



F.2 Asymmetric Treatment of Retained Earnings

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on National Accounts

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Background

- Reinvested earnings (RIE) are recorded only for equity in foreign direct investment (FDI) and investment funds, but not for other types of equity (cross-border portfolio and domestic investments).
- This treatment 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.
- The guidance note (GN) also briefly considers the treatment of share buybacks as income distribution, given that they may be seen as a substitute to dividends.

The Issue

- Imputing RIE for FDI is based on the presumption that the foreign investor has control of or influence on the company, and therefore has direct access to its net income.
- Two inconsistencies are the main focus of this GN:
 - ◆ **Inconsistency 1 – FDI vs Portfolio Investment**
 - 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.
 - However, the RIE rule was mainly designed to appropriately measure national income (portfolio cross-border positions are large and with an increasing prevalence of share buybacks).

The Issue

- ◆ **Inconsistency 2 – Foreign vs Domestic Direct Investment Relationship**
 - **Domestic direct investment is not an SNA concept.** Thus, RIE transactions are not imputed for resident-to-resident investment relationships (the only income of resident shareholders are dividends).
 - **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 principle that corporations are separate institutional units:
 - Are firms able to make own decision on retaining/distributing income, regardless of the level of influence of shareholders?
 - Does imputing RIE contradict the *mutual agreement* features of the definition of transactions?
 - **Extending the RIE to public corporations** was envisaged in the previous SNA/BPM review but was rejected in favor of defining new rules on superdividend and capital injections.

The Issue: Allocation of Retained Earnings on Equity

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

Options for Consideration

- **Option 1:** Keep the status quo (i.e., the current treatment in both *BPM6* and *2008 SNA*).
- **Option 2:** Leave the core accounts (BOP and SNA) unchanged but add supplementary information on RIE for portfolio investment in BOP (and possibly memorandum items) and SNA; and supplementary information on RIE for public corporations and RIE for overall investment in resident enterprises in SNA.
- **Option 3:** Extend the concept of RIE that is currently applied to foreign direct investors to public 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:** Discontinue the current treatment of RIE for FDI.

Options for Consideration

- Extension of the concept of RIE to other type of equity relationship:

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

FITT Recommendation: Option 2

- From conceptual and practical perspectives, a majority of FITT members see the need for enhancing coherence and internal consistency in the system of accounts.
- A majority of FITT members favored **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 SNA and BOP unchanged.
- However, from a **conceptual view**, the majority of opinions favored the extension of RIE proposed in either **Option 3** (public corporation and cross-border portfolio) or **Option 4** (all type of equity).
 - ▶ Noting their implementation may be problematic in economies with less developed statistical systems or less comprehensive statistical business registers.

FITT Recommendation on Share Buybacks

- Although FITT members expressed broad support to treat share buybacks as **income distribution in the core accounts**, the preference was to prepare a separate/subsequent GN that discusses the treatment in detail examining all possible implications.
- This view was also shared by a majority of DITT members.

DITT Views

- DITT members expressed split views between **Option 1** (keeping the status quo) and **Option 5** (removing the RIE from FDI in BOP), while **Option 2** received substantial support, also taking into account the feasibility difficulties associated with **Option 3** and **Option 4**.

Public Consultation Outcomes

- The recommended **Option 2** was supported by **around 35 percent** of the respondents—many of them reasoning the pragmatic aspects explained in the GN.
- **Option 3** was the most attractive to respondents (**27 percent**) among the options proposing extension of the RIE to other types of equity holdings in the core accounts and often considered as the best solution from the methodological perspective among all the options proposed in the GN.
- The remaining respondents selected **Option 1 (18 percent)**, **Option 5 (12 percent)**, and **Option 4 (9 percent)**.
- The overwhelming majority of respondents agreed with the GN's proposal of preparing a separate GN to discuss in detail the statistical treatment of buyback shares.

Outcomes of BOPCOM

- The Committee was split with around half supporting Option 2 and others expressing preference for either Option 4 or Option 1
- Most members that expressed preference for other options, deemed Option 2 as an acceptable compromise/a second-best solution, subject to (i) testing its feasibility; (ii) establishing a clear order of priorities for supplementary collections; and (iii) considering the views of national accountants (as for all joint Task Teams' items) before taking a final decision.
- All members supported the preparation of a separate GN to address share buybacks.

Actions:

- FITT to await the outcome of the July meeting of the AEG and revise the GN incorporating the Committee's and the AEG's comments.
- Subject to the AEG opinion, the supplementary data collections for Option 2 will be tested with a sample of volunteer countries covering at least portfolio investment and domestic equity relationships.
- The updated version of the GN, incorporating the Committee's and the AEG's comments as well as the outcomes of the feasibility testing and possibly of guidance note D.16.

Questions for the AEG

- 1. Do you 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. Do you 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?*