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# Chapter 21: Measuring corporate activity

## A. Introduction

21.1 The purpose of this chapter is to discuss aspects particular to corporations in both the financial and non-financial corporation sectors. It begins in section B by discussing the demography of corporations; how they come about, how they disappear and how they merge with one another. The consequences of these actions in the SNA are almost all to do with recording the acquisition of the owner's equity in corporations and in some cases reclassification of assets and liabilities between sectors.

21.2 Section C looks at some sub-sectoring of corporations and how this can be effectively deployed for analysis.

21.3 Section D considers the relationships between corporations in the domestic economy and in the rest of the world. Much of this section is concerned with aspects of globalisation and the derivation of relevant indicators.

21.4 Section E recalls some of the discussion in chapter 20 and looks further at the contribution of assets to production.

21.5 Section F looks at the consequences of financial distress and the implications of remedial action for recording within the SNA.

21.6 The last section, section G, covers a rather different subject and looks at the emergence of commercial accounting standards over the last several years and how the process of developing new standards can be instrumental in helping to develop new approaches within the SNA.

## B. The demography of corporations

21.7 Maintaining a list of corporations is similar in many ways to maintaining a list of all individuals present in the country. It is necessary to record new corporations as they come into being, to record those that cease to be and also to record significant changes in those that continue to exist. For example, a business register must note when the main activity of an enterprise changes from one type of activity to another.

### 1. The creation of corporations

21.8 Corporations can come into being in a number of ways. One is when what was previously an unincorporated enterprise within the household sector becomes incorporated. (The exact process of incorporation, such as when this may or must happen and how it is effected, will depend on the company law in effect in the country concerned.) When this happens, the assets and liabilities that were previously indistinguishably part of the household are separated off and become those of the corporation. This leads to a change in classification of the assets and liabilities from the household sector to the appropriate corporations sector being recorded in the other change in the volume of assets account. The definition of an institutional unit includes the requirement that it is able to acquire assets and incur liabilities on its own behalf. When a corporation is separated from its owning household, not only are its assets and liabilities separated but so also is the responsibility for the liabilities. Once an enterprise is incorporated, the owning household no longer has a claim on the assets and has no responsibility for the liabilities but instead owns the equity in the corporation.

21.9 An individual may simply decide to set up a business, set up a legal entity and begin operations. Initially, there may be no assets of the entity and no liabilities but as these accrue they belong to the corporation and the owner's equity increases correspondingly. On a larger scale, there may be an agreement between a number of units, one or more of whom propose a business plan and one or more of whom agree to finance the operation. A formal agreement results in which the split of the rewards from the enterprise's activity is determined and also the

division of the responsibilities. It is not necessary for the corporation to issue shares for the agreement on the share of the profit arising from the activities of the enterprise to be binding. The assets of the new corporation are recorded as being acquired by it and an amount of owner's equity in the corporation incurred as a liability towards the parties supplying the finance is also recorded.

21.10 Corporations may also come into being at the initiative of government or a unit in another economy. In addition, a corporation may come into existence by the splitting of a previously existing corporation. This possibility is discussed below under mergers and acquisitions.

## 2. The dissolution of corporations

21.11 Similarly there are several ways in which corporations may go out of existence. The first is when an entity is wound up after having been declared bankrupt. When this happens, the receiver (the unit responsible for administering the end of the corporation) sells all of its assets and distributes the proceeds amongst those having a claim on the corporation in a legally predetermined order. The shareholders are always the last to be allocated any proceeds. In the case where the corporation is bankrupt it is quite common that the shareholders may receive nothing. Only in very exceptional circumstances will the shareholders have any responsibility to provide funds towards settling other liabilities of the corporation.

21.12 A corporation may be wound up voluntarily by its owners. When this happens the assets are sold and they are divided amongst the owners according to the shares each has in the corporation. If the company is one that had issued shares, it can only be wound up if all shareholders agree or if all the shares are first acquired by a sufficiently small number of units who can reach agreement to wind up the corporation. The acquisition of all shares of a corporation need not be a preliminary to the corporation ceasing to exist; it may simply continue with a smaller number of shareholders or even as a private unlisted corporation.

21.13 A third way in which a corporation may disappear is through it being merged with another corporation. This too is discussed below under mergers and acquisitions.

## 3. Nationalisation and privatisation

21.14 The government may decide to take ownership of a corporation for a number of reasons, either because it is felt it is in the public interest for government to control the corporation, in response to financial distress or for other political motivations. When this happens the ownership of the corporation passes to the government but the assets of the corporation remain on its balance sheet unless the government decides to nationalise the corporation and disband it at the same time. Often but not always, government may make a payment to the previous owners of the corporation but this may not necessarily correspond to their view of a fair price. Unless the corporation is dissolved, the process of nationalisation leads to a change in the ownership of the corporation from private units to the government but the assets and other liabilities of the corporation continue to be owned by the corporation. Owners' equity in the corporation is recorded as a transaction in the financial account. There is also a reclassification of the assets and liabilities of a corporation being nationalised from the national private sub-sector to the public sub-sector recorded in the other change in the volume of assets account.

21.15 The government may also decide to privatise a corporation currently controlled by government. When this happens the most usual mechanism is that its shares are offered to the public either for sale or, in some cases, without charge or perhaps at a price lower than the market would bear. When shares are offered free or at a reduced price, a capital transfer from government to the eventual shareholders needs to be recorded in the accounts as well as the acquisition of shares. As with nationalisation, only the equity in the corporation changes hands, not its assets and other liabilities, and the change in ownership of the equity is recorded as a transaction in the financial account. The ownership of the assets and liabilities remains with the corporation but they are reclassified from the public to national private sub-sector in the other changes in the volume of assets account.

21.16 There is more discussion on nationalisation and privatisation in chapter 22.

## 4. Mergers and acquisitions

21.17 The terms merger and acquisition have slightly different meanings.

21.18 A *merger* refers to the combination of two or more corporations to share resources in order to achieve common objectives. A merger implies that, as a result of the operation, only one entity will survive and frequently occurs following an acquisition (described below). There are several types of merger possible. For example, the *Benchmark Definition of Foreign Direct Investment* identifies the following cases:

a. A *statutory merger* relates to the business combination where the merged (or target) corporation will cease to exist. The acquiring corporation will assume the assets and liabilities of the merged corporations. In most cases, the owners of merged corporations remain joint owners of the combined corporation.

b. A *subsidiary merger* relates to an operation where the acquired corporation becomes a subsidiary of the parent corporation. In a reverse subsidiary merger, a subsidiary of the acquiring corporation will be merged into the target corporation.

c. *Consolidation* is a type of merger which refers to a business combination whereby two or more corporations join to form an entirely new corporation. All corporations involved in the merger cease to exist and their shareholders become shareholders of the new corporation. The terms consolidation and merger are frequently used interchangeably. However, the distinction between the two is usually in reference to the size of the combining corporations. Consolidation relates to an operation where the combining corporations have similar sizes while merger generally implies significant differences.

d. A *reverse merger* is a deal where the acquiring corporation ceases to exist and merges into the target corporation. If a corporation is eager to get public listing in a short period of time, it can buy a corporation with listed shares and merge into it in order to become a new corporation with tradeable shares.

e. A *merger of equals* is a type of merger where the corporations involved are of similar size.

21.19 An *acquisition* is a transaction between two parties based on terms established by the market where each corporation acts in its own interest. The acquiring corporation achieves control of the target corporation. The target corporation becomes either an associate or a subsidiary or part of a subsidiary of the acquiring corporation.

a. A *takeover* is a form of acquisition where the acquiring corporation is much larger than the target corporation. The term is sometimes used to designate hostile transactions. However mergers of equals (in size or belonging to the same sector of activity) may also result in a hostile takeover.

b. A *reverse takeover* refers to an operation where the target corporation is bigger than the acquiring corporation.

21.20 A *divestment (de-merger)* refers to the selling of the parts of the corporation due to various reasons:

a. A subsidiary or part of the corporation may no longer be performing well in comparison to its competitors;

b. A subsidiary or a part may be performing well but may not be well positioned within the industry to remain competitive and meet long-term objectives;

c. Strategic priorities of the corporation to remain competitive may change over time and lead to divestments;

d. Loss of managerial control or ineffective management;

e. Too much diversification may create difficulties and thus lead the parent corporations to reduce the diversification of its activities;

f. The parent corporation may have financial difficulties and may need to raise cash;

g. Divestments may be realised as a defence against a hostile takeover.

21.21 Corporate divestments can be conducted in different ways:

a. A *corporate sell-off* is the sale of a subsidiary to buyers that are other corporations in most cases.

b. A *corporate spin-off* occurs when the divested part of a corporation is floated on the stock exchange. The newly floated corporation is separately valued on the stock exchange and is an independent corporation. The shares in the newly listed corporation are distributed to the shareholders of the parent corporations who thereafter own shares of two corporations rather than one.

c. An *equity carve-out* is similar to a corporate spin-off but the parent retains the majority control. This form has the advantage of raising cash for the divestor.

d. *Management buy-outs and buy-ins* occur when the buyer is the manager or a group of managers of the corporation that is being sold off.

21.22 In all these cases, transactions in the equity of the two corporations involved need to be recorded in the financial account and, possibly, a change of classification by sector in the other changes in the volume of assets account.

## C. Sub-sectors

21.23 The sub-sectoring of the corporations sectors is discussed in chapter 4. It is proposed that there should be a three-way split of corporations between those that are national private corporations, those that are controlled by the government and those that are foreign controlled. Within each of these it is desirable to identify market non-profit institutions (NPIs).

21.24 The reason for identifying NPIs is twofold. In the first place, in order to have a comprehensive picture of NPIs, as described in chapter 23, it is necessary to be able to identify those market NPIs that are assigned to the corporations sector. Identifying them separately may be unexpected to some users, since there is often a misconception that all NPIs are non-market and fall in the NPISH sector. The other reason for identifying NPIs separately is that for some analyses it may be desirable to analyse corporations excluding the NPIs if it is felt that their economic behaviour is significantly different.

21.25 In identifying publicly controlled corporations, there is a question about how to provide long time series if there has been a significant change in the number and type of corporations subject to public control during the period. One possibility is to provide a time series that includes only those corporations that were subject to public control at each period in question. If interest focuses on how much of the corporate sector was controlled by the government, and how this has changed over time, this gives an appropriate picture. However, if the intent is to explore the behaviour of the same group of corporations over time it may be more appropriate to take the current definition of publicly controlled corporations and use this set of corporations over the time period considered regardless of whether or not they were publicly controlled for the whole of that period.

21.26 Identifying foreign controlled corporations is key to looking at the interaction between the domestic economy and the rest of the world. Exploring this in greater detail is the subject of the following section.

## D. Relations between corporations in different economies

21.27 Deregulation of markets, technological innovations and cheaper communication tools have allowed investors to diversify their participation in competitive markets overseas. In consequence, a significant increase in cross-border financial movements including direct investment has become a key factor in international economic integration, more generally referred to as globalisation.

21.28 Regular analysis of direct investment trends and developments is an integral part of most macroeconomic and cross-border financial analysis. It is of prime importance to policy analysts to identify the source and destination of these investments. A number of indicators based on direct investment statistics facilitate the measurement of the extent and impact of globalisation.

### 1. Foreign direct investment

21.29 Foreign direct investment (FDI) is a key feature of the balance of payments and it is useful to review some of the basic concepts associated with this. Further details can be found in the *OECD Benchmark Definition of Foreign Direct Investment*, the fourth edition of which was published in April 2008.

21.30 Direct investment is a category of cross-border investment associated with a resident in one economy (*the direct investor*) having control or a significant degree of influence on the management of an enterprise (*the direct investment enterprise*) that is resident in another economy.

21.31 Direct investment may also allow the direct investor to gain access to the economy of the direct investment enterprise which it might otherwise be unable to do. The objectives of

direct investment are different from those of portfolio investment whereby investors do not generally expect to influence the management of the enterprise.

21.32 Direct investment enterprises are corporations which may either be subsidiaries in which over 50% of the voting power is held, or associates in which between 10% and 50% of the voting power is held or they may be quasi-corporations such as branches which are effectively 100% owned by their respective parents. Enterprises that have no direct investment influence upon one another (that is the 10% voting power criterion is not met) but are directly or indirectly influenced in the ownership hierarchy by the same enterprise (which must be a direct investor in at least one of them) are described as fellow enterprises.

21.33 Direct investment relationships are identified according to the criteria of the Framework for Direct Investment Relationships (FDIR, described in the *Benchmark Definition*), including both direct and indirect relationships, through a chain of ownership. Suppose that corporation A owns 80% of corporation B and B owns 70 % of C; if A is a direct investor in B and B is a direct investor in C then A is also a direct investor in C.

## 2. The role of non-resident SPEs in FDI

21.34 One complication in looking at FDI information is that increasingly, non-resident SPEs are used as a conduit for FDI. This distorts the country and industry analysis of FDI. If the tax rules of a country where many SPEs are resident change, the SPEs may relocate with an apparent major change in the location of FDI. However, when looking at the ultimate destination of the FDI there may have been no change. For this reason, when non-resident SPEs are involved in an FDI investment chain, there is strong encouragement to provide supplementary information based on the first non-SPE counterpart in the host or investing economy (in the outward or inward chain) as appropriate.

## 3. FDI accounts

21.35 Direct investment statistics embody three distinct statistical accounts:

a. Investment positions;

b. Financial transactions, and

c. Associated income flows between enterprises that are related through a direct investment relationship.

21.36 Direct investment positions show the total stock of investment made abroad and received from abroad, divided between equity and debt, at a given reference point in time. FDI positions as a percentage of GDP indicate the extent of globalisation at a given point in time. These structural indicators designate the interdependence of economies.

21.37 Financial transactions show the net inward and outward investments with assets (acquisitions less disposals or redemptions) and liabilities (incurrence less discharges) presented separately by instrument in any given period. FDI financial flows expressed as a percentage of GDP provide one indicator of the changes over that period in the degree of globalisation of an economy. This indicator provides early information on the relative attractiveness of economies (both domestic and foreign) for new investments after allowing for the withdrawal of investments or disinvestment during the same time period.

21.38 Direct investment income provides information on the earnings of direct investors and of the direct investment enterprises. Direct investment earnings arise from (i) equity consisting of distributed earnings as well as undistributed earnings which are treated as reinvestment of earnings in that enterprise and (ii) from interest on inter-company loans, trade credit and other forms of debt. FDI income flows as a percentage of GDP provide information on the relative importance of the earnings of direct investment in both the reporting economy and abroad.

## 4. Ultimate investing country

21.39 The standard presentation of FDI shows the country of the immediate counterparty and the industry of the immediate counterparty for outward FDI. For inward FDI, it is possible to determine not only the immediate counterparty but also the ultimate investor. The ultimate investor for this purpose is the enterprise that has control over the investment decision to have an FDI position in the direct investment enterprise. As such the ultimate investor controls the immediate direct investor. It is identified by proceeding up the immediate direct investors ownership train through the controlling links (ownership of more than 50% of the voting power) until an enterprise is reached that is not controlled by another enterprise. If there is no enterprise that controls the immediate direct investor, then the direct investor is effectively the ultimate investor in the direct investment enterprise.

21.40 The country in which the ultimate investor is resident is the ultimate investing country in the

direct investment enterprise. It is possible that the ultimate investor is a resident of the same economy as the direct investment enterprise. (A controls B controls C. A and C are resident in the same economy but B is resident in another.)

21.41 In order to transform the standard presentation by country to the supplementary ultimate investing country presentation, the entire FDI position that is attributed to the country of residence of the immediate direct investor is allocated to the ultimate investing country. When there is more than one immediate direct investor in a direct investment enterprise, the entire inward FDI position of each immediate direct investor is reallocated to the respective ultimate investing country based on the ultimate controlling parent of each of the immediate direct investors. This method ensures that the levels of direct investment into a country according to the standard presentation and according to the supplementary presentation are the same.

### 5. Multinational enterprises

21.42 As well as information relating to foreign direct investment where only a 10% voting power is required to identify a foreign to direct investor, there is interest in analysing the activities of multinational enterprises (MNEs) where at least 50% of the voting power is held. Thus the MNEs correspond to foreign control enterprises in the sense of sub-sectors in the SNA. (There is a small distinction between the Benchmark Definition and BPM6 and the SNA on the question of control. For FDI and in the BPM6, the 50% of voting power rule is applied rigidly but the SNA is more flexible. See chapter 4.)

21.43 Statistics on the activities of MNEs, also known as Foreign AffiliaTe Statistics (FATS), are elaborated in the OECD *Handbook on Economic Globalisation Statistics*. Work is ongoing to ensure the consistency of these various sets of statistics.

### 6. Out-sourcing

21.44 There are two ways in which a corporation A in economy X may have another corporation B in economy Y assemble parts for it. Although the effect appears similar, the consequences for recording in the accounts are quite different. If A and B are unrelated enterprises, then B contracts to do work for A in return for a fee. (This case is described elsewhere, for example in chapter 28.) In this case there is no recorded transfer of the items from A to B (or X to Y). Only the agreed fee is recorded as a transaction between the two economies.

21.45 However, if A and B both belong to the same group of corporations, then it may be the case of that there is a transfer of the risks and rewards of the items on their dispatch from A to B. The question is whether a realistic price is entered for the items in the trade figures for both A (and X) and B (and Y) as the items move internationally. When A and B are related, a practice known as "transfer pricing" is sometimes used. Suppose the tax regime in Y is more liberal than that in X. It may then be the case that A artificially lowers the price of the items dispatched to B in order to minimise profits in X while B records a higher profit subject to the lower tax regime in Y. In principle, international accounting standards and the balance of payments recommendations indicate that items transferring across borders should be valued at "arm's-length" prices, that is to say prices that would prevail if there were no relationship between the two corporations involved. Making such an adjustment is not easy but it is in the interests of tax authorities, customs officials and the statistician to see whether appropriate adjustments can be made if the sums involved are significant and adjustments can be made with sufficient reliability.

## E. The contribution of assets to production

21.46 Chapter 20 discusses the role of capital services in production and the calculation of multi-factor productivity (MFP). The assets to be considered in calculating productivity are those fixed assets that are both owned and used by the enterprise plus any natural resources and other non-produced assets including contracts, leases and licences and possibly marketing assets they both own and use. Assets that are not legally owned by the enterprise but are subject to a financial lease are included in the calculations in the same way that they are recorded on the balance sheet of the enterprise. However, assets that are leased under an operating lease agreement are excluded. This may mean two enterprises undertaking similar activities using similar assets may show different productivity figures because one uses assets it owns and the other assets that it leases. An area for supplementary analysis is to consider compiling information on assets according to the using rather than the owning industry and to look at the implications for operating surplus and productivity of the use of leased rather than owned assets.

## F. The consequences of financial distress

21.47 Signs that a non-financial enterprise is suffering financial distress include the level of profits that it has been generating recently and possibly the level of dividends it is able to offer. It is also probable that it suffers a cash flow problem and is unable to meet its liabilities on a timely basis. Competitors may take the opportunity to launch a takeover bid. However, if no takeover bid is offered the question here is how the corporation may survive if at all.

21.48 In a similar way, a financial enterprise may suffer financial distress because it has difficulty in raising finance and is unable to service its liabilities. Again this is a circumstance in which a competitor may launch a takeover bid but this may not always be forthcoming.

21.49 If the enterprise, whether financial or non-financial, is deemed to be of national importance this may be an instance where government steps in and offers either to take over the enterprise, in effect nationalising it, or may offer a major capital injection in return for a degree of control, possibly full control, of the enterprise. The recording of nationalisation and capital injections by government is discussed in chapter 22.

21.50 Another possibility is that the government offers a guarantee to the creditors of the enterprise in distress. The activation of a one-off guarantee is treated in the same way as a debt assumption. The original debt is liquidated and a new debt is created between the guarantor and the creditor. In most instances, the guarantor is deemed to make a capital transfer to the original debtor, unless the guarantor acquires an effective claim on the creditor, in which case it leads to the recognition of a financial asset (a liability of the debtor).

### 1. Bad debts

21.51 All enterprises, but especially financial corporations, may suffer from bad debts and this phenomenon may be particularly acute when other aspects of the economy also exert financial pressure on the enterprise. Within the SNA, loans are always recorded as the amount that is due to be repaid to the creditor. In cases where the debtor has a bad credit rating this may overstate the market value of the loan. This is seldom done on a loan by loan basis but is regularly done for classes of loans.

21.52 In such cases the SNA recommends that memorandum items be compiled for the accounts showing the nominal and market value of bad loans and the implications for interest flows, the amount of interest accruing on the nominal value, the amount of interest outstanding from previous periods and the amount relating to the current period that is unpaid. Elaborating the accounting for non-performing loans is one item on the research agenda as explained in annex 4.

### 2. Concessional lending and debt rescheduling

21.53 There is detailed discussion of government's role in concessional lending, debt rescheduling and bailouts in section D of chapter 22.

## G. Links to commercial accounting

21.54 In recent years, the International Accounting Standards Board (IASB) has become increasingly important as the standard setter for commercial accounting. The IASB promulgates International Financial Reporting Standards (IFRS) and at present more than 100 countries are involved in this process of harmonisation. Many large companies especially multinationals, already apply these international accounting standards.

21.55 The principles underlying the IFRS are in most cases entirely consistent with the principles of the SNA. In particular, it is worth noting that the introduction to the standards explains that economic substance should take precedence over legal form. The IFRS, like the SNA pays attention not only to the conceptually preferred approach but also practical possibilities.

21.56 The process of developing a new standard is a threefold one. In the first step, a document discussing the arguments for and against a new standard is proposed and it is released with an invitation to comment. Once the comments are received and analysed, if it is decided to

proceed, an exposure draft is prepared and posted for global comment. Only if the exposure draft receives substantial favourable comment is a formal standard developed. At each stage, the documentation available discusses the background to the standard as well as its formal wording.

21.57 Since it is inevitable that national accounting information for large companies in particular must be drawn from data compiled according to the international accounting standards, it would be advantageous for the national accounts fraternity to take a greater interest in the three stages of developing international accounting standards and contribute their points of view.

21.58 Two particular areas where the IFRS adopts approaches somewhat different from the SNA are in the area of the recognition of holding gains and losses as income and in the recording of provisions and contingent liabilities. Further examination of the IASB position could be helpful in refining the SNA treatment of these issues, if not by accepting the IASB position entirely, at least by showing a reconciliation between their position and that of the SNA.

21.59 In addition to the IASB that applies to private corporations, the International Public Sector Accounting Standards Board (IPSASB) performs a similar function for government bodies. There is reference to IPSASB in chapter 22.