ANNEX 6

Reinvested Earnings and Reinvestment of Earnings

1. Definition

536. In a relationship between a direct investor and a direct investment enterprise (DIE), the net current earnings of a DIE that are not distributed as dividends to the shareholders (or the equivalent in the case of quasi-corporate enterprises) are deemed distributed, as investment income, to the direct investor (DI), proportionate to its (their) holdings of shares (or equivalent) in the DIE.[68] As this is an imputed transaction, a counterpart imputation (of equal value but opposite direction) is required in the financial account representing the reinvestment of the funds back into the DIE. The income imputation is referred to as *reinvested earnings* (RE) (Box A.6.1), while the financial account entry is referred to as *reinvestment of earnings income*, to differentiate it from the income transaction.

Box A.6.1 **Reinvested earnings on direct investment**

The net[69] operating surplus/deficit of the DIE

plus:

property income receivable[70] and current transfers receivable

minus:

property income payable [including dividends payable to DI(s)],[71] current transfers payable,[72] including current taxes payable on the income, wealth, etc., of the direct foreign investment enterprise, but excluding withholding taxes[73] and taxes on holding gains.

times

the DI's (DIs) share of the DIE's equity (or equivalent)

equals

Reinvested earnings payable

68. That is, shares on issue for an incorporated enterprise, or the equivalent for an unincorporated enterprise. Where the shares issued (or equivalent) differ from voting power, the same principle for the distribution of dividends should be used. For the most part, it is the DI's percentage holding of shares on issue (or equivalent) that determines the ratio under which reinvested earnings are deemed distributed, not the level of voting power.
69. *Net* in this context refers to net of charges for consumption of fixed capital.
70. For a DIE, the property income receivable includes reinvested earnings from any DIE in which it is a DI.
71. Including branch profit remittances.
72. Capital transfers *e.g.* investment grants received, should not be included.
73. Withholding taxes are deemed to be paid by the non-resident owner, not by the resident entity.

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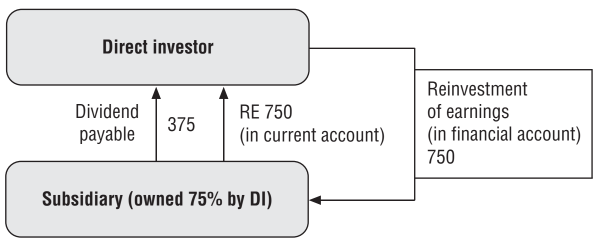
537. It should be noted that RE (and reinvestment of earnings) can be both negative or positive in sign for both the DI and the DIE. Typically, RE will be a debit for income payable by the DIE to the DI, and a credit for such income receivable by the DI (with the offsetting entries for reinvestment of earnings in the direct investment transactions and positions accounts reflecting the opposite directions for these flows). However, if a DIE generates a loss from its current operations (that is, the sum of its operating surplus and its net property income is negative), or if it declares a dividend for more than it has earned in the reference period, a negative debit should be recorded in the Direct Investment Income Account under RE for the DIE (and, correspondingly, a negative credit for the DI). An offsetting negative entry should also be recorded in the Direct Investment Transactions Account (and also be reflected in the Direct Investment Positions Account) of the DIE's economy for the reinvestment of earnings; correspondingly, a positive entry for the same amount should appear in the same accounts of the DI's economy. These entries should be made for both the asset/liability and the directional presentations for both economies. Where a DIE is 100% owned by its DI(s), it will have no net saving of its own, but where there are shareholders not in a FDI relationship with the DIE (whether portfolio investors, if residents of economies other than that of the DIE, or other shareholders who are residents of the same economy as the DIE), the DIE will have savings of its own.

538. To illustrate the recommended treatment, take for example, a direct investment enterprise which is 75% owned by a direct investor and for which the remaining 25% of the equity is held by small investors (resident or non-resident). If the profits (calculated as described) in a reference period are 1 500 units and 500 units in dividends are paid out to all investors, the direct investor's share of reinvested earnings is calculated as 75% of profits (*i.e.* direct investment income on equity amounts to 0.75 x 1 500 = 1 125) less 75% of dividends (*i.e.* 0.75 x 500 = 375) which equals 750. This is shown in diagrammatic form below in Figure A.6.1.

539. The savings of the DIE are therefore 250 *i.e.* 1,500 less 500 dividends less 750 reinvested earnings attributable to the direct investor.

Figure A.6.1. **Example of a DIE with 75% direct investor holdings**



Net operating surplus *plus* net interest income receivable *plus* dividends receivable and remitted profits of quasi-corporations *plus* reinvested earnings receivable *less* net transfers payable	*less*	Dividends payable or remitted profits of quasi-corporations	*less*	Reinvested earnings (75% of 1 000)	*equals*	Net saving of DIE
1 500	*minus*	500	*minus*	750	=	250

2. Components

2.1. Net operating surplus

540. It is recommended that net operating surplus (NOS) be recorded on the same basis as in the national accounts, that is, all value added from the operations of the enterprise (that is, gross output less intermediate inputs) *less* consumption of fixed capital. NOS does not include property income (receivable or payable) or any realised or unrealised holding gains or losses arising from valuation changes, exchange rate changes, write-offs, etc.

2.2. Net interest income receivable

541. Net interest income receivable is the difference between the accrual, during the current period, of interest receivable on all interest bearing financial assets *less* the accrual, during the current period, of interest payable on all interest bearing liabilities, regardless of whether any payments have been made. Included is all interest payable or receivable to/from DIs and/or DIEs.

2.3. Dividends and distribution of profits of quasi-corporations receivable and payable

542. Dividends are paid to a company's shareholders from its earnings and are recorded in FDI statistics as of the date they are declared payable. Dividends may be declared payable from current period operations, but they may also be financed from other sources *e.g.*, from reserves developed during a longer period or from capital sales or realized capital gains. Dividends may be declared payable even if the enterprise is losing money. For quasi-corporations, remitted profits are treated in the same manner.

2.4. Net current transfers receivable

543. Net current transfers are the difference between current transfers receivable and current transfers payable. They cover all items for which there is no *quid pro quo* of a current nature. Most common are corporate income taxes and other kinds of tax payable, but withholding taxes and taxes on capital gains are not included. These are deemed payable by the shareholders.

2.5. Current Operating Performance Concept

544. *Direct investment income on equity* as defined under the Current Operating Performance Concept (COPC) covers the sum of NOS *plus* net interest receivable *plus* dividend income receivable *plus* reinvested earnings receivable *plus* net current transfers receivable. It does **not** include any realised or unrealised holding gains or losses arising from valuation changes, exchange rate changes, write-offs, etc. See Chapter 4 for the full definition.

3. Accounting practices

545. Accounting practices vary across the world, so it is recommended that direct surveys of both DIEs and DIs be conducted, to obtain the data on the appropriate conceptual basis, as set out in the schematic above. However, in some instances, it may not be possible to conduct direct surveys and recourse may have to be made to other sources of information, most notably, the annual reports of enterprises. However, in many cases annual reports do not include an aggregate that fully complies with the COPC, even though income for the

year is calculated and published with a number of sub-components and sub-aggregates. Accordingly, it will be necessary for the compiler to make calculations in order to transform the published aggregates to the COPC.

546. If, for example, companies publish an aggregate of profit/loss after financial items, the link to COPC will be as follows in Box A.6.2:

Box A.6.2 **Profit/ loss after financial items**

Profit/loss after financial items[74]

Plus share of profits of associates (proportionate to holdings of shares on issue)[75]

Minus Realised capital gains

Minus Unrealised capital gains

Plus Realised capital losses

Plus Unrealised capital losses

Minus Realised exchange rate gains

Minus Unrealised exchange rate gains

Plus Realised exchange rate losses

Plus Unrealised exchange rate losses

Plus Write-down/write offs (excluding consumption of fixed capital as a charge has already been made for this in the calculation of "net profit/loss after financial items")

Minus Any extraordinary or exceptional income included in profit/loss after financial items and not included in the adjustments above

Plus Any extraordinary or exceptional expense included in profit/loss after financial items and not included in the adjustments above

Minus net interest receivable on financial derivative contracts[76]

Plus net interest payable on financial derivative contracts

Minus Current taxes on profit for the period (excluding withholding taxes and taxes on holding gains)

= Income for the period, using the COPC

74. This item is obtainable from company accounts and normally represents, for the reference period, all revenue arising from trading activity including revenue from extraordinary and exceptional items as well as relevant capital or currency exchange gains/losses and interest or other income receivable from financial assets; *less* associated expenses arising from such trading activity including extraordinary and exceptional expenses as well as any interest payable or other expenses on loans or other debt. It is calculated before deduction of any taxes.

75. It is assumed that the profit/loss of controlled enterprises has already been included in the profit/loss after financial items. If this is not the case, it should be included in this line.

76. In compiling FDI income, net interest receivable and payable on financial derivative contracts are not treated as income. This is in line with the balance of payments and national accounts recording of income. The treatment here is to remove them from the books of those enterprise accounts that treat them as if they were income.

547. If there is no sub-aggregate available, the calculations may have to be made from the total profit published (the so-called "all inclusive"), which adds some more variables as in Box A.6.3:

Box A.6.3 **Net profit/loss for the year**

Net profit/loss for the year

Minus Realised capital gains

Minus Unrealised capital gains

Plus Realised capital losses

Plus Unrealised capital losses

Minus Realised exchange rate gains

Minus Unrealised exchange rate gains

Plus Realised exchange rate losses

Plus Unrealised exchange rate losses

Plus Write-downs/Write offs (excluding consumption of fixed capital as a charge has already been made for this in the calculation of "net profit/loss")

Minus Extraordinary income,

Plus Extraordinary expenses,

Minus Other current taxes (excluding withholding taxes and taxes on holding gains)

= **Income for the period, using the COPC**

4. Recording in FDI statistics[77]

548. In principle, income on direct investment is recorded at the time it is earned. However, actual data for the calculation of income are often only available on an annual basis, with a considerable time lag; in the meantime, it is necessary to provide estimates of the net disposable income (COPC) for the current period, often on a quarterly basis. In that case, information should be sought directly from the DIEs and the DIs resident in the economy, from which indicators may be developed to calculate dividends payable and reinvested earnings. These indicators might include estimates of gross and net value added, net income receivable, and net current taxes. In addition, an indication from past practice of dividend payments might also be used – companies often maintain the same dividend payments, regardless of the underlying earnings of the enterprise, for many years. But as both dividends and reinvested earnings are components of income, approximating the totality of dividends and reinvested earnings is more important than approximating the components. While preliminary, and subject to revision, this approach is preferable to merely extending the data for past year(s) to the current period (and dividing by four to provide quarterly estimates), until the information is available from the respondents' complete annual reports and/or tax returns.

5. Consolidation

549. In line with the Framework for Direct Investment Relationships (see Annex 4), the RE of each enterprise "down the ownership" chain should be attributed to each of the direct

77. The recording is identical in the balance of payments.

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investors up the chain. Accordingly, if A (Level 1) is owned 100% by B (Level 2), B is owned 50.01% by C (Level 3), and C is 40% owned by D (Level 4), then A's RE represent part of the net investment income of B, and, as a result, they are part of the sources of revenue that form part of the RE that are deemed distributed to C by B, and then as part of B's RE that are deemed distributed to A. See Text Box A.6.4. Where ownership is less than 100%, the proportional ownership should be applied, even when there is more than one DI. This principle applies whether A, B, and C are each in separate economies from D, or are in the same economy, but separate from D.

Box A.6.4. **Calculation of reinvested earnings along a chain of related direct investment enterprises**

	Level 1	Level 2	Level 3	Level 4
Ownership by next level	A	B	C	D
	100 per cent	50.01 per cent	40 per cent	
NOS	200	250	300	350
Minus Corporate taxes payable	–50	–60	–70	–90
Plus Dividends receivable from DIE		+50	+60	+100
Minus Dividends payable to all shareholders	–50	–120	–250	
Plus Reinvested earnings receivable from DIE		+100	+110	+60
Minus Reinvested earnings payable to DI	–100	–110	–60	
Equals Net saving	0	110	90	420
In Direct Investment Transactions and Positions account				
Direct investment liabilities: reinvestment of earnings	+100	+110	+60	
Direct investment assets: reinvestment of earnings	0	–100	–110	–60

Note: The offsetting reinvestment of earnings entries in the direct investment transactions and positions accounts should be reflected in both the asset/liability and directional presentations

550. In the situation where enterprise C owns 50% or less of B, then enterprises A and B are not in a direct investment relationship with enterprise D under the FDIR. As enterprise D is not considered to have significant influence over enterprise B, enterprise D cannot be considered to have significant influence over the earnings distribution and savings decisions of enterprise B. As a result, the reinvested earnings that accrue to enterprise C from enterprise B are not considered part of enterprise C's current operating profit that accrues to enterprise D. The calculation in Text Box A.6.4 would show 16 in reinvested earnings accruing to enterprise D from enterprise C (rather than 60) with 16 being reinvested by enterprise D in enterprise C.

551. Normally, when companies perform elimination of group transactions, they use data on the *total* profits, including holding gains and losses, foreign exchange gains and losses, write offs and write downs, and dividends. It is, therefore, imperative that clear instructions be provided to respondents to enable them to report on the required basis.