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.*