Working Party on National Accounts

Treatment of reinvested earnings in the Canadian System of National Accounts: Conceptual and measurement issues

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OECD Conference Centre
Beginning at 9:00 a.m. on the first day

This document has been prepared by Patrick O'hagan (Statistics Canada) and will be presented under item 9 of the draft agenda

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Treatment of reinvested earnings in the Canadian System of National Accounts: Conceptual and measurement issues

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OECD Working Party on National Accounts
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Background — Reinvested Earnings (RIE) on foreign direct investment

International standards ... **SNA93**

- No general agreement among national accountants on RIE
- Was the full impact of RIE on the sequence of accounts laid out ... considered?

International standards ... review process for **SNA08 extensive**

- ... but resolved (up front) not to review RIE
- SNA update vehicle — WPFS-led *Task Force on the Valuation and Measurement of Equity* — dealt with SNA93 inconsistent stock-flow treatment of RIE ... Result was change to Revaluation Account in SNA08 (12.113)
- Remaining Canadian concerns w/r to RIE
- ABS 2004/2012 papers reacted to potential issues with RIE
- RIE on SNA research agenda
Summary of concerns and treatment of RIE — Canadian System of National Accounts

CSNA 1997 historical revision → implementation of SNA93 and BPM5

- No agreement in Canada that RIE would improve relevance ...
- Some accuracy concerns
- DECISION: Implemented RIE in BOP only ... with 2 reconciliation items in NRES sector of the national accounts (transparency)

CSNA 2012 historical revision → implementation of SNA08 and BPM6

- No change to 1997 position or treatment of RIE in the Canadian System of National Accounts
- No issues with users w/r to this dual treatment in the last 15 years
OBJECTIVE #1 Follow BPM5 and BPM6

- BOP RIE imputed receipts-payments on outward-inward FDI positions added to dividends and branch earnings to generate FDI profits estimates in cross-border investment income flows
- Re-invested portion of the FDI income receipts and payments flows are then added to FDI financial flows — payments to inward FDI flows; receipts to outward FDI flows

RESULT: Some awkward quarterly analysis of FDI flows … arguably, misinformation for users in reporting imputed re-investment in high profile FDI flows statistics (relevance)?

- RIE concept of book profits fits with book value IIP FDI stocks, as these reflect accumulated earnings
- … but less well with market value FDI (release October 2012), Other changes in Assets Account (planned for 2014), and the SNA concept of corporate operating surplus
OBJECTIVE #2: Maintain relevance other measures

- GNI, related aggregates, exclusive of RIE … though we may add RIE in release *supplementary* measures of GNI for international comparability purposes
- Sector accounts unaffected by RIE … exception non-resident sector, which reconciles (i) sector saving (and NLB) with the current account balance of the BOP and (ii) with the same adjustment to the financial account NLB
- Market value equity positions in the sector balance sheet accounts related to (i) financial transactions and (ii) price changes
- Forthcoming *Revaluation Account* (2014?) will articulate full value of capital gains/losses on all components of equity (no exceptions for FDI) … much clearer for users
SNA08 RIE: Quadruple entry system+ for flows

- Inclusion of RIE receipts-payments in BOP current account such that NRES sector saving includes net RIE. Offset in the corporate sector, where saving is ↑ or ↓ by net RIE … implies that RIE reflected in financial transactions

- BOP financial account, RIE represents *imputed re-investment* added to outward FDI equity asset flows (receipts) and inward FDI equity liability (payments) flows.

- *Mirrored* in sector financial accounts … NRES sector shows *imputed re-investment* in inward FDI equity asset flows (payments) and outward FDI equity liability flows (receipts)

- Offset in the corporate sector financial account matrix two-fold:
  - LIABILITIES: Net new equity issue totals must also include *imputed RIE* flows (for FDI investee enterprises) in financial transactions
  - ASSETS: Net new equity acquisitions must also include *imputed RIE* flows (for FDI investor enterprises) in financial transactions

- All of this, has implications for SNA stock-flow sequence …
### SNA08 RIE: Stock-flow sequence of accounts must include RIE adjustments

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<th>BSA_{t-1} Stocks</th>
<th>FA_{t} Transactions</th>
<th>OCAA - RA_{t} Revaluations</th>
<th>OCAA – OCVA_{t} Volume Δ</th>
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Some Canadian concerns with RIE in SNA core accounts

National accounting ... corporate financial accounting

- RIE argued early 1960’s BPM manual ... a reflection of a tendency of those experts to want to reflect financial accounting in BOP and IIP
- But national accounting is not corporate accounting, though the former relies on the latter (increased convergence in IFRS)
- SNA concept of current income not the financial accounting one ... that reflects earnings of unconsolidated subsidiaries in parents’ financial statements (equity basis ... as does RIE for MNEs). In fact, Canadian enterprise surveys take steps not to overstate income in this way
- RIE seems more of a globalization concept (or related to G-20 nationality-based statistics for MNEs) than SNA income concept ... analytically interesting, but relevant to core SNA?
Some Canadian concerns with RIE in SNA core accounts

DATA QUALITY

- Concerns — especially on outward FDI RIE receipts
- Concerns — on both RIE receipts and payments allocated to accounts of domestic corporate sectors and sub-sectors
- Concerns — potentially significant RIE fluctuations due to M&A activity … corporate organizational changes in GNI (?)

Nature of inter-corporate ownership

- … very different in nature than collective investment schemes
- FDI is a lasting interest and/or influence; and the FDI investor (arguably, the ultimate parent) makes a decision in most quarters to (i) leave a significant portion of earned funds in the subsidiary (not re-invest) and (ii) withdraw some via dividends — this is the economic reality reflected in transactions
- In this sense … should GNI reflect the current portion of long-term cross-border FDI ownership claims in current income?
Some Canadian concerns with RIE in SNA core accounts

SNA income on an accrual basis

- Accrual concept in SNA … RIE is not a short-term SNA accrual concept
- Rather, RIE is a form of long-term claim on past-current-future income (FDI lasting interest argument)

Income and financial transactions

- Arguably, income has no place in financial transactions, except as short-term accruals charged to current income/expense and recorded as either short-term receivables or payables
- RIE as equity transactions is counter-intuitive … and reference to RIE as income on equity has been dropped from the Securities Handbook Vol3 (given the security-by-security approach)
- RIE in equity transactions does not improve the relevance of sector accounts … based on sources and uses of funds
Some Canadian concerns with RIE in SNA core accounts

SNA valuation of assets

- RIE is a book value FDI concept … valuation principle to measure FDI from the books of the investee enterprise — such that the current portion of retained earnings fundamental part of book value FDI stock ∆`s.

- With market valuation of equity in SNA balance sheets and IIP-FDI, RIE seems like a dated concept. Market valuation for relevant assets-liabilities provides a coherent framework for assessment of revaluations, transactions, income

SNA revaluation account

- All equity assets and liabilities should reflect the full price effect of stock market fluctuations … to except FDI (relevance?)

- Argument that reversing RIE in revaluation account “deflates” the RA (see table above) — separates the earnings component from the animal sprits component of market fluctuations. If so, then why not extend to all equity components?
Practical issues and considerations

Potential distortions and remedies

- RIE is restrictive to just cross-border inter-company ownership ... can lead to various actual-perceived distortions in different countries depending on the composition and changes in the composition of investment ... if say all inward investment direct and all outward investment portfolio, or if M&A activity unusual

- It has been argued that RIE be further extended
  - to domestic inter-company investment?
  - to government investment in public enterprises?
  - to all cross-border investment, direct and portfolio?
  - to all ultimate owners in an economy → zero corporate saving?

The last extension is one end of the *all or nothing* argument. It could be argued in light of market valuation for positions that RIE be re-considered as an SNA concept
Where to go from here?

Questions ... comments

Canadian position

- Does this difference matter? We think not, as we have
  - Full implementation of SNA08 RIE in BOP statistics
  - No implementation of SNA08 RIE in sector accounts ... but with transparency, and no significant international comparability issues
  - Plan to release supplementary measures of GNI for international comparability

International standards

- Possible need for further development and research ... RIE on SNA research agenda along with other income-asset issues

Data compilation issues ... user issues

- Issues for compilers in different economies, increasing interpretability challenges for users (e.g., addition of OCAA)?

Questions ... comments