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F.2 Asymmetric Treatment of Retained Earnings

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F.2 Asymmetric Treatment of Retained Earnings[1]

Retained earnings of foreign direct investment (FDI) enterprises are considered in the international statistical standards as being remitted to the direct investors and reinvested by them. The corresponding income flows are called "reinvested earnings" (RIE). The treatment of retained earnings as RIE is circumscribed to FDI and does not extend to cross-border portfolio investment or to domestic equity relationships, which induces asymmetries in the reflection of corporate profits in official statistics and might be seen as giving rise to issues of interpretability and comparability of macroeconomic indicators.

This Guidance Note (GN) discusses several recording options to address these methodological asymmetries, ranging from removing the RIE treatment from all macroeconomic statistics, including FDI, to extending it to all equity relationships. It concludes that while there might be a conceptual preference for the extension of RIE to all equity investments, it is recommended, at least for practical reasons, that the treatment be universally applied only in supplementary information. The GN also briefly discusses the treatment of share buybacks as income distribution, given that they may be seen as a substitute to dividends, and recommends that a separate/subsequent GN should discuss this treatment in detail.

SECTION I: THE ISSUE

BACKGROUND

1. **Retained earnings correspond to the net distributable income that has not been distributed to shareholders in the form of dividends** (*System of National Accounts 2008 (2008 SNA)*, paragraph 7.139 and others; the sixth edition of the *Balance of Payments and International Investment Position Manual (BPM6)*, paragraph 11.34 and others).[2] Retained earnings of foreign direct investment (FDI) enterprises are considered in the international statistical standards as being remitted to the direct investors and reinvested by them and are called reinvested earnings (RIE)**.**

2. **The *BPM6* records RIE as being distributed to direct investors in proportion to their equity ownership in the enterprise.** A direct investor is seen as entitled to all the income generated[3] by its subsidiaries, associates, and branches, irrespective of whether the income is distributed in the form of dividends (or branch profits) or retained as RIE (*BPM6*, paragraph 3.74). RIE are considered as the income earned and not distributed by companies and are recorded as direct investment income in the current account and as a transaction in equity in the financial account (*BPM6*, paragraphs 8.15–8.16 and 11.33–11.47).

3. **Just as in the *BPM6*, the *2008 SNA* treats retained earnings of foreign corporations included in FDI (e.g., foreign affiliates of multinational corporations) as though they had been distributed and then reinvested by the shareholder** (*2008 SNA*, paragraphs 3.64 and 7.137–7.139). Similar to *BPM6*, the item is called reinvested earnings; the corresponding equal entry in the financial

[1] Prepared by Nabila Akhazzan, Marcelo Dinenzon, Cyril Rebillard, Marshall Reinsdorf (all IMF), Mher Barseghyan, Simon Boesenberg, Maja Gavrilovic, Celestino Giron (ECB), and Philippe de Rougemont (Eurostat).

[2] See also *OECD Benchmark Definition of FDI, 4th Edition*, paragraphs 199 and 220, and Annex 6.

[3] In proportion of its equity ownership.

account is called reinvestment of earnings (*2008 SNA,* paragraph 26.88). As a result of this treatment, the net saving of corporations which are 100 percent owned by foreign direct investors is zero.

4. **However, reinvested earnings are recorded only for equity in FDI and investment funds, but not for other types of equity.**[4] The treatment as RIE is therefore not extended to all cross-border portfolio investment.

5. **Similarly, the *2008 SNA* does not recommend the classification of resident-to-resident investment relationships as domestic direct investment,** and therefore, the RIE treatment of retained earnings does not arise in any domestic equity link.

6. ***BPM6* explains its treatment of RIE (also followed by *2008 SNA* for FDI) by the fact that a direct investor has significant influence on the management of the FDI enterprise.** The reasoning is that direct investment involves a controlling shareholder, or with sufficient influence, who has effective access to the earnings of the corporation (*BPM6*, paragraph 11.41 and *2008 SNA*, paragraph 7.138). Therefore, the decision to retain some earnings within the enterprise represents a conscious, deliberate investment decision on the part of the direct investors. An imputed distribution of the retained earnings is included in the income of the direct investors, which they then reinvest in the enterprise (*BPM6*, paragraph 3.17). This reinvestment of investors' imputed income under equity captures the fact that the retained earnings are available to the enterprise to use to acquire assets or extinguish liabilities.

7. **Dividends payments reduce RIE (which can be negative—see *2008 SNA*, paragraph 26.64 and *BPM6,* paragraph 11.46).** As a result dividends do not affect the overall income paid to FDI shareholders and only affect the split between dividends and RIE, as well as the financial accounts where they are seen as mere cash payments (that need not equal the earnings accrued by the enterprise) counterbalanced by financial transactions in equity.[5] This is contrary to the treatment of dividends from non-FDI corporations (earned on portfolio or on domestic direct investment), where the dividend payments affect the overall income paid by the corporation and the corresponding decreases in corporate value are reflected as holding losses, and not as transactions.

8. **Nonetheless, a similar treatment to that of RIE is applied in statistical manuals (*2008 SNA*, paragraph 7.152) to collective investment funds** (as well as to some pension funds),[6] whereby the income earned by the funds is deemed all distributed (D.443 – *Investment income attributable to investment fund shareholders*) and thus received by the equity instrument (F.52) holders, irrespective of whether actually distributed (D.4431) or actually retained (D.4432), using the *European System of*

[4] Reinvested earnings corresponding to the whole ownership chain are attributed to direct investors who are in a direct investment relationship with the direct investment enterprises (i.e., when equity participation by direct investors meets directly or indirectly the 10 percent threshold). However, retained earnings are not attributed to investors when the equity participation provides less than 10 percent of the voting power (*BPM6*, paragraph 11.40).

[5] Disproportionately large dividends (superdividends) are directly treated as withdrawal of equity without leading to entries in dividends and RIE (*2008 SNA,* paragraph 7.131). For a review of the treatment of superdividends in FDI see GN "D.17 Identifying Superdividends and Establishing the Borderline Between Dividends and Withdrawal of Equity in the context of Direct Investment".

[6] In relation to Investment income payable on pension entitlements (D.442), a very similar recording applies for defined contribution pensions funds (see *2008 SNA,* paragraph 7.148), while the SNA foresees a somewhat different recording for defined benefit pension funds (as the income payable is set equal to the stock of claims time the appropriate actuarial discount rate—*2008 SNA,* paragraph 7.150).

Accounts 2010 (ESA 2010) sub-codification). As a result, the savings of these investment funds are emptied (like in the case of companies whose direct investors hold 100 percent of the company).[7]

9. **The current recording of dividends from non-FDI corporations is sometimes described as a deviation to the strict accrual principle (including by the *2008 SNA*, in paragraph 7.130),** the income earned by investor being recorded at time the share price goes ex-dividend rather than at time the investee's income is earned, and can also be criticized for adversely impacting the crucial income/revaluation boundary. On the latter, indeed, the fall in share value that is mechanically occurring upon dividend distribution is recorded in the system as holding loss, while no price actually changed and only the composition of the investor's assets portfolio changed (more cash/receivable, less equity). This inconsistency is removed by RIE and is otherwise not visible/important for annual accounts or when companies pay large dividends out of their income, but becomes visible in quarterly accounts and with the growing tendency of companies to resort to share buybacks for releasing cash to shareholders.

10. **Share buybacks have indeed considerably developed over the past decades, now reaching large amounts and exceeding the amount of dividends distributed by companies in some leading markets.** Share buybacks are perceived by investees as effective substitutes to dividends for returning cash because they typically allow tax optimization (across shareholders) and provide them flexibility (they can interrupt the program at will). Although the buyback is obviously a financial transaction from the point of view of the seller, this is not the case for the buyer who sees this as a substitute to dividends (or for the community of the shareholders as a whole). This leads to increasingly underestimating the income of shareholders (overestimating holding gains) and distorting the distribution of savings across sectors.

11. **Two inconsistencies in the international standards caused by the use of the RIE approach only for certain transactions are the main focus of this Guidance Note (GN).** First, FDI relationships are treated differently from foreign portfolio investment relationships[8] (other than investment fund shares). Second, domestic direct investment relationships are treated differently from investment relationships between residents and nonresidents. In the rest of the GN, the term direct investment and portfolio investment will be used both for cross-border and domestic equity relationships.

Inconsistency 1 – Direct Investment vs Portfolio Investment

12. **RIE transactions are not recorded for foreign portfolio investment, that is, foreign investment where a nonresident investor owns less than 10 percent of the equity in an enterprise.** The increase in value in the FDI due to retained earnings is regarded a transaction, rather than a revaluation. In contrast, in the case of portfolio investment, retained earnings are recorded as the saving of the enterprise and the associated increase in the value of the investor's enterprise equity is recorded as a revaluation. The justification for the different treatment is that portfolio investors have an insignificant influence on the management of an enterprise and therefore have little input into the enterprises' saving decisions. Conditioning the treatment of retained earnings on investors' degree of control shifts the recording of financial returns on foreign investment positions arbitrarily between the income balance and revaluation, merely based on distribution decisions. The treatment of retained earnings does not affect

[7] Moreover, the holding gains recorded by their investors are set exactly equal to the holding gains recorded on the fund's assets.

[8] And other equity relationships that might be covered in other investment.

the value of net foreign assets, but it does affect the share of the growth of net foreign assets that is accounted for statistically by the transactions as opposed to by revaluation.

13. **Moreover, to the extent that the RIE rule was mainly designed in order to appropriately measure national income, it might be argued that the current asymmetric treatment prevents fulfilling this objective,** which becomes significant when net portfolio cross-border positions are large and with an increasing prevalence of share buybacks.

14. **At the same time, it can also be argued that minority shareholders indeed do not have a say** on whether to distribute or instead reinvest the profit of the company shareholders invested in.

Inconsistency 2 – Foreign vs Domestic Investment Relationship

15. **Except in the special case of FDI, the *2008 SNA* treats corporate earnings that are retained as saving of corporations.** Domestic direct investment is not an SNA concept, so no distinction is made between investors who own a controlling or influencing stake in an enterprise resident in the same economy and investors who own small portions of the outstanding stock. Thus, RIE transactions are never imputed for resident-to-resident investment relationships and the income of resident shareholders always depends on how much of its income the corporation decides to distribute as dividends.

16. **At the same time, the *2008 SNA* entertains as part of its research agenda extending the RIE approach to domestic equity relationships, particularly for public corporations** (*2008 SNA,* paragraph 7.140). Extending the RIE to public corporations was envisaged in the previous SNA/BPM review as a way to tackle the problem that governments could play on transactions with public corporations so to impact the deficit, but was rejected in favor of defining new rules on superdividend and capital injections.

17. **The *2008 SNA* indeed warns that such an extension of RIE to domestic links would "have serious implications for interpretation of the accounts since it would be built on a different paradigm from the current treatment of dividends and corporate saving" (*2008 SNA,* paragraph A4.29).** The SNA regards corporations as independent institutional units, and as institutional units they own assets, are responsible for liabilities, and engage in transactions (*2008 SNA*, paragraphs 4.1–4.6). It also notes that corporations are legally recognized as separate entities from their owners, who enjoy limited liability (*2008 SNA*, paragraph 4.38b). Accruing income for the owners when a dividend is declared rather than as the corporation earns the income is perceived by many as consistent with the SNA paradigm that corporations are separate institutional units. Nonetheless, it is observed that this paradigm is not followed for FDI and for investment funds.

18. **Table 1 shows how the allocation of the saving associated with a corporation's retained earnings to either the corporation or the investor varies with the type and residency of the investor.** The enterprise will have no saving if the RIE approach is applied because imputed distributions of its retained earnings will allocate the saving to the shareholders. In the current standards, the allocation of the saving depends on whether the corporation-to-shareholder relationship is one of direct investment or portfolio investment, and whether it is a cross-border relationship or a domestic relationship.

Table 1. Allocation of Retained Earnings on equity other than Investment Fund shares in the Current Standards

	Direct Investment	**Portfolio Investment**
Domestic Equity Relationship	Retained earnings allocated to *saving of the **corporation***	Retained earnings allocated to *saving of the **corporation***
International Equity Relationship	Retained earnings allocated to *saving of the **shareholder** (FDI, RIE)*	Retained earnings allocated to *saving of the **corporation***

ISSUES FOR DISCUSSION

19. **A key issue is whether enterprises should have saving.** Letting corporations have their own saving would be consistent with a strict treatment of them as distinct institutional units. The decision to save rather than to pay dividends is 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. Moreover, assuming that a transaction in income and equity is taking place between the participated corporation and the shareholder irrespective of the decision taken by the corporation in this respect might be seen as contradicting the definition of transaction in the standards where *mutual agreement* features prominently (e.g., *BPM6*, paragraph 3.4). This argument may be less compelling for 100 percent owned subsidiaries (particularly special purpose entities (SPEs)) or even for controlled entities.

20. **Letting enterprises whose owners have limited liability have saving is also consistent with their legal existence as independent entities.** This avoids the need for an over-simplified allocation of all the benefits of its retained earnings—or costs of its losses—to common shareholders. Moreover, the level of saving of an enterprise is a useful indicator of the extent to which it intends to fund investment from internal resources. In line with this view, some analysts do not include RIE in FDI when measuring foreign capital inflows because they do not consider it new foreign capital to the economy as it was generated in the host economy.

21. **On the other hand, this issue of the saving of corporations may be more a question of terminology/presentation than of substance.** Users routinely ask what is meant by "saving" of corporations—as saving is usually understood as what is left of disposable income after final consumption, a concept not applicable to the corporation sectors (i.e., corporations do not have final consumption expenditure), and they often understand it better when described as "retained earnings" (as noted in paragraph 9.11 of the *2008 SNA*, another term to describe retained earnings is the "undistributed incomes" of corporations). While extending RIE to all corporations' equity links would indeed set their net saving (B.8n in the SNA balancing and net worth items) to zero, their retained earnings could still be transparently observed by users, by looking at their net RIE—such that no loss of information would be entailed. Similarly, on the recipient side no loss of information is entailed either because users would be able to observe what is the RIE component (larger, if an extension is implemented) of their saving. In the specific case of households, it has to be acknowledged that increases in share prices resulting from retained earnings contribute heavily to incentivize consumption, and the saving ratio appears artificially

depressed under the current treatment non RIE-based (as income do not cover the additional income—i.e., consumption capacity—arising from RIE). The creation of an alternative balance could solve the communication problem.

22. **The view that earnings accrue to investors as they are earned can also be justified.** Owners' limited liability may have little practical impact, or even no impact in the case of direct investors who may be obligated to stand behind the debts of their enterprise for reputational reasons or the case of FDI in a branch. As owners of the corporation, all shareholders benefit from its earnings regardless of whether they are distributed or not. Retained earnings contribute to the change in market value of the corporation, and the whole question is whether this contribution is better recorded as a transaction or as a revaluation. Also, any holder of equity in a corporation that retains earnings could, in principle, sell shares to affect a situation that is identical to the one in which the corporation actually distributed the earnings as dividends. Conversely, companies may distribute dividends in kind by way of extra shares, which is economically very similar to retaining earnings, and these would be recorded as income (*2008 SNA,* paragraph 7.129).

23. **The current mixed approach in which the saving of enterprises is treated differently depending on whether they are owned by foreign direct investors, portfolio investors, or resident investors causes some asymmetries.** Because earnings are not passed through to shareholders who have no control nor influence over their use for dividends or investment or who are resident in the same economy, the amount of saving recorded for an enterprise depends on the mix of investors that own it. The net saving of an enterprise that is 100 percent owned by foreign direct investors equals zero (*2008 SNA*, paragraph 26.65). In contrast, all the retained earnings of an enterprise that is 100 percent owned by portfolio or resident investors are recorded as saving of the enterprise, and the growth of the wealth of the investors is recorded as a revaluation. A situation where the impact of the asymmetry treatment becomes evident is that of corporate inversions, which result in shifts of net primary income receipts and related national accounts indicators (e.g., GNI) from the economy of the inverter to the economy of the new foreign parent company (see GN "D.4 Corporate Inversions" for a detailed discussion).

24. **The *2008 SNA* research agenda identifies the asymmetry as particularly relevant for public corporations (*2008 SNA,* paragraphs A4.29 and 7.140).** The extension of RIE to public corporations would be a way to decisively tackle the incentive for governments to use their ownership relationship with their controlled corporations to artificially optimize the deficit figures (for instance by distributing large dividends to meet specific deficit targets in a given year and recapitalizing (later) the companies through capital injections described as subscriptions of equity). Although, these problems have been contained by new superdividend and capital injection rules (*2008 SNA*, paragraphs 7.131 and 22.138), in practice these rules are subject to contestations notably because they are ad-hoc and do constitute deviations to general principles. It is indeed debatable to reclassify a distribution of income as financial only because of the time of distribution. Similarly, capital injections are always net worth neutral at time of injections, such that treating them as expenses is debatable. Those problems would largely disappear by extending RIE to public corporations: the government deficit would then be reduced when investees' earnings are earned (rather than when distributed) and would be increased when investees' losses occur (rather than when actually covered). This would ensure a better measurement of the government net lending/net borrowing at any particular point in time.

25. **The treatment of FDI is based on the presumption that the foreign investor has control or influence of the company, and therefore has direct access to its net income.** Public corporations also have a controlling shareholder, so routing retained earnings of public corporations to the government would also improve the logical consistency of the system of accounts. The consistent principle would be that the retained earnings are routed in cases of controlling shareholder.[9] This treatment of public corporations would also eliminate the potential for large swings in government saving, which can occur when the classification of the public corporation changes between market producer and non-market producer.

26. **Imputing distributions of retained earnings to all kinds of shareholders would make the role of saving in the growth of shareholders' assets more visible and make the measures of institutional sector saving, national saving, and the current account balance more meaningful.** For example, holding gains are often responsible for most of the growth of household net worth in the accounts for institutional sectors, but adding retained earnings on equity owned by households would reveal a more significant role of saving in building wealth. As another example, national income and the current account balance of an economy that has a large net negative position in foreign portfolio investment would better reflect the resources available to residents if the claims of foreign portfolio investors on retained earnings of resident corporations were taken into account.

27. **The uncertain assumptions involved in estimating retained earnings might be a practical disadvantage of giving them a more prominent role in the accounts.** The assumptions include the service lives used to model consumption of fixed capital, the definition and location of software and other intellectual property assets, the assignment of prices to inventory additions and withdrawals, among others. However, these assumptions are routinely made for the compilation of RIE on FDI and for the allocation of retained earnings on collective investment schemes.[10]

28. **Note that a resolution of a single asymmetric treatment in isolation might make the others more problematic.** For instance, applying the RIE treatment to foreign portfolio investment only would make the difference between the treatment of cross-border investment and the treatment of domestic investment even greater. Similarly, extending the current treatment of FDI to domestic investment by controlling shareholders would expand the difference in treatment between direct and portfolio relationships.

29. **At the same time, expanding such differences may be acceptable or even commendable in consideration of the reason the RIE on FDI is enforced:** to the extent that RIE is largely designed to better measure national income, its extension to cross-border portfolio investment is warranted and the difference in treatment with domestic transactions is also warranted; similarly if this RIE treatment is justifiable by the shareholder control criterion, this then justifies an extension to domestic direct investment relationships. However, such an extension to domestic investment links can potentially

[9] It should be noted that the RIE relating to FDI is based on a 10 percent threshold, while the threshold would be set at 50 percent for public corporation. The notion that an associate can control the distribution is probably less solid than in the case of a controlling parent. At the same time, it can be understood that the *2008 SNA*/*BPM6* found it convenient to use the existing categories when defining the RIE boundary.

[10] See also GN "D.3 Treatment of Collective Investment Institutions".

complicate the interpretation of the saving of institutional sectors due to changes over time in how enterprises are classified.

OPTIONS TO CONSIDER

30. **The authors of this GN have considered five options, as follows** (the implications of the options are discussed throughout the GN):

Option 1: Keep the status quo (i.e., the current treatment in both *BPM6* and *2008 SNA).*

Option 2: Leave the core balance of payments accounts and national accounts unchanged, but add supplementary information on portfolio investment RIE to the balance of payments (and possibly memorandum items) and national accounts and supplementary information on public corporations RIE and overall investment in resident enterprises RIE to the national accounts.

Option 3: Extend the concept of RIE that is currently applied to foreign direct investors to public controlled corporations and/or to cross-border portfolio investors.

Option 4: Extend the concept of RIE that is currently applied to foreign direct investors to all equity holdings in the national accounts and balance of payments accounts.

Option 5: Eliminate asymmetries by discontinuing the current treatment of RIE for FDI (with the possibility to keep the treatment in supplemental tables or memorandum items).

31. **Table 2 sketches the implications of the options proposed on the core accounts and supplemental information.**

Table 2. Options to Consider

						RIE in …
		Option 5	**Option 2**			*supplemental tables/ memorandum items*
	Option 5	**Option 1 to 4**	**Option 3 and 4**		**Option 4**	*core accounts*
RIE applied to …	*none*	*FDI enterprises*	*public corporations*	*foreign portfolio investment*	*private domestic equity stakes*	

SECTION II: OUTCOMES

32. **It is the majority view of the FITT members, both from conceptual and practical perspectives, that there is a need for enhancing coherence and internal consistency in the system of accounts as regards the treatment of corporate income.** This would call for examining possible avenues for achieving it and would lead to reject Option 1 as a way forward. A possible approach for

enhancing the conceptual coherence of the accounts would be to apply the RIE treatment uniformly to controlling/influencing shareholders, both foreign and domestic. The owner control/influence rationale used to justify the RIE treatment for FDI is equally applicable to domestic investment.

33. **In practice, this sort of consistency may be costly to achieve because distinguishing the relevant enterprises that have a local controlling shareholder will require adapted databases.** It should also be noted that the RIE treatment requires the attribution of the income generated to the ultimate shareholders, which in turn requires knowledge of ownership chain. However, many statistical institutes and central banks maintain databases on the ownership structures of resident companies which distinguish between resident and nonresident ownership but do not provide a complete breakdown of resident ownership by sector except where there is a security-by-security database. In addition, the extension of the RIE to domestic investment links can also be carried out by way of macro-adjustments, using equity cross-sector whom-to-whom positions.

34. **Extending the RIE treatment only to public corporations (as in Option 3) would probably be more practical than extending it to all domestic investment involving a controlling shareholder but would improve the coherence of the accounts only slightly for some economies.** For others, it would still be a significant improvement to *2008 SNA* owing to the prominence of the general government deficit and because it could allow dropping the superdividend and capital injection rules that were designed to prevent manipulations of this key indicator but have proved both time and resource consuming to implement and occasionally controversial.

35. **By the same token, extending instead the RIE to all cross-border (also as in Option 3) equity links would ensure a more correct measurement of another key indicator: national income (GNI etc.).** While such an extension may pose some compilation challenges, these may be less severe than for FDI or at least not more severe.[11] It is noted that while removing the current treatment of RIE in FDI (as in Option 5) would indeed result in enhanced methodological consistency, it would also hamper some of the analytical and policy usefulness of GNI in the context of globalization: the distortions in the geographical allocation of operating surplus and other corporate income caused by MNE operations are partially corrected by the RIE treatment in FDI (making GNI or NNI more robust indicators than GDP for countries with high presence of MNE subsidiaries).

36. **Extending the RIE treatment to all enterprises regardless of the owners' residency and control (Option 4) would allow the system of accounts to follow a coherent, unified approach that fully reflects owners' claims on the retained earnings of their enterprises.** When applied consistently this approach will attribute the saving to the ultimate beneficiary of the retained earnings. Nevertheless, this approach presents significant practical challenges of implementation. Maintaining internal consistency of the accounts means that the approach must be applied to all sectors that contain enterprises or equity investors and also to all relationships between resident investors/enterprises and nonresident enterprises/investors. This will be challenging in practice[12] and the effects on important

[11] A proxy (such as well publicized Price Earning Ratio (PER) and Dividend yields) could be used to considerably reduce the compilation burden; if not perfectly accurate or perfectly aligning on statistical standards, such proxies can nonetheless remove the largest misreporting of portfolio income, at low cost.

[12] But probably not more than the current RIE in FDI. Also note for instance that the proliferation of sec-by-sec infrastructures worldwide eases compilation.

aggregates such as the current account balance, national saving, and household saving would be significant. The practical challenges could possibly lead to delays in implementation, reduced reliability, and important breaks in time series, hampering international comparability and comparisons over time, unless simplifying assumptions are used.[13]

37. **Regarding Option 2, items published as supplemental information can be based on alternative definitions without generating concerns about the internal consistency, international comparability, and time series continuity of the core accounts.** This allows the timetable for their development to be flexible. A pragmatic outcome would therefore be a conceptual acceptance of the proposition that RIE should apply to all equity investments, while recommending that, for practical reasons, the treatment be universally applied only in supplementary information (in the context of balance of payments statistics, this option could also consider that RIE on cross-border portfolio investment be added as memorandum items to the standard presentation—instead of as supplementary items).[14]

38. **Under an extended RIE a treatment in supplementary tables, the RIE treatment would continue to be applied to FDI in the core accounts.** The supplementary information would include an alternative presentation of the balance of payments accounts in which the RIE treatment is also applied to portfolio investment, and alternative measures of income, saving and investment at the national level and for the institutional sectors in which the RIE treatment is applied to all equity investment. The alternative measure of government deficit could be compiled and labeled as such.

39. **The FITT consultation on the subject although yielded a majority of opinions favoring Option 4 or 3 (extension of RIE) from a conceptual viewpoint, expressed preference for Option 2 as a pragmatic solution that leaves the decision on whether to publish the (then supplementary) information to compiling agencies themselves,** while leaving the core national accounts and balance of payments unchanged (not the least because the implementation of Option 4 may be problematic in economies with less developed statistical systems or less comprehensive statistical business registers—Option 3 may likely have similar issues to Option 4).[15] In a subsequent consultation, DITT members expressed split views between Option 1 (keeping the status quo) and Option 5 (removing the RIE treatment in FDI), while Option 2 received some substantial support, also taking into account the feasibility difficulties associated with Options 3 and 4.

40. **At the same time, although the FITT expressed broad support to treat share buybacks as income distribution in the core accounts, the preference was to have a more detailed discussion in a separate/subsequent GN.** This treatment would contribute to reductions in asymmetries in the

[13] Simplifying assumptions for recalculating historical data is common for statistical series. In the case in question, portfolio income can usefully be adjusted based on the PER/dividend ratio, while domestic DI links merely reallocate savings across sectors which can be done using equity shareholdings, in a manner similar to what is done for CII income (D.443).

[14] It is noted that for any option entailing the extension of the RIE treatment (Options 2 to 4) the new BPM Compilation Guide would have to contain a detailed discussion of the implications regarding data collection and statistical compilation.

[15] Out of 13 FITT views, eight supported Option 2 either as a first choice or as a preferred option for feasibility reasons (and another member indicated support for Option 2 as a second-best alternative). Among those that did not expressly support Option 2 as a recommended solution, three supported Option 4 (another one as a second choice), one Option 3, and another one Option 5.

treatment of corporate income distribution as share buybacks programmes may be seen as a substitute to dividends. However, the FITT expressed preference to prepare a separate/subsequent GN that discusses the treatment in detail examining all possible implications (Annex 1 presents an illustration of a possible implementation of such treatment). This view was also shared by a majority of DITT members.

41. **Given the practical difficulties in the implementation of Option 2, it is recommended that its feasibility is tested.** Testing would be particularly needed if options affecting the core accounts (Options 3 or 4) are adopted, as the resource implications for agencies would presumably be larger and the impact on headline macroeconomic indicators would deserve a careful examination.

Questions for Discussion:

1. *Does the Committee agree with Option 2, extending the treatment of RIE to all equity relationships in supplemental tables without affecting the core accounts?*
2. *If not, please express a preference for any other option proposed in the GN?*
3. *Does the Committee agree with the proposal to prepare a separate detailed GN on the treatment of share buybacks, considering the possibility of treating them as income distribution?*

Annex 1. Why and How to Expense Share Buybacks[16]

WHY EXPENSING SHARE BUYBACKS?

1. Share buyback occurs when companies repurchase their own shares on the market. Share buybacks can be carried out with the purpose of distributing them back in the context of options programs, less often in view of later resale, or as a mean to release funds to shareholders—as substitute or in addition to regular dividends.

2. In the past three decades, share buybacks have extraordinarily developed for this third motive; two main reasons explaining this: (i) share buybacks are often highly tax-efficient from the point of view of the whole of shareholders, and (ii) share buybacks are very flexible for companies, as they can stop these programs in case of need, while they are often reluctant to cut regular dividends owing to adverse reputational effects. Some companies (notably hi-tech ones) have even had a policy of never distributing regular dividends, instead carrying out heavy share buybacks.

3. Share buybacks are currently treated as financial transactions (F.5) in statistical manuals, largely because the event is undisputedly a financial transaction from the point of view of the share seller: disposing of shares and getting cash in place—for an unchanged net worth. Given that the system must be consistent, the transaction must then also be a financial transaction in the accounts of the buyer (the company). However, for the latter, this is more a substitute for handing out dividends, and recording the transaction as such (D.42) would make sense.

4. In addition, from the point of view of the whole of shareholders, treating share buybacks as income would also make sense, because, in their perspective, the company is releasing to them cash made on earnings although in a different legal form than dividends. Limited cases where companies distribute all their earnings via share buybacks rather than via dividends are not uncommon and do entail that no income is ever recorded in the SNA at the moment: this has the potential of adversely affecting income measurement, the saving rates within an economy, and also GNI. This bias in income measurement is already at play for significant amounts, as, for example, share buybacks have exceeded (for a number of years already) the dividends paid out by quoted companies in the US (exceeding one trillion dollars a year—close to five percent of GDP).

5. In this sense, expensing share-buybacks while keeping the current core framework could thus be considered as an intermediate approach between Option 4 and Options 2/1 of this GN, because this approach would significantly increase the distribution of income across the economy (as Option 4 would do) but still stay within the boundary of Options 2/1 (which insist that the saving of corporations should not be set to zero). The question is whether, by handing out cash to shareholders, the corporations are taping in their savings or not. Many think they do, and de facto many companies borrow to do so.

6. It can be also noted that share buybacks are reported similarly to dividends in companies' financial statements (IFRS): as financing transactions. This serves to recall that seeing dividends as income in the SNA is to a certain extent a convention deemed necessary to appropriately measure the income of shareholders and notably households (that use these resources to consume); but in concept, a

[16] Prepared by Philippe de Rougemont (Eurostat).

dividend can be conceived as essentially a return of cash to shareholders, which is in fact net worth neutral to them (and indeed the price of shares falls when the dividend is distributed). It has thus been argued by some that the true income on equity is the company's earnings, that is: dividend plus reinvested earnings (D.42+D43). Some others have gone the other direction, proposing that dividends are not included in income altogether.

HOW TO EXPENSE SHARE BUYBACKS?

7. Some wonder how a proposed reclassification of buybacks as D.42 would work because it is very clear that the seller is merely engaging in a financial transaction. Thus, it would not be reasonable to record D.42 revenue in the seller accounts. Such a direct reclassification of the cash transaction as D.42 could have catastrophic effects, allowing, for instance, governments to generate revenue at will by merely reselling shares (purchased in advance on the market) to the company during its buyback programme at the moment that is convenient. Also, the measure of GNI would vary according to whether many or few nonresidents participate in buyback programmes, which is undefendable.

8. In addition, from a source data point of view, it seems highly uncertain if data on share transactions can reliably identify if the latter is carried out with the issuing company (i.e., as part of the buyback programme) or with the rest of the market. Also, it could be argued that, in concept, the distinction may not make sense at all, notably if the buyback is carried out via financial intermediaries or via other markets organized such that sellers cannot identify who are the buyers.

9. Given the above, one proposal (that needs to be further investigated) would be to simply impute a dividend for the amount and at time of share buyback in both the account of the company (use/expenditure/debit) and that of all shareholders (resource/revenue/credit). The counterpart of this imputed D.42 is F.5, in the same way as in reinvested earnings (D.43). The allocation across shareholders is also in the same way as reinvested earnings. This would be a deviation from current rules, whereby some D.42 would now be an imputed flow rather an observed flow, but would be justified by the fact that the imputation is based on an observed flow and by the need to treat share buybacks as distribution of income.

10. In the accounts of the company, the outflow of cash currently coded (-)F.5L becomes D.42. In the account of the shareholders as a whole, there is a D.42 that is imputed across all shareholders against (+)F.5A, while the share seller itself records the following: (-)F5.A against cash received (+)F2A, in addition to its apportioned D.42/(+)F.5A.

11. The proposal is thus not to classify the buyback transaction itself as nonfinancial, because the seller indeed carries out a financial transaction, but to use the amount and time of buyback to impute a dividend applying the reinvested earnings method, with the same effects, although the rationale to do so is different. This difference in rationale is not so problematic: as mentioned in the GN, the reinvested earnings method is already applied in other circumstances, for instance in collective investment schemes (D.443)—also based on a different rationale to D.43.

12. Because the proposal is to merely impute a further D.42 corresponding to the share buyback in addition to the regular dividends, the new total D.42 should nonetheless be superdividend tested. This is to ensure that share buybacks that merely seek to distribute the earnings of a period are treated as

income, while share buybacks that essentially aim a liquidating a large part of the company should be treated as financial.

13. Following the introduction above, one could wonder whether the proposed treatment of share buybacks should depend on the subsequent use of the shares bought back. The proposal rejects the notion that a different recording should be applied depending on use, because one should generally not classify according to the ulterior motive of the transaction, and because no information will generally be available for this. Also, it is adequate that a subsequent use is treated separately.