IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS

BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

ISSUES PAPER 18

DIRECT INVESTMENT – REINVESTED EARNINGS

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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'.

	BPM5, §278	***IMF Textbook, §411***	***BMD, §28***	***SNA, 7.122***
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.c. 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 incomes[2].

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).

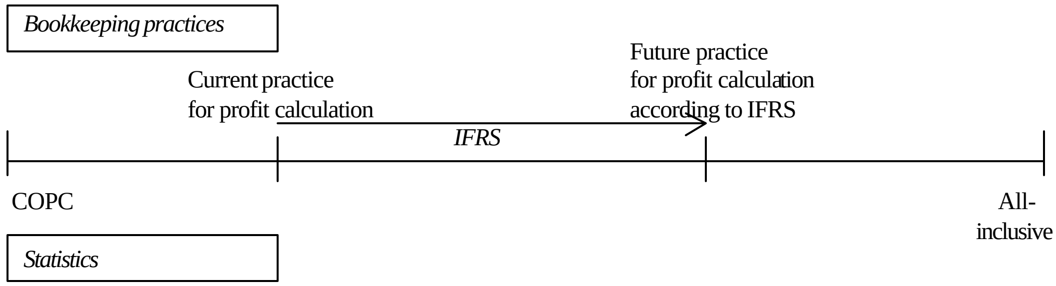
Normal operations are not defined at all in BPM5. What is normal? It could be considered to use a wording in the new Manual like 'all operations that are directly and indirectly related to the current (and future) ongoing business activity of the entity'. Abnormal operations, costs and results could 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 statistics[3]. 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 ant 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

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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

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Chapters 1, 10 and 11