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.

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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 own 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.*

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

<u>Disadvantages</u>: 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*

<u>Advantages</u>: 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 it's 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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