indirect ownership of the equity of those enterprises. Tables in Annex 1 of the document illustrate the specific treatment:
 - Table 8, which shows an example involving a chain of fully-owned subsidiaries in four countries, indicates that the full amount of the reinvested earnings of an enterprise in Country 4 is included in the total reinvested earnings reported for Country 3, and again up the chain of ownership in the total reinvested earnings reported for Countries 2 and 1.
 - Table 4 gives examples of longer chains involving partially-owned enterprises using the same method of carrying forward up the chain of ownership the share of the reinvested earnings of indirectly owned direct investment enterprises.
- Although the fifth edition of the IMF *Balance of Payments Manual (BPM5)*, the *Balance of Payments Textbook*, and the *Balance of Payments Compilation Guide* do not specifically address the issue of calculating reinvested earnings of indirectly owned direct investment enterprises, *BPM5* is deemed to be consistent with the *Benchmark Definition*.

II. Concerns/shortcomings of the current treatment

- The recommended treatment of carrying the reinvested earnings of an enterprise into the calculation of reinvested earnings for the country of residence of the indirect investor can

lead to multiple-counting of those earnings at a global level.¹ To illustrate, in the case of a chain of fully-owned subsidiaries in four countries, the original amount of 550 of reinvested earnings of an enterprise in Country 4 at the bottom of the chain is included in the calculation of reinvested earnings not only of Country 3, but also of Country 2 and Country 1. As a result, the original amount of reinvested earnings has been included in the reinvested earnings of three different countries and has increased to 1,650 in the global total for reinvested earnings—a figure three times higher than the original earnings.² The more indirectly owned enterprises in the chain, the higher the multiple-counting of the reinvested earnings.³

- The treatment of reinvested earnings of indirectly owned enterprises appears to be inconsistent with the recommended treatment of other direct investment transactions, such as equity capital and other capital transactions, which are not carried up the ownership chain, but are shown only in the direct investment data of the two countries directly involved in the transaction.
- The *Annotated Outline (AO)* for the revision of *BPM5* raises the option of changing the method of recording reinvested earnings to eliminate multiple counting at a global level in instances of extended chains of ownership.

III. Possible alternative treatments

- Retain the present system of including the amount of reinvested earnings of an enterprise in a given country all the way up the chain of indirect ownership, recognizing both the apparent inconsistency with the treatment of other direct investment transactions, and the fact that it leads to multiple-counting of the amount of reinvested earnings at the global level.

¹ These concerns were discussed in an IMF note to the March 2003 meeting of the OECD Workshop on International Investment, which agreed that the present treatment should be reviewed.

² See Table 8 of Annex 1 of the *Benchmark Definition*.

³ The problem also exists in cases of partially-owned subsidiaries. Table 4 of Annex 1 of the *Benchmark Definition* illustrates a situation where the percentage ownership of the parent company in the direct investment enterprise is 51 percent in all instances, and the reinvested earnings of Company E in Country 5 attributable to the direct investor is an amount of 51. In this instance, the 51 in reinvested earnings of Company E is included in the reinvested earnings of related enterprises as follows: Company D in Country 4 = 51, Company C in Country 3 = 26, Company B in Country 2 = 13, and Company A in Country 1 = 7. As a result, the original 51 in reinvested earnings of Company E has increased in the global data to 97, almost double the original amount.

- Limit the inclusion of reinvested earnings of an enterprise in a given country to the country directly above it in the chain of ownership, i.e. to treat the calculation of reinvested earnings in a manner similar to the treatment of other direct investment transactions involving indirectly owned enterprises, namely to include them only in the data of the two countries that are directly involved in the imputed transaction.
- Establish an arbitrary limit to the number of steps up the chain of indirect ownership that the reinvested earnings of an enterprise at the bottom of the chain should be included.

IV. Points for discussion

1. *Do DITEG members consider that the present treatment of reinvested earnings of indirectly owned enterprises in an extended chain of ownership is conceptually correct and should therefore be retained, notwithstanding (i) the potential for multiple-counting, and (ii) the apparent inconsistency with the treatment of other direct investment transactions between direct investors and indirectly owned direct investment enterprises? If so, what is the conceptual rationale for the present treatment?*
2. *Do DITEG members consider that the inclusion of reinvested earnings of an enterprise in a given country should be limited to the country directly above it in the chain of ownership, i.e. the reinvested earnings should be included only in the data of the two countries that are directly involved in the imputed transaction?*
3. *Do DITEG members consider that an arbitrary limit should be established on the number of steps up the chain of indirect ownership that the reinvested earnings of an enterprise at the bottom of the chain should be included? If so, what should that limit be?*

References

Benchmark Definition of Foreign Direct Investment, third edition, OECD, 1996.

Table 4 of Annex 1. Earnings of Partially Owned Enterprises.

Table 8, Annex 1. Earnings of Fully Owned Subsidiaries

The Fully Consolidated System, Note by the IMF presented to the OECD Workshop on International Investment Statistics, March 2003 (DAFFE/MC/STAT(2003)8 for background information on the issue.

Annotated Outline for the Revision of BPM5, IMF, April 2004

Chapter 10, paragraph 10.42, and the appendix that includes changes raised as an option.